PUBLIC FINANCE

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PUBLIC FINANCE

Unit - I

Nature and scope of public finance - Rationale for government intervention – Musgrave's three function of government – types of government intervention – production versus provision –regulation of markets – sources of public revenue – deficit financing.

Unit - II

Theories of taxation– ability and benefit principles of taxation (Lindhal) – Principle of maximum social advantage – taxable capacity – shifting, incidence and impact of taxes – types of taxes – characteristics of good tax system.

Unit - III

Theories of public expenditure – Wagner's law – Peacock hypothesis – Samuelson theory of public goods– basics of cost benefit analysis.

Unit - IV

Deficit financing – monetarist versus Keynesian views – pattern of deficit financing – public debt management and implication for growth, inflation and interest rate

Unit - V

Centre-state relationship - Finance Commissions – Its role in filling vertical and horizontal fiscal imbalance – plan transfers and discretionary transfers – latest finance commission report of the union and state governments - India's fiscal policy – tax reforms, expenditure pruning, fiscal deficit - fiscal and monetary policy nexus.

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1.1.1 Objectives:

The main objectives of this lesson are to

- Comprehend nature and scope of public finance
- Describe the various definitions on public finance
- Subject mater of public finance
- Musgrave's three functions of Government

1.1.2 Introduction

Public finance is the area of general economics that deals with the financial operations of the federal, state, and local governments. It is a study of the revenue and expenses of the federal, state, and local governments, as well as the guiding principles behind them.

Public finance is the study of how public organisations, whether they be at the federal, state, or local levels, manage their financial resources. These tasks require money to be spent on them. The cost is covered by revenue obtained from taxes, fees, sales of goods and services, and loans. The public authorities' revenue comes from a variety of sources. The field of public finance investigates how money is obtained, how it is spent on various things, etc. Therefore, public finance is concerned with the revenue and expenses of public authorities as well as the principles, issues, and policies associated with these matters. We can examine some significant definitions of public finance offered by some of the field's top experts.

Dalton claims that public finance is concerned with the revenue and expenses of public authorities as well as their coordination. The process of raising and disbursing funds, as well as the collection and expenditure of tax revenue for governmental operations, are at the heart of public finance economics. According to professor Richard Musgrave, "the complex of problems that centres on the revenue-expenditure process of government is traditionally referred to as public finance."

According to Taylor, public finance examines how the government, the state's principal organ, raises and disburses the necessary funds. Thus, the operation and policies of the fiscal public treasury are addressed by public finance.

1.1.3 Importance of Public Finance

- Provision of public goods: Public funding is required to provide public goods like roads, military services, and street lighting, among others. Due to the fact that businesses receive no payment from private individuals, they will have no incentive to produce such goods.
- Governments can combat or lessen unfavourable effects of a market economy thanks to public finance. The spillovers or externalities are the side effects. Consider pollution. The governments can enact legislation to limit pollution, implement recycling programmes, or impose fees or taxes on activities that contribute to pollution.
- Governments can redistribute income with the aid of public finance. Governments can impose taxes on the wealthier citizens and provide goods and services for the less fortunate in order to lessen economic inequality.
- Numerous programmes in public finance are available for balancing the incomes of the wealthy and the poor. Social security, welfare, and other social programmes are examples of such programmes.
- The notion of a welfare state and the importance of public finance have gained more acceptance. The classical economists' view of modern governments as police states is no longer valid.

- Public finance has expanded along with the extent of the government's involvement in economic activity. Some of the government's main focus areas through fiscal operations include creating employment opportunities, controlling economic fluctuations like boom and depression, maintaining economic stability, etc.

1.1.4 Subject Matter of Public Finance

The process of raising and allocating funds for the operation of the government is at the heart of public finance economics. As a result, the primary area of study in public finance is the analysis of public revenue and expenditure. But in these two symmetrical areas of public finance comes the issue of how to organise the collection and distribution of resources. It must also address the issue of what to do if state revenues are insufficient to cover public expenditures. "Financial administration" plays a role in resolving the first issue. The process of public borrowings or the mechanism of public debt must obviously be studied in relation to the latter issue. Public debt and financial management both give rise to a number of unique issues, so traditionally, these are treated as separate branches of the subject. As a result, the study of public finance can be divided into four main categories (as per tradition):

- Public Revenue: Public Revenue is the term used to describe state income. In this branch, we investigate the various methods public entities use to generate revenue. We also look at the fundamentals of taxation, its results, how taxes are distributed among the social classes, etc.
- Public Expenditure: It addresses the guidelines and issues surrounding the distribution of public spending. We examine the fundamental rules governing the distribution of public funds through various channels, the categorization and justification of public expenditures, as well as government spending priorities and welfare state initiatives.
- Public Debt: When tax revenues are insufficient to cover expenditures, governments borrow. Public debt is a study of different debt-raising theories, practises, and outcomes from an economic perspective. It also covers techniques for managing and repaying public debt.
- Financial Administration: It deals with the methods of creating budgets, various budget types, and financing for war and development, among other things. As a result, financial administration refers to

the process used to carry out financial operations. In other words, financial administration is the study of how the state's finances are organised and distributed.

1.1.5 Rationale for Government Intervention

We will start by examining the need for an economic system. The fundamental economic issue of scarcity arises from the fact that no society's resource base can produce all the economic goods and services that its members desire due to qualitative as well as quantitative constraints. In order to answer fundamental questions like what, how, and for whom to produce, as well as how much resources should be set aside to ensure growth of productive capacity, an economic system should be in place. Modern society generally offers three alternative systems—the market, the government, and a mixed system—through which resource reallocation decisions may be made. In the mixed system, markets and governments both decide on resource allocation at the same time.

Adam Smith is frequently referred to as a fearless proponent of free markets and minimal government intervention. However, Smith recognised that the government plays a significant role in resource allocation when he emphasised the government's role in national defence, the maintenance of justice and the rule of law, the establishment and upkeep of highly beneficial public institutions, and the production of public goods that the market may be unable to produce due to a lack of sufficient profits. The state's role in the economy has been clearly gaining importance since the 1930s, particularly as a result of the Great Depression, and as a result, the traditional functions of the state as described above have been supplemented with what are referred to as economic functions. All governments are expected to play a significant role, even though there are differences between nations in terms of the type and degree of government intervention in the economy. This is based on the idea that government intervention will always have a positive impact on how the economy performs.

1.1.6 Musgrave's Three Functions of Government

Musgrave summarised the three crucial economic functions of the government—allocation, distribution, and stabilization—in his Theory of Public Finance (1959). The market mechanism is used to distribute the resources. The government must step in to direct, correct, and supplement the markets in the event of market failure, which occurs when markets are unable to allocate resources in a microeconomic efficient manner.

1. **Allocation function:** Public goods are a classic example of a market that has failed. Public goods cannot be supplied by markets. While the need for private goods is felt individually, such gods are desired by all. Private goods can be effectively and optimally provided by markets when producers are influenced by consumer demands. The properties of non-exclusion and nonrivalry, however, render market exchange ineffective when it comes to public goods. Additionally, it would be ineffective to prevent anyone from enjoying the advantages of consuming a public good. The issue of free riders then arises from this. Non-exclusion suggests that individuals can forgo paying for the use of a public good by assuming that others are doing so, thereby escaping the obligation to pay. The issue of voluntary payment refusal for public goods can easily be resolved by the government through the imposition of taxes. The government must judiciously determine the amount of supply of these goods. Individuals may refrain from revealing their true preference and the government may resort to the voting process. Decision making through voting becomes a substitute of preference revelation and taxes become a method of collecting cost shares. Thus, an approximate efficient solution can be achieved through government provision of public goods.

2. **The Distribution function:** Given the distribution of income and pattern of consumer preferences, the study of economics focuses on the efficient use of limited economic resources. The distribution of factor endowments, which is in turn determined by the factor pricing process, affects how income is distributed. When there is perfect competition, the factors are compensated with the marginal product's value. However, when there is insufficient competition, factors only receive the value of the marginal product. Furthermore, even if factor prices are established in a setting of competition, this does not ensure an equitable distribution of income. Individual utilities are difficult to compare based on their income, and redistribution policies have significant efficiency costs. (in form of welfare losses associated with taxes and change in consumer and producer surpluses). Thus, the question– what constitutes a fair distribution is a difficult one. It is here where the government plays

a critical role. Redistribution is implemented through:

a. Tax redistribution– Progressive taxation of high-income groups and provision of subsidy for the low-income group.

b. Use of progressive taxation to finance programs targeted to benefit low income groups.

c. Combination of taxes on goods consumed largely by high-income groups and subsidy on goods consumed largely by low-income groups.

3. **The stabilization function:** The government's functions of allocation and distribution have a big impact on the macroeconomic factors in the nation. Economic goals like high employment, price stability, a sound balance of payments, and maximum social welfare cannot be realised through market functioning. The government assumes a greater role in augmenting the market for the achievement of desired macroeconomic goals. Without, proper policies, economy of any country is subject to wide economic fluctuations such as unemployment and inflation. The great depression is one important example in this regard. It exposed the loopholes of the market system and exhibited the important role played by the governments in revival of the global economy. In recent years, with the growth of globalization, countries are even more vulnerable to market fluctuations. The recent US sub prime crisis and the global economic downturn is prime example in this regard. It has exposed the loopholes and vulnerabilities of growing economic and financial international integration. The government plays an instrumental role in affecting the aggregate demand the key parameter affecting employment level and the price levels. Aggregate demand depends upon the income of the consumers, which in turn depends on factors such as present and past income, wealth of the consumer. In any adverse event government action through an expansionary/ restrictive monetary and fiscal measures can restore equilibrium conditions.

1.1.7 Let us sum up

This lesson introduces you to the concept, meaning, nature, scope and importance of Public Finance. Public finance is the area of general economics that deals with the financial operations of the federal, state, and local governments. It is a study of the revenue and expenses of the federal, state, and local governments, as well as the guiding principles behind them. Public finance is the study of how public organisations, whether they be at the federal, state, or local levels, manage their financial resources. These tasks require money to be spent on them. The cost is covered by revenue obtained from taxes, fees, sales of goods and services, and loans. This lesson also highlighted the Musgrave's three functions of Government.

1.1.8 Self-Assessment Questions

1. Describe the nature and scope of Public Finance.
2. Give the definitions of Public Finance.
3. State the subject matter of Public Finance.
4. What are the Musgrave's three functions of Government?

1.1.9 References:

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Lesson 1.2 - Government Intervention

Structure

1.2.1 Learning Objectives

The main objectives of this lesson are to

- Know the government intervention to alert the free market equilibrium
- step in to achieve specific goals
- Identify different the various types government interventions
- Know the different between Production and provision

1.2.2 Introduction

The definition of government intervention is any regulatory action taken by a government that has a direct impact on a market economy in order to alter the free market equilibrium. Due to market failures and inefficiencies, it is necessary. The government enacts rules and regulations to achieve outcomes that are impossible under a free market in order to pursue specific social and economic goals and enhance welfare.

Governments can take action when problems arise using a variety of tools. For instance, they could make use of new funding, taxes, or programmes. If local government agencies are unable to handle natural disasters, a government may also step in. Not just humanitarian or physical issues, but also economic issues, may be to blame for such disasters.

Depending on the type of economic system a country uses will determine the significance of such an intervention. Such intervention is important in the case of a command economy system. The government decides what is best for the economy and then distributes the resources available in that way. Additionally, it makes choices regarding the production and distribution of goods. The role of the private sector in this system is minimal, and may even be zero.

A free-market economy, on the other hand, operates in reverse and prioritises reducing intervention. It uses a demand and supply mechanism to operate freely. Compared to the command economy system, this mechanism ensures a more effective allocation of resources. In addition, a government's role in a free market economy is typically limited to enforcing laws that recognise and protect private property ownership. Despite this, the private sector is extremely important to this system. Additionally, compared to a market economy, there are more interventions in a mixed economy system. Nevertheless, it lacks the diversity of a market economy. Government and the private sector both have important roles to play.

1.2.3 Reasons

Governments may step in to achieve specific goals. Let's examine a few of them.

- modifying consumer behaviour;
- protecting individuals through consumer protection laws
- Protecting the national economy
- Enhanced market efficiency
- Provision of essential infrastructure
- Limitation of monopoly power
- Redistribution of wealth and income

1.2.4 Types

- **Price Controls:** These are laws governing how much something costs, how much someone makes, or how fast those things change. Such restrictions may be imposed by the government on a variety of products. Or, it can impose restrictions on any market that deals with a single good. There are two types of price controls.
- **Price Floor:** This is the lowest price at which one may sell goods or provide services. It aims to protect vendors.

- Price ceiling: This is the highest price that suppliers may demand for a good or service. Its goal is to protect consumers by making sure that the offerings are within the means of as many of them as possible.
- **Subsidy:** A government may offer grants, tax breaks, or cash as incentives to businesses or individuals in order to encourage the production of particular goods and services. For instance, it could be a payment made to suppliers to help them lower their production costs and increase their output. Individuals are then able to access goods and services at a lower cost, raising their standard of living.
- **Taxes:** For governments, taxes are the main source of revenue. They use taxes to pay off debt and finance various programmes. Additionally, a government typically uses the money to boost economic capital by providing public goods like roads, bridges, trains, national defence, etc. Long-term growth in an economy's production capacity depends on this economic capital. Taxpayers may be subject to direct government taxation, such as income tax. As an alternative, they could levy taxes in an indirect manner, like through the GST, VAT, or sales tax.
- **Regulations:** Regulations guarantee the smooth operation of economic activities. There are numerous government regulations, and each one has a different effect on economic activity. Let's examine a few of the various regulation categories.
- **Environment:** For instance, governments introduce numerous regulations addressing how business operations affect the environment. One illustration is the introduction of environmental safety standards.
- **Employment:** The government enacts laws, rules, and regulations pertaining to ethical hiring practises, compensation, and the safety and health of employees.
- **Competition:** To encourage fair competition, governments impose specific regulations, such as those governing mergers and acquisitions and antitrust. Additionally, this category includes deregulation, such as removing restrictions on foreign investors' share ownership.
- **Consumer Protection:** This category guards against deceptive practises in relation to price restrictions, product descriptions, and safety and health requirements.

1.2.5 Production versus provision

Public provisions and public production are two different concepts related to the provision of public goods and services. While both are important for the functioning of a society, they have some significant differences.

Public provisions refer to the provision of public goods and services by the government through contracts with private entities. In this model, the government is responsible for determining the need for a particular public good or service, such as healthcare or education, and then contracts with private entities to provide it. The private entities may be for-profit or not-for-profit organizations, and they are responsible for delivering the service or goods to the public. On the other hand, public production refers to the government's direct production of public goods and services. In this model, the government itself produces and provides the public good or service, such as the construction of roads or the provision of public transportation.

One of the main differences between public provisions and public production is the level of control that the government has over the delivery of the public good or service. In the case of public provisions, the government contracts with private entities, which are responsible for delivering the goods or service according to the terms of the contract. The government has limited control over how the private entities provide the goods or services, and it relies on contractual mechanisms to ensure that the private entities deliver the public goods or services in the desired manner. In contrast, in the case of public production, the government has complete control over the delivery of the public good or service. The government is responsible for the production and delivery of the good or service, and it has direct control over the quality, delivery, and pricing of the public good or service. Another difference between public provisions and public production is the level of competition that exists in the delivery of the public good or service. In the case of public provisions, the government contracts with private entities, which may compete with each other to provide the best service at the lowest cost.

In contrast, in the case of public production, there is no competition as the government is the sole provider of the public good or service. This lack of competition can lead to inefficiencies and higher costs for the public. Finally, public provisions and public production have different implications for the role of the government in the economy. Public provisions rely on the market to provide public goods and services, with the government acting as a regulator and facilitator. In contrast, public production involves the government taking a more active role in the economy by producing and delivering public goods and services directly.

Public provisions and public production are two different models for the provision of public goods and services. While both are important for the functioning of a society, they have significant differences in terms of the level of control the government has over the delivery of the public good or service, the level of competition that exists, and the implications for the role of the government in the economy. Understanding these differences is important for policymakers when deciding on the best approach for providing public goods and services.

1.2.6 Let us Sum up

The government intervention definition refers to a regulatory action carried out by any government that directly impacts a market economy to change the free market equilibrium. It is necessary because of the market inefficiencies and failures. To pursue specific social and economic goals and improve welfare, the government introduces rules and regulations to deliver unachievable results under a free market. he significance of such an intervention depends on the type of economic system a nation adopts. In the case of a command economy system, such intervention is significant. The government identifies what is best for the economy and allocates the available resources accordingly. Moreover, it makes decisions related to the manufacturing and distribution of goods. Under this system, the private sector's role is minimal; it can even be zero. On the other hand, a free market economy functions in reverse and focuses on minimizing intervention. It operates freely via a demand and supply mechanism. This mechanism ensures a more efficient allocation of resources than the command economy system. Moreover, under a free market economy, a government's role is typically restricted to imposing rules for recognizing and safeguarding private property ownership. That said, the private sector plays a crucial role in this system. Moreover, in the case of a mixed economy system, the interventions are more when compared to a market economy. That said, it is not as diverse as a market economy. Both the government and the private sector play a crucial role.

1.2.7 Self-Assessment Questions

1. Which government interventions cause a consumer or producer surplus?
2. Is government intervention good?
3. Are government interventions to alleviate poverty sustainable?
4. How firms can respond to government intervention?

1.2.8 References

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Lesson 1.3 - Regulation of Markets

Structure

1.3.1 Objectives

The main objectives of this lesson are to

- Explore the market regulation
- Understand rationale of regulation

1.3.2 Introduction

Market regulation refers to the rules imposed by the government to change the behaviour of firms and correct market failure. Market regulation is often controlled by the government and involves determining who can enter the market and the prices they may charge. The government body's primary function in a market economy is to regulate and monitor the financial and economic system.

1.3.3 Objectives of Market Regulation

Market regulation aims to prevent undercapitalized financial firms from making excessively risky investments, control fraud, agency issues, promote fairness, set mutually beneficial standards, and guarantee the funding of long-term liabilities.

1. **Prevent Fraud:** Because financial customers aren't always technologically sophisticated enough to do so themselves, market regulators put systems in place to do so.

2. **Control Agency Issues:** Regulators address agency issues by establishing minimal requirements for agent competency, such as the CFA or GIPS.
3. **Promote Fairness:** By limiting the profits that insiders could take from the markets, regulators hope to increase fairness. For instance, laws that prohibit insider trading help to level the playing field.
4. **Establish Mutually Beneficial Standards:** By requiring compliance with accounting standards established by the IASB, FASB, and others, regulators facilitate easy company comparisons for analysts.
5. **Prevent Excessive Risk:** Regulators mandate that financial institutions maintain minimum capital requirements to ensure that they fulfil their obligations and that the owners of the institution have some "skin in the game."
6. **Ensure Liabilities are Funded:** Regulators keep an eye on insurance firms and pension funds to make sure sufficient reserves are kept on hand to cover liabilities because managers of these organisations frequently underestimate long-term liabilities, particularly when there is an incentive to do otherwise.

Regulation is a type of government intervention in markets that entails the creation and enforcement of rules. It is a crucial subject because regulation may have an impact on businesses, people, and the economy both at the macro and micro levels. Regulation may emerge either proactively to prepare for the effects of market environment changes or reactively to address some occurrence(s). For instance, changes brought about by technological advancements in the markets due to new communication methods and computer applications have resulted in a variety of regulation, both proactive and reactive. Regulations have also evolved in response to financial crises and unfavourable historical behaviours or actions. Regulations are required because market solutions may not always be suitable. In other words, regulations are in place to safeguard consumers from market flaws.

How to handle systemic risk (the risk of the financial system failing) and the results of risk-taking by financial institutions presents a significant challenge for financial regulators.

Additionally, topics like electronic privacy, environmental regulation, and labour regulation are getting more attention.

Business operations may be significantly impacted by how regulations are created and implemented. Changes in the regulatory landscape and regulatory ambiguity can also have a significant impact on business choices. To predict and comprehend the effects of potential changes in the regulatory environment and of specific regulations is thus one of the major challenges facing professionals in the finance industry.

There are numerous places and sources where regulation comes from. It is helpful to have a framework that details the different regulators and types of regulation, as well as the areas of regulation that could have an impact on the object of interest (such as the economy as a whole). The framework will be useful in evaluating potential consequences of new regulations. It can also be useful in determining how regulation affects various entities. In response to a specific issue, multiple regulators may create regulations. The goals of each pertinent regulator may differ, and they may decide to use various regulatory tools to address the problem. The regulator should take both costs and benefits into account when creating regulations. The net regulatory burden (private costs minus private benefits of regulation) may also be significant in the analysis. Regardless of the viewpoint, it might be challenging to evaluate potential costs and benefits. Nevertheless, weighing the advantages and disadvantages of regulation is an important component of regulatory analysis.

1.3.4 Rationale for Regulation

In its most common usage, regulation refers to an effort to proscribe or impose costs on undesirable behaviour in order to control or influence private behaviour in the desired direction. Regulation is typically only justified under unique circumstances due to the potential negative effects it may have on economic efficiency and private incentives. As a result, there are three categories of justifications for regulatory interventions: preventing market failures, limiting or eliminating anti-competitive behaviour, and advancing the general welfare. Below are details for each set.

To prevent market failure

Market failure occurs when the market mechanism is unable to efficiently allocate resources in order to maximise social welfare. When there are externalities, natural monopolies, asymmetric information, or the provision of public goods, market failures can occur. When one company can serve the entire market more effectively than two or more companies combined due to increasing returns to scale, this is known as a natural monopoly. Natural monopolies benefit from scale advantages that shield them from competition; entry by other firms typically results in inefficient production, meaning that the average cost of output is significantly higher when there are multiple firms present than when there is only one. To protect the interests of consumers in these situations, regulation may be necessary. In doing so, regulation may prevent the entry of new businesses into the market and defend the incumbent operator's monopoly. Railway lines and water distribution are two examples. Telecom is no longer a natural monopoly in India as a result of regulatory reforms, increasing demand, and technology that lowers fixed costs. Although the electricity industry was once a bundled monopoly, unbundling has resulted in the introduction of competition in some areas. Transmission and distribution remain natural monopolies in two segments. The government still maintains a natural monopoly over the water industry.

To check anti competitive practices

Businesses might engage in anti-competitive behaviour like price fixing, market sharing, or abusing their position of dominance or monopoly. Laws that allow for official action can aid in discouraging such behaviour. A competitive and dynamic environment can be created through regulation through a set of transparent, consistent, and non-discriminatory rules that will allow market participants to flourish. Without it, anticompetitive behaviour and regulatory shortcomings might prevent the market system from producing outcomes that are socially optimal.

To promote the public interest

Concerns about the promotion of the public interest, a crucial government policy goal, give rise to a third set of justifications. An essential justification for regulation can be found in ensuring equal access, eliminating discrimination, using affirmative action, or any other issue of public importance. Major laws in India on this subject include:

- Support pricing i.e. government offering to buy wheat or rice from farmers at a price which is higher than the market price.
- Public distribution system: supply of food grains at a price which is lower than the market price.
- Free distribution of piped water and free power to agriculture – these are regulatory decisions to levy zero tariffs which stem from

policy stances.

- Free power to agriculture which happens before elections -- a policy with regulatory.

1.3.5 Let us Sum up

Market regulation is often controlled by the government and involves determining who can enter the market and the prices they may charge. The government body's primary function in a market economy is to regulate and monitor the financial and economic system. Market regulation aims to prevent undercapitalized financial firms from making excessively risky investments, control fraud, agency issues, promote fairness, set mutually beneficial standards, and guarantee the funding of long-term liabilities. In its most common usage, regulation refers to an effort to proscribe or impose costs on undesirable behaviour in order to control or influence private behaviour in the desired direction. Regulation is typically only justified under unique circumstances due to the potential negative effects it may have on economic efficiency and private incentives. As a result, there are three categories of justifications for regulatory interventions: preventing market failures, limiting or eliminating anti-competitive behaviour, and advancing the general welfare.

1.3.6 Self-Assessment Questions

1. Define market regulation.
2. What are the objectives of Market Regulation?
3. Explain the three categories of justifications for regulatory interventions.

1.3.7 References

1. Musgrave, R.A. and P.B. Musgrave (1976), "Public Finance in Theory and Practice", McGraw Hill, Kogakusha,Tokyo.
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Lesson 1.4 - Public Revenue

Structure

1.4.1 Objectives

The main objectives of this lesson are to

- Learn about the various sources of Public Revenue
- Study the canon of Taxation or good tax system
- Know the various types of Taxes

1.4.2 Introduction

This falls under the umbrella of public finance. It discusses the various revenue sources that the state may use. Tax revenue, commercial revenue from the cost of goods and services provided by public enterprises, administrative revenue from fees, fines, etc., and gift and grant money are some of these sources. Public revenue or public income refers to all of the government's income. Professor Dalton gave two definitions of public revenue: a narrow definition and a broad definition.

1. Narrow sense: In the narrow sense, it includes income from taxes, prices charged by public sector undertakings for goods and services, and income from administrative activities like fees and fines.
2. In a broader sense: Public receipts refer to all of the government's income over a specific time period, including income from public enterprises as well as borrowing from individuals and banks.

1.4.3 Sources of Public Revenue

Tax sources and non-tax sources can be used as a general classification of the sources of public funding.

Taxes

1. The government imposes taxes on the populace, and citizens are required to pay taxes without expecting a reward.

Taxes on income, wealth, and property, as well as taxes on commodities, were the three main sources of tax revenue.

"A tax is compulsory contribution from the person to the State defray the expenses incurred in the common interest of all without any reference to the special benefits conferred." So defines Prof. Seligman and almost all writers define the tax in a similar manner.

Taussig defines the tax by distinguishing it from other charges of the government. According to him, the essence of a tax, as distinguish from other charges of the government, is the absence of a direct quid pro quo between the tax payer and the public authority. Absence of quid pre quo means the absence of direct and proportional benefit to the tax pay from the government. The tax payer may reap more than proportional benefit, or less than proportional benefit, or no benefit at all for the amount paid as tax to the government. For example, if an education tax is levied to support public schools for children, a poor man with many children may reap larger benefits from the public school. On the other hand, a rich man without any child may not reap any benefit at all. Hence, in the case of all taxes there are no proportional benefits attached to the tax payer.

Taxes' characteristics

1. The citizen must make mandatory payments to the government. Everyone is required to pay it, regardless of caste, colour, or creed, age, or sex. Punishment results from refusal to pay it or from late payment.
2. A personal obligation is imposed. It means that the tax payer has a responsibility to pay the tax and should never consider doing so.
3. There is no direct gain or exchange of favours between the State and the populace. The government offers the tax payer many benefits, but no tax payer has the right to claim a direct benefit simply because they are paying taxes.

4. It is payments made to cover costs incurred in the interest of all citizens. Public utilities must be provided by governments. Governments must spend a tremendous amount of money on this. As a result, taxes are levied against every citizen in order for everyone to bear a similar burden.
5. Some taxes are levied to achieve specific goals, such as taxing petrol to lower consumption and taxing luxuries to divert resources from the production of necessary goods.
6. Without representation, there is no tax. This indicates that tax proposals must be approved by the appropriate assembly of elected representatives.

Non-Tax Revenue

Commercial Revenue (a). Administrative Revenue (Fee, Fine, Special Assessment)

(Income from Public Property and Enterprises)

Gifts and grants, along with c) Others,

Commercial Revenue: The money that public businesses make from the sale of their products and services. For instance, postage, toll, and interest on borrowed money payments. Because they take the form of prices for goods and services offered by the government, they are also known as prices.

Administrative Revenue: The income that the government receives in exchange for carrying out its administrative duties is referred to as administrative revenue. The following is a list of the key administrative revenue items.

Fees: According to Prof. Seligman, a fee is a payment made to cover the expense of each ongoing service that the government provides for the general good. The government imposes payments in the form of fees. For instance, there are fees for court, licences, passports, etc.

Penalties and Fines: As a form of retaliation for breaking the law, people are subject to fines and penalties. They are put in place to deter crime. Penalties and fines are chosen at random.

Special evaluations: "A special assessment is a compulsory contribution levied in proportion to the special benefit derivedto defray the cost of specific improvement to property undertaken in the public interest," according to Prof. Seligman. For instance, the cost of the plots on either side of a highway built by the government will inevitably increase. Therefore, it may be necessary for the landowners to pay a portion of the government's costs. These fees are referred to as special assessments.

Gifts and grants: Generally speaking, gifts and grants are sums of money given from one government to another for the purpose of carrying out particular tasks, such as a federal grant to a state government. Gifts are voluntarily made contributions to the government made for specific purposes.

Additional sources of income

The issuance of currency, escheat, forfeitures, and borrowings are additional sources of income.

Forfeitures: A forfeiture is a fine the court imposes when a party fails to show up in court to fulfil a specific contract as required.

Escheat: Properties that pass to the government because they have no legal heirs or a will are referred to as escheats.

Currency Issue: The government generates revenue by printing paper money. By printing paper money, additional resources are intended to be created. It is typically avoided because once this type of financing is initiated, it can be challenging to stop. Further inflation results from this. Loans: This is another way that the government can raise money. That is done by taking out loans from the general public in the form of deposits, bonds, etc. External borrowings are also included.

1.4.4 Canons of taxation

- **Canon of Equity:** In the words of Adam Smith, "The subjects of every State ought to contribute towards the support of the Government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the State". According to the economists, Adam Smith was an advocate of the system of progressive taxation. It implies that the rich should be taxed more and the poor less.
- **Canon of Certainty:** According to Adam Smith, the tax which an individual has to pay should be certain, not arbitrary. The tax-payer

should know in advance how much tax he has to pay, at what time he has to pay the tax, and in which form the tax is to be paid to the government. In other words, every tax should satisfy the canon of certainty.

- **Canon of Convenience:** According to Canon, every tax should be levied in such a manner and at asuch a time that it affords the maximum convenience to the tax-payer. The reason is that the taxpayer makes a sacrifice at the time of payment of the tax. Hence, the government should see to it that the tax-payer suffers no inconvenience on account of the payment of the tax.
- **Canon of Economy:** According to this Canon, the tax should be such as to bring the maximum part of the collected revenue into the government treasury. In other words, the cost of tax-collection should be the minimum. If a major portion of the tax proceeds is spent on the collection of the tax itself then such a tax cannot be considered as a good tax.
- **Canon of Elasticity:** According to this Canon, every tax imposed by the government should be elastic in nature. In other words, the income from the tax should be capable of increasing or decreasing according to the requirements of the country. For example, if the government needs more income at a time of crisis, the tax should be capable of yielding more income through an increase in its rate.
- **Canon of Productivity:** According to this Canon, the tax should be of such a nature as to yield sufficient income to the government. If a tax yields poor income, it cannot be considered as a productive tax. According to this Canon, it is better to go in for a few productive taxes rather than to impose a large number of unproductive taxes on the people. A large number of unproductive taxes create difficulties not only for the people but also for the government because it gets no special increase in income from them.
- **Canon of Variety:** The physiocrats advocated the imposition of one single tax, viz. a tax on land. But the modern economists do not agree with this view of the Physiocrats. According to them, the tax system should contain a large variety of taxes on persons as well as commodities. The reason is that if the government levies a single tax, it will become easier for the tax-payers to evade it. But if the government imposes a large variety of taxes, it will be difficult for the people to evade or to avoid them.

- **Canon of Simplicity:** According to this Canon, every tax should be simple so that the tax-payer can understand its implications without the help of experts. If the tax is complex and complicated, the tax payers will have to seek the assistance of tax experts to understand its implication. Besides a complicated tax also increases the chances of corruption in the country.
- **Canon of Flexibility:** What this implies is that the tax should be based upon certain well defined principles so that it may need no justification from the side of the government. In other words, the tax-payers should have no doubt about its desirability. From this point of view, the old taxes are considered to be better than new taxes because the people have already got accustomed to the old taxes.

1.4.5 Types of tax

In discussion on public finance, many types of taxes are met with, and writers have classified them into different categories. Generally, taxes are classified into (1) Direct and Indirect Taxes; (2) Taxes on Income and taxes on Capital; (3) Taxes on property and taxes on Commodities; and (4) Taxes on person and taxes on things. In the above four types of classifications, only the first classification is considered very important as the other classifications are related more to the base of taxes.

Direct and Indirect Taxes

According to Dalton, "A direct tax is one which is really paid by a person on whom it is imposed whereas an indirect tax, though imposed on a person, is partly or wholly paid by another." To put is more simply, a direct tax is a tax wherein the tax-payer and the tax-bearer are the same person. In the case of indirect taxes, the tax-payer and the tax-bearer are different persons.

This classification is based on the process of shifting the burden of the tax. In the case of direct tax, the impact and the incidence of the tax lie on the same point, i.e., the burden of the tax cannot be shifted. In the case of indirect tax, the impact and incidence fall at different points or persons, i.e., the burden of the tax can be shifted. A good example of a direct tax is Income Tax and a good example of an indirect tax is Sales Tax. In the former, the tax-payer and the tax-bearer happened to be the same person, while in the case of latter, the tax-payer and the tax-bearer are different persons.

It is also stated that this classification is based on the intention of the legislature while imposing the tax. If the legislature intends that the burden of the tax should not be shifted and it should be borne by the payer himself, then it is a direct tax. If the legislature intends that the burden of the tax should be shifted, then it is an indirect tax.

De Marco makes this classification on the following grounds: "Direct taxes strike the citizens income at the moment of its production. Indirect taxes are those which strike the private consumption of citizens and also transfer of property. They strike the income at the moment when the citizen spends it to acquire other goods."

Another distinction is made by Mrs. Hicks. She writes: "The essence of the British distinction between the direct and indirect taxes lies in the relation between the tax-payer and the revenue authorities." If the taxes have to be calculated afresh in each case, necessarily there will be personal and direct relationship between the tax-payer and the tax-collector and this can be termed as direct taxes, e.g., Income-tax. In certain other cases, it is convenient for the revenue authorities to have the tax collected through the agency of manufacturers or merchants who are used as unofficial tax collectors. In these cases, there is no direct relationship between tax payers and revenue authorities and the taxes so collected may be termed indirect taxes, e.g., Sales tax. There is also wrong assumption in the classification that direct taxes are personal taxes and indirect taxes are commodity taxes. It is not so. Commodities do not pay taxes. In all cases of taxes, the payment is made only by persons. Though there are lot of controversies regarding the basis of classification of direct and indirect taxes, both types of taxes are levied by the government.

1.4.6 Deficit Financing

Deficit financing is nothing but financing the budget deficit incurred due to excess government expenditures. It means generating funds to finance the deficit which results from excess expenditure over revenue. The gap is being covered by borrowing from the public by the sale of bonds or by printing new money.

1.4.7 Purpose of Deficit Financing

- To finance defence expenditures during war
- To lift the economy out of depression so that incomes, employment,

invest¬ment, etc.all rise

- To activate idle resources as well as divert resources from unproductive sectors to productive sectors with the objective of increasing national income and, hence, higher economic growth

1.4.8 Let us Sum up

There are various sources of public revenue through which the government funds its expenses. There are two primary sources of this – tax and non-tax revenue. Tax revenue includes direct and indirect taxes, while fees, penalties, donations, grants, and more come under non-tax sources. By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. It refers to the guiding rules and principle to make tax collection system effective and functional. In fact, canons of taxation are related to the administrative part of a tax as it is related to the rate, amount, method and collection of a tax.

In discussion on public finance, many types of taxes are met with, and writers have classified them into different categories. Generally, taxes are classified into (1) Direct and Indirect Taxes; (2) Taxes on Income and taxes on Capital; (3) Taxes on property and taxes on Commodities; and (4) Taxes on person and taxes on things. In the above four types of classifications, only the first classification is considered very important as the other classifications are related more to the base of taxes.

1.4.9 Self-Assessment Questions

1. What is Public Revenue?
2. What are the sources of Public Revenue?
3. Explain the Canon of Taxation.
4. Define Deficit financing.

1.4.10 References

1. Musgrave, R.A. and P.B. Musgrave (1976), "Public Finance in Theory and Practice", McGraw Hill, Kogakusha,Tokyo.
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UNIT-II

Lesson 2.1 - Classification of Taxation

Structure

2.1.1 Objectives

The main objectives of this lesson are to

- Know the classifications of taxation
- Describe the various definitions on taxation
- Learn about the merits and demerits of advantages of Direct Tax
- Learn about the merits and demerits of advantages of Indirect Tax

2.1.2 Introduction

There are numerous taxation theories in public economics. To pay for public-sector expenses, governments at all levels (national, regional, and local) must raise money from a variety of sources. "Such things as defending the country and maintaining the institutions of good government are of general benefit to the public," wrote Adam Smith in The Wealth of Nations (1776). Therefore, it makes sense for the entire population to chip in on the cost of taxes. It is also reasonable to demand other things from a tax system, like that the taxes people pay correspond in some way to their financial capacities. Four major criteria are met by good taxes. They are: (1) proportionate to taxpayers' incomes or capacities to pay; (2) predictable rather than arbitrary; (3) due at times and in a manner that are convenient for taxpayers; and (4) inexpensive to administer and collect.

2.1.3 Classification of Taxation

The forms, nature, objectives, and methods of taxation are some of the different criteria used by economists to categorise taxes. The following major headings are used to categorise the taxes:

A. Direct taxes, which can be proportional, progressive, or regressive

B. Specific, Ad valorem, single, and Multiple Indirect Taxes

C. Additional taxes include those on income, real estate, capital goods production, value-added tax (VAT), modified value-added tax (MODVAT), and goods-and-services tax (GST).

According to Dalton, "A direct tax is one which is really paid by a person on whom it is imposed whereas an indirect tax, though imposed on a person, is partly or wholly paid by another." To put is more simply, a direct tax is a tax wherein the tax-payer and the tax-bearer are the same person. In the case of indirect taxes, the tax-payer and the tax-bearer are different persons.

This classification is based on the process of shifting the burden of the tax. In the case of direct tax, the impact and the incidence of the tax lie on the same point, i.e., the burden of the tax cannot be shifted. In the case of indirect tax, the impact and incidence fall at different points or persons, i.e., the burden of the tax can be shifted. A good example of a direct tax is Income Tax and a good example of an indirect tax is Sales Tax. In the former, the tax-payer and the tax-bearer happened to be the same person, while in the case of latter, the tax-payer and the tax-bearer are different persons.

It is also stated that this classification is based on the intention of the legislature while imposing the tax. If the legislature intends that the burden of the tax should not be shifted and it should be borne by the payer himself, then it is a direct tax. If the legislature intends that the burden of the tax should be shifted, then it is an indirect tax. De Marco makes this classification on the following grounds: "Direct taxes strike the citizens income at the moment of its production. Indirect taxes are those which strike the private consumption of citizens and also transfer of property. They strike the income at the moment when the citizen spends it to acquire other goods."

Another distinction is made by Mrs. Hicks. She writes: "The essence of the British distinction between the direct and indirect taxes lies in the relation between the tax-payer and the revenue authorities." If the taxes have to be calculated afresh in each case, necessarily there will be personal and direct relationship between the tax-payer and the tax-collector and this can be termed as direct taxes, e.g., Income-tax. In certain other cases, it is convenient for the revenue authorities to have the tax collected through the agency of manufacturers or merchants who are used as unofficial tax collectors. In these cases, there is no direct relationship between tax payers and revenue authorities and the taxes so collected may be termed indirect taxes, e.g., Sales tax.

There is also wrong assumption in the classification that direct taxes are personal taxes and indirect taxes are commodity taxes. It is not so. Commodities do not pay taxes. In all cases of taxes, the payment is made only by persons. Though there are lot of controversies regarding the basis of classification of direct and indirect taxes, both types of taxes are levied by the government.

2.1.4 The Merits and Advantages of Direct Tax

4. The direct tax will be proportionate depending on the 'ability of the tax-payer to pay' and in this respect there will be equity in this type of tax. In the case of income tax, people with lesser income have to pay less tax and people with larger income have to pay more tax.
5. Direct taxes are collected at the source, and it will be clastic and productive. Increased rate of the tax will bring revenue without much expenditure.
6. The possibilities of leakage will be very rare and the whole tax paid reaches the treasury of the State.
7. Above all, there is an element of certainty in the case of direct taxes. The payer knows the exact amount to be paid and the time of payment.
8. It is possible to trace the effects of direct taxes very easily and if need be, minimize the adverse effects only.

2.1.5 The Disadvantages of Direct Taxes Direct taxes have always been unpopular among the people.

i. These taxes have been opposed sometimes with political disturbances.

ii. This may lead to evasion by the taxpayers by making false declarations and maintaining two sets of accounts. This will undermine the morale of the people. A direct tax is a tax on honesty'. Whoever is honest would pay taxes by declaring the income properly. Those who are dishonest will be cheating the tax department by making false statement and concealing their incomes. The government in their turn will be announcing or sanctioning better benefits through 'Voluntary Disclosure Scheme' or through similar schemes, in order to unearth black money from these dishonest tax-payers or those who evade taxes.

iii. In the collection of these taxes, there are more possibilities of arbitrary official action in making assessments of income of individuals. It may even go to the extent of official harassment. Of course, this type of disadvantage holds good in all types of taxes, in modern days, especially when the official machinery is very corrupt.

2.1.6 The Advantages of Indirect Taxes

i. The first merit and advantage of an indirect tax is that it is convenient both to the tax-payer and the taxing authorities. The indirect taxes are less annoying to the people, as the tax-payers may not be knowing that they are paying taxes to the government in the form of increased prices. Indirect taxes are like sugar-coated pills in the form of higher selling prices. This will help the government in realising the revenue very easily without becoming unpopular, as in the case of direct taxes. The consumer of articles taxed will be paying in small instalments. The State will be able to collect the tax in a lump sum from the merchants, importers and exporters or producers. Hence, Colbert said that this is like 'plucking the goose with least squealing'. Indirect taxes are difficult to evade.

ii. It is only through indirect taxation the State can reach all classes of people and collect money for the coffers of the State. State cannot levy direct taxes, like income tax, to poor people in general.

iii. Further, this tax will quiet the agitation on the part of rich people who might complain that they are the only people contributing to the running of the State. Through indirect taxes, these rich people may larine some emotional satisfaction that other classes of people are also made to pay towards the upkeep of the State.

An indirect tax may be effectively used in restructuring the consumption pattern of the society, it may check consumption of harmful articles like liquor, cigarettes, etc.) By heavily taxing these harmful articles, the government may divert the purchasing power towards the purchase of useful articles and thereby create beneficial consumption pattern.

2.1.7 The Disadvantages of Indirect Taxes

i. The first criticism against an indirect tax is that it may not be equitable. Taxes on essential commodities is an unjust levy and it will fall heavily on the poor people

ii. The yield from indirect taxes will be always uncertain. The yield depends on the elasticity of demand for the taxed commodity. If the government wants to be certain of revenue, it must tax the necessary commodities at a high rate, as these commodities will have inelastic demand. But such a measure would create adverse effect on the economy. It may affect the ability to work and save on the part of low-income classes.

iii. Indirect taxes may prove uneconomical at times. The cost of collection of these taxes would be very heavy. The State must maintain a large army of officials to check evasion of these taxes and to collect the taxes properly.

2.1.8 Let us Sum up

Taxation is the term used to describe the mandatory financial charge or other type of levy that a governmental entity imposes upon a taxpayer (an individual or legal entity) in order to pay for various public expenditures. The way taxes are collected, how they affect the distribution of income, and the types of goods and income they apply to are just a few of the variables that can be used to classify taxes.

Direct taxes must be paid to the government directly and are imposed on people or organisations. They consist of corporate tax, wealth tax, income tax, etc. Indirect taxes are levied on goods and services and are paid by the party who ultimately bears the tax's economic burden to an intermediary. Sales tax, VAT, and excise tax are a few examples.

2.1.9 Self-Assessment Questions

1. What is Taxation?
2. Define Direct Tax
3. What is Indirect Tax.
4. Mention advantages of Direct Tax
5. Explain the disadvantages of Indirect Tax.

2.1.10 References

Musgrave, R.A. and P.B. Musgrave (1976), "Public Finance in Theory and Practice", McGraw Hill, Kogakusha,Tokyo.

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Web Resources

https://www.investindia.gov.in/taxation
https://www.britannica.com/money/topic/taxation
https://www.investopedia.com/terms/t/taxation.asp

Lesson 2.2 - Theories of Taxation

Structure

2.2.1 Objectives

After reading this lesson, you will be able to understand

- Ability and benefit principles of taxation
- Ability-to-pay approach
- Theory of Ability to Pay
- Lindahl's model benefit approach
- Bowen model benefit approach

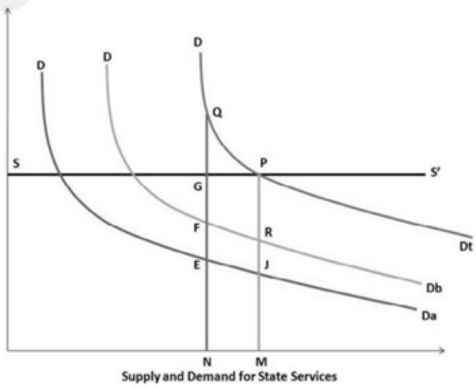
2.2.2 Introduction

A tax is a required payment made to the government by people or businesses based on predetermined rules or criteria, such as income earned, property owned, capital gains realised, or expenditures made (money spent) on both domestically produced and imported goods. The idea accepts that taxes are levied in order to finance government services. People pay taxes in proportion to the benefits they receive from government spending if taxes are levied using the benefit principle. The idea accepts that taxes are levied in order to finance government services. People pay taxes in proportion to the benefits they receive from government spending if taxes are levied using the benefit principle. People pay taxes in proportion to the benefits they receive from government spending if taxes are levied using the benefit principle. Therefore, the highest tax rates should be paid by those who benefit the most from public services like roads, hospitals, public schools, and colleges. But if the benefit principle of taxation is upheld, the government will have to calculate the benefits received by different individuals and groups and set taxes accordingly.

2.2.3 Ability and benefit principles of taxation

In modern public-finance literature, there have been two main issues: Who can pay and who can benefit (Benefit principle) have been the two main topics in contemporary public-finance literature. The ability theory put forth by Arthur Cecil Pigou and the benefit theory created by Erik Lindahl have both had an impact. The "voluntary exchange" theory is a later iteration of the benefit theory. According to the benefit theory, taxes are set automatically because taxpayers pay a certain amount for each benefit they receive from the government. In other words, tax payments are disproportionately made by those who benefit most from public services. The Lindahl model and the Bowen model are two models that use the benefit approach that are discussed in this lesson.

2.2.3.1 Lindahl's model



Lindahl tries to solve three problems:

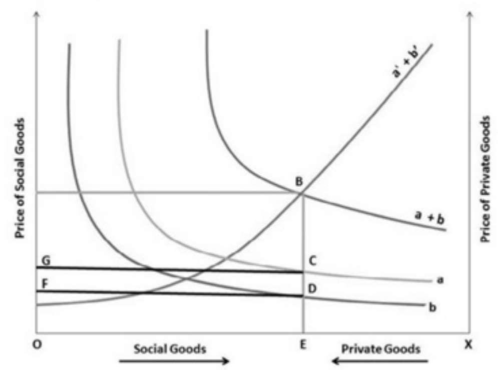
- Extent of state activity
- Allocation of the total expenditure among various goods and services
- Allocation of tax burden

In the Lindahl model, it is assumed that social good production is linear and homogenous if SS is the supply curve of state services. The demand curves for taxpayers A and B are denoted by DDa and DDb, respectively. The total demand schedule for state services in the community is produced by adding the two demand curves horizontally. A and B each pay a different share of the services' vertically measured cost. When ON represents the volume of state services produced, A and B each contribute NE and NF, with NG serving as the cost of supply. The state increases its supply to OM because it is nonprofit. A contributes MJ and B contributes MR (the total cost of supply) at this level. At point P, equilibrium is attained through voluntary exchange.

In order to determine the effective level of provision for public goods, the Lindahl equilibrium proposes that individuals pay for the provision of a public good according to their marginal benefits. In the equilibrium state, everyone consumes the same amount of public goods, but prices may vary because different people may value different public goods differently. The resulting sum that each person must pay for their proportional share of the public goods is known as the Lindahl equilibrium price.

2.2.3.2 Bowen Model

Bowen's model has greater practical significance because it shows how the opportunity cost of private goods is lost when social goods are produced at the expense of rising costs. If there is one social good and two taxpayers (A and B), for instance, their demand for social goods is represented by a and b, and as a result, a+b is the total demand for social goods. A'+b' represents the supply curve and indicates that goods are produced at increasing costs. Since the value of private goods foregone determines the production cost of social goods, the demand curve for private goods is also represented by a'+b'. The distribution of a given national income between social and private goods, as desired by taxpayers, is determined by the intersection of the cost and demand curves at B; as a result, there should be OE social goods and EX private goods. The respective demand schedules of A and B also determine their respective tax shares. The area (ABEO) out of which A is willing to pay GCEO and B is willing to pay FDEO is the total tax requirement.



Bowen's model

2.2.4 Advantages and limitations

The direct relationship between revenue and expenditure in a budget is the benefit theory's advantage. In the public sector's allocation processes, it simulates market behaviour.

The benefit theory has challenges, despite being straightforward in its application:

- It restricts the range of government operations
- Only applicable when beneficiaries can be observed directly (impossible for most public services);
- Taxation in accordance with the benefit principle would leave the distribution of real incomes unchanged.
- Government cannot support the poor or take action to stabilise the economy.

2.2.5 Ability-to-pay approach

The ability-to-pay strategy separates government revenue and spending. There is no trade-off; taxes are determined by taxpayers' financial capacity. Taxpayers view paying taxes as making a sacrifice, which raises the questions of what that sacrifice should be for each taxpayer and how it should be measured:

- Equal sacrifice: All taxpayers should experience the same overall utility loss as a result of taxes (the rich will pay higher taxes than the poor).
- Equal proportional sacrifice: All taxpayers should experience the same proportional loss of utility as a result of taxation.
- Equal marginal sacrifice: All taxpayers should experience the same

instantaneous loss of utility (as determined by the derivative of the utility function) as a result of taxation. As a result, this will require the least overall sacrifice (the least sacrifice overall).

- Mathematically, the conditions are as follows:
- Equal absolute sacrifice=U(Y)-U(Y-T), where y=income and t=tax amount
- Equal proportional sacrifice=(U(Y)-U(Y-T))/U(Y), where U(Y)=total utility from y
- Equal marginal sacrifice=(dU(Y-T))/(d(Y-T))
- To help the government determine how to achieve justice or equity in taxation, economists have proposed a variety of taxation theories or guiding principles over time. In a nutshell, the main theories or principles are:

Benefit Theory

This theory contends that the state ought to tax people in proportion to the benefits they receive. A person should contribute more to the government the more benefits they receive from government actions. The following reasons have led to harsh criticism of this principle:

In the first place, if the state upholds a specific link between the benefits conferred and the benefits derived. It will go against the tax's fundamental tenet. As is common knowledge, taxes are mandatory payments made to the government to cover costs and provide for the taxes are mandatory payments made to the government to cover costs and provide for the general welfare. A tax does not directly result in anything.

Second, it is impossible to estimate the benefit received by a specific person on an annual basis because the majority of the expenses incurred by the slate are for the general benefit of its citizens. Thirdly, because they use the state's services more frequently, the poor will be required to pay the highest taxes if this theory is put into practise.

The Cost of Service Concepts

Some economists believed that the concept of equity or justice in taxation would be satisfied if the state collected the actual cost of the service provided from the people. The cost of service principle can undoubtedly be used to some extent in situations where the services are provided for a fee and are relatively simple to calculate, such as with postal and railway services, electricity supply, etc. However, because it cannot be precisely determined, the majority of the expenses incurred by the state cannot be fixed for each person. How, for instance, can the cost of service provided by the police, military, judicial system, etc. to various people be quantified? Dalton has also disproved this theory, arguing that there is no reciprocity in taxes.

2.2.6 Theory of Ability to Pay

The most well-known and widely accepted tenet of equity or justice in taxation is that a nation's citizens should contribute to the government in accordance with their financial capacity. Taxes should be assessed based on a person's ability to pay them, which seems very fair and reasonable. For instance, if person A has a higher taxable capacity than person B, the former should be required to pay higher taxes than the latter.

It appears that justice can be served if taxes are imposed in accordance with the aforementioned principle. However, this is not the end of our problems. The truth is that when we apply this theory in practise, we actually run into problems. The definition of "ability to pay" is problematic. Regarding the precise definition of a person's ability or faculty to pay, economists are divided. The following are the main viewpoints put forth in relation to this:

- **a).Ownership of Property:** According to some economists, owning property is a very good way to gauge someone's ability to pay. This idea is categorically rejected on the grounds that a person who makes a lot of money but doesn't spend it on real estate will avoid paying taxes. On the other hand, if someone else who makes money purchases real estate, he will be taxed. Is it not absurd and unjustifiable that someone with a high income is exempt from paying taxes while someone with a low income is subject to them?
- **b) Tax on the Basis of Expenditure:** According to some economists, a person's capacity to pay taxes should be determined by the expenses they incur. The tax should be higher the more is spent, and vice versa. The argument is flawed and unfair in every way. Spending is higher for someone with a large family than for someone with a small one. If income is used as a measure of one's capacity to pay, the person who already has a large number of dependents will be required to pay more taxes than the person who only has a small family. Thus, this cannot be justified.

- c) Income as the Foundation: According to the majority of economists, determining a man's capacity to pay should be based on his income. It seems perfectly just and fair to ask one person to contribute more to the support of the government than another if their income is higher than theirs. Because of this, the ability to pay someone back has been determined to be best determined by their income in the modern tax systems of the nations of the world.

2.2.7 Let us Sum up

Taxes are the primary source of funding for the government. A tax is a mandatory payment made by people and businesses to the government based on pre-established criteria, such as income earned, property owned, capital gains realised, or expenditures made (money spent) on both domestically produced and imported goods. Taxation involves compulsion because many people disagree with paying taxes. Regardless of their personal preferences, the taxpayers are obligated to make certain payments. Due to this compulsion, the collection of taxes may have a significant impact on how people behave and how the economy operates. As a result, it is important to consider these effects when choosing a tax system to ensure that it does not prevent society from achieving its economic objectives. Furthermore, the tax burden must be distributed among different people in a way that is consistent with these goals if society is to achieve its objectives.

The benefit theory contends that taxes are automatically determined because taxpayers pay a specific sum for each government benefit they receive. In other words, those who profit most from public services pay a disproportionate amount of taxes. Two models that make use of the benefit approach are covered in this lesson: the Lindahl and the Bowen models. Lindahl equilibrium is a quasi-market equilibrium for the sole benefit of the general public. Supply and demand for the good, as well as the cost and revenue associated with its production, are balanced, just as they are in a competitive market equilibrium. Bowen's model has greater practical significance because it shows how the opportunity cost of private goods is lost when social goods are produced at the expense of rising costs. If there is one social good and two taxpayers (A and B), for instance, their demand for social goods is represented by a and b, and as a result, a+b is the total demand for social goods. A'+b' represents the supply curve and indicates that goods are produced at increasing costs. According to the benefit theory, people should be taxed in proportion to the benefits they receive from the government. The more benefits a person receives from government actions, the more they should contribute to the government. The reasons for this principle's harsh criticism are as follows: First, if the state maintains a particular connection between the benefits conferred and the benefits derived. It will contradict the main tenet of the tax. Taxes, as everyone knows, are required payments made to the government to cover expenses and ensure the general welfare. A tax has no immediate impact on anything.

2.2.8 Self-Assessment Questions

1. What is the benefit and ability-to-pay principle of taxation?
2. Mention the limitations of benefit received theory.
3. What is the benefit principle including Lindahl theory?
4. Mention the assumptions of Bowen model?
5. Explain the main determinants of ability to pay?

2.2.9 References

1. Musgrave, R.A. and P.B. Musgrave (1976), “Public Finance in Theory and Practice”, McGraw Hill, Kogakusha,Tokyo.
2. Sundharam, K.P.M. (2003),Public Finance, S. Chand and Sons, NewDelhi.
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Lesson 2.3 - Principle of Maximum Social Advantage

Structure

2.3.1 Objectives

The main objectives of this lesson are to

- Comprehend nature and scope of maximum social advantage
- Describe the Point of Maximum Social Advantage
- Know the Gains and Losses from Budget Operation
- Study the proportionate principle

2.3.2 Introduction

The most fundamental principle at the heart of public finance, in Dalton's opinion, is the maximisation of social benefit. Therefore, the best public finance system is one that ensures the greatest social benefit from its fiscal operations. The states' guiding principle is to maximise social benefit.

According to the maximisation of social benefit, taxes are subject to rising marginal social costs while public spending is subject to declining marginal social benefits. In order to maximise social advantage, an equilibrium must be reached where the marginal social advantages of public expenditures are equal to the marginal social sacrifice of taxation. In the words of Dalton, "Public expenditure in every direction must be carried just so far, that the advantages to the community of a further modest rise in any direction are just counter-balanced by the disadvantage of a corresponding small increase in taxation or in the receipts from any other sources of public expenditure and public income." Hugh Dalton asserted that "the best system of public finance is that which guarantees the maximum social advantage from the operations which it conducts."

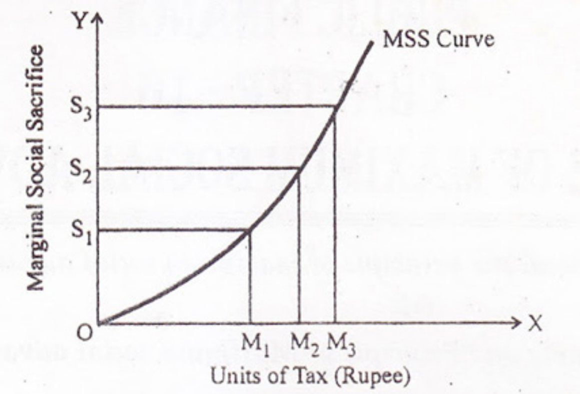
However, the following presumptions are the foundation of this principle:

a. All taxes cause sacrifice, and all government spending has a positive impact.
b. Taxes are the only source of public revenue; there are no other ways for the government to make money.
c. The government only has a balanced budget, with neither a surplus nor a deficit.
d. Taxes are subject to increasing marginal social sacrifice and public spending is subject to diminishing marginal social benefit.

The cornerstone of public finance is the "Principle of Maximum Social Advantage (MSA)". According to the Principle of Maximum Social Advantage, public finance results in economic welfare when public spending and taxation are carried out up to the point where the benefits from the MU (Marginal Utility) of spending are equal to the imposed sacrifice or marginal disutility by taxation.

2.3.3 Marginal Social Sacrifice (MSS)

The maximisation of social advantage is a principle explained by Hugh Dalton. Low-level social benefits. Marginal Social Sacrifice (MSS) is the term used to describe the amount of social sacrifice made by the general public as a result of the imposition of an additional tax unit. Every tax that the government imposes results in a reduction in utility. According to Dalton, the additional burden (marginal sacrifice) brought on by additional taxation units continues to rise, meaning that the overall social sacrifice rises at an increasing rate. This is due to the fact that when taxes are imposed, the community's stock of money decreases. The marginal utility of money keeps rising due to the declining supply of currency. Eventually, every additional taxing unit has a greater impact and demands a greater sacrifice from society. Because of this, the marginal social cost keeps rising. The diagram below illustrates the marginal social sacrifice:

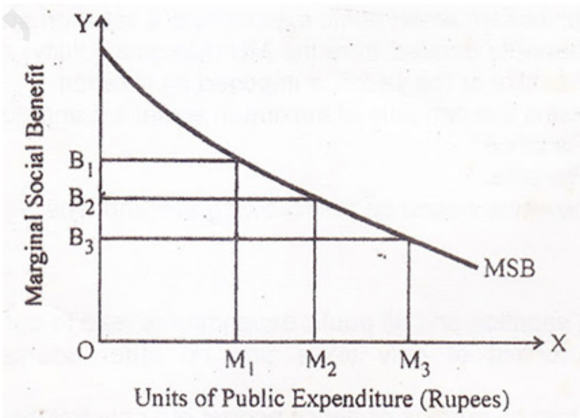


Increasing Marginal Social Sacrifice Curve

The Marginal Social Sacrifice (MSS) curve appears to rise from left to right in the diagram above. This shows that the level of sacrifice also rises with each additional taxation unit. The marginal social sacrifice was OS1 when the unit of taxation was OM1, and as taxation increased to OM2 and beyond, it increased to OS2 as well.

2.3.4 Marginal Social Benefit (MSB)

Taxation burdens the populace, whereas public spending benefits everyone. Marginal Social Benefit (MSB) is the benefit that society receives from an additional unit of public expenditure. The social benefit from each additional unit of public expenditure decreases as more and more units of public expenditure are spent, just as the marginal utility of a good to a consumer declines as more and more units of the good are made available to him. The most important social activities are initially funded by public spending units. The amount of money the government spends on social activities is decreasing over time. As a result, as seen in the following figure, the marginal social benefit curve slopes downward from left to right:

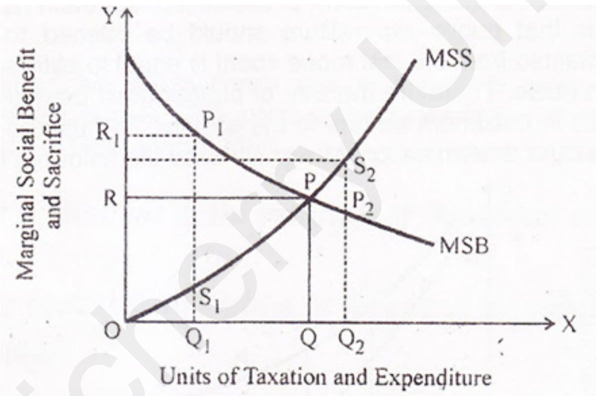


Diminishing Marginal Social Benefit Curve

The marginal social benefit (MSB) curve slopes downward from left to right in the illustration above. This suggests that the social benefit of government spending is declining at an increasingly rapid rate. The marginal social benefit was OB1 when the public expenditure was OM1, and it is reduced at OB2 when the public expenditure is OM2, and so on.

2.3.5 The Point of Maximum Social Advantage

At the point where marginal social sacrifice crosses the marginal social benefits curve, social advantage is maximised. At point P in the diagram, the marginal utility or social benefit equals the marginal disutility or social sacrifice. The marginal utility or social benefit will be lower and the marginal disutility will be higher after this point.

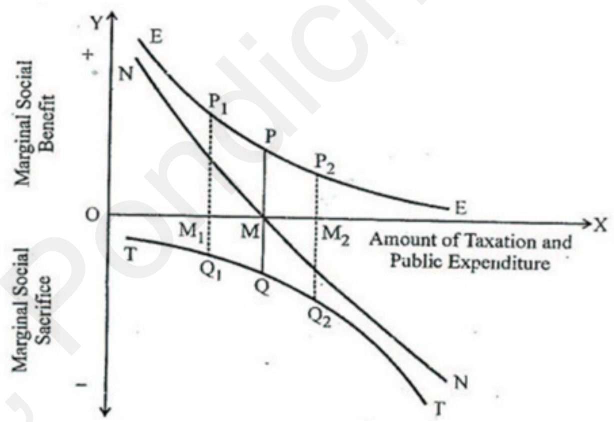


Maximum Social advantage is obtained at the Point of Intersection of MSS and MSB Curves

Social advantage peaks at point P. The marginal social benefit at Point P1 is P1Q1 at this time. Greater than the minimal social sacrifice S1Q1 is this. It makes more sense to raise taxation and public spending because the marginal social sacrifice is less than the marginal social benefit. This is because every additional unit of tax revenue collected and spent by the government increases the net social benefit. As long as the levels of taxation and spending are to the left of the point P, this situation of rising taxes and public spending will continue. The units of taxation and public spending increase to OQ at point P, where the marginal utility or social benefit equals the marginal disutility or social sacrifice. The greatest social advantage has thus been attained at this point. The marginal social cost S2Q2 would be higher than the marginal social benefit P2Q2 if we advanced to OQ levels of units. Any further increase in taxation and government spending, therefore, beyond point P, could reduce the social benefit. This is so that the marginal disutility or social sacrifice, which will be greater than the marginal utility or social benefit, will increase with each additional unit of taxation. This demonstrates that the greatest social benefit can only be realised at point P, which is the location where the marginal social benefit of public spending equals the marginal social sacrifice of taxation.

Richard Musgrave, an economist, interpreted the maximum social advantage principle as the maximum welfare principle of budget determination. The principle explains that taxation and public spending should be carried out up to the point where the satisfaction from the last unit of money spent is equal to the sacrifice from the last unit of money taken in terms of taxes, according to Musgrave. To put it another way, it should be done up until the point where the marginal social benefit and the marginal social sacrifice are equal. Musgrave used Fig., in which the size of the budget (level of taxation and public expenditure) is shown on the X-axis, to illustrate his interpretation. MSB is measured on the positive Y-axis, and MSS is measured on the negative Y-axis.

2.3.6 Gains and Losses from Budget Operation



The marginal social benefit (MSB) of increasing amounts of money spent as public expenditures, distributed optimally among various public uses, is represented by the curve EE in the first quadrant. Because MSB decreases with an increase in public spending, it moves from left to right. The marginal social sacrifice (MSS) is represented by the curve TT in the fourth quadrant. The MSS rises as more taxation units are collected from the populace. As a result, the curve SS in the fourth quadrant with rising MSS slopes downward from left to right. The marginal net benefits (MNB), which are derived from incremental additions to the public budget, are measured by the NN curve. MSS is subtracted from MSB to determine MNB. The MNB at various budget sizes is measured by the vertical distance between the EE curve and the TT curve. At OM, where MNB is zero, the ideal budget size is established. The marginal social benefit MP and the marginal social sacrifice MQ are equal at this budget size (MSB = MSS). The MNB curve NN cuts the X-axis at point M where marginal net benefit is zero (MSB-MSS = 0), as MSB and MSS are measured in the opposite directions. MSB will be greater than MSS and MNB will be positive at any point to the left of M, let's say M1. As long as MNB is positive, expanding the budget is advantageous. Consequently, there will be a tendency to shift from M1 to M. If the budget size is greater than M, let's say M2, MSS will be greater than MSB, and MNB will be negative. Therefore, reducing the budget's size and switching from M2 to M will be advantageous for the government. The point where the marginal net benefit is zero, in Musgrave's opinion, determines the budget's ideal size. As MSB = MSS at this point, this corresponds to the point of greatest social advantage.

The maximisation of social advantage has drawn criticism for a number of reasons. The following are the primary practical challenges:

i. Measurement Challenges for Social Benefits I Theoretically, the marginal utility analysis is used to explain the maximisation of social advantage. It is very challenging to measure objectively both the marginal benefits of public expenditure and the marginal disutility on sacrifice of public revenue.

ii. Unfounded Hypotheses: Assuming that every government expenditure is advantageous and that every tax burdens society is unrealistic. For instance, taxes on cigarettes and alcohol can benefit society; spending on social expenses like health care will also benefit society, whereas an unnecessary increase in defence spending may divert resources away from beneficial activities, harming society's welfare.

iii. Ignorance of Non-Tax Revenue: According to the taxation as a whole principle, all public expenditures are paid for by taxes. However, in reality, a sizable portion of public spending is also paid for by additional means, such as taxes, public borrowing, profits from public sector businesses, imposition of fees and penalties, etc. Dalton disregards all of these additional sources.

iv. Lack of divisibility: Only when public expenditure and taxation are divided into smaller units can the marginal benefit from public expenditure and marginal sacrifice from taxation be compared. But practically speaking, it is impossible.

v. Large Budget Size: The government's financial operations entail the collection of sizable sums of money from taxes and other sources as well as the disbursement of sizable sums through public expenditures. It is challenging to quantify the effects of small additional amounts of these on the neighbourhood. The public authorities are therefore unable to estimate the marginal benefits and the marginal sacrifice in practise.

vi. Change in Condition: Economic conditions are dynamic and constantly changing. Under some circumstances, what might be thought of as the point of greatest social advantage might not be under others. For instance, increased government spending and revenue are beneficial to the community during times of war. At a higher level of national income, what is ideal may not still be so. The maximum social advantage is therefore difficult to pinpoint.

vii. Different Periods: Both the current and upcoming generations will be affected by the effects of many public projects over a protracted period of time. It becomes necessary to calculate the social benefits from public expenditures over both the short and long term in order to determine the maximum social advantage.

viii. Differences in concepts: Taxes are paid by individuals, and the cost of doing so is felt on a personal or micro level. Whereas, through public spending in a community, all people benefit together on a macro level. Many economists contend that comparing micro and macro concepts using the same criteria is neither feasible nor desirable.

ix. Misuse of Public Funds: The maximisation of social advantage is based on the supposition that public funds are used in the most efficient way possible to produce minimal social benefit. However, a significant portion of public funds are frequently wasted on activities that don't advance society.

x. Contra-cyclical Measures: The government must implement counter-cyclical measures to combat recession, control inflation, and lower the rising unemployment rate, among other things. The maximisation of social advantage cannot be used in this circumstance. For instance, in order to increase effective demand and combat recession, the government may implement specific policies like tax reductions. Additionally, the government may raise tax rates during inflationary periods to reduce demand and raise interest rates to encourage people to save money.

Every fiscal operation, both in terms of revenue and expenditure, should be viewed as a series of purchasing power transfers that must ultimately result in an improvement in the general well-being of the populace. In this context, Dalton articulated the maximisation of social advantage and argued that a welfare state's financial operations must be in line with this principle. When the marginal social benefit of public spending and the marginal social sacrifice of taxation are equal, or when MSB = MSS, maximum social advantage is reached. This demonstrates that in order to achieve the greatest possible social benefit, public spending should continue until the marginal social benefit of the last rupee or dollar spent equals the marginal social sacrifice of the last unit of rupee or dollar taxed.

2.3.7 Proportionate Principle

J. S. Mill and some other classical economists proposed the proportionate taxation principle as a way to satisfy the idea of justice in taxation. These economists believed that equal sacrifice would be demanded if taxes were assessed in proportion to people's incomes. However, contemporary economists hold a different perspective. They claim that the marginal utility of income decreases as income rises. Only by taxing those with high incomes more heavily and those with low incomes less heavily can the equality of sacrifice be realised. In all current tax systems, they favour progressive taxation.

2.3.8 Let us Sum up

The most fundamental principle at the heart of public finance, in Dalton's opinion, is the maximisation of social benefit. Therefore, the best public finance system is one that ensures the greatest social benefit from its fiscal operations. The states' guiding principle is to maximise social benefit. Therefore, the maximisation of social benefit should be the guiding principle for a state's best financial activities. It is obvious that taxation alone reduces people's utility, whereas public spending alone increases community utility. Taxation by the government causes some social unhappiness or dissatisfaction. This waste comes in the form of the sacrifice made when paying taxes, which involves giving up purchasing power. Therefore, the maximum social advantage is attained when the government maximises the surplus of social gain or utility (resulting from public expenditure) over the social sacrifice or disutility (involved in paying taxes) in its financial activities. According to the maximisation of social benefit, taxes are subject to rising marginal social costs while public spending is subject to declining marginal social benefits. In order to maximise social advantage, an equilibrium must be reached where the marginal social benefits of public expenditures are equal to the marginal social sacrifice of taxation. In the words of Dalton, "Public expenditure in every direction should be carried just so far, that the advantages to the community of a further small increase in any direction is just counter-balanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other sources of public expenditure and public income."

2.3.9 Self-Assessment Questions

1. How is maximum social advantage achieved?
2. What are the assumptions of maximum social advantage?
3. Differentiate between Marginal Social Sacrifice and Marginal Social Benefit.
4. Explain the Musgrave's Approach to Maximum Social Advantage

2.3.10 Suggested Readings

1. Musgrave, R.A. and P.B. Musgrave (1976), "Public Finance in Theory and Practice", McGraw Hill, Kogakusha,Tokyo.
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Lesson 2.4 - Taxable Capacity

Structure

2.4.1 Objectives

Main objectives of this lesson are to

- Learn about taxable capacity
- Know the types of taxable capacity
- Study the significance of the Concept of Taxable Capacity
- Analyse the incidence of Taxation
- Know the theories of Tax Shifting and Incidence
- Learn about the principles of a Good Tax System
- Understand the concept of Canons of Taxation

2.4.2 Introduction

The term "taxable capacity" refers to the maximum amount of resources that a nation can provide through taxation, both in routine and unusual circumstances. In other words, it refers to the maximum level of ease with which a nation's citizens can bear the burden of taxation. To determine the maximum amount of taxation that a nation or its citizens could be subjected to in order to raise public funds, it is necessary to determine their taxable capacity. This needs to be done without worsening the economy further, as that might defeat the purpose of taxes altogether. The term "taxable capacity" refers to the maximum amount of resources that a nation can provide through taxation, both in routine and unusual circumstances. In other words, it refers to the maximum level of ease with which a nation's citizens can bear the burden of taxation. It is merely the highest amount that a government may impose on the populace. The government will overtax the public if it goes over this critical threshold, or the upper limit.

2.4.3 Types

The terms "taxable capacity" and "taxable capacity" are used interchangeably.

1. Absolute Taxable Capacity: After allowing for the bare minimum of subsistence for the people, the State could take whatever it wanted. The absolute taxable capacity of the population has been reached if there is no increase in state revenue, which is the indicator of absolute taxable capacity.

2. Relative Taxable Capacity: This term describes the relative contribution made by two communities to the government's common expenses. In relation to the capacities of other communities, it is, in other words, the ability of one community to incur a particular common expense. As an illustration, there are two communities: the rich community and the poor community. It is possible to get the wealthy to contribute more to a shared expense than the poor. Due to their higher incomes, the wealthy can afford to pay.

Influences on Taxable Capacity People's ability to pay taxes rises along with the nation's prosperity due to a variety of economic and non-economic factors. As a result, the idea of taxable capacity is more flexible than rigid

The following are some of the factors that have an impact on a nation's population's ability to pay taxes:

1. Taxpayer psychology: Taxable capacity is said to have increased if more people are willing to make sacrifices. The people are forced to pay higher taxes during times of war. During times of prosperity, people are generally upbeat and willing to pay higher taxes.

2. Wealth Distribution: If wealth is distributed equally, the amount that can be taxed is constrained. If it is concentrated with a small number of people, they may be forced to bear a heavy tax burden.
3. The nature of taxation: A scientifically framed tax system increases the amount that is taxable. The taxable capacity will decrease if the tax system has a negative impact on people's ability to produce.
4. Taxation's goal: The people of the nation are willing to pay taxes if the goal is to raise funds and promote economic development (on agricultural, industrial, and infrastructural development). In contrast, if it is used to pay for war expenses such as ammunition, this will unavoidably lower the population's ability to pay taxes.
5. Economic development level: The level of economic development of the nation affects the population's ability to pay taxes. Compared to developing nations, highly developed nations have higher tax capacities.
6. Political circumstances: It depends on internal prosperity and political stability. Peace both inside and outside the nation will create a favourable environment for increased economic activity, which will raise the country's tax base.
7. Population: It is based on the population's size and rate of growth. The taxable capacity declines if population growth exceeds the rate of national income growth.
8. Size of National Income: Any community's ability to collect taxes is based on the size of the nation's gross domestic product, which in turn depends on variables like the amount of available natural resources and other resources, how much of them are used, how advanced technology is, and other factors. A community's capacity to pay taxes rises as its wealth increases.

2.4.4 Significance of the Concept of Taxable Capacity

The government will undoubtedly find knowledge of the community's taxable capacity to be extremely useful in a variety of situations.

a. The data will be helpful for the mobilisation of financial resources for economic planning purposes.
b. In times of war, it is crucial for the government to be aware of the

maximum amount that the populace can contribute to the war effort.

c. Even in normal times, it will stop the government from enacting pointless taxes that might be more annoying than useful and could cause unrest among the populace.

d. The idea has application in federal finance. Comparing the various contributors is necessary in federal finance not only to distribute tax burdens but also to make it easier to find solutions to the various issues related to the financial relationships between the constituent states and the federal government.

Thus, the maximum level of taxation is determined by the sum of all these factors. The taxable capacity rises in tandem with the economy's continued progress towards prosperity and affluence. The amount of taxable capacity varies from one nation to the next and occasionally within one nation. But calculating taxable capacity cannot be done using a mathematical formula.

2.4.5 Impact of a tax, the incidence of a tax and tax shifting

Direct and indirect taxes are distinguished by the terms "impact of a tax," "incidence of a tax," and "tax shifting."

Impact of a Tax: The first resting point of a tax is its impact. For instance, the manufacturer is responsible for paying any excise duty levied on the manufacture of a good, even though the cost of the tax is ultimately passed along to the final consumer and included in the product's price. In this case, the manufacturer is affected while the consumer is affected by the incidence.

Shifting the burden (payment) of a tax from one person to another is known as tax shifting. For instance, in the GST scenario, the final recipient of the tax is the consumer rather than the producer. The manufacturer TRANSFERRED the cost of the taxes to the final consumer.

Tax incidence: INCIDENCE is where a tax burden finally rests. It reveals who is ultimately responsible for paying the tax.

In the case of direct taxes, such as personal income tax, the income earner is the one who is affected by the tax and must also pay the incidence. No one will take on the tax burden in his place. Conversely, in the case of an indirect tax, some business organisations will be willing to bear a portion of the tax (by providing a consumer concession) in order to increase the sale. In this instance, the tax has been shifted backward. In the case of personal income tax, this shifting is not possible because both the impact and the incidence will be on the same person. Therefore, a tax whose burden cannot be transferred is a direct tax.

2.4.6 Incidence of Taxation

Taxes are not always borne by the individuals who initially paid them. They are frequently transferred to others. Tax incidence refers to where a tax is ultimately imposed. The individual who is ultimately responsible for paying the tax burden is affected. The modern theory defines incidence as the adjustments made to the income distribution due to changes in the budgetary policy.

Effect and Frequency: A tax has an impact on the person who pays it initially, and an incidence affects the person who ultimately must bear it. The impact therefore falls on the final consumers.

Effects and Incidence: A tax's effect refers to any unintended consequences.

The imposition of tax has a number of effects, such as decreased demand.

The Real Burden and the Financial Burden The total amount of money collected by the treasury serves as a proxy for a tax's financial burden. For instance, the consumer must pay an additional Rs. 50 for sugar each month; this is the financial burden he must bear. However, if he has to cut back on his sugar intake, then economic welfare will suffer. The real cost of taxes is this inconvenience, financial hardship, or, to put it another way, the loss of economic welfare.

2.4.7 Theories of Tax Shifting and Incidence

Earlier Theories: The earlier theories may be classified into:

a. **Concentration or surplus theory:** In accordance with the concentration theory, every tax has a tendency to target a specific class of people who also happen to profit from their products' surpluses.

b. **Diffusion or Diversion** Theory: According to the diffusion theory, the tax eventually spread throughout the entire society. That is, there are actually several tax placements made in the end. The diffusion process was carried out through shifting or an exchange process.

Factors determining Tax Incidence

a. **Elasticity:** When analysing incidence, we take into account both supply and demand elasticity. If the demand for the taxable good is elastic, the tax will typically be passed along to the producer; however, if the demand is inelastic, the tax will primarily be borne by the consumer. The burden will typically fall on the buyer in elastic supply scenarios and on the producer in inelastic supply scenarios.

b. **Cost:** Cost is a crucial consideration because it is the only way for the tax burden to be shifted. The tax does not change if the price remains the same.

c. **Time:** In the short term, the producer is unable to modify plant or equipment. Therefore, he may not be able to reduce supply and may have to bear some of the tax if demand declines as a result of price increases brought on by the tax. However, a full adjustment can eventually be made and the tax can be transferred to the consumer.

d. **Cost:** Taxes increase the price, which in turn decreases demand, which in turn lowers output. Costs are impacted by changes in production scale, and the impact varies depending on whether the industry has decreasing, increasing, or constant costs. For instance, if the industry is characterised by declining costs, a reduction in production scale will increase the cost and, consequently, the price, shifting the tax burden to the consumer.

e. **Tax type:** The type of tax will unquestionably affect the incidence of taxation. For instance, a consumer bears the brunt of an indirect tax.

f. **Market form:** The market form is another element that affects the incidence of taxation. Since neither a single producer nor a single consumer can influence the price in a market with perfect competition, shifting taxes in either direction is impossible. However, in a monopoly, a producer is able to control the price and thereby shift the tax.

Distinguish Taxation's incidence and its impact

The phrase "impact" refers to the immediate outcome or initial imposition of the tax. A tax's effects are felt by the person it is imposed on first. As a result, the impact of the tax is felt by the person who is able to pay it to the government. As such, a tax's impact refers to the act of impinging.

The location of the tax's ultimate or direct financial burden is referred to as its incidence. It represents the transfer of the tax burden to the main tax payer.

When the tax finally rests or settles on the person bearing it, incidence occurs. In actuality, it is the end result of shifting. As a result, a tax is imposed on the person who is left with no other option but to shoulder the tax's direct financial burden.

Thus, the difference between the impact and incidence of taxation is clear:

a. Impact and incidence both refer to the tax's overall burden; impact refers to the tax's initial burden.
b. While incidence happens at the point of settlement, impact happens at the point of imposition.
c. A tax has an effect on the person from whom it is collected and an incidence on the person who will ultimately pay it. Let's say soap is subject to an excise duty as an example. Due to their obligation to pay it to the government, it first affects the producers. But by increasing the cost of soap by the appropriate amount, the manufacturers may be able to collect it from the consumers. In that scenario, consumers eventually pay the tax, and as a result, they bear the impact.
d. Incidence can be changed, but impact cannot. For the shifting process ends with incidence. However, there are times when there is no option for shifting, such as with income tax or other direct taxes, and the impact and incidence both apply to the same person.

2.4.8 Principles of a Good Tax System

Taxes, which are mandatory payments made by people or businesses to the government to cover government expenses, have an impact on both the economy and social life of the community. The impact could be beneficial to the economy or detrimental. There are criteria and principles for evaluating tax systems, therefore, in order to prevent or minimise harm to the economy. The Canons of Taxations are another name for these standards.

2.4.9 Canons of Taxation

- **Equity:** Equity requires that taxes be collected in a way that encourages fairness. The idea of "from each according to his ability to pay" or "benefits received" is really what the principle of equity is all about. A tax system is referred to as a progressive tax system when it takes proportionately more income from higher income earners than from lower income earners. The tax system ought to be equitable, with a progressive rate structure and a minimum exemption policy. As a result, equals ought to be treated fairly, and unequals ought to be treated unfairly.
- **Simplicity:** A tax system should be straightforward. The tax system should be simple enough for the taxpayer to understand, and the tax base should be well-known. If there is any neglect or failure to comply with tax law, the taxpayer should be able to calculate their liability and the associated penalties. The amount shouldn't be decided by the tax collector because doing so would disadvantage the taxpayer, place them at the collector's mercy, and possibly make the tax system arbitrary.
- **Economics:** The administration of the tax system ought to be the least labour- and resource-intensive. As it makes no sense to spend more than is earned, the cost-benefit analysis is stressed. To determine whether a tax system is uneconomical or not, optimisation of collection costs is required; both pecuniary and non-pecuniary costs should be taken into account.
- **Unquestionably:** The imposition of tax should result in the anticipated revenues to support government long-term planning. While taxes on some commodities are predictable, they are less so on others. On the other hand, this criterion supports the idea that the taxpayer should know precisely and exactly when to pay, how to pay, and how much to pay. Convenience: This states that taxes should be collected in a way and at a time that is most likely to benefit the taxpayer. A tax system that allows for the payment of tax at month's end, right after crop harvest seasons, or that allows for the payment of tax through mechanisms like PAYE or other

withholding arrangements can be considered convenient for tax-payers; however, a tax system that burdens tax-payers with high taxes long after their income is spent is inconvenient.

- **Elasticity of Tax to Changes in Tax Base:** An effective tax system should be flexible to changes in the tax base; a tax is elastic when the amount of revenue it generates grows at a rate that is equal to or greater than the growth of income, the economy, or economic activity. The flexible tax system generates enough income for the projects that are planned.

2.4.10 Let us Sum up

The term "taxable capacity" refers to the maximum amount of resources that a nation can provide through taxation, both in routine and unusual circumstances. In other words, it refers to the maximum level of ease with which a nation's citizens can bear the burden of taxation. To determine the maximum amount of taxation that a nation or its citizens could be subjected to in order to raise public funds, it is necessary to determine their taxable capacity. This needs to be done without worsening the economy further, as that might defeat the purpose of taxes altogether. Taxes, which are mandatory payments made by people or businesses to the government to cover government expenses, have an impact on both the economy and social life of the community. The impact could be beneficial to the economy or detrimental. There are criteria and principles for evaluating tax systems, therefore, in order to prevent or minimise harm to the economy. The Canons of Taxations are another name for these standards.

The canons of taxation were first presented by Adam Smith in his famous book The Wealth of Nations. These canons of taxation define numerous rules and principles upon which a good taxation system should be built. Although these canons of taxation were presented a very long time ago, they are still used as the foundation of discussion on the principles of taxation.

2.4.11 Self-Assessment Questions

1. What is mean by taxable capacity.
2. Explain the types of taxable capacity.
3. Briefly discuss the theories of Tax Shifting and Incidence

4. What is the significance of canons of taxation?
5. Which canon of taxation is advocated by Adam Smith?

2.4.12 References

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UNIT - III

Lesson 3.1 - Theories of Public Expenditure

Structure

3.1.1 Objectives

3.1.2 Introduction

3.1.3 Factors Increasing Public Spending

3.1.4 Categorization of public spending

3.1.5 Theories of growth of public expenditure

3.1.6 Samuelson Theory of Public Goods

3.1.7 Let us Sum up

3.1.8 Self-Assessment Questions

3.1.9 References

3.1.1 Objectives

Tha main objectives of this lesson are to

- Scope of increasing Public Spending
- Categorization of public spending
- Describe the various theories of growth of public expenditure.
- Understand the Samuelson Theory of Public Goods.

3.1.2 Introduction

Public expenditures are the costs a government bears for (i) its own upkeep, (ii) the well-being of society and the economy, and (iii) aiding other nations. In reality, though, it is getting harder and harder to distinguish between the portion of public spending meant for maintaining the government itself and the total due to the expansion of State activities. In almost every nation historically, public spending has risen steadily over time. Traditional philosophy and thinking, on the other hand, did not support this trend because they believed that the market mechanism provided a better framework for the operation of the economy and the distribution of its resources. The government shouldn't attempt to make decisions on behalf of other people, it was argued, because each economic unit is the best judge of its own economic interests. Additionally, whereas a private economic entity was motivated by its own financial interests, the public sector was not. Its effectiveness was therefore certain to be very low. Public spending would not have increased as quickly as it did if this philosophy had been followed in its entirety. However, in practise, the state was powerless to ignore issues with social injustice and economic growth. It was unable to watch in silence as the people suffered. As a result, various iterations of socialist and welfare philosophies were accepted.

Nevertheless, despite the fact that public spending has grown quickly over the past 200 years or so in almost every State, and despite its expanding significance to national economies, this field is still understudied. According to Lowell Harris, "economists have generally focused on the theory of taxation. In terms of how public spending affects employment, prices, etc., the theory of public expenditure has largely been restricted to generalisations. Of course, it should be noted that recent research in the area of public spending has helped to eliminate this deficit.

3.1.3 Factors Increasing Public Spending

1. **Country size and population:** Nearly all nations are expanding their geographic range. The modern government's operations can be found everywhere, even in no-man's land. Assuming a fixed size for a nation, population growth in developing nations has increased significantly. Public spending in these sectors has increased as a result of the expansion of the government's administrative activities (like the military, police, and judiciary).
2. **Defence Spending:** War threats are to blame for the massive increase in public spending. The second half of the 20th century has not seen any major wars. But war still looms large and continues to pose a threat. Sole sovereignty necessitates a larger budgetary allocation for military readiness.
3. **Welfare State:** The modern state is a "welfare state," as opposed to the "police state" of the 19th and 20th centuries. Socialistic ideals are still present even in a capitalist system. Since socialism is respected in this country, modern governments have openly advocated for the socioeconomic advancement of the general populace.

Numerous socioeconomic initiatives are made to advance human welfare. Large sums of money are spent by modern governments on economic development. It actively contributes to the creation of goods and services. The government provides funding for this investment. Along with development initiatives, welfare initiatives have expanded significantly. It invests money in offering a range of social security benefits.

Under government patronage, social sectors like health and education are given special consideration. It develops both social and economic infrastructure, including that related to transportation, electricity, etc. All of these things require a significant amount of money. Modern governments are the only sources of funding for these activities because a sizeable sum is needed to finance them. However, the political leaders (Ministers, MPs, and MLAs to have political mileage, as well as by the bureaucrats (MPLAD)) greatly shape and influence the government's various welfare programmes.

4. **Economic Progress:** A modern government can significantly influence how an economy is shaped. Private investors are completely unable to support a nation's economic growth. Due to the private sector's limitations, modern governments now invest in a variety of industries to promote economic growth. The presence of economic infrastructure is a major determinant of economic development. The only way to improve an economy's structure is to build up its economic infrastructure, such as roads, transportation, and electricity. Obviously, the government spends money to fund these activities.
5. Price Growth Increased government spending is frequently attributed to rising prices brought on by inflation.

3.1.4 Categorization of public spending

Public spending is divided into two categories:

a. Revenue Spending and

b. Capital Spending.

Spending from current sources is revenue expenditure. For instance, it includes maintenance and administrative expenses. This expense is recurring in nature. Capital expenses are one-time purchases that are of a capital nature. It is a one-time expense. For instance, spending on multi-purpose projects, large factories like steel plants, or the purchase of land, machinery, and equipment. The revenue budget or revenue account relates to the government's ongoing, recurring financial transactions. The government's revenue budget consists of its revenue receipts, and it uses these revenues to pay for its expenses. Taxes, duties, fees, fines, penalties, income from government estates, receipts from government commercial enterprises, and other miscellaneous items are all included in the Revenue Account, along with their corresponding expenditures. Tax receipts, business profits, and other non-tax receipts such as administrative revenue (fees, fines, special assessments, etc.), gifts grants, and other receipts are all included in revenue receipts. Interest payments, defence costs, significant subsidies, pensions, etc. are examples of revenue expenditures.

The purchase and sale of capital assets are related to the capital account. A capital budget is a forecast of the government's anticipated capital inflows and outflows for the fiscal year. It is made up of capital investments and capital outlays. The capital account deals with expenses that are typically financed by borrowing money with the goal of increasing tangible assets of a material nature or of lowering recurring liabilities, such as building projects, irrigation schemes, etc.

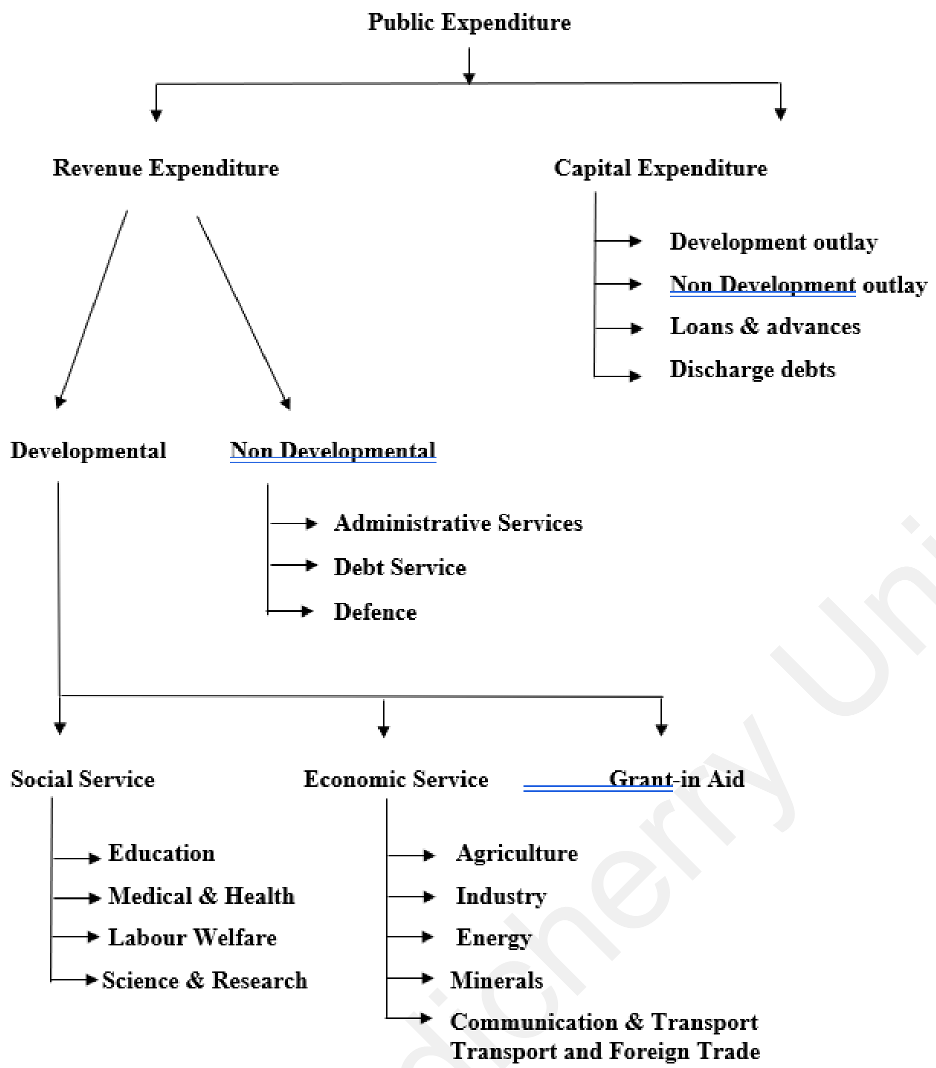
Capital Receipts include

a. Borrowings
b. Recovery of loans and advances
c. Disinvestments and
d. Small savings.

Capital Expenditure includes

a. Developmental Outlay
b. Non-developmental outlay
c. Loans and advances and
d. Discharge of debts.

This can be explained as follows:



3.1.5 Theories of growth of public expenditure

As is well known, public spending has significantly increased in all nations of the world in recent years. The following are the three key theories of the increase in public spending:

a. Adolph Wagner's hypothesis

b. Wiseman – Peacock hypothesis and

c. Colin Clark's Critical Limit Hypothesis

3.1.5.1 Adolph Wagner's hypothesis

Adolph Wagner (1835–1917) thought there was a causal link between rising public spending and economic growth. His "Law of Increasing State Activity" postulate states that as per capita income and output rise in industrialised counties, those counties' public spending must correspondingly rise as a percentage of overall economic activity.

Comprehensive comparisons of various nations and eras, he continued, "show that among progressive people, with whom alone we are concerned, an increase in the activity of both central and local governments takes place on a regular basis." The central and local governments are experiencing a significant and sustained increase. constantly take on new tasks, while carrying out both old and new tasks more fully and effectively.He described the pattern of public spending.

Conclusions:

1) The percentage of spending on goods provided by the government rises as the amount of national income does.

2) The escalating pressure for social progress and economic growth naturally led to higher public spending.

3.1.5.2 Wiseman – Peacock hypothesis

Wiseman and Peacock assert that public spending does not rise gradually and steadily. The rise in public spending over time has been gradual and step-like. They researched the UK's experience over a secular time span (1890–1955). They looked at the variations in government spending over time rather than the trend of public spending. The three related concepts are mentioned in the general approach to the hypothesis.

1. Displacement effect
2. Inspection effect and
3. Concentration effect.

The displacement effect refers to the transition from an older level of spending and taxation to a new, higher level. People and governments are compelled by war and other social disturbances to find solutions to pressing issues that were previously disregarded. The inspection effect is what's meant by this. That is, the state was given new obligations in the form of higher debt interest rates, war pensions, etc. When society is experiencing economic growth, there appears to be a tendency for the central government's economic activities to account for an increasing share of all public sector economic activity.

3.1.5.3 Critical Limit Hypothesis (Colin Clark)

Colin Clark came up with the theory soon after the Second World

War. It is worried about the amount of taxation that can be tolerated. The tolerance level's upper bound is 25% of GNP. Even with a balanced budget, inflation still happens when the government's share of spending exceeds 25% of the GNP.

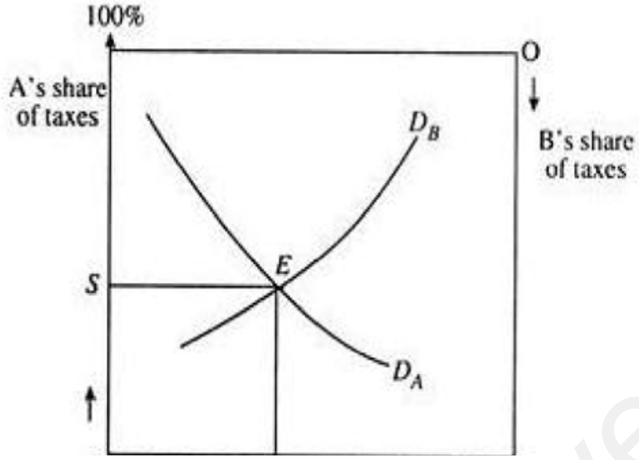
3.1.6 Samuelson Theory of Public Goods

Paul Samuelson proposed the theory of public goods in 1954. It asserts that goods that are consumed collectively are non-competitive and non-excludable. The Pure Theory of Public Expenditure was another name he used for the theory. The theory emphasises what Samuelson referred to as free riders—those who participate in the collective consumption without helping to maintain it by pretending to have less than they actually do. An example of the free rider aspect of the theory would be the entrepreneur who is charging Rs.100 for customers to watch the fireworks. Rather than pay, many free riders allow others to pay, while they enjoy the show from their windows or yards or from a nearby public area.

Voluntary Exchange Model: It is an approach to the analysis of the provision of public goods which seeks to establish conditions under which these goods can be provided on the basis of unanimous agreement— i.e. without coercion. This may be contrasted with the generally observed arrangement that the provision of public goods is financed by compulsory taxation and not by voluntary agreement. The voluntary approach was first advanced by Knut Wicksell who argued that:

1. Each public good should be financed by a separate, identifiable tax.
2. The unanimous agreement of all members of the society would be required to decide on the amount of the good to be supplied.

At the outset individuals would be aware of their allotted share of any tax to be levied. The problem would then be to decide the level of provision. The analysis was extended by Lindahl, who presented a model in which both the share of taxes and the amount of good were open to debate. In Lindahl's model, equilibrium requires each individual to pay a tax rate just equal to the individual's marginal utility from the good. This can be shown for a two-person community (consisting of A and B) which has quantity of public good along horizontal axis and the share of tax paid by A and B along vertical axis.



A's share of taxes increases from the bottom to up and S's share of taxes increases from top to down. The schedule DA indicates the amount of the good A will wish to demand at different levels of his tax share. As his share of the cost goes down, his desired level of provision increases. DB indicates B's preferences—again, as his share of the cost falls, his preferred quantity of the good increases. The Lindahl equilibrium involves producing Q1 of the good with tax shares as indicated at point S.

In the Lindahl model, public goods are provided in a manner which ensures everyone gains from their provision i.e. The provision of goods is always a Pareto improvement. Lindahl's analysis adds the condition that each individual consumes his most-preferred or 'optimal' amount of the public good given his tax share. Despite the appeal of the model, difficulties arise in its application. In particular, the problems of reaching unanimous agreement and the possibility that individuals will not indicate true preferences (i.e. they may seek to be free riders) under-mine the usefulness of the model.

There is an interesting duality between the definitions of private and public goods on one hand and properties of equilibriumprices on the other. In terms of quantities, for private goods the sum of individual quantities consumed add up to the quantity produced, while, for public goods, individual consumption equals aggregate production. In terms of prices, on the other hand, for private goods each consumer price equals producer price, while for public goods individual consumer prices add up to producer price.

There is, however, one crucial difference between a Lindahl equilibrium and a competitive equilibrium for private goods. With private goods, individuals facing given prices have clear incentives to reveal their true preferences by equating their marginal rates of substitution to relative prices, at least if the economy is sufficiently large relative to the individual. Without paying, the individual is excluded from enjoying the benefits of consumption.

With public goods this no longer holds. Because an individual has the same quantity of public goods available to him whether he pays or not, he has an incentive to misrepresent his preferences and to be a free rider on the supply paid for by others. Moreover, this problem is likely to be particularly severe when the number of individuals is large, since his own contribution will then make little difference to the total supply.

The equilibrium of Lindahl model is not compatible with individual incentives to reveal preferences truthfully; for this reason Samuelson (1969) has referred to the individual Lindahl prices as pseudo-prices and to the equilibrium as pseudo-equilibrium. In this case, one would conjecture that because all individuals have the same incentives to understate their true marginal willingness to pay, the Lindahl mechanism would result in equilibrium levels of public goods supply which would be too low relative to the optimum.

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But there is really no need to associate the problem of preference revelation with this procedure alone; as another extreme, one might think of the case where individuals are asked to state their preferences on the assumption that the cost to them is completely independent of their stated willingness to play, but there is a positive association between this and the quantity supplied.

Then there will be incentives to exaggerate the willingness to pay and a consequent tendency towards oversupply. Thus, the general problem which arises is how to design a mechanism that will allow the decision-maker to implement the efficiency condition. The development (1954-55) by Paul Samuelson of the modern theory of public goods must be counted as one of the major breakthroughs in the theory of public finance.

In these two very short papers Samuelson posed and partly solved the central problems in the normative theory of public expenditure:

i. How one can define goods analytically that are consumed collectively, that is for which there is no meaningful distinction between individual and total consumption?

ii. How one can characterize an optimal allocation of resources to the production of such goods?

What can be said about the design of an efficient and just tax system which will finance the expenditures of the public sector? What is required is a satisfactory theory of market failure. Criteria for just taxation had developed independently of any analysis of the expenditure side of the public budget. Still, Samuelson's formulation was a great leap forward, presenting an integrated solution to all three problems.

3.1.7 Let us Sum up

Public expenditure refers to the expense incurred by the government for the realisation of the collective necessities of the people. These expenditures are brought in for the sustenance of government areas and the usefulness of the community as a whole. Public spending is divided into two categories: a) revenue spending and b) capital spending. Spending from current sources is revenue expenditure. For instance, it includes maintenance and administrative expenses. This expense is recurring in nature. Capital expenses are one-time purchases that are of a capital nature. It is a one-time expense. For instance, spending on multi-purpose projects, large factories like steel plants, or the purchase of land, machinery, and equipment. The revenue budget or revenue account relates to the government's ongoing, recurring financial transactions. The government's revenue budget consists of its revenue receipts, and it uses these revenues to pay for its expenses. Taxes, duties, fees, fines, penalties, income from government estates, receipts from government commercial enterprises, and other miscellaneous items are all included in the Revenue Account, along with their corresponding expenditures. Tax receipts, business profits, and other non-tax receipts such as administrative revenue (fees, fines, special assessments, etc.), gifts grants, and other receipts are all included in revenue receipts. Paul Samuelson proposed the theory of public goods in 1954. It asserts that goods that are consumed collectively are non-competitive and non-excludable. The Pure Theory of Public Expenditure was another name he used for the theory. The theory emphasises what Samuelson referred to as free riders—those who participate in the collective consumption without helping to maintain it by pretending to have less than they actually do. An example of the free rider aspect of the theory would be the entrepreneur who is charging Rs.100 for customers to watch the fireworks. Rather than pay, many free riders allow others to pay, while they enjoy the show from their windows or yards or from a nearby public area.

3.1.7 Self-Assessment Questions

1. What are the two major ways of public expenditure?
2. Why does public expenditure increase?
3. Write a note on Adolph Wagner's hypothesis.

4. Mention the Wiseman – Peacock hypothesis
5. Explain the Samuelson Theory of Public Goods.

3.1.8 References

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Lesson 3.2 - Cost Benefit Analysis

Structure

3.2.1 Objectives

Tha main objectives of this lesson are to

- Describe the various definitions on Cost benefit anlaysis
- Know the Welfare Foundations of Cost Benefit Analysis
- Understand the Cost benefit anlaysis

3.2.2 Introduction

According to Prof. Marglin, the function of cost-benefit analysis is to "determine the broad strategy of growth by allocating resources among sectors in the perspective and Five-Year Plans. However, the Plans' growth strategy leaves many tactical decisions open, and it is these tactical choices that fall under the purview of cost-benefit analysis. In a planned economy, it offers better criteria for project evaluation. By maximising the gap between the present value of benefits and costs of a project, it aids the planning authority in making wise investment decisions to achieve optimal resource allocation. Cost-benefit analysis, then, "purports to describe and quantify the social advantages and disadvantages of a policy in terms of a common monetary unit." The objective function can be written as Net Social Benefit (NSB)=Benefits—Costs, where benefits and costs are calculated using inputs' accounting or shadow prices rather than their actual market prices.

3.2.3 Definitions

Cost benefit Analysis (CBA) is Analysis undertaken to judge any project or investment whether government or private and find out its worth and facilitate its comparison with other available opportunities of investment. In other words we can say CBA finds out the worth of an investment by ranking optional investment. Before taking up an investment one must judge its cost and benefits. It can be adopted at Macro and Micro level.

CBA has been established primarily as a tool for use by governments in making their social and economic decisions. Given sufficient information, CBA can:

- Calculate the net benefits for each proposal
- Rank proposals by their net benefits
- Recommend the proposal with the greatest net benefit

A cost-benefit analysis is a method for calculating the benefits of a decision or course of action minus the costs related to that decision or course of action. Measurable financial metrics, such as revenue generated or costs avoided as a result of the project's decision, are part of a cost-benefit analysis. Intangible benefits, costs, or effects of a choice, like employee morale and customer satisfaction, can also be considered in a cost-benefit analysis. Sensitivity analysis, discounting of cashflows, and what-if scenario analysis for multiple options may all be included in a more complex cost-benefit analysis. All things being equal, it will typically be advantageous for the business to take on a project if the analysis shows more benefits than costs.

3.2.4 Why is CBA useful?

CBA examines costs and benefits from the perspective of the community as a whole:

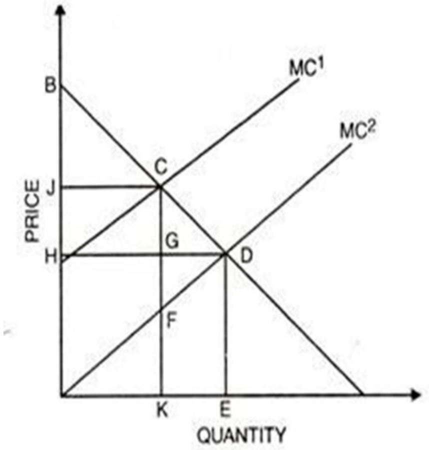
- It forces a wider view on decision makers
- Promotes comparability and encourages consistent decision making
- Its aim is to maximize community net benefits
- CBA includes all costs and benefits – it tells the whole story

3.2.5 Understanding Cost-Benefit Analysis

Prudent managers perform a cost-benefit analysis to assess all potential costs and revenues that a company might generate from the project before starting a new project or building a new plant. The analysis's findings will determine whether the project is financially feasible or whether the business should move forward with a different project. The opportunity cost will frequently be considered in a cost-benefit analysis as part of the decision-making process. Opportunity costs are benefits that might have been realised if a different alternative had been chosen. The missed or forgone opportunity as a result of a choice or decision is, in other words, the opportunity cost. Project managers can weigh the advantages of various action plans, rather than just the one currently being considered in the cost-benefit analysis, by taking opportunity costs into account. The cost-benefit analysis is more thorough and helps to make better decisions because it takes into account all available options and potential missed opportunities. To see if the benefits outweigh the costs, the results of the total costs and benefits should be quantitatively compared. If so, moving forward with the project would be the sensible choice. If not, the company should reevaluate the project to see if it can be modified to raise benefits or lower costs in order to make the project viable. If not, the business should probably steer clear of the project.

3.2.6 Welfare Foundations of Cost Benefit Analysis

Cost-benefit analysis is used to direct funding towards initiatives that will benefit society most overall. The maximisation of social utility is the maximisation of net benefit. In 1844, Dupuit became the first to study this issue. Let's examine a diagram of his arguments that was created assuming perfect competition.



An increase in KEDF expenses results in an increase in benefits. Thus, the triangle FDC represents the net increase in benefits. The GCD and GFD segments make up this triangle. GCD stands for the increase in consumer surplus, while GFD stands for the increase in producer surplus. Dupit suggested using combined surplus to gauge changes in welfare brought on by the imposition of a bridge crossing toll. But new investment can be included in this analysis as well.

3.2.7 Let us Sum up

The origins of cost-benefit analysis can be traced to a French engineer and economist named Jules Dupuit in the 19th century. It is an easy way to compare project costs and benefits in 1936 to decide whether to move forward with a project or not. Cost benefit analysis is a process used to evaluate any project or investment, whether it be public or private, determine its value, and make it easier to compare to other investment opportunities. CBA is an analytical tool used to weigh the advantages and disadvantages of proposed regulations. A cost benefit analysis is performed to assess how effectively or ineffectively a planned action will be carried out. To arrive at a net result, the analysis relies on the addition of positive factors and the subtraction of negative ones.

3.2.8 Self-Assessment Questions

1. Define Cost benefit analysis.
2. How to Do a Cost-Benefit Analysis?
3. Why is CBA useful?
4. Explain the Welfare Foundations of Cost Benefit Analysis.

3.2.9 References

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UNIT - IV

Lesson 4.1 - Deficit Financing

Structure

4.1.1 Objectives

The main objectives of this lesson are to

- Understand the concept of deficit financing
- Know the Main Objectives of Deficit Financing
- Identify the methods of Deficit Financing
- Understand the benefits of Debt Financing
- Find out the Types of Deficit Financing
- How Does Government Budget Deficit Occur?
- Differentiate between Monetarism vs. Keynesian Economics

4.1.2 Introduction

Deficit financing is the practise of a government spending more than it is bringing in, and making up the difference by borrowing or creating new money. Although there are many reasons why there may be a budget deficit, the term typically refers to a deliberate effort to boost the economy by lowering tax rates or increasing government spending. Government deficits may have a significant impact on a country's economy. It is generally accepted that the outdated ideal of an annual balanced budget should be replaced with one that is balanced over the course of an economic cycle. Some economists have completely given up on the idea of a balanced budget because they believe it to be an inadequate standard for determining public policy. However, government inefficiency may also contribute to deficit financing, reflecting widespread tax avoidance or wasteful spending rather than the implementation of a deliberate countercyclical policy.

In areas without developed capital markets, deficit financing may result in the government owing money to foreign creditors. Budget surpluses may also be desirable in and of themselves in many less developed nations as a way to promote private saving. A policy of deficit financing involves the government spending more than it takes in as tax revenue. The government borrows money or creates new money to make up the difference between its spending and its revenue. The term "budget deficit" refers generally to the deliberate actions taken to stimulate the economy by lowering the tax rate and increasing government spending, even though it may occur for a variety of reasons.

4.1.3 Definitions

Deficit financing, which is similar to debt financing but refers to specific methods used by governments to increase the number of debt instruments they currently have on the market, is according to Tyler Lacoma.

The Indian Planning Commission states that "the term deficit financing is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on current revenue or of capital accounts."

The tool, according to Webster's Dictionary, is deficit financing. The practise of spending more money than is brought in as revenue in the government and making up the difference through borrowing or creating new money. The phrase typically describes a deliberate effort to boost the economy by reducing tax rates or raising government spending.

4.1.4 Objectives

The Main Objectives of Deficit Financing are:

- To pay for wartime defense-related expenses.
- To get the economy out of a slump so that investments, income, and employment increase.
- To mobilise the best resources and shift funding from unproductive to productive sectors with the primary goal of raising national income and spurring faster economic growth.
- To upgrade the nation's infrastructure, giving taxpaying citizens peace of mind that their money is being wisely spent.

4.1.5 Deficit financing's Function in Developed Economies

During the Great Depression, deficit financing was crucial in a developed economy. Banks and the general public are unwilling to take the risk of investing during the depression because demand and spending are at extremely low levels. Instead, they favour building up their cash reserves. The machinery and capital equipment are all there; however, the incentive to produce is lacking because of a lack of aggregate demand. Let's say the government increases the economy's purchasing power (by financing the deficit). The level of effective demand is then likely to rise in order to meet this demand, forcing idle machinery and capital equipment into service. The level of production will consequently rise. Inflationary tendencies won't be created if this increase can keep up with the rise in overall spending levels.

4.1.6 Benefits of Debt Financing

The fact that the deficit is not only worse should be taken into account. Deficit spending, such as tax cuts or government purchases of goods and services, can halt currency depreciation and assist in bringing the economy out of a recession. Deficit financing therefore aids in economic stabilisation. Due to the deficit financing, the company's outlook also improves as the economy does, which may encourage crowding-in, or an increase in investment.

Deficits allow us to fund infrastructure and spread the cost over a longer period of time, much like how individuals finance the purchase of a home or car or how local governments use bond issues to fund public schools. This makes it possible for us to buy infrastructure that, if financed all at once, we might not be able to. In order to finance deficits, the government typically borrows money from the RBI. The government receives a profit in exchange for the interest it pays to the RBI. Resources are used much earlier through deficit financing than in a different way. The process of development is sped up. This makes it possible for the government to acquire resources with little resistance.

4.1.7 Strategies to Combat Deficit Financing

The following steps are taken to address deficit financing:

- The amount of deficit financing ought to be capped at what the economy requires.
- Efforts should be made to reduce the extra cash that was used to purchase the new component. In order to prevent saved money from entering the mainstream again soon after its withdrawal.
- Limiting the price of goods, especially wage-goods, and distributing them fairly through formal or informal rationing will significantly reduce the inflationary impact on low-income groups of people and on the economy's cost structure.

4.1.8 Methods of Deficit Financing

- Borrowing from the Central Bank: One of the key tools available to the government in this regard is borrowing money from the RBI in the form of new money.
- Issuing New Currency – To increase the flow of money throughout the economy, the government may either borrow money in the form of new currency from the Central Bank or issue new currency on its own.
- Withdrawing all of its bank account's accumulated cash balances.

4.1.9 Types of Deficit Financing

The Different Types of Deficit Financing or Budget Deficit Are:

- Revenue Deficit
- Fiscal Deficit

- Primary Deficit

Let us Discuss the Types of Deficit Financing in Brief:

The difference between revenue receipts and revenue expenditures is known as the revenue deficit.

When RE > RD, the revenue deficit formula is revenue expenditure minus revenue receipts.

Fiscal Deficit: The difference between total expenditure and total receipt, excluding borrowings, is known as the fiscal deficit.

The formula for calculating a country's fiscal deficit is as follows: Total Expenditure (Revenue Expenditure + Capital Expenditure) - Total Receipts Other Than Borrowing (Revenue Receipts + Capital Receipts Other Than Borrowing).

Primary Deficit: The primary deficit denotes the distinction between interest expenses and the fiscal deficit.

Primary Deficit Formula: Fiscal deficit - Interest Payment

While the primary deficit depicts the government's borrowing needs without regard to interest payments on prior loans, the fiscal deficit depicts the borrowing needs of the government with regard to interest payments on prior loans. In other words, a primary deficit denotes borrowing by the government to cover current-year expenses and revenues.

4.1.10 How Does Government Budget Deficit Occur?

When estimated government spending grows faster than estimated revenue, a budget deficit or deficit financing results. Either raising the tax rate or mandating higher prices for goods and public utility services can be used to account for these discrepancies. Additionally, the government's accumulated cash reserves or borrowing from the banking system can be used to cover the deficit.

In India, the current budget deficit of the union government is said to be financed through borrowing from the Reserve Bank of India and drawing down the government's cash reserve. The government's cash balance is made active and enters circulation when it is withdrawn.

Once more, the RBI issues loans in these circumstances when the government borrows money from it. Consequently, new money enters the economy in both instances. It should be noted that deficit financing does not include government borrowing from the bank through the sale of bonds.

4.1.11 Monetarism vs. Keynesian Economics

Milton Friedman's direct criticism of John Maynard Keynes' Keynesian economics theory is known as monetarist economics. Simply put, the key distinction between these two schools of thought is that Keynesian economics focuses on government spending, whereas monetarist economics involves the control of money in the economy. Monetarists contend that the economy's money supply should be managed while the rest of the market is left to correct itself. Conversely, Keynesian economists contend that unless an intervention encourages consumers to increase their purchases of goods and services, a struggling economy will continue to contract.

These two macroeconomic theories have a direct bearing on how legislators formulate monetary and fiscal policies. Monetarists would be most concerned with filling up their petrol tanks, while Keynesians would be most concerned with keeping their engines running, if both types of economists were compared to drivers.

4.1.11.1 Keynesian Economics

Demand-side economics uses terminology that is identical to Keynesian economics. According to Keynesian economists, the best way to manage the economy is to manipulate consumer demand for goods and services. These economists do not, however, completely discount the importance of the money supply to the economy and the impact it has on GDP. They do, however, think that it takes a long time for the economy to adjust to any monetary influence. Keynesian economists think that government spending, net exports, and consumer spending can all change the direction of the economy. The New Keynesian economic theory, which builds on this conventional approach, might be appealing to supporters of this theory as well. The 1980s saw the introduction of the New Keynesian theory, which emphasises price behaviour and government intervention. Both theories are in response to the economics of the depression.

4.1.11.2 Monetarism

As their name suggests, monetarists are certain that the money supply governs the economy. They hold the view that managing the money supply directly affects inflation and that managing the money supply to combat inflation can affect future interest rates. Consider the effects that increasing the amount of money in the economy would have on consumer expectations and the production of goods. Consider now removing money from the economy. How do supply and demand fare? Milton Friedman, the father of monetarist economics, declared in public that the Federal Reserve was to blame for the Great Depression because he believed that monetary policy was so essential to a robust economy. He made the implication that the Federal Reserve should control the economy.

4.1.11.3 Key Differences

	Keynesian	**Monetarist**
Control of Economy	The government ought to step in and influence consumer demand for goods and services.	The Federal Reserve should oversee the regulation of money in circulation.
Inflation	To adjust demand and control inflation, adjust government spending	Control inflation by increasing or decreasing the money supply.
Unemployment	focuses more on lowering unemployment than lowering inflation; if people increase their savings and cut back on their spending, the government may need to spend more.	emphasises lowering inflation more than maintaining low unemployment; real wage unemployment is likely to be avoided by natural wage adjustments.
Views of Each Other	The economy's time to adapt to monetary policy changes is too long	Government spending may actually increase inflation rather than control it and may compete with private sector spending, which is preferred to public spending.

_4.1.12 Let us Sum up

Deficit financing is the practise of a government spending more than it is bringing in, and making up the difference by borrowing or creating new money. Although there are many reasons why there may be a budget deficit, the term typically refers to a deliberate effort to boost the economy by lowering tax rates or increasing government spending. Government deficits may have a significant impact on a country's economy. It is generally accepted that the outdated ideal of an annual balanced budget should be replaced with one that is balanced over the course of an economic cycle.

During the Great Depression, deficit financing was crucial in a developed economy. Banks and the general public are unwilling to take the risk of investing during the depression because demand and spending are at extremely low levels. Instead, they favour building up their cash reserves. The machinery and capital equipment are all there; however, the incentive to produce is lacking because of a lack of aggregate demand. Let's say the government increases the economy's purchasing power (by financing the deficit). The level of effective demand is then likely to rise in order to meet this demand, forcing idle machinery and capital equipment into service. The level of production will consequently rise. Inflationary tendencies won't be created if this increase can keep up with the rise in overall spending levels.

The Different Types of Deficit Financing or Budget Deficit Are: Revenue Deficit, Fiscal Deficit and Primary Deficit.

Milton Friedman's direct criticism of John Maynard Keynes' Keynesian economics theory is known as monetarist economics. Simply put, the key distinction between these two schools of thought is that Keynesian economics focuses on government spending, whereas monetarist economics involves the control of money in the economy. Monetarists contend that the economy's money supply should be managed while the rest of the market is left to correct itself. Conversely, Keynesian economists contend that unless an intervention encourages consumers to increase their purchases of goods and services, a struggling economy will continue to contract. These two macroeconomic theories have a direct bearing on how legislators formulate monetary and fiscal policies. Monetarists would be most concerned with filling up their petrol tanks, while Keynesians would be most concerned with keeping their engines running, if both types of economists were compared to drivers.

4.1.13 Self-Assessment Questions

1. Define the term Deficit financing.
2. What are the Methods of Deficit Financing?
3. Explain the Types of Deficit Financing
4. How Does Government Budget Deficit Occur?
5. Differentiate between Monetarism vs. Keynesian Economics

4.1.14 References

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Lesson 4.2 - Public Debt

Structure

4.2.1 Objectives

The main objectives of this lesson are to

- Understand the objectives and Classification of Public Debt
- Know the advantage and disadvantage of Public Debt
- Explore the Burden of Public Debt
- Assess the efficiency and Welfare Losses from Taxation
- Describes the Public Debt and Growth
- Mention the importance of Public Debt Management
- Assessing the Debt

4.2.2 Introduction

A state's source of revenue collection is its public debt. Debt owed by foreign nationals to the state is referred to as public or local debt. Public debt is created when the government borrows money. Banks, businesses, organisations, people, and business houses can all be sued by the government for debt. The government may collect debt from both domestic and foreign sources, or from both. In times of economic hardship, emergencies like war or drought, etc., the public debt is one of the most crucial sources of revenue for the government.

4.2.3 Definitions of Public Debt

"Public debt is a way of collecting income from public officers," claims Dalton.

Public debt is a relatively recent phenomenon, and Prof. J.K. Mehta

Claims that it will manifest itself in practise as democratic governments advance.

Public debts "create the conditions for war and additional expenditure," according to Adam Smith.

4.2.4 Objectives of Public Debt

- To Reduce Inflation: When prices rise, a condition is called inflation. Therefore, government can wrest a sizable amount of labour from the populace by taking on debt, but modern economists contend that government taxation, as opposed to borrowing, is more crucial for eradicating inflation because, if borrowed funds are never put to productive use, the burden on the government to repay the debt increases. However, waste tax revenue is easily deducted from government coffers, relieving pressure on the economy's production.
- To finance development plans: There is never enough money in an underdeveloped economy. As the ability to pay the bill is lower in these nations. Government cannot therefore hide behind high taxation. But making arrangements for development plans is also crucial in order to eradicate poverty from the nation. The only option in this situation is to take on public debt. Therefore, in order to conduct financial transactions, the governments of

underdeveloped nations take on debt from citizens, from other governments, or from foreign governments.

- The Finance Public Enterprises: In order to arrange financing for independently operating commercial enterprises, the government also incurs debt.
- Development of Education and Health Services: The government may also incur debt to build and develop these and other services of this nature. Although it does not provide any direct funding and is not profitable from a monetary standpoint, this contributes to the improvement of normal social welfare.
- To fund a war: The government may issue debt to fund self-defense efforts. With increased international pressure and the threat of nuclear war, the country needs a lot of money to protect itself from foreign attacks, pay for self-defense services, and arrange for modern decoration. However, due to the negative effects on production, it is very challenging to fund modern wars solely through taxation. Therefore, in order to deal with this kind of situation, the government can seek protection from both domestic and foreign public debt.
- To Create a Social Society: In order to create a socialist society, the government currently nationalises business and industry and runs it on its own. However, this requires a significant amount of funding, which the government can only obtain by incurring debts.
- To pay for administrative expenses until receiving income: Tax revenue is available at the end of the year, but expenses must be covered from the beginning of the year. As a result, at the start of the year, the government incurs debt, which it then repays when it receives income at the end of the year.
- To Win Over the Public: When the people are unable to pay their taxes, the government is forced to take on debt. Even when the public is more capable, the government occasionally refrains from raising taxes because the general consensus is still positive.

4.2.5 Classification of Public Debt

Debt has been divided by economists according to use, target, time limit, and terms of payment. The various forms of public debt include the following:

4.2.5.1.Internal and External Debt

Internal Debt: Public debts taken from within a country are considered internal debts, whereas debts taken from foreign governments are considered external debts. According to Dalton, "A debt is internal if given by those people or organisations living in that area that is controlled by the local officer of taking debt," which includes foreign nationals and international organisations.

A debt is considered external if it was given by individuals or organisations residing elsewhere. Because a large portion of the debtor country's income is paid to the foreign country when interest is paid on its external debt, that country's net income is reduced. However, this effect is not felt when interest is paid on its internal debt. Whether the interest on internal debts is paid by tax payers or is withheld from them and used to pay the interest on war debts, it has no impact on the nation's national income, which returns to its previous level of stability. This is a technique used to take money out of one pocket of the taxpayer and put it in another.

4.2.5.2. Productive and Unproductive Debt

This classification depends upon on the use of public debt. Debts can be used for the production works and unproductive debt.
The use of public debt determines this classification. Debts may be used for productive or unproductive purposes.

Productive debt: Productive debts are those debts used in plans that generate income, such as railroad, electricity, and irrigation plans. These plans' income can be used to cover both the principle and yearly interest payments. Therefore, debts that have the same costs or assets with higher costs are considered productive or reproductive debts. Thus, pressure from productive debt never existed on the government or the taxpayer.
Unproductive debt: These debts are used in plans for which no income is provided, such as war. Unproductive debts are those debts, and the back is where no assets are. War is not the only factor contributing to unproductive debt; at some point, interest rate losses also played a role.

4.2.5.3. Redeemable and Irredeemable Debt

Debts that the government promises to repay on a specific date are referred to as redeemable debts. Terminable debt is another name for these obligations.

Irredeemable or perpetual debts are those that have no chance of repayment and are referred to as irredeemable or perpetual debt. Governments are required to make the same arrangement to pay back debts that are not repaid. If the government decides that these debts will be repaid with tax revenue, which is almost always the best option for this work, they will need to impose new taxes. Government must therefore pay interest and principal on a set future date in the case of redeemable debts.

4.2.5.4. Funded and Non-Funded Debt

Funded and non-funded debt is another way to categorise public debt.

Long-term debts are referred to as funded debts. In other words, funded debts are those debts for which payments are made within a year. However, this is not a guarantee that it will be possible to pay off these debts within a year.

Treasury bonds fall under the category of unfunded debts because they are issued for terms of three or six months and have a maximum duration of one year. Even so, it is obvious that in the case of funded debts, it is the government's duty to make the regular interest payment to the debtor; in other words, the debtor's obligation to make their principal payment is entirely on the government.

4.2.5.5. Voluntary and Compulsory Loans

Government debts are typically of a voluntary nature and are made to individuals and organisations who are under the control of the government bonds.

Today, mandatory loans are not very popular, but during times of war, the government may exert pressure on citizens to make loans. Government assistance is also available to those who are depressed, allowing for a reduction in labour force and a halt to rate increases.

4.2.5.6. With Rate of Interest and without Rate of Interest

Debt with Rate of Interest: On loans with a rate of interest, the government pays the borrower interest at a fixed rate after a set amount of time.

Debt without Rate of Interest: When the government borrows money, there is no interest to be paid.

4.2.5.7. Purchasable and Non–Purchasable Debt

Government securities are included in the category of 'purchasable debts,' which cannot be sold and bought separately.

Instead, those securities are included in non-purchasable debts, whose sale and purchase are not possible on the open market and who can only be returned to the government at a fixed rate.

4.2.5.8. Total Debt and Net Debt

Total Debt: The sum of all government debts at a given point in time is referred to as total debt.

Net debt is the amount that remains after subtracting any funds that the government has raised to pay off its debts from the total amount owed.

4.2.5.9. Short Term and Long Term Debt

Government borrowing for a brief period of time is referred to as short-term debt. These debts are repaid within the one-year time frame required to finish the debt's tenure.

Long Term Debt: Long Term Debt is when a government borrows money for a very long time. The time of returning it is not predetermined. When the debt was paid off, the lender received regular interest.

4.2.6 Advantage of Public Debt

1. **Increase in Origin of Money:** Public debts encourage industries in the nation, increasing production and national income, which raises the standard of living for citizens.
2. A suitable repayment balance is one that favours taking on debt while also solving the issue of foreign investment.
3. **Economic development:** Public debts enable developing nations to carry out their economies.
4. **Control of Natural Disasters:** The government uses public debt as a tool to manage natural disasters.
5. **Successful War Conduct**: - Today's wars are extremely expensive. So, borrowing money is necessary for fighting a war.
6. Equitable and appropriate distribution of debts leads to an increase

in harmony and cooperation.

7. Public debts are reliable sources of investment, and everyone believes it is profitable to place money in them.
8. **Public Works:** The government can carry out public works and plans such as the construction of roads, water and electricity, canals, bridges, etc. with the aid of public debts.
9. **Non-economic Benefits:** Goodwill between nations that take and give debts from public debts is fostered.

4.2.7 Disadvantages of Public Debt

1. **Misuse of National Resources:** When taking on public debt, such conditions as requiring the industries to partially control the nation debtor must be put in place. An excessive amount of money is sent to foreign nations as interest due to the misuse of national resources.
2. **Fear of Government Bankruptcy:** If debt is easily obtained by the government, there is concern that it may acquire a sizable debt load whose repayment may prove to be impossible.
3. **Extravagancy's nature:** Extravagancy is feared when public debt starts to accumulate rapidly.
4. **Political Burden:** The debtor nation loses its political independence when the debt-giving nation interferes with its government's policies to protect its citizens' capital.
5. There is a fear of emergency situations like political unrest and war brought on by public debt.
6. **Public Burden:** When loans are taken out for unproductive projects, the public is forced to shoulder a greater share of the tax burden to pay them back.
7. **Economic backwardness:** - Foreign debt weakens the nation's economy and causes it to become dependent on outside sources for its growth.

4.2.8 Redemption of Public Debt

Repayment of the debt is referred to as redemption. All public debts must be repaid as quickly as possible, with the exception of long-term investments in independent businesses. When they are issued, provisions for control and the regular transfer of debt must be made. The government looks for ways to put off paying off its debts. However, it must be done while remaining confident in the timely repayment of debt; every possible caution must be taken into account.

Advantages of Debt Redemption

1. Government bankruptcy is prevented.
2. It discourages additional, pointless government spending.
3. Debtors' confidence in the government is strengthened.
4. In the future, it will be simpler for the government to issue debt.
5. It brings down the price of debt management.
6. Early debt repayment relieves future payments of the tax burden.
7. These resources are transferred to private investment after public debt has been paid. A climate for private investment develops in that circumstance.
8. Reimbursement could serve as a deflationary tool.

4.2.9 The Burden of Public Debt

External debt is created when a nation borrows money from other nations or foreigners. It owes everyone everything. When a nation borrows money from another, it is required to pay both the principal and interest on the debt. You must pay this amount in foreign currency or in gold. The debtor country will be forced to export its goods to the creditor country if it does not have a sufficient amount of foreign currency on hand. A debtor country must reduce its domestic consumption in order to produce enough exportable surplus to be able to export goods. As a result, an external debt lowers society's potential for consumption because it results in a net reduction in the resources available to citizens of the debtor country to meet their current consumption needs. Many developing nations, including Poland, Brazil, and Mexico, experienced severe economic hardships in the 1990s as a result of their high levels of external debt. They were compelled to reduce domestic consumption in order to generate an export surplus that would allow them to pay off their external debts, which included the principal and interest on previous borrowings.

The debt-service ratio, which returns a country's principal and interest repayment obligations for a given year on its external debt as a percentage of its exports of goods and services (i.e., its current receipt) in that year, measures the burden of external debt. In 1999, it was 24 % in India. A nation's ability to consume is limited when it has an external debt, which places a burden on society. The production possibilities curve of the society is shifted inward as a result. When we focus on internal debt instead of external debt, we see that the narrative is different. It causes three issues:

a. Effects of increased taxes having a distorting effect on incentives,
b. The transfer of scarce societal resources from the profitable private sector to the unprofitable capital sector, and
c. Outlining the economy's growth rate. It is possible to now briefly discuss these three issues.

4.2.10 Efficiency and Welfare Losses from Taxation

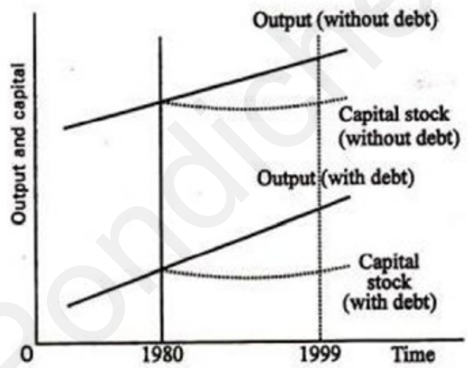
The government must pay interest on any debt it incurs when borrowing money from its own people. Taxes on people are used to pay interest. There may be negative effects on incentives to work and save if people are forced to pay more taxes simply because the government must pay interest on debt. If the same person was both a tax payer and a bond holder at the same time, it might be a happy coincidence. But even in this situation, it is impossible to escape the distortions that taxes always have on incentives. Mr. X might work less and save less if the government taxes him more to cover the interest. Both outcomes, or either one, must be regarded as a distortion of effectiveness and wellbeing. Furthermore, repaying the debt money redistributes income (welfare) from the poor to the rich if the majority of bondholders are wealthy individuals and the majority of taxpaying citizens are those of modest means.

4.2.11 Capital Displacement (Crowding-Out) Effect

Second, the limited capital available to society is diverted from the profitable private sector to the unprofitable public sector if the government borrows money from the people by selling bonds. The private sector's lack of capital will cause the interest rate to increase. The government actually competes with other borrowers for borrowed money while selling bonds, raising interest rates for all borrowers. Numerous economists have expressed concern about the competition for resources due to the recent large deficits. Additionally, higher interest rates have discouraged borrowing for private investment, a phenomenon known as crowding out. This, in turn, will cause the economy's growth rate to slow down. Therefore, a drop in living standards is unavoidable. This appears to be the most severe impact of high public debt. According to Paul Samuelson, "Perhaps the most serious consequence of a large public debt is that it dispenses capital from the stock of national wealth. The rate of economic growth slows as a result, and future living standards will drop.

4.2.12 Public Debt and Growth

Public debt slows growth by shifting the limited capital available to society from the private sector to the unproductive public sector. Without public debt, an economy expands much more quickly than it does with debt. A large public debt may be harmful to long-term economic growth when all the effects of government debt on the economy are taken into account. the link between debt and growth. Let's assume that an economy operated without debt over time, in which case potential output and the capital stock would proceed along the hypothetical path shown by the solid lines in the diagram.



Public dept, Capital Formation and Growth

Now imagine that the government continues to run large deficits and debt; as debt grows over time, more and more capital is displaced, as indicated by the dashed capital line. Increased inefficiencies and distortions further lower output as the government raises taxes on citizens to pay debt interest.

What's worse is that as external debt grows, national income declines and the amount of GNP that must be set aside annually to pay off the debt rises. When we take into account all of the effects of public debt, we can see that output and consumption will increase more slowly than they would have if there were no significant deficit or debt in the government. This seems to be the most crucial aspect of the massive public debt's long-term effects on economic growth. Paul Samuelson and W. D. Nordhaus, in their conclusion, said that "a large government debt tends to reduce a nation's growth in potential output because it displaces private capital, increases the inefficiency from taxation, and forces a nation to service the external portion of the debt."

There is no doubt a perception among some people that the nation's constrained economic resources are being drained by the interest payments on the repayment of the national debt. Using our resources to pay interest on the debt is a complete waste of money. This claim is false because paying interest on a domestically held debt does not at all prevent using economic resources. It goes without saying that we will lose resources if foreigners hold our debt. Internal debt repayment in the case of domestically held (internal) debt entails a transfer of income from Indian taxpayers to Indian bondholders of the same generation. Since taxpayers and bondholders are typically separate legal entities, the effects of a large national debt are invariably ones of income redistribution. Internal debt, however, does not entail any depletion of the country's actual economic resources.

4.2.13 Public Debt Management

The process of developing and implementing a plan for managing the government's debt in order to raise the necessary funds over the medium to long term at the least expensive rate possible, consistent with a prudent level of risk, is known as public debt management. Additionally, it should achieve any additional public debt management objectives that the government may have set, like creating and maintaining a productive market for government securities.

In accordance with this definition, the objectives of government debt management (DeM) should be to:

- Satisfy the government's borrowing needs;
- Borrow at the lowest cost over the medium to long term;
- Maintain a responsible level of risk in the debt portfolio; and
- Satisfy any additional objectives the government may have set, such as creating and maintaining an effective market for government debt securities.

Trade-offs must be made while keeping in mind the cost-risk objectives. Borrowing in low-coupon foreign currencies is typically less expensive for emerging market nations than borrowing in their own currencies. The risk in the portfolio is, however, typically increased by foreign currency borrowing (increased foreign currency exposure). Even though borrowing at the short end of the yield curve is typically less expensive than borrowing at a longer maturity, the risk will rise because short-term interest rates are more volatile and loans require more frequent refinancing (increased interest rate exposure and refinancing risk). In light of this, analysing various borrowing scenarios and the trade-offs that must be made is a crucial component of developing a strategy. These trade-offs will ultimately be determined by the government's risk tolerance, which will be reflected in the strategy document.

Therefore, the primary responsibility of the debt manager is to achieve the portfolio's desired composition, which reflects the government's preferred cost/risk trade-offs. The medium-term debt management strategy (MTDS), which is based on cost-risk trade-offs of the debt service flow in the actual and anticipated debt portfolio under various scenarios, annual borrowing plans developed in accordance with the strategy, and borrowing and other DeM operations carried out to achieve the strategy's objectives are the DeM tools. The DeM strategy puts the DeM goals into practise and places a strong emphasis on managing the risk exposure built into the debt portfolio in particular, potential changes in the cost of debt servicing, and the financial impact these changes may have.

The central government's debt portfolio typically constitutes the only part of the government DeM strategy's purview. When some local governments and administrations are given the authority to borrow in the markets to meet their own financing needs, coordination issues may arise if the strategy's scope is expanded to include their debt portfolios. The central government (i.e., the ministry of finance, MoF), in order to guarantee that all borrowings are in line with the strategy, would need to approve each local borrowing operation in order to include such borrowing within the scope of the DeM strategy. This might not be a realistic option or the best way to limit subnational borrowing. It must be made clear that the coverage of public debt will vary depending on the specific legal system in each nation. The audit must adhere to the country's domestic laws and its specific mandate.

The following is stated regarding the DeM's scope in the World Bank/IMF Guidelines: The primary debts that the federal government has control over should be included in debt management. These obligations frequently include both marketable and non-marketable debt, such as retail debt in some circumstances and concessional financing obtained from official bilateral and multilateral sources. Depending on the political and institutional structures, different countries may include or exclude the larger public sector debt from the central government's authority over debt management. For the purposes of government DeM, "debt" is simply and generally defined as financial liabilities created by borrowing, credits accepted under suppliers' credit agreements, issuance of debt securities for purposes other than borrowing funds (such as to regularise accumulated arrears), and assumption of the payment obligations under a government loan guarantee (i.e., the government takes over the loan from the borrower in case of default). However, the term "debt" has a much broader meaning in the macroeconomic statistical system because it is intended to cover all obligations to make payments in the future that have the potential to put the entire economy—not just the government and public corporations—at risk of solvency and liquidity issues. Additionally, the scope has been expanded to include the entire public sector, including the national government, local governments, the central bank, and public corporations. In light of this, the term "debt" is used to refer to all financial claims that call for the payment of interest and/or principal by the debtor to the creditor at some future date or dates. The Guide on Public Debt Statistics classifies the following financial instruments as debt instruments based on this broader definition: special drawing rights, money and deposits, debt securities, loans, insurance, pension plans, and provisions for calls under standardised guarantee schemes, as well as other payables. The only instruments covered by both definitions, when compared to the more restrictive definition of debt frequently used in DeM, are debt securities, loans, and supplier credits.

However, for statistical purposes, nations are required to submit those data to the International Monetary Fund (IMF) and to the World Bank when taking out loans from it. Finally, deciding on fiscal policy should not involve the government DeM. Fiscal and DeM policies have very different goals, and to accomplish them, different methods are employed. The budget division and the macroeconomic unit typically take the lead in developing and implementing fiscal policy strategies, including the debt sustainability analyses (DSAs), even though a dedicated debt management office (DMO) is typically in charge of DeM operations. The use of government spending, revenue collection (taxation), and loan proceeds to affect a nation's economy is known as fiscal policy. The stabilisation of economic output, better resource allocation, and realisation of a "fair" wealth distribution are all common goals of fiscal policy. A least-distorting budgetary policy that is balanced over the business cycle and sound public finances in the form of unambiguous budget deficits and debt ceilings are part of the fiscal policy strategy to achieve these goals. The creation of a medium-term fiscal framework backed by a sound debt sustainability analysis and annual budget bills are the two most crucial fiscal policy tools. To encourage a just distribution of wealth, tax laws and government transfers are additional fiscal policy tools. Debt limits are another tool that can be used to prevent loose, risky, or even irresponsible fiscal policy. Therefore, determining the ideal level of debt as a tool for fiscal policy is not involved in creating the DeM strategy. An alternative is to conduct a DSA, or fiscal sustainability analysis, to monitor the debt level in relation to its fiscal risks and the projected expansion of the economy.

4.2.14 Assessing the Debt

What kind of financial burden does the national debt place on current and future generations of taxpayers? The interest that must be paid to borrow money and keep a debt of this magnitude is one of the most obvious and significant burdens of the national debt. As new debt is taken on each year, the national debt's interest burden grows. Interest must be paid each year because the debt is not being repaid.

Future generations, who will be responsible for paying the interest on the existing debt, will bear the increasing burden of debt service, or the cost of maintaining the debt. However, many of the recipients of the interest payments will be Indian citizens who own government securities. Should we settle the obligation? First of all, even over a long period of time, it would be extremely difficult—possibly impossible—to raise the necessary funds through taxes and other sources of income. The average taxpayer would become poorer due to the increased tax burden, while the holders of government securities would become richer with their newly redeemed funds as a result of the debt's repayment.

Additionally, a portion of the debt is external, or owned by a third party. While this is not a major issue in normal circumstances, it would result in a significant rupee outflow from India during an accelerated repayment period. Finally, a series of surplus budgets would be required to pay off the national debt. A surplus budget, however, has a contractionary effect on the economy, as Keynes noted. Economic activity would decrease while the debt was being repaid. In other words, slowing down economic activity would be the opportunity cost of reducing the national debt.

4.2.15 Let us Sum up

A state's source of revenue collection is its public debt. Debt owed by foreign nationals to the state is referred to as public or local debt. Public debt is created when the government borrows money. Banks, businesses, organisations, people, and business houses can all be sued by the government for debt. The government may collect debt from both domestic and foreign sources, or from both. In times of economic hardship, emergencies like war or drought, etc., the public debt is one of the most crucial sources of revenue for the government.

External debt is created when a nation borrows money from other nations or foreigners. It owes everyone everything. When a nation borrows money from another, it is required to pay both the principal and interest on the debt. You must pay this amount in foreign currency or in gold. The debtor country will be forced to export its goods to the creditor country if it does not have a sufficient amount of foreign currency on hand.

A debtor country must reduce its domestic consumption in order to produce enough exportable surplus to be able to export goods. As a result, an external debt lowers society's potential for consumption because it results in a net reduction in the resources available to citizens of the debtor country to meet their current consumption needs.

The process of developing and implementing a plan for managing the government's debt in order to raise the necessary funds over the medium to long term at the least expensive rate possible, consistent with a prudent level of risk, is known as public debt management. Additionally, it should achieve any additional public debt management objectives that the government may have set, like creating and maintaining a productive market for government securities.

4.2.16 Self-Assessment Questions

4. What is Public Debt?.
5. What is the main source of public debt?
6. Mention the advantages and disadvantages of Public Debt
7. Explain the types of public debt.
8. How can we reduce public debt?
9. What are the major components of public debt in India?
10. Public Debt Management – Comment.

4.2.17 References

1. Musgrave, R.A. and P.B. Musgrave (1976), "Public Finance in Theory and Practice", McGraw Hill, Kogakusha,Tokyo.
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Web Resources

https://www.indiabudget.gov.in/doc/rec/annex9.pdf

https://www.clearias.com/public-debt/

UNIT - V

Lesson 5.1 - Centre-State Relationship

Structure

5.1.1 Objectives

Tha main objectives of this lesson are to

- Learn about the Indian Fiscal System
- Know the revenue for central and state government
- Understand the expenditure for central and state government

5.1.2 Introduction

The term "fiscal system" refers to a country's ability to raise revenue and capital resources, the procedures to be followed when doing so, and, in the case of a federation like ours, the rules governing the interactions between the constituent units of the federation. Taxation, spending, debt management, and intergovernmental fiscal relations are all within its purview. The federal Indian constitution serves as the foundation for the country's fiscal system. The Union of Central Government and the State Government are the two levels of government that are envisioned by the constitution. The state government allocates the duties and funds for local bodies because they are not included in the constitution.

Fiscal System

It alludes to how the state manages its financial resources for taxation and capital investments. Therefore, the fiscal system includes the government's budgetary activities, such as activities for raising revenue, borrowing money, and spending it.

Fiscal Policy

The term "fiscal policy" refers to the use of taxes, public spending, and debt management to accomplish specific goals.

The management of the federal and state governments' revenue and spending, as well as public debt, deficit financing, budgets, and tax structures, are all included or mentioned when discussing the Indian fiscal system.

5.1.3 Sources of Revenue for Central Government

The revenue of the Central Government consists of the following elements

i. Tax revenue

ii. Non-tax revenue

Tax revenue comes broadly from three sources

a. Taxes on income and expenditure,
b. taxes on property and capital transactions, and
c. taxes on goods and services

Non-tax revenue includes:

a. currency, coinage, and mint.
b. Interest income, dividend income, and other non-tax income.

5.1.4 Sources of Revenue for State Government

The main sources are

a. state tax revenue
b. share in central taxes
c. income from social, commercial and economic service and profits of state-run enterprises.

d. State tax revenue includes among others, land revenue, stamp, registration and estate duty etc.

5.1.5 Expenditure of the Central Government

The two main categories of expenditures made by the central government are (i) Plan Expenditures and (ii) Non-Plan Expenditures. Outlays for agriculture, rural development, irrigation and flood control, energy, industry and minerals, transport, communications, science and technology, the environment, and economic services, among other things, are included in the plan expenditures.

Defence, subsidies, interest payments, and general services make up the majority of non-plan expenses.

5.1.6 Expenditure of State Government

The State Governments also have two broad categories of spending, similar to the Union Government:

a. Non-Development Expenditure and
b. Development Expenditure.

There are two types of public debt held by the Indian government: internal and external.

Internal debt consists of loans obtained on the open market, prize bonds, compensation bonds, and treasury bills issued to the RBI and other commercial banks, among other things.

External debt is made up of loans from the World Bank, the IMF, the ADB, as well as individual nations like the USA, Japan, and others. The government can use deficit financing as a tool to close the gap between revenue receipts and revenue expenditures.

5.1.7 Let us Sum up

The term "fiscal system" refers to a country's ability to raise revenue and capital resources, the procedures to be followed when doing so, and, in the case of a federation like ours, the rules governing the interactions between the constituent units of the federation. Taxation, spending, debt management, and intergovernmental fiscal relations are all within its purview. The federal Indian constitution serves as the foundation for the country's fiscal system. The Union of Central Government and the State

Government are the two levels of government that are envisioned by the constitution. The state government allocates the duties and funds for local bodies because they are not included in the constitution. The revenue of the Central Government consists of the following elements : (i) Tax revenue and (ii) Non-tax revenue. Sources of Revenue for State Government are: (a) state tax revenue, (b) share in central taxes, (c) income from social, commercial and economic service and profits of state-run enterprises. State tax revenue includes among others, land revenue, stamp, registration and estate duty etc.

5.1.8 Self-Assessment Questions

1. Discuss the sources of Revenue for Central Government.
2. Explain the sources of Revenue for State Government.
3. State the expenditure of the Central Government.
4. Mention the expenditure of State Government.

5.1.9 References

1. Musgrave, R.A. and P.B. Musgrave (1976), "Public Finance in Theory and Practice", McGraw Hill, Kogakusha,Tokyo.
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Lesson 5.2 - Finance Commissions

Structure

5.2.1 Objectives

The main objectives of this lesson are to

- Study the role of Finance Commission in India
- Know the status of Finance Commission
- Discuss the history of Finance Commission
- Explore the duties of the Finance Commission
- Study the role of Finance Commission in Fiscal Federalism
- Describe the functions of Fifteenth Finance Commission

5.2.2 Introduction

The defence, the social environment, the financial situation, etc. are just a few examples of the dynamics that affect each nation's ability to survive. The nation's Finance Commission is the main force behind ensuring sustainability and stability. Articles 280 and 281 of the Indian Constitution establish the Finance Commission of India. The chairman of the Finance Commission is qualified in public affairs and has experience working with different economists and academics who support and advise commission members. It is a constitutional body with authority akin to that of a judge or court. The commission is established by the Indian President.

5.2.3 Functions of Finance Commission

Following are the different functions of the Finance Commission of India:

- The allocation of the Union's and the State's net tax proceeds, which must be or may be divided between them, as well as the allocation of the states' respective shares of these proceeds.
- The grant-in-aid of the state's revenue from the Consolidated Funds of India should be managed according to the code of conduct.
- The steps necessary to increase a state's consolidated funds in order to increase Panchayat resources on the basis of suggestions made by the Indian Finance Commission.
- Any other transactions made by the President of India to the Commission in the interest of sound finance; the steps necessary to increase a state's consolidated funds in order to increase the resources available to its municipalities in accordance with the recommendations made by the Finance Commission of India.

5.2.4 Role of Finance Commission In India

- In India, the finance committee was established with the primary responsibilities of assessing the financial health of the national and state governments, choosing the tax-sharing structure, and establishing rules for allocating taxes among the states. The fiscal federalism structure is strengthened by the finance commission's effective coordination with all levels of government in carrying out decision-making. The recommendations made by the commission are intended to keep state and federal spending on the same level. A finance commission is required in order to address issues pertaining to the financial relationship between the federal and state governments.

- The Finance Commission of India plays a crucial role in allocating the proceeds of divvying up taxes between the Union and State governments, or in the case of taxes collected centrally but distributed to the states, in establishing the guidelines for such distributions.
- The Finance Commission also divides the proceeds of income tax between the Union and State governments. But only the Union Territories are responsible for paying the Central Government's taxes.
- In accordance with the provisions of the Article, the President presents the Finance Commission's recommendations to the Lok Sabha and Rajya Sabha, along with a justification of the next course of action. The rules governing grants made from the Consolidated Fund of India in support of state revenues are also regulated by the Finance Commission.

In India, the Finance Commission plays a significant role in this. The Commission is still in charge of giving consideration to any matters that the President refers to it for consideration in the interest of sound finance.

5.2.5 Status of Finance Commission

- According to Article 280 of the constitution, the President of India elects members of the Finance Commission. In addition to the chairperson, there are five other members. Five years are spent implementing FC's recommendations. The President's order implements the recommendations for Union taxes and duties, while executive orders implement the recommendations for profit sharing, the form of central assistance, and debt relief.

5.2.6 History of Finance Commission

Since its independence in 1947, India has had 15 different finance commissions. The list of finance commissions, along with the chairman and relevant years, is provided below.

1. From 1952 to 1957, K.C. Neogy served as the first Finance Commission's chair.
2. From 1957 to 1962, K. Santhanam served as the chairman of the second finance commission.
3. From 1962 to 1966, the Third Finance Commission, which was presided over by A.K. Chanda, was in operation.
4. P.V. Rajamannar served as the chairman of the Fourth Finance Commission, which ran from 1966 to 1969.
5. Mahaveer Tyagi served as the chairman of the Fifth Finance Commission, which was in place from 1969 to 1974.
6. K. Brahmananda Reddy served as the chairman of the sixth finance commission, which ran from 1974 to 1979.
7. J.M. Shelat served as the chairman of the 7th Finance Commission, which ran from 1979 to 1984.
8. From 1984 to 1989, Y.B. Chavan served as the chairman of the 8th Finance Commission.
9. N.K.P. Salve served as the chairman of the 9th Finance Commission, which ran from 1989 to 1995.
10. K.C. Pant served as the chairman of the 10th Finance Commission, which ran from 1995 to 2000.
11. From 2000 to 2005, A.M. Khusro served as the chairman of the 11th Finance Commission.
12. From 2005 to 2010, C. Rangarajan served as the chairman of the 12th Finance Commission.
13. Dr. Vijay L. Kelkar served as the chairman of the 13th Finance Commission, which was in place from 2010 to 2015.
14. Dr. Y. V. Reddy served as the chairman of the 14th Finance Commission, which was in place from 2015 to 2020.
15. N. K. Singh served as the chairman of the 15th Finance Commission, which was in place from 2020 to 2026.

5.2.7 Duties of the Finance Commission

The commission is given the power and duty to develop and carry out fiscal policies taking into account the center-state financial relations. The finance commission's job is to assess each state's financial standing and make recommendations for improvement. The following are some appropriate actions that should be taken in this regard that highlight the need for a finance commission:

- The sharing of central government taxes with various states;
- The distribution of central taxes to various states;
- Fiscal initiatives to strengthen state finances.

5.2.8 Role of Finance Commission in Fiscal Federalism

The finance committee's job as the top administrative body is to take charge of the sharing and distribution of fiscal authority while addressing issues of imbalance and disparity. There may be circumstances where states spend more money than they take in. Again, regional restrictions prevent some states from having adequate access to resources. In light of this circumstance, it suggests rules regarding how much of the federal government's funds should be divided among the states, maintaining fiscal federalism's equalisation. The following are some of the various tasks performed by the finance commission under fiscal federalism:

5.2.9 Tax Revenue Sharing

To reduce the disparity between states, which is essential for fiscal federalism, the commission suggests sharing central taxes with the states based on some justifiable criteria. The following criteria for tax sharing are listed:

- **Population:** A state's population gives an indication of how much money it needs to spend.
- **Area:** The state's administrative expenses will be proportional to its area.
- Per capita Income: States that have lower per capita incomes are eligible for higher tax sharing and grants.
- Economic Activities: Because some states may have more farming land or forests than others, which limits the opportunities for other economic activities, a larger share may be given to those states.

5.2.10 Handling Horizontal Imbalance

The finance commission is crucial in addressing the imbalances brought about by variations in the magnitude of financial benefits attained by various states. It examines growth rates, developmental status, and capital requirements for various states. Additionally, it offers suggestions on how to reduce capital deficits and ensure that sufficient public goods and services are available.

5.2.11 Addressing Vertical Imbalance

The vertical imbalances caused by the asymmetry in the distribution of taxing authority among the various tiers of government (the federal government, state governments, and local entities) are also handled by the finance commission. The central government's tax collection covers a wider area. The state governments invest a lot of money in the subnational development of social and economic sectors. The finance commission's responsibility is to provide the necessary mechanisms, such as grants-in-aid and shared tax revenue.

5.2.12 Review and Progress

Examining the effects of the suggestions made by the previous finance commission is one of the finance commission's key responsibilities. The need for a finance commission is evident when examining the fiscal health of the federal government and state governments and suggesting a path forward. Additionally, it investigates the effects of new taxes on the economy and at the federal and state levels.

In terms of financial matters, the Indian federal structure permits a division of authority and duties between the centre and the states. This includes the ability to spend money, generate revenue, and collect taxes. It is crucial to include provisions for a fair distribution of fiscal authority in a fiscal federalism structure. Generally speaking, the responsibility for achieving specific goals of fiscal stability at the individual level should be delegated to all levels of administration. The finance committee plays a crucial role in helping to improve the fiscal structure of the federal government and economic efficiency.

5.2.13 Fifteenth Finance Commission

The 15th Finance Commission, chaired by Mr. N. K. Singh, was established in November 2017 to make recommendations regarding the distribution of funds from the federal government to the states for the five-year period between 2020 and 25. The role and mandate of the Commission have been the subject of some recent discussion. We describe the function of the Finance Commission in this context. The Finance Commission is a legally mandated body established every five years to make recommendations regarding the financial ties between the center-states. Each Finance Commission is required to submit recommendations on:

i. the distribution of central grants to states;

ii. the sharing of central taxes with states;

iii. ways to strengthen state finances and supplement panchayat and municipal resources; and

iv. any other issues that have been referred to the commission.

Composition of transfers: The central taxes that have been devolved to the states are untied funds that can be used however the states see fit. Over time, tax devolution to the states has made up more than 80% of all central transfers to the states. The centre also awards grants to states and local governments, which are required to be put to a specific use. Between 12% and 19% of the total transfers have been made up of these grants. The Commission's primary charge has not changed over time, despite being given the additional duty of looking into different issues. The 12th Finance Commission, for instance, assessed the financial standing of the states and provided relief to those that passed their Fiscal Responsibility and Budget Management laws. The effects of the GST on the economy were examined by the 13th and 14th Finance Commissions. The 13th Finance Commission also gave states financial incentives to expand their forest cover.

The 15th Finance Commission, which was established in November 2017, will suggest transfers from the federal government to the states. In addition, it has been instructed to: (i) examine the effects of the 14th Finance Commission's recommendations on the fiscal position of the federal government; (ii) review the debt levels of the federal government and the states and recommend a roadmap; (iii) examine the effects of the GST on the economy; and (iv) recommend performance-based incentives for states based on their efforts, among others, to control spending on populist measures and promote business accessibility.

Fiscal Transfers: The fiscal transfer system consists of four parts or channels, with implied hierarchical controls. Transfers of Financial Commissions First, while only 35 percent of general government revenues are generated by state governments, they account for nearly 57 percent of those expenses. The constitution mandates that a Finance Commission be established every five years to devolve to the states portions of the proceeds of some taxes assigned to the Centre for reasons of efficiency and administrative ease. This is done in order to cover the resulting shortfall. A set of unwavering guidelines for incoming commissioners has not developed because the rules for determining transfer awards have varied from commission to commission. When the amount of debt relief is normalised by the state domestic product of the year in which it was granted, the trend is clearly one of decreasing relative commitment to central debt forgiveness over time. Minor debt relief has been periodically granted by the Centre to states on the recommendations of succeeding Finance Commissions. Finance commissions expressed agreement with the argument that greater tax share awards and special block grants with absolute rupee values were necessary to close the deficit gap during the 1970s and 1980s due to the mismatch between state development mandates and insufficient taxation instruments. As a result, Central finances became unstable as the Centre attempted to raise its own tax revenues or borrow money in order to satisfy the decisions of the Finance Commission and pay for rising percentages of state expenditures. Block grants have been given to states based on their projected gap on non-plan account between projected revenues and projected expenditures for a five-year period, as opposed to tax shares, which were given to states based on objective criteria like population and disparities in per capita state income. The Commission bases its recommendations for tax devolution and grants-in-aid in accordance with the Constitution on these projections in order to produce a fictitious balance or surplus on the non-plan current account.

The President of India established the Finance Commission as a constitutional body to make recommendations regarding interstate financial relations. Two reports had to be submitted by the 15th Finance Commission, which was presided over by Mr. N. K. Singh. In February 2020, the first report, which contained suggestions for the fiscal year 2020–21, was submitted to Parliament. On February 1, 2021, the final report with recommendations for the years 2021 to 26 was presented to Parliament.

Share of states in central taxes: It is advised that states pay 41% of the central taxes from 2021 to 2026, the same as they did from 2020 to 21. This is less than the 42% share that the 14th Finance Commission suggested for the years 2015 to 20. The newly created union territories of Jammu and Kashmir and Ladakh will be supported by the center's resources through the 1% adjustment.

Criteria for devolution: The weights given to each of the criteria used by the Commission to determine each state's share of central taxes are shown in Table 1 below. The criteria for allocating central taxes among states during the period of 2021–26 is the same as it was for 2020–21. The individual share of states may still change, though, because the reference periods used to calculate income distance and tax efforts (2015–18 for 2020–21 and 2016–19 for 202–25) are different. Table 2 in the annexure lists each state's individual share of the taxes the centre delegated. Below, we describe a few indicators.

Table 1: Criteria for devolution

Criteria	14th FC 2015-20	15th FC 2020-21	15th FC 2021-26
Income Distance	50.0	45.0	45.0
Area	15.0	15.0	15.0
Population (1971)	17.5	-	-
Population (2011)#	10.0	15.0	15.0
Demographic Performance	-	12.5	12.5
Forest Cover	7.5	-	-
Forest and Ecology	-	10.0	10.0
Tax and fiscal efforts*	-	2.5	2.5
Total	100	100	100

Note: #14th FC used the term "demographic change" which was defined as Population in 2011. *The report for 2020-21 used the term "tax effort", the definition of the criterion is same.

Sources: Reports of the 14th and 15th Finance Commissions; PRS.

Table 2: Individual share of states in the taxes devolved by the centre (out of 100)

State	14th FC 2015-20	15th FC 2020-21	15th FC 2021-26
Andhra Pradesh	4.305	4.111	4.047
Arunachal radesh	1.370	1.760	1.757
Assam	3.311	3.131	3.128
Bihar	9.665	10.061	10.058
Chhattisgarh	3.080	3.418	3.407
Goa	0.378	0.386	0.386
Gujarat	3.084	3.398	3.478
Haryana	1.084	1.082	1.093
Himachal radesh	0.713	0.799	0.830
Jammu & Kashmir	1.854	-	-
Jharkhand	3.139	3.313	3.307
Karnataka	4.713	3.646	3.647
Kerala	2.500	1.943	1.925
Madhya Pradesh	7.548	7.886	7.850
Maharashtra	5.521	6.135	6.317
Manipur	0.617	0.718	0.716
Meghalaya	0.642	0.765	0.767
Mizoram	0.460	0.506	0.500
Nagaland	0.498	0.573	0.569
Odisha	4.642	4.629	4.528
Punjab	1.577	1.788	1.807
Rajasthan	5.495	5.979	6.026
Sikkim	0.367	0.388	0.388
Tamil Nadu	4.023	4.189	4.079
Telangana	2.437	2.133	2.102
Tripura	0.642	0.709	0.708
Uttar Pradesh	17.959	17.931	17.939
Uttarakhand	1.052	1.104	1.118
West Bengal	7.324	7.519	7.523
Total	**100**	**100**	**100**

- **Income distance**: The distance between a state's income and that of the state with the highest income is known as income distance. The average GSDP per capita over the three-year period between 2016–17 and 2018–19 has been used to calculate a state's income. To maintain equity among the states, a state with a lower per capita income will receive a larger share.

- **Demographic performance:** As part of its mandate, the Commission was required to base its recommendations on population statistics from 2011. As a result, the Commission's recommendations were based on population data from 2011. States' efforts to manage their population have been rewarded using the demographic performance criterion. States will receive higher scores on this criterion if their fertility ratio is lower.

- **Forestry and ecology:** This criterion was determined by dividing the total amount of dense forest in all the states by the percentage of dense forest in each state.

- **Tax and fiscal efforts:** States with better tax collection efficiency have been rewarded using this criterion. It is calculated as the difference between the average state GDP per capita and the average own tax revenue per capita over the three years between 2016–17 and 2018–19.

- The following grants will be given from the center's resources between 2021 and 2026 (for more information, see Tables 3 and 4 in the annexure):

- **Grants to address the revenue deficit:** To address the revenue deficit, 17 states will receive grants totaling Rs. 2.9 lakh crore.

- **Sector-specific grants:** States will receive grants totaling Rs. 1.3 lakh crore for eight different sectors, including (i) health, (ii) school education, (iii) higher education, (iv) the implementation of agricultural reforms, (v) the upkeep of PMGSY roads, (vi), (vii), (viii), statistics, and (viii) aspirational districts and blocks. These grants will include some performance-based funding.

- **State-specific grants:** The Commission suggested 49,599 crore in state-specific grants. The following will be covered: (i) social needs; (ii) administrative governance and infrastructure; (iii) water and sanitation; (iv) preservation of culture and historical monuments; (v) expensive physical infrastructure; and (vi) tourism. The Commission suggested setting up a high-level committee at the state level to examine and keep track of how grants allocated to particular states and industries are being used.

- Grants to local bodies will total Rs. 4.36 lakh crore (part of the grants will be performance-linked), with Rs. 2.4 lakh crore going to rural local bodies, Rs. 1.2 lakh crore to urban local bodies, and Rs. 70,051 crore going to local governments for health grants. All three Panchayat tiers—village, block, and district—will be eligible to receive grants for local bodies. The following uses of the health grants will be made possible: (i) converting rural sub-centres and primary healthcare centres (PHCs) into health and wellness centres (HWCs); (ii) assisting with the development of diagnostic infrastructure for primary healthcare activities; and (iii) assisting with the development of urban HWCs, sub-centres, PHCs, and public health units at the block level.

- Grants to local organizations—aside from health grants—will be divided among the states according to population and area, with a weighting of 90% and 10%, respectively. Except for health grants, the Commission has established requirements for obtaining these grants. The entry-level requirements include (i) publishing provisional and audited accounts in the public domain (an additional requirement for urban bodies after 2021–2022) and (ii) fixing minimum floor rates for property taxes by states and improving the collection of property taxes. If a state does not establish a State Finance Commission by March 2024 and implement its recommendations, no grants will be given to local government entities of that state after that date.

- **Disaster risk management:** The Commission recommended keeping the current cost-sharing arrangements for disaster management funds between the federal government and the states. The cost-sharing ratio between the centre and the states is as follows: (i) 75:25 for all other states; (ii) 90:10 for the states in the north and Himalayan regions. The total corpus of the state disaster management funds will be Rs 1.6 lakh crore (the center's share is Rs 1.2 lakh crore).

Table 3: Grants for 2021-26 (five years) (Rs crore)

Grants	Amount
Revenue deficit grants	**2,94,514**
Local governments grants	**4,36,361**
Urban Local Bodies	*1,21,055*
Rural Local Bodies	*2,36,805*
Health Grants	*70,051*
*Other Grants**	*8,450*
Disaster management grants	**1,22,601**
Sector-specific grants	**1,29,987**
Health	*31,755*
School Education	*4,800*
Higher Education	*6,143*
Implementation of agricultural reforms	*45,000*
Maintenance of PMGSY roads	*27,539*
Judiciary	*10,425*
Statistics	*1,175*
Aspirational districts and blocks	*3,150*
State-specific grants	**49,599**
Total	**10,33,062**

Note: *Other grants to local bodies comprise grants for: (i) incubation of new cities (Rs 8,000 crore), and National Data Centre (Rs 450 crore).

Source: Report of the 15th Finance Commission for 2021-26; PRS.

Table 2: Individual share of states in the taxes devolved by the centre (out of 100)

State	14th FC 2015-20	15th FC 2020-21	15th FC 2021-26
Andhra Pradesh	4.305	4.111	4.047
Arunachal Pradesh	1.370	1.760	1.757
Assam	3.311	3.131	3.128
Bihar	9.665	10.061	10.058
Chhattisgarh	3.080	3.418	3.407
Goa	0.378	0.386	0.386
Gujarat	3.084	3.398	3.478
Haryana	1.084	1.082	1.093
Himachal Pradesh	0.713	0.799	0.830
Jammu & Kashmir	1.854	-	-
Jharkhand	3.139	3.313	3.307
Karnataka	4.713	3.646	3.647
Kerala	2.500	1.943	1.925
Madhya Pradesh	7.548	7.886	7.850
Maharashtra	5.521	6.135	6.317
Manipur	0.617	0.718	0.716
Meghalaya	0.642	0.765	0.767
Mizoram	0.460	0.506	0.500
Nagaland	0.498	0.573	0.569
Odisha	4.642	4.629	4.528
Punjab	1.577	1.788	1.807
Rajasthan	5.495	5.979	6.026
Sikkim	0.367	0.388	0.388
Tamil Nadu	4.023	4.189	4.079
Telangana	2.437	2.133	2.102
Tripura	0.642	0.709	0.708
Uttar Pradesh	17.959	17.931	17.939
Uttarakhand	1.052	1.104	1.118
West Bengal	7.324	7.519	7.523
Total	**100**	**100**	**100**

• Income distance: The distance between a state's income and that of the state with the highest income is known as income distance. The average GSDP per capita over the three-year period between 2016–17 and 2018–19 has been used to calculate a state's income. To maintain equity among the states, a state with a lower per capita income will receive a larger share.

• Demographic performance: As part of its mandate, the Commission was required to base its recommendations on population statistics from 2011. As a result, the Commission's recommendations were based on population data from 2011. States' efforts to manage their population have been rewarded using the demographic performance criterion. States will receive higher scores on this criterion if their fertility ratio is lower.

• Forestry and ecology: This criterion was determined by dividing the total amount of dense forest in all the states by the percentage of dense forest in each state.

• Tax and fiscal efforts: States with better tax collection efficiency have been rewarded using this criterion. It is calculated as the difference between the average state GDP per capita and the average own tax revenue per capita over the three years between 2016–17 and 2018–19.

The following grants will be given from the center's resources between 2021 and 2026 (for more information, see Tables 3 and 4 in the annexure):

- Grants to address the revenue deficit: To address the revenue deficit, 17 states will receive grants totaling Rs. 2.9 lakh crore.
- Sector-specific grants: States will receive grants totaling Rs. 1.3 lakh crore for eight different sectors, including (i) health, (ii) school education, (iii) higher education, (iv) the implementation of agricultural reforms, (v) the upkeep of PMGSY roads, (vi), (vii), (viii), statistics, and (viii) aspirational districts and blocks. These grants will include

some performance-based funding.

- State-specific grants: The Commission suggested 49,599 crore in state-specific grants. The following will be covered: (i) social needs; (ii) administrative governance and infrastructure; (iii) water and sanitation; (iv) preservation of culture and historical monuments; (v) expensive physical infrastructure; and (vi) tourism. The Commission suggested setting up a high-level committee at the state level to examine and keep track of how grants allocated to particular states and industries are being used.
- Grants to local bodies will total Rs. 4.36 lakh crore (part of the grants will be performance-linked), with Rs. 2.4 lakh crore going to rural local bodies, Rs. 1.2 lakh crore to urban local bodies, and Rs. 70,051 crore going to local governments for health grants. All three Panchayat tiers—village, block, and district—will be eligible to receive grants for local bodies. The following uses of the health grants will be made possible: (i) converting rural sub-centres and primary healthcare centres (PHCs) into health and wellness centres (HWCs); (ii) assisting with the development of diagnostic infrastructure for primary healthcare activities; and (iii) assisting with the development of urban HWCs, sub-centres, PHCs, and public health units at the block level.
- Grants to local organizations—aside from health grants—will be divided among the states according to population and area, with a weighting of 90% and 10%, respectively. Except for health grants, the Commission has established requirements for obtaining these grants. The entry-level requirements include (i) publishing provisional and audited accounts in the public domain (an additional requirement for urban bodies after 2021–2022) and (ii) fixing minimum floor rates for property taxes by states and improving the collection of property

taxes. If a state does not establish a State Finance Commission by March 2024 and implement its recommendations, no grants will be given to local government entities of that state after that date.

- Disaster risk management: The Commission recommended keeping the current cost-sharing arrangements for disaster management funds between the federal government and the states. The cost-sharing ratio between the centre and the states is as follows: (i) 75:25 for all other states; (ii) 90:10 for the states in the north and Himalayan regions. The total corpus of the state disaster management funds will be Rs 1.6 lakh crore (the center's share is Rs 1.2 lakh crore).

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State-specific grants	**49,599**
Total	**10,33,062**

Note: *Other grants to local bodies comprise grants for: (i) incubation of new cities (Rs 8,000 crore), and National Data Centre (Rs 450 crore).

Source: Report of the 15th Finance Commission for 2021-26; PRS.

States	Revenue deficit grants	Grants to local bodies			Disaster management
		Health grants	Rural local bodies	Urban local bodies	
Andhra Pradesh	30,497	2,601	10,231	5,231	6,183
Arunachal Pradesh	0	259	900	459	1,382
Assam	14,184	1,484	6,253	3,197	4,268
Bihar	0	6,017	19,561	9,999	7,824
Chhattisgarh	0	1,799	5,669	2,900	2,387
Goa	0	167	293	149	63
Gujarat	0	3,341	12,455	6,367	7,316
Haryana	132	1,617	4,929	2,520	2,715
Himachal Pradesh	37,199	521	1,673	855	2,258
Jharkhand	0	2,370	6,585	3,367	3,138
Karnataka	1,631	2,929	12,539	6,409	4,369
Kerala	37,814	2,968	6,344	3,242	1,738
Madhya Pradesh	0	4,902	15,527	7,938	10,059
Maharashtra	0	7,067	22,713	11,611	17,803
Manipur	9,796	234	690	353	234
Meghalaya	3,137	311	711	363	363
Mizoram	6,544	166	362	185	259
Nagaland	21,249	303	486	249	228
Odisha	0	2,454	8,800	4,498	8,865
Punjab	25,968	2,131	5,410	2,764	2,736
Rajasthan	14,740	4,423	15,053	7,696	8,186
Sikkim	1,267	111	165	84	279
Tamil Nadu	2,204	4,280	14,059	7,187	5,637
Telangana	0	2,228	7,201	3,682	2,483
Tripura	19,890	453	746	381	378
Uttar Pradesh	0	9,716	38,012	19,432	10,685
Uttarakhand	28,147	797	2,239	1,145	5,178
West Bengal	40,115	4,402	17,199	8,792	5,587
Total	**2,94,514**	**70,051**	**2,36,805**	**1,21,055**	**1,22,601**

Note: Break-up of following grants is not available in the above table: (i) Sector-specific grants for school Education (Rs 4,800 crore) and aspirational districts and blocks (Rs 3,150 crore), and (ii) grants to local bodies for incubation of new cities (Rs 8,000 crore), and National Data Centre (Rs 450 crore).

Sources: Report of the 15th Finance Commission for 2021-26; PRS.

Certain sector-specific grants							State-specific grants
Health	PMGSY Roads	Statistics	Judiciary	Higher Education	Agriculture		
877	344	19	295	250	4,209		2,300
133	1,508	49	20	48	107		400
2,161	3,103	57	610	171	748		1,375
3,223	1,694	77	960	483	1,720		2,267
588	911	54	200	146	917		1,660
56	0	5	15	50	63		700
1,070	330	51	310	298	2,818		2,860
695	128	40	300	146	1,696		2,003
377	2,222	21	50	70	247		1,420
1,014	966	48	275	179	677		1,300
1,233	398	45	295	299	2,290		6,000
607	113	20	405	181	1,086		1,100
2,340	2,109	102	690	349	4,587		1,765
2,710	613	63	1,240	520	3,285		2,750
191	1,193	28	30	54	101		900
187	544	23	30	54	86		800
115	546	14	15	48	86		700
153	372	23	10	51	124		525
962	1,949	45	425	218	1,271		1,775
902	230	43	145	156	1,966		1,545
1,186	1,618	57	460	332	3,301		2,322
100	484	7	5	45	41		500
1,002	506	47	250	347	2,632		2,200
624	255	46	245	189	1,665		2,362
265	502	17	85	55	228		875
6,150	1,465	114	1,825	893	5,334		3,495
728	2,322	25	70	83	277		1,600
2,106	1,114	35	1,165	428	3,438		2,100
31,755	**27,539**	**1,175**	**10,425**	**6,143**	**45,000**		**49,599**

5.2.14 Fiscal roadmap

- **Fiscal deficit and debt levels:** The Commission recommended that by 2025–2026, the government reduce the fiscal deficit to 4% of GDP. It suggested a fiscal deficit ceiling for states of (i) 4% in 2021–2022; (ii) 3.5% in 2022–2023; and (iii) 3% in 2023–2026. A state may use the unused borrowing amount (calculated in rupees) in subsequent years (within the four-year period of 2021–2026) if it is unable to use the sanctioned borrowing limit in its entirety during the first four years (2021–2025).

- Upon implementing reforms to the power sector, such as (i) reducing operational losses, (ii) reducing revenue gaps, (iii) reducing the payment of cash subsidies by adopting direct benefit transfer, and (iv) reducing tariff subsidies as a percentage of revenue, states will be granted additional annual borrowing worth 0.5% of GSDP during the first four years (2021–25).

- The Commission noted that the suggested course for the fiscal deficit for the federal government and the states will lead to a decrease in total liabilities for both: (i) the federal government, from 62.9% of GDP in 2020–21 to 56.6% in 2025–26; and (ii) all of the states combined, from 33.1% of GDP in 2020–21 to 32.5% by 2025–26. A powerful intergovernmental group should be established to: (i) review the Fiscal Responsibility and Budget Management Act (FRBM), (ii) suggest a new FRBM framework for the centre and states, and (iii) oversee its implementation.

- **Raising revenue:** Asset- and income-based taxation should be strengthened. It is necessary to broaden the scope of provisions relating to tax deduction and collection at source (TDS/TCS) in order to lessen the over-reliance on income tax on salaries. State-level stamp taxes and registration fees have a lot of unrealized potential. The market value of properties should be recorded, and computerised property records should be integrated with transaction registration. State governments should simplify their property valuation process.

- **GST:** A solution must be found for the GST's inverted duty structure between intermediate inputs and final outputs. The multiple rate structures and numerous downward adjustments have compromised the GST rate's ability to generate revenue. The 12%

and 18% rates should be combined to simplify the rate structure. The GST base needs to be expanded, and states need to step up field efforts to ensure compliance.

- **Financial management procedures:** It is important to create a thorough framework for public financial management. Establishing an independent fiscal council with the authority to review state and federal records is necessary. The Council will only serve as a consultative body. While eventual adoption of accrual-based accounting is being thought about, a time-bound plan for the gradual adoption of standard-based accounting and financial reporting for both the centre and states should be prepared. The federal government and the states shouldn't finance any expenditures outside of their approved budgets or in any other way that is opaque. It is necessary to develop a uniform framework for reporting contingent liabilities. The accuracy and consistency of macroeconomic and fiscal forecasting should be improved on by the federal government and the states.

- To ensure consistency with the center's legislation, particularly with the definition of debt, states should amend their fiscal responsibility laws. Other than ways and means advances and the Reserve Bank of India's overdraft facility, states should have more options for short-term borrowing. To effectively manage their borrowing programmes, states may establish a separate debt management cell.

5.2.15 Other recommendations

- **Health:** By 2022, states should spend more than 8% of their total budget on health. By 2022, primary healthcare spending should account for two-thirds of all health spending. Health centrally sponsored schemes (CSS) ought to be adaptable enough to let states change and improve. In CSS for health, the emphasis should be on results rather than inputs. There should be an All India Medical and Health Service.

- **Defence and internal security budgeting:** To fill the gap between budgetary demands and allotment for capital outlay in defence and internal security, a special non-lapsable fund called the Modernization Fund for Defence and Internal Security (MFDIS) will be established. Over the course of five years (2021-26), the fund will have an estimated corpus of Rs. 2.4 lakh crore. The Consolidated Fund of India will transfer Rs 1.5 lakh crore of this amount. The remaining funds will be raised through actions like the privatisation of defence public sector companies and the monetization of defence lands.

- **Centrally-sponsored schemes (CSS):** A threshold for annual allocation to CSS should be established below which funding for a CSS should be halted (to phase out CSS that have outlived their usefulness or have insignificant outlay). All CSS must be subjected to independent evaluation within a predetermined time frame. The funding pattern should be decided upon up front in a clear manner and maintained over time.

5.2.16 Let us Sum up

According to Article 280 of the Indian Constitution, the President of India creates the Finance Commissions on a regular basis to establish the financial ties between the national government of India and the various state governments. The Finance Commission (Miscellaneous Provisions) Act of 1951 authorised the creation of the First Commission. Since the 1950 promulgation of the Indian Constitution, fifteen finance commissions have been established. The terms of reference, which vary for each commission and specify the terms of qualification, appointment, and disqualification as well as the term, eligibility, and powers of the Finance Commission, govern how each commission operates. The commission, which has a chairman and four other members, is established by the constitution and appointed every five years. In India, the finance committee was established with the primary responsibilities of assessing the financial health of the national and state governments, choosing the tax-sharing structure, and establishing rules for allocating taxes among the states. The fiscal federalism structure is strengthened by the finance commission's effective coordination with all levels of government in carrying out decision-making. The recommendations made by the commission are intended to keep state and federal spending on the same level. A finance commission is required in order to address issues pertaining to the financial relationship between the federal and state governments. The 15th Finance Commission, chaired by Mr. N. K. Singh, was established in November 2017 to make recommendations regarding the distribution of funds from the federal government to the states for the five-year period between 2020 and 25. The role and mandate of the Commission have been the subject of some recent discussion. We describe the function of the Finance Commission in this context. The Finance Commission is a legally mandated body established every five years to make recommendations regarding the financial ties between the center-states.

5.2.17 Self-Assessment Questions

1. Explain the Functions of Finance Commission.
2. Mention the role of Finance Commission in India
3. Briefly discuss the history of Finance Commission
4. Briefly discuss the recommendations of Fifteenth Finance Commission

5.2.18 References

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Web Resources

https://prsindia.org/policy/report-summaries/report-15th-finance-commission-2021-26
https://doe.gov.in/15th%20finance%20commission
https://panchayat.gov.in/finance-commission/central-finance-commissions-reports-related-to-rural-local-bodies-rlbs/
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Lesson 5.3 - India's Fiscal Policy

Structure

5.3.1 Objectives

- Know the objectives of Fiscal Policy
- Understand the types of Fiscal Policy
- Study the Instruments and components of Fiscal Policy Instruments
- Discuss the recommendations of Chellaiah's Tax Reforms Committee, 1991
- Differentiate between Monetary policy and fiscal policy

5.3.2 Introduction

In order to influence macroeconomic conditions, particularly employment, inflation, and macroeconomic variables like the overall demand for goods and services, fiscal policy refers to the use of governmental spending and tax policies. The primary goal of these measures is to stabilise the economy. In order to achieve these macroeconomic goals, monetary and fiscal policy actions are frequently combined.

Fiscal policy deals with all aspects of the government's revenue and outlays. Budgeting and taxation are just two examples of the fiscal policy tools used to address the economy's most important issues. The following are the three pillars of Indian fiscal policy. Government revenues, government spending, and public debt. The fiscal policy is established by the Ministry of Finance with assistance from NITI Ayog.

5.3.3 Fiscal Policy Objectives

1. **Price Stability :** This policy mainly oversees the total control of pricing for all goods and things. It controls prices while the country is experiencing an economic crisis and keeps them stable when there is inflation; as a result, it controls prices across the board. The government promotes price stability by controlling the supply of necessary goods and services. As a result, it makes financial investments in rationing, stores with fair prices, and a plentiful supply of food grains. Additionally, it offers subsidies for utilities like transportation, water, and cooking gas, maintaining their costs at levels that are affordable to the average person.

2. **Full Employment**: In every country that needs to improve its economic situation, employment should be given top priority. The likelihood of development is increased because India has the most youth. In many ways, the younger generation is superior to the older generation. As a result, if our country could achieve full or nearly full employment, it would improve our economic statistics. The fiscal policy influences all employment-related decisions. In a variety of ways, the government increases the number of employment opportunities. One is that creating public sector businesses creates jobs. Two, it offers incentives and other benefits to the private sector, such as tax breaks, reduced tax rates, and so forth, to boost output and employment. Furthermore, it encourages individuals to start small, cottage, and rural businesses in order to create jobs. You can do this by providing them with tax advantages, incentives, subsidies, and low-interest loans, among other things.

3. **Economic Growth:** Particular fiscal policy measures can increase

the country's growth rate and help it meet its needs. One way the government encourages economic growth is through the establishment of heavy industries like steel, chemicals, fertilisers, and industrial machinery. It also constructs infrastructures like roads, bridges, railways, schools, hospitals, water and electricity supplies, telecommunications, and other facilities that aid in economic development.

5.3.4 Fiscal Policy Types

1. **Expansionary Fiscal Policy:** This refers to the decisions that governments make regarding how much money they will contribute to the national economy. As a result, it generates a lot of goods and services. As a result of all the growth, it also increases employment opportunities and boosts personal and governmental profits.

2. **Contractionary Fiscal Policy:** This is the second category of fiscal policy. This is used when the economy is booming. However, the quick economic growth can occasionally be dangerous. In this case, the government is attempting to halt the current economic boom. This also contributes to controlling both inflation and economic growth.

3. **Neutral Fiscal Policy:** This fiscal strategy is used when the nation's economy is in balance. It suggests that things are moving well given the economic highs and lows. It includes government spending that is financed by taxes imposed on individuals, companies, or segments of the economy. and won't have any effect on the state of the country's economy.

5.3.5 Fiscal Policy Instruments

1. **Consumption control:** This strategy aims to boost the country's savings. As a result, it can be used to make future purchases and enhance the country's current economic situation.
2. **By boosting investment rates:** This may be the best course of action to enhance the economy's present and future conditions. When people invest, money is put to good use and increases in value daily rather than being wasted on unneeded items. As a result, the future economy of the country will significantly improve.
3. **Infrastructure Development:** A nation's infrastructure plays a big

part in whether or not it is regarded as developed or underdeveloped. Therefore, the development of infrastructure is more important if we want to boost the economy.

4. The maximum tax rate on luxury and overseas goods is 100%. Some goods that are imported into India directly from other countries are subject to this tax rate. The country benefits the most from its revenue as a result. Additionally, it will promote domestic product purchases, advancing the industries of the country.
5. There are other crucial factors to take into account in addition to overcharging for some items based on their quality and other factors. The massive tax that the government levied on luxury goods is the main cause of the increase in product prices. The income generated by luxury goods will be at its highest thanks to this sizeable tax, which will have a direct impact on the country's economic health.

5.3.6 Fiscal Policy Components

- Government Receipts
- Government Expenditures
- Public Accounts of India

5.3.6.1 Government Receipts : These government receipts account for the government's revenue, which is comprised of taxes, interest, investment income, cess, and other sources of income that the country has produced. This amounts to all of the government's funding from all sources. Government receipts come in two different varieties. Revenue Receipts A revenue receipt is any form of payment from the government that neither increases liabilities nor decreases assets. Tax revenue and other sources of income can also be subtracted from this. Non-tax revenues include the interest and dividends received on government investments, as well as cess and some other receipts. The two types of tax revenues are direct tax and indirect tax.

Capital Receipts: Capital receipts are all payments made by the government that result in a rise in liabilities or a fall in assets. Governments use these funds to operate efficiently. A cash flow that comes in is another type of capital receipt. If the government borrows money because it has to return it to the government it was borrowed from, it is referred to as a debt receipt. Recipients of non-debt receipts are those who make payments that are not repaid. Around 75% of all budgets are made up of non-debt receipts. The majority of capital receipts come from loans made to individuals, some foreign governments, and the Reserve Bank of India. Revenue Receipts: Recipients of non-debt receipts are those who make payments that are not repaid. Around 75% of all budgets are made up of non-debt receipts. The majority of capital receipts (RBI) come from loans taken by the general public, some foreign governments, and the RBI.

5.3.6.2 Government Expenditure

Revenue expenditures: They are one-time expenses that typically occur now or within a year. Since they include the costs required to pay for the government's ongoing operational costs (OPEX), revenue expenditures are nearly identical to operating expenses. maintenance and repair expenses on state-owned property on a regular basis. They are ongoing costs as opposed to the majority of capital expenditures, which are one-time costs. An example would be paying taxes on government-owned property, rent, employee salaries, and electricity.

Capital Expenditure: investments in capital made by the government to fund, expand, or run its operations and generate revenue. purchasing fixed assets, which are tangible long-term assets, and long-term assets like equipment. As a result, capital expenditures are frequently for larger amounts than revenue expenditures. The purchase of industrial machinery, commercial purchases, other government expenditures like furniture, infrastructure investment, etc. are examples.

5.3.6.3 Public Accounts of India (Public Debt)

The Public Account of India records the flows for transactions in which the government merely serves as a banker. This fund was established under Article 266(2) of the Constitution. It considers transaction flows in which the government only acts as a banker. Minor savings, provident funds, and other examples are provided. They must eventually be returned to their original owners because this money does not belong to the government. As a result, spending from the public account does not need to be approved by the Parliament.

5.3.7 Tax Reforms

Reforming the tax code is a crucial part of fiscal consolidation. You would already be aware as aspiring economists of the significance of tax reform in relation to both fiscal stabilisation and structural adjustment. In the end, a strong revenue system is the only way to achieve fiscal stabilisation. The main goals of the tax reform programme, an increase in productive efficiency and a decrease in costs, depend heavily on the features of the tax structure. In August 1991, the government established a high-powered committee, headed by renowned public finance expert Dr. Raja J. Chelliah, to make recommendations for a thorough overhaul of the central tax system. The committee's name was Tax Reforms Committee.

5.3.8 Chellaiah's Tax Reforms Committee, 1991

The tax reforms committee (TRC) was tasked with reviewing the nation's current tax system and recommending appropriate reforms to make it more equitable, inclusive, flexible, and tax-compliant. As is well known, a system of incorporating moderate rates on a broad base yields the best results in terms of compliance, efficiency, and equity. This is how the TRC described its methodology. Therefore, the committee's main strategy was to make the tax system straightforward, effective, and transparent while also being effective in terms of generating revenue. The committee also believed that a good tax system should generate the majority of the government's income through direct taxes. Regarding indirect tax, the committee wanted a system of taxation that was based on value added at every stage while also taking simplicity and transparency into consideration.

Issues With India's Taxation System

- Foreign investment into India has been impacted by retrospective taxation.
- In order to strengthen business and investment ties, an unstable policy environment with regard to taxes and tariffs needs to be resolved.
- Complexity and litigation are brought on by the intricate web of tax laws enacted by the Central and numerous State Governments.
- A lower tax base results from increased thresholds offered for personal income taxes and exemptions, tax breaks, preferential tax rates, deferral of tax liabilities, etc.
- Corruption and tax evasion threaten the state's methods of governance.
- The weak points in the tax administration, such as a lack of technical

know-how and funding, poorly written laws, and corruption.

- Structural problems like a low level of financial literacy, a sizable portion of the informal economy, and a high proportion of cash-based transactions

5.3.9 Direct Tax Reforms

- Direct tax is a progressive tax, meaning that as an individual's or an entity's income increases, so does the proportion of tax liability. Income tax, corporate tax, dividend distribution tax, securities transaction tax, fringe benefit tax, and wealth tax are a few examples of direct taxes.
- A number of committees, including the Arbind Modi Committee on Income Tax Reforms and the Akhilesh Ranjan Panel on Formulating a New Direct Tax Code (DTC), aim to update, consolidate, and streamline India's direct tax laws (such as the Income-tax Act of 1961 and the Wealth Tax Act of 1957) into a single body of law.

5.3.10 Need for Direct Tax Reforms

- Rationalisation of the income tax system given that the slabs of 10%, 20%, and 30% for personal income tax have largely not changed over the past 20 years.
- The pressing need to simplify the corporate tax code. For instance, in 2014–15, companies with profits under $1 million paid an average tax rate of 29.37%, while those with profits over $500 million paid an average tax rate of only 22.88%.
- Increase the tax base and avoid potential revenue losses brought on by lower tax rates and a more straightforward tax system.
- Continue to maintain a balance between direct and indirect taxes; for instance, direct tax contributions have decreased from 60% in 2010–11 to 52% in 2017–18.

5.3.11 Measures Taken by the Government

- A number of initiatives have been started to increase tax compliance, including the E- Sahyog portal for online return filing, an extension of the Single Window Interface for Facilitating Trade (SWIFT) for Indian Customs, etc.
- Simplifying tax laws, such as exempting a certain group of people

from Section 50CA's and Section 56's anti-abuse provisions.

- Offering relief to startups by extending until FY21 the capital gains exemptions from the sale of residential properties for investments in startups and resolving angel tax issues, among other things.
- Implementing a variety of anti-tax avoidance measures, such as Advanced Pricing Agreements (APAs), General Anti-Avoidance Rules (GAAR), etc.

Direct Tax Code (DTC)

The goal was to streamline and strengthen the tax system by combining all of the federal government's direct tax laws. DTC seeks to achieve horizontal equity among various taxpayer classes in accordance with top international standards. The numerous tax breaks and deductions should gradually be eliminated in order to broaden and deepen the tax base. Such tax reforms will boost compliance, making taxes simpler and resulting in a more reliable and stable taxation system.

Proposal for Direct Tax Code (DTC)

- In the 2012–2013 fiscal year, the government adopted the increased tax slabs that had been proposed.
- The corporate income tax rate should be 30% without a surcharge.
- Instead of the previous tax rate of 18.5%, the Minimum Alternate Tax (MAT) rate should be 20%.
- A select few programmes, such as PF, gratuities, pension funds, etc., would still fall under EEE.

Vivad Se Vishwas Scheme

- The purpose of this scheme was to reduce ongoing income tax litigation while also bringing in timely revenue for the government and the benefit of taxpayers.
- The tax department will close all legal cases against the people/ businesses that choose the scheme after they pay the required tax, and any pending criminal charges will also be dropped.

Faceless Tax Assessment Scheme

- For income tax-related businesses, a taxpayer or assessee is not required to go to a department office or meet with a representative.

- It was introduced in 2019 to encourage effective tax administration, reduce physical contact, uphold accountability, and implement team-based evaluations.

Indirect Tax Framework

- Consumption-based taxes known as indirect taxes are levied on the purchase and sale of goods and services.
- Indirect taxes, such as the goods and services tax, customs duty, excise duty, sales tax, etc., are paid to the government by the seller of the good or service, who then passes the tax on to the end-user, or buyer of the good or service.

Goods and Services Tax (GST)

This indirect tax system was put in place to collect taxes and reduce tax evasion; it is simple for customers to understand and will lessen the tax burden on business; it also ensures that there is no cascading effect of the tax and that tax laws, procedures, and rates are uniform. Unlike the manufacture of goods, the sale of goods, or the provision of services, GST is applicable to the supply of goods or services.

Recent Measures by The Government

- The Taxation Laws (Amendment) Ordinance 2019 gave existing domestic companies a 22% tax rate break starting in the 2019–20 fiscal year (FY) if they do not take advantage of any specific exemptions or incentives.
- The Taxation Laws (Amendment) Ordinance 2019 has reduced the tax rate for new domestic manufacturers to 15% if they do not take advantage of any specified exemptions or incentives.
- From 18.5% to 15%, the rate of MAT has also been decreased.
- The Dividend Distribution Tax (DDT), which companies were exempt from paying under the Finance Act of 2020, was eliminated.

5.3.12 Monetary policy and fiscal policy

Fiscal and monetary policies are two distinct instruments that affect a nation's economic activity.

A nation's central banks create and oversee its monetary policies, which are aimed at controlling the money supply and interest rates in an economy.

A government's spending and taxation priorities are managed through its fiscal policy. The government uses it as a means of promoting economic growth and stabilisation.

To control the fiscal deficit of the economy, governments can alter fiscal policy by enacting measures and altering tax rates.

Difference Between Fiscal Policy and Monetary Policy

A nation's economic standing can be tracked, managed, and regulated by wise economic decisions. The two national policies that can aid in bringing stability and a smooth development are the nation's fiscal and monetary policies. A fiscal policy is one that deals with how much money the government spends and how much it receives in tax revenue. On the other hand, monetary policy is primarily focused on the movement of money within the economy. Fiscal policy refers to the government's plan for taxation, spending, and other financial operations to achieve the nation's economic goals. As an alternative, monetary policy is a plan used by financial institutions like the Central Bank to control the flow of credit in the economy of the nation.

Basis For Comparison	Fiscal Policy	Monetary Policy
Meaning	Fiscal policy is the method by which the government influences the economy by using the proceeds from taxes and spending decisions.	Monetary policy is the method by which the central bank controls the amount of money in the economy.
Administered by	Ministry of Finance	Central Bank
Nature	Every year, the fiscal policy is altered.	The nation's economic situationdetermines how the monetary policy will change.
Related to	Government Revenue & Expenditure	Banks & Credit Control
Focuses on	Economic Growth	Economic Stability
Policy instruments	Tax rates and government spending	Interest rates and credit ratios
Political influence	Yes	No

5.3.13 Let us Sum up

Fiscal policy deals with all aspects of the government's revenue and outlays. Budgeting and taxation are just two examples of the fiscal policy tools used to address the economy's most important issues. The following are the three pillars of Indian fiscal policy. Government revenues, government spending, and public debt. The fiscal policy is established by the Ministry of Finance with assistance from NITI Ayog. In India, the government uses fiscal policy as a guide to determine how much money it should spend to support economic activity and how much money it needs to take in from the system to keep things running smoothly. Fiscal policy has become more crucial recently in order to achieve rapid economic growth in India and around the world. One of the main objectives of the Indian government's fiscal policy is to achieve rapid economic growth. Together with monetary policy, fiscal policy is a key component of managing an economy.

5.3.14 Self-Assessment Questions

1. Define the term Fiscal Policy
2. Mention the Objectives and scope of Fiscal policy.
3. What are the types of Fiscal policy
4. Elaborate the instruments of fiscal policy
5. Discuss the components of fiscal policy
6. Chellaiah's Tax Reforms Committee, 1991 – Discuss.
7. Explain the measures Taken by the Government on fiscal policy
8. Differentiate between Monetary policy and fiscal policy

5.3.15 References

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