PUBLIC FINCANCE

VI SEMESTER

CORE COURSE

BA ECONOMICS

(2011 Admission)

UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

Calicut university P.O, Malappuram Kerala, India 673 635.

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SCHOOL OF DISTANCE EDUCATION

STUDY MATERIAL

Core Course

BA ECONOMICS

VI Semester

PUBLIC FINANCE

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MODULE I

MEANING AND SCOPE OF PUBLIC FINANCE

Meaning and Scope of Public Finance. Public Finance—Meaning and Scope- Public and Private finance- principles of Maximum Social Advantage—Public Goods, Private Goods, Mixed Goods and Merit Goods (Concepts Only)

Public finance is a field of economics concerned with how a government raises money, how that money is spent and the effects of these activities on the economy and society. It studies how governments at all levels—national, state and local—provide the public with desired services and how they secure the financial resources to pay for these services.

Public finance deals with the finances of public bodies – national, State or Local – for the performance of their functions. The performance of these functions leads to expenditure. The expenditure is incurred from funds raised through taxes, fees, sale of goods and services and loans. The different sources constitute the revenue of the public authorities. Public finance studies the manner in which revenue is raised; the expenditure is incurred upon different items etc. Thus, public finance deals with the income and expenditure of public authorities and principles, problems and policies relating to these matters. We can analyse some important definitions of public finance given by some leading authorities in public finance.

Economists	Publication	Definition
Charles F. Bastable	Public Finance – 1892	For all States – whether crude or highly developed – some provisions of the kind are necessary and there for supply and application of state resources constitute the subject matter of a study which is best entitled in English as Public Finance
Dalton	Principles of Public Finance- 1922	One of those subjects which lies on the border line between Economics and Politics. It is concerned with the income and expenditure of public authorities and with the adjustment of one to the other
Harold Groves	-----	A field of enquiry that treats the income and out goes of governments –federal, state, and local
PE. Taylor	The Economics of public finance	Public Finance is the fiscal science, its policies are fiscal policies, its problems are fiscal problems

Mrs. Ursula Hicks	Public Finance	The main content of Public Finance consists of the examination and appraisal of the methods by which governing bodies provide for the collective satisfaction of wants and secure the necessary funds to carry out this purpose
CS Shoup	-----	The discipline of Public Finance describes and analyses the government services, subsidies and welfare payments and methods by which the expenditure to these ends are covered through taxation, borrowing, foreign aid and creation of new money

According to Professor Hugh Dalton,the term 'Public authorities' refers to the Government or State at all levels –National, State, and Local.

Harold Groves' definition outlines the types of governments whose finances are studied in Public finance.

According to Taylor, public finance studies the manner in which the state through its organ, the government, raises and spends the resources required. Public Finance is thus concerned with the operation and policies of the fisc - The State treasury.

The definition of public Finance by Mrs.Ursla Hicks highlights the satisfaction of collective wants which in turn leads to the need to secure necessary resources.

The definition of CS Shoup enlarges the scope of Public Finance for modern governments to include different types of expenditure and different sources of revenue.

All the definitions stated above illustrate the scope of Public Finance. From these definitions, we can conclude that Public Finance is an enquiry into the facts, techniques, principles, theories, rules and policies which shape, direct, influence and govern the use of scarce resources, with alternative uses, of the government.

IMPORTANCE OF PUBLIC FINANCE

1) Provision of public goods: -For providing public goods like roads, military services and street lightsetc. public finance is needed. Business firms will have no incentive to produce such goods, as they get no payment from private individuals.

2) Public finance enables governments to tackle or offset undesirable side effects of a market economy. The side effects are called spill overs or externalities. For example, pollution. The governments can introduce recycling programmes to lessen pollution or they can make laws to restrict pollution or impose pollution charges or taxes on activities that bring about pollution.

3) Public finance helps governments to redistribute income. To reduce the inequality in the economy, the governments can impose taxes on the richer people and provide goods and services for the needy ones.

4) Public finance provides many a programme for moderating the incomes of the rich and the poor. Such programmes include social security, welfare and other social programmes.

5) The acceptance of the principle of welfare state, the role of public finance has been increasing. Modern governments are no more police states as the classical economists viewed.

6) As the scope of state participation in the economic activity is widening, the scope of public finance has also been increasing. Generation of employment opportunities, control of economic fluctuations like boom and depression, maintaining economic stability etc. are some of the thrust areas of the governments through fiscal operations.

SUBJECT MATTERS OF PUBLIC FINANCE

The subject matters of Public Finance can be broadly classified in to five categories –a) Public revenue b) Public expenditure c) Public debt d) Financial administration e) Economic stabilization and f) Federal Finance.

Public Revenue:

The income of the states is referred to as Public Revenue. In this branch, we study the various ways of raising revenue by the public bodies. We also study the principles and effects of taxation and how the burden of taxation is shared among the various classes of society etc.

Public Expenditure

It deals with the principles and problems relating to the allocation of public spending. We study the fundamental principles governing the flow of public funds in to different channels, classification and justification of public expenditure; expenditure policies of governments and the measures adopted for welfare state etc.

Public Debt

The governments borrow when its revenue falls short of its expenditure.Public debts is a study of various principles and methods of raising debts and their economic effects. It also deals with the methods of repayments and managements of public debts.

Financial Administration

It deals with the methods of Budget preparation, various types of Budgets, war Finance, Development Finance etc. Thus, financial administration refers to the mechanism by which the financial functions are carried on. In other words, financial administration studies the organizing and disbursing of the finances of the State.

Economic stabilization and Growth

The use of Public revenue and Public expenditure to secure stability in levels of prices by controlling inflationary as well as deflationary pressures is studied. Similarly the income and expenditure policies adopted by the government so as to attain full employment, optimum use of resources, equitable distribution of income etc. are also studied.

FEDERAL FINANCE

Under federal finance we study the principles and policies governing the distribution of functions and funds among the public authorities in a federal set up. In a federal set up there are different levels of governments-centre, state and local.

Public Finance and Private Finance

The understanding and the study of public finance is facilitated by a comparison of the public or government finance with private or individual finance. Such a comparison will help us to know how the aims and objectives and methods of public Finance operation are similar or differed from the financial operations of the individual.

Similarities

1. Both the State as well as individual aim at the satisfaction of human wants through their financial operations. The individuals spend their income to satisfy their personal wants whereas the state spends for the satisfaction of communal or social wants.

2. Both the States and Individual at times have to depend on borrowing, when their expenditures are greater than incomes

3. Both Public Finance and Private Finance have income and expenditure. The ultimate aim of both is to balance their income and expenditure.

4. For both kinds of finances, the guiding principle is rationality. Rationality is in the sense that maximization of personal benefits and social benefits through corresponding expenditure.

5. Both are concerned with the problem of economic choice, that is, they try to satisfy unlimited ends with scarce resources having alternative uses.

Dissimilarities

1. The private individual has to adjust his expenditure to his income. i.e., his expenditure is being determined by his income. But on the other hand the government first determines its expenditure and then the ways and means to raise the necessary revenue to meet the expenditure.

2. The government has large sources of revenue than private individuals. Thus at the time of financial difficulties the state can raise internal loans from its citizens as well as external loans from foreign countries. In the case of private individual, all borrowings are external in nature.

3. The state, when hard pressed, can resort to printing of currency, as an additional source of revenue. In fact, during emergencies like war, it meets its increased financial obligations by printing new currency. But an individual cannot raise income by creating money.

4. The state prepares its budget or estimates its income and expenditure annually. But there is no such limitation for an individual. It may be for weekly, monthly, or annually.

5. A surplus budget is always good for a private individual. But surplus budgets may not be good for the government. It implies two things. a) The government is levying more taxes on the people than is necessary and b) the government is not spending as much as the welfare of the people as it should.

6. The individual and state also differ in their motives regarding expenditure. The individuals hanker after profit. Their business operations are guided by private profit motive. But the states expenditure is guided by the welfare motive.

7. The private individual spends his income on various items in such a manner as to secure equi-marginal utilities from them. The government on the contrary does not give as much importance to this law as a private individual does. Modern government sometimes incur cretin types of expenditure from which there do not derive any advantage but they do incur this expenditure to satisfy cretin sections of the community.

8. Individuals always seek quick returns they save only a small amount for future and spend more to satisfy their current needs. Individual tend to think more on present as they are dead in the long run.Similarly they seldom spend if it does not yield any money income. On the other hand, State has a long term perspective of its expenditure. It does not care only for immediate benefit. State spends on projects having long gestation period. The burden of taxation is borne by the present generation in the interest of long run welfare of the community. Similarly sometimes government may have to spend on schemes which may not yield any money income at all (e.g. Public Health).

9. An individual's spending policy has very little impact on the society as a whole. But the state can change the nature of an economy through its fiscal policies.

10. The pattern of expenditure in the case of private finance is often influence by customs, habits social status etc. The pattern of government expenditures is guided by the general economic policy followed by the government.

11. Private Finance is always a secret affair. Individual need not reveal their financial transactions to anyone except for filing tax returns. But Public Finance is an open affair. Government budget is widely discussed in the parliament and out sides. Public accountability is an important feature of public finance.

12. Individuals can plan to postpone their private expenditure. But the state cannot afford to put off vital expenditure like defence, famine relief etc. Findlay Shiraz says that compulsory character is an important future of public finance.

Major Fiscal Functions

According to Professor Musgrave there are three major fiscal or budgetary functions of the governments. They are a) Allocation functions b) Distribution functions and c) Stabilization functions.

THE ALLOCATION FUNCTION

There are certain cases in which the wants of all individuals cannot be satisfied through market mechanism. In such cases the public sector or the governments have to provide goods and services. The allocation branch of public finance deals with the provision of social goods. Social goods are those goods and services produced to satisfy collective wants. Collective wants are those wants which are demanded by all members of the community in equal or more or less equal amounts. The allocation branch explains the process by which the resources in use are divided between private goods and social goods by which the mix of social good is chosen.

THE DISTRIBUTION FUNCTION

The very important feature of a market economy is the disparity in the distribution of income and wealth. The distribution function of public finance deals with the adjustment of the distribution of wealth and income to ensure "fair or just" state of distribution. That is, the distribution function of public finance deals with the determination of taxes and transfer payments policies of the governments.

THE STABILIZATION FUNCTION

The stabilization function explains the macroeconomic aspect of budgetary policy. In other words, the stabilization function deals with the use of budgetary policy as a means of maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth, with allowances for effects on trade and balance of payments. The major instruments of stabilization policy are monetary policy and fiscal policy. This function is otherwise known as compensatory finance.

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE One of the important principles of public finance is the so – calledPrinciple of Maximum Social Advantage explained by Professor Hugh Dalton. Just like an individual seeks to maximize his satisfaction or welfare by the use of his resources, the state ought to maximize social advantage or benefit from the resources at its command.

The principles of maximum social advantage are applied to determine whether the tax or the expenditure has proved to be of the optimum benefit. Hence, the principle is called the principle of public finance. According to Dalton, "This (Principle) lies at the very root of public finance"

He again says "The best system of public finance is that which secures the maximum social advantage from the operations which it conducts." It may be also called the principle of maximum social benefit. A.C. Pigou has called it the principle of maximum aggregate welfare.

Public expenditure creates utility for those people on whom the amount is spent. When the volume of expenditure is small with a slighter increase in it, the additional utility is very high. As the total public expenditure goes on increasing in course of time, the law of diminishing marginal utility operates. People derive less of satisfaction from additional unit of public expenditure as the government spends more and more. That is, after a stage, every increase in public expenditure creates less and less benefit for the people. Taxation, on the other hand, imposes burden on the people. So, when the volume of taxation becomes high, every further increase in taxation increases the burden of it more and more. People under go greater scarifies for every additional unit of taxation. The best policy of the government is to balance both sides of fiscal operations by comparing "the burden of tax" and "the benefits of public expenditure". The State should balance the social burden of taxation and social benefits of Public expenditure in order to have maximum social advantage.

Attainment of maximum social advantage requires that;

a) Both public expenditure and taxation should be carried out up to certain limits and no more.

b) Public expenditure should be utilized among the various uses in an optimum manner, and

c) The different sources of taxation should be so tapped that the aggregate scarifies entailed is the minimum.

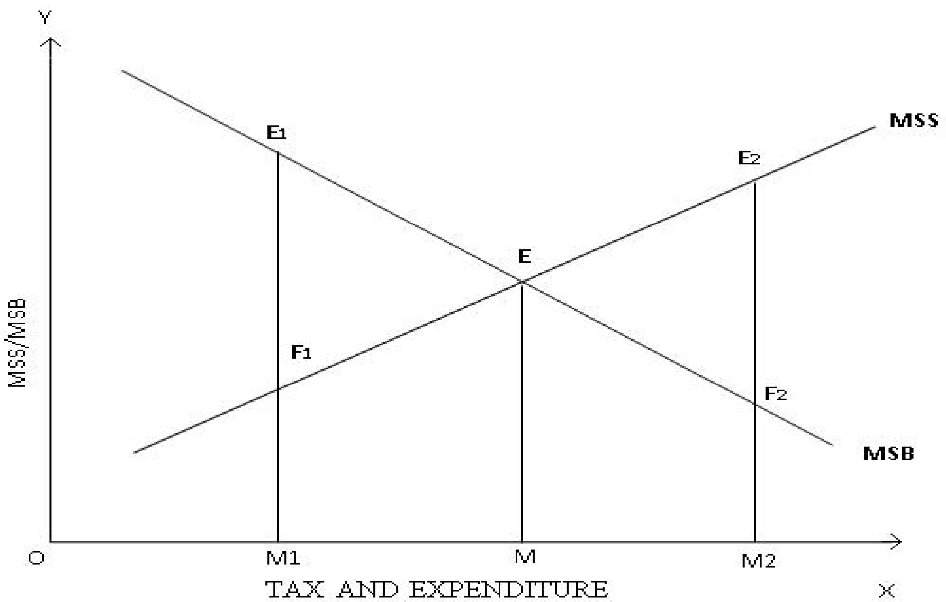
Assumptions of the Principle

- ❖ The public revenue consists of only taxes (and not of gifts, loans, fees etc.) and the state has no surplus or deficit budgets.
- ❖ Public expenditure is subject to diminishing marginal social benefits and the taxes are subject to increasing marginal cost or disutility.

According to Dalton, maximum social advantage is at a point where the Marginal Social Sacrifice (MSS) of taxation and Marginal Social Benefit (MSB) are equal. The point of equality between MSS and MSB is referred to as the point of maximum social advantage or least aggregate social sacrifice.

Musgrave calls Dalton's principle as "Maximum Welfare Principle of Budget Determination." He puts that the optimum size of the budget is determined at point where Net Social Benefit (NSB) of fiscal operations to the society becomes zero. The NSB is the difference between MSB and MSS. (NSB=MSB-MSS). Musgrave presented Dalton's principle of MSA with some slight differences.

Diagrammatic Representation



The curves MSS and MSB show the marginal social scarifies of taxation and marginal social benefit of public expenditure respectively. MSS curve slopes up words since taxation increases marginal social sacrifices. MSB curves slopes down wards showing that public benefit goes on declining with every increase in public expenditure. The ideal point of financial operations is where the governments collect OM taxation from the society and uses it for public expenditure. At this point , MSS is exactly equal to MSB (Point E) at OM 1 , MSS is M1 F1 which is less than MSB (M1 , E1) thus depicting a loss of welfare to the society (E1 F1). Similarly, the government is collecting OM2 taxation to finance larger public expenditure; The MSS is higher than MSB by E2 F2. So the ideal level of taxation and expenditure is at OM. According to Dalton "Public expenditure in every direction, should be carried just so far that the advantage to the community of a further small increase in any direction is just counter balanced by the disadvantage of a corresponding increase in taxation or in receipts from any other source of public income. This gives the ideal public expenditure and income".

CATEGORIES OF GOODS

PUBLIC GOODS

The indivisible goods, whose benefits cannot be priced, and therefore, to which the principle of exclusion does not apply are called public goods. The use of such goods by one individual does not reduce their availability to other individuals. For example, the national defence.

Characteristics of Public goods

1) **Non-rival in consumption: -** One person's consumption does not diminish the amount available to others. Once produced, public goods are available to all in equal amount. **Marginal cost of providing the public goods to additional consumers is ZERO.**

2) **Non-excludable:-** Once a public good is produced, the suppliers cannot easily deny it to those who fail to pay. That is, those who cannot (or do not agree to) pay its market price are not debarred or excluded from its use.

3) **Free-rider problem: -** People can enjoy the benefits of public goods whether pay for them or not, they are usually unwilling to pay for public goods. This act is the so-called free-rider problem.

PRIVATE GOODS

Private goods refer to all those goods and services consumed by private individuals to satisfy their wants. For example, food, clothing, car etc.

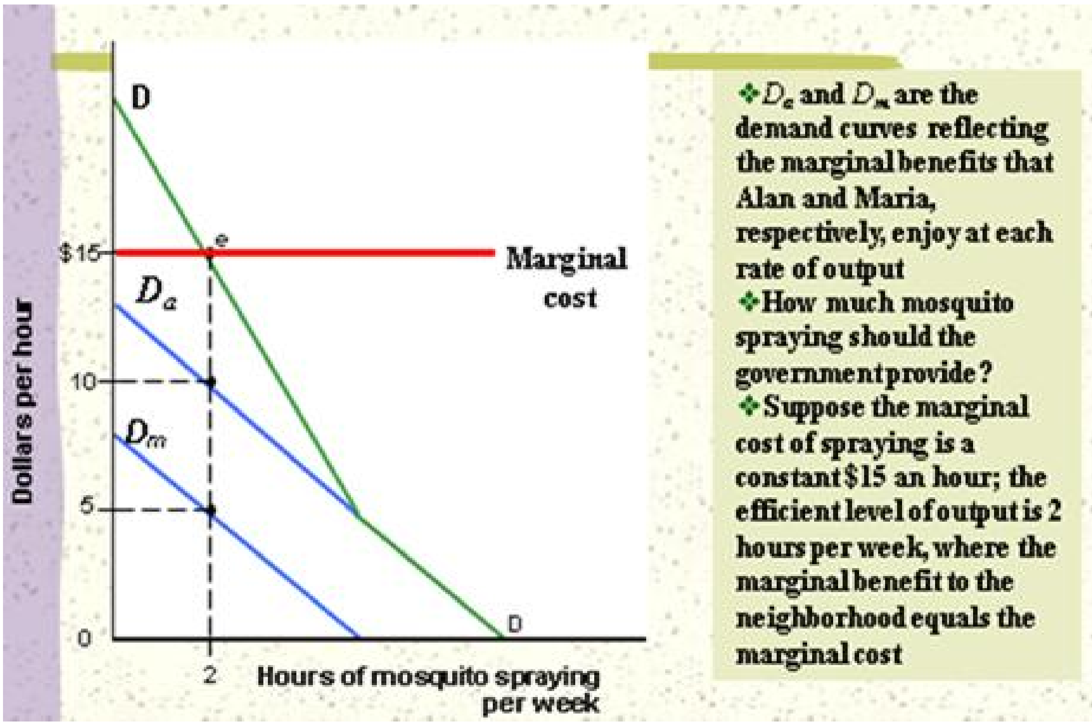
FEATURES

1) **Excludable: -** The suppliers of private goods can very well exclude those who are unwilling to pay.

2) **Rivalry in consumption: -** One person's consumption reduces the amount available to others. That is**,** the amount consumed by one person is unavailable for others to consume.

3) **Revealed Preference: -** The consumers reveal their preferences through effective demand and market price. These revealed preferences are the signals for the producers to produce the goods the individuals want.

Market demand for **private goods** is obtained by **horizontal summation** of individual demand curves and that of a **public good** is obtained by **vertical summation** of individual demand curves.



MIXED GOODS

Mixed goods are those goods having benefits which are wholly internalized (rival) and others, the benefits of which are wholly externalized (non-rival). The cost of producing such goods partly covered by private contributions and partly by government subsidy.

MERIT GOODS

Those goods whose consumption and use are to be encouraged are called merit goods (e.g.; education) and goods whose consumption and use are to be discouraged are called non-merit goods or demerit goods (e.g., liquor, narcotic etc.) drugs Merit goods are socially desirable goods which promote social welfare. **Merit goods are rival and excludable**. Governments provide merit goods in order to ensure distributional justice. These are goods which governments feel if people will under consume or produce and therefore should be subsidized or provided free. Examples of merit goods are education, mid-day meals in schools, essential food articles etc.**This concept was introduced by Prof.R.A.Musgrave in 1959.**

CATEGORIES OF GOODS

CHARACTERISTICS	RIVAL	NON-RIVAL
EXCLUDABLE	PRIVATE GOODS • CAR • PIZZA • FOOD	QUASI-PUBLIC • CABLE TV • UNCROWDED SWIMMING POOL
NON-EXCLUDABLE	OPEN ACCESS • OCEAN FISH • MIGRATORY BIRDS	PUBLIC GOODS • NATIONAL DEFENCE • SREET LIGHT

MODEL QUESTIONS

1) What is public finance? Discuss the scope or subject matter of public finance.
2) Distinguish between public finance and private finance.
3) What is the role of public finance in the economic development of a country?
4) What are the fiscal functions of governments according to Professor Musgrave?
5) Explain the principle of maximum social advantage theory.
6) Write short notes on:
   a) Public wants and private wants.
   b) Merit goods and mixed goods.
   c) Importance of public finance.

MODULE II

PUBLIC EXPENDITURE

PUBLIC EXPENDITURE–Meaning and Importance-Reasons for Growth of Public Expenditure-Wagner's Hypothesis, Peacock—Wiseman Hypothesis-Canons of Public expenditure-Effects of Public Expenditure.

Public Expenditure: Meaning and Importance

The expenses incurred by the governments for its own maintenance, preservation and welfare of the economy as a whole is referred to as public expenditure. In other words, it refers to the expenses of public authorities-central, state and local governments in a federation-for the satisfaction of collective needs of the citizens or for promotion of economic and social welfare. The development functions include education, public health, social security, irrigation, canal, drainage, roads, buildings, etc. The major cause of increase in the public expenditure is nothing but, these developmental functions. Hence, the study of public expenditure has become very significant in the study of public finance.

The two major reasons for the same are: a) the economic activities of the state has increased manifold and b) nature and volume of public expenditure have greatly affected the economic life of the country in a different manner. i.e., it has affected production and distribution and general level of economic activities.

In the laissez-faire era the state was assigned a very limited role to play. The functions assigned to the state where based on the principle of least interference or **'that government is the best which spends the least.'** According to the classical school led by Adam Smith restricted the functions of the state to **'Justice, Police and Arms.'** They considered government expenditure wasteful and that money could be used much well by private persons than by the government. Adam Smith in his magnum opus **'TheWealth of Nations'** published **in 1776** observed that the sovereign has three main duties to perform as a) to protect the society from violence and invasion of other independent societies b) to protect against injustice and c) erecting and maintaining certain public works.

According to David Ricardo, **'If you want a peaceful government you must reduce the budget'.** JB Say opined that **'the very system of all plans of finance is to spend little and the best of all taxes is that which is least in amount'.**

In recent time, public expenditure has been increased enormously. The main reason is that the functions of governments have been increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, a German economist, presented his famous **'Law of Increase of State Activities.'** He states that 'comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments.' This increase is both intensive and extensive.

Prof. RA Musgrave, the twentieth century economist, advocated public expenditure since a government is forced to do many activities such as 1) activities to secure a reallocation of resources 2) redistribution activities, 3) stabilizing activities and 4) commercial activities.

Governments constantly undertake new functions while they perform both old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a satisfactory fashion are satisfied by the central and local governments.

Causes for the Increase in Public Expenditure:

One of the most important features of the present century is the phenomenal growth of public expenditure. Some of the important reasons for the growth of public expenditure are the following.

1) **Welfare state**: Modern states are no more police states. They have to look in to the welfare of the masses for which the state has to perform a number of functions. They have to create and undertake employment opportunities, social security measures and other welfare activities. All these require enormous expenditure.

2) **Defence expenditure**: Modern warfare is very expensive. Wars and possibilities of wars have forced the nation to be always equipped with arms. This causes great amount of public expenditure.

3) **Growth of democracy**: The form of democratic government is highly expensive. Theconduct of elections, maintenance of democratic institutions like legislatures etc. cause great expenditure.

4) **Growth of population**: tremendous growth of population necessitates enormous spending on the part of the modern governments. For meeting the needs of the growing population more educational institutions, food materials, hospitals, roads and other amenities of life are to be provided.

5) **Rise in price level**: Rises in prices have considerably enhanced public expenditure in recent years. Higher prices mean higher spending on the part of the govt. on items like payment of salaries, purchase of goods and services and so on.

6) **Expansion public sector**: Counties aiming at socialistic pattern of society have to give more importance to public sector. Consequent development of public sector enhances public expenditure.

7) **Development expenditure**: for implementing developmental programs like Five Year Plans, Modern governments are incurring huge expenditure.

8) **Public debt**: Along with debt rises the problem like payment of interest and repayment of the principal amount. This results in an increase in public expenditure.

9) **Grants and loans to state governments and UTs**: It is an important feature of public expenditure of the central government of India. The government provides assistance in the forms of grants-in-aid and loans to the states and to the UTs.

10) **Poverty alleviation programs**: As poverty ratio is high, huge amount of expenditure is required for implementing alleviation programmes.

Classification of public expenditure:

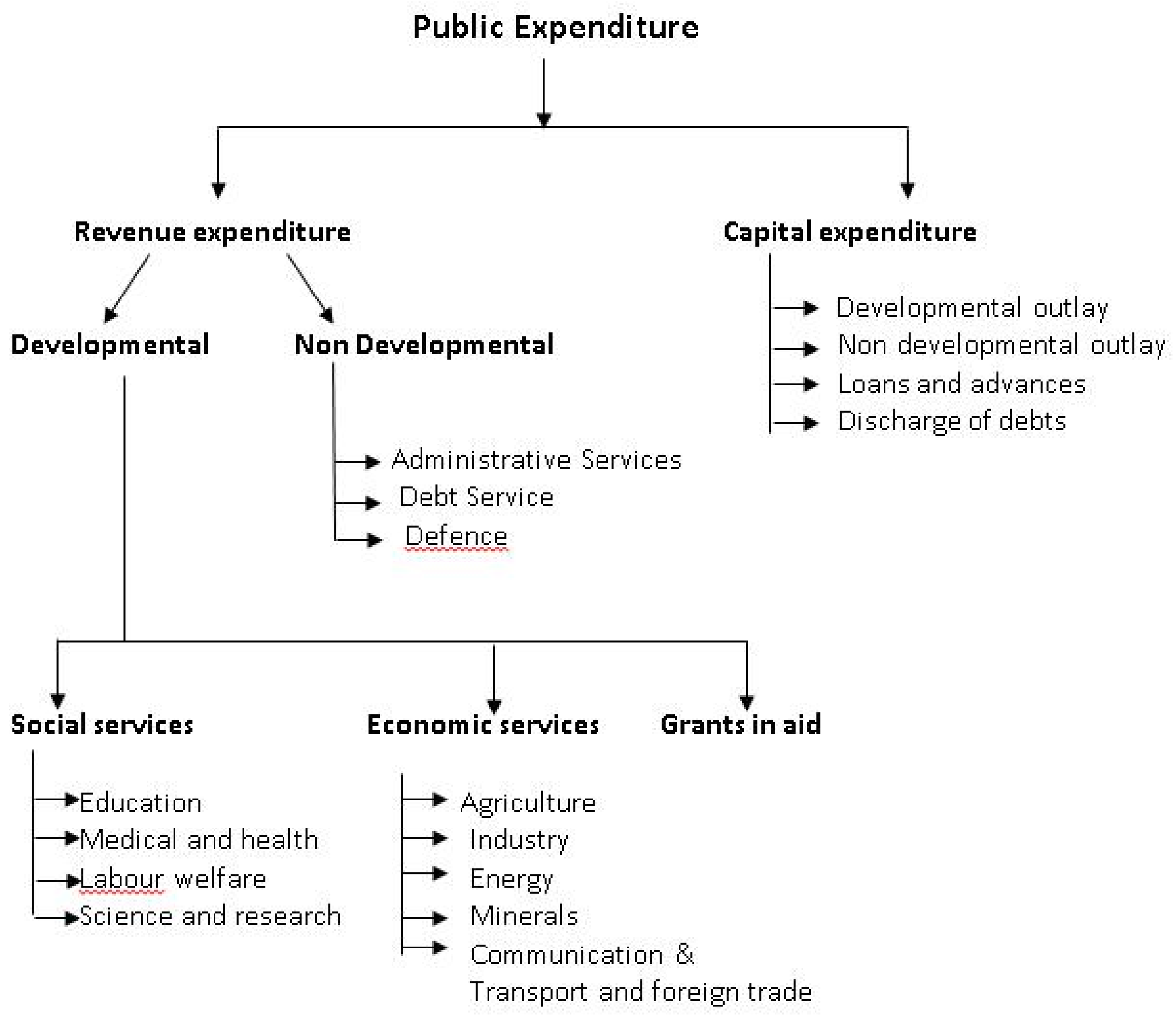
Public expenditure has been classified in to a) **Revenue expenditure** and b) **Capital expenditure.** Revenue expenditure is current expenditure. For example, it includes administrative expenditure and maintenance expenditure. This expenditure is of a recurring type. Capital expenditure is of capital nature and is incurred once for all. It is non-recurring expenditure. For example, expenditure in building, multi-purpose projects or on setting up big factories like steel plants, money spent on land, machinery and equipment.

Revenue Budget or Revenue Account is related to current financial transactions of the government which are of recurring in nature. Revenue Budget consists of the revenue receipts of the government and the expenditure is met from this revenues.Revenue Account deals with Taxes, duties, fees, fines and penalties, revenue from Government estates, receipts from Government commercial concerns and other miscellaneous items, and the expenditure therefrom.

Revenue Receipts include receipts from taxation, profits of enterprise, other non-tax receipts like administrative revenue (fees, fines, special assessment etc.), gifts grants etc. Revenue expenditure includes interest-payments, defense expenditure, major subsidies, pensions etc.

The Capital Account is related to the acquisition and disposal of capital assets. Capital budget is a statement of estimated capital receipts and payments of the government over fiscal year. It consists of capital receipts and capital expenditure. The capital account deals with expenditure usually met from borrowed funds with the object of increasing concrete assets of a material character or of reducing recurring liabilities such as construction of buildings, irrigation projects 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:



Theories of growth of public expenditure

As we know in modern times all the countries of the world have witnessed an enormous increase in public expenditure. The three important theories of the growth public expenditure are the following:

1) Adolph Wagner's hypothesis

2) Wiseman – Peacock hypothesis and

3) Colin Clark's Critical Limit Hypothesis.

Adolph Wagner's Hypothesis:

Adolph Wagner (1835-1917) believed that there was a cause-effect relationship between economic growth and public expenditure. His hypothesis of'Law of Increasing State Activity"lays that as a percapita income and output increase in industrialized counties, the public expenditure of those counties necessarily grows as a proportion to total economic activity. He explained that **'comprehensive comparisons of different countries and different times shows that among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments. The increase is both extensive and intensive, the central and local governments. Constantly undertake new functions, while they perform both old and new functions more effectively and completely.'**He explained the trend of public expenditure.

Conclusions:-

1) As the national income increases in amount, the percentage of outlayfor government supplied goods is greater.

2) Increased public expenditure was the natural result of economic growth and continued pressure for social progress.

Wiseman – Peacock hypothesis:

According to Wiseman and Peacock Public Expenditure does not increase in a smooth and continuous manner. The increasing public expenditure over time has occurred in a **step-like manner**. They studied the experience of the United Kingdom for a secular period (1890-1955). Instead of studying the trend of public expenditure, they studied the fluctuations in government expenditure over time. The general approach to the hypothesis refers to the three related concepts.

1) Displacement effect 2) Inspection effect and 3) concentration effect.

The movement from older level of expenditure and taxation to a new and higher level is called the displacement effect.

War and other social disturbances force the people and governments to find solutions of important problems, which had been neglected earlier. This is called the inspection effect. That is, new obligations imposed on state, in the form of increased debt interest and war pensions etc.

The concentration effect refers to the apparent tendency for the central govt. economic activities to become an increasing proportion of the total public sector economic activity when the society is experiencing economic growth.

Critical Limit Hypothesis: (Colin Clark):

The hypothesis was developed by Colin Clark immediately after the Second World War. It is concerned with the tolerance level of taxation. By maximum limit of the tolerance level is 25% of GNP. When the share of government expenditure exceeds 25% in the GNP, inflation occurs even in balanced budget.

CANONS OF PUBLIC EXPENDITURE

The canons or principles of public expenditure are the fundamental rules which govern the public expenditure policy of the governments. The method and direction in which the public expenditure utilized is of paramount importance

Professor Alfred G.Buchler made some guidelines for the utilization of expenditure by the public authorities. They are as follows: -

a) Public expenditure should promote the welfare of the society.
b) Careful judgement should be exercised by the public authority and the electorate to ensure that the advantages of the public expenditure should exceed the costs and that the fund utilized by the governments will be more conducive to social welfare than the same funds would, if privately utilized.
c) Public expenditure should be utilized in the order of priority of welfare. That is, the services which will bring about maximum welfare should be undertaken first.

Prof. Findlay Shirras has explained four canons of public expenditure. They are canon of benefit, canon of sanction, canon of economy and canon of surplus.

CANON OF BENEFIT

The ideal of this is maximum social advantage. That is, public expenditure should be planned so as to yield maximum social advantage and social welfare of the community as a whole and not of a particular group. Public expenditure must be spent in those directions which will maximise utility. It is possible only when the marginal utility from different uses is equal. The public authorities should distribute resources so as to increase production, reduce inequalities of income distribution, preserve social life of the people, and improve the quality of social life etc. **"Other things being equal, expenditure should bring with itsimportant social advantages such as increased production, the preservation whole against external attack and internal disorder and as far as possible a reduction in**

the inequalities of income. In short, public funds must be spent in those directions most conducive to the public interest. i.e., maximum utility is to be attained in public expenditure."---Findlay Shirras.

CANON OF ECONOMY

This implies that the state should be economical in spending money.It should not spend more than the necessary amount on items of expenditure. The sole aim is to avoid extravagance and corruption. Social benefit can be maximised when resources are not wasted. While incurring public expenditure social costs are to be minimised. To satisfy this canon Project Appraisal and Cost Benefit Analysis are to be adopted. **"Economy means protecting the interests of the tax payers not merely in effecting economies in expenditure, but in developing revenue."—Shirras.**

CANON OF SANCTION

According to this canon, no expenditure should be incurred without the proper approval of the sanctioning authority. It also implies that the spending authorities should spend the amount for which it has been sanctioned and to see that the sanctioned amount is properly utilized. Public accounts are to be audited at the end of financial year. This canon acts as check on arbitrary, unwise and reckless spending of public funds.

CANON OF SURPLUS

This canon believes in the avoidance of deficit in public expenditure. According to Findlay Shirras,**"Public authorities must earn their living and pay their way like ordinary citizens. Balanced budget must, as in the private expenditure; the order of the day. Annual expenditure must be balanced without the creation of fresh credits unrepresented by the new assets."** Modern governments does not consider balanced budget a virtue always. In an inflationary condition a surplus budget is desirable as it reduces purchasing power of the individuals. Similarly, in the time of depression a deficit budget is recommended in order to enhance the purchasing power of the people.The canon of surplus is not relevant in modern public finance.

OTHER CANONS OF PUBLIC EXPENDITURE

CANON OF PRODUCTIVITY

Public expenditure should promote production and increase the working efficiency of the people. Major part of public expenditure should be incurred on developmental activities. The aim of public expenditure should be maximum production, employment and income.

CANON OF ELASTICITY

There should be flexibility in government expenditure. That is, the government may be able to change its public expenditure policy with changing conditions. It means that public expenditure should increase during periods of emergency and reduce during normalcy.

CANON OF EQUALITY

This implies that public expenditure should be incurred in such a way that inequality in the distribution of income should be reduced. For achieving this canon the benefit of public expenditure should conferred more on the poorer section of the society.

CANON OF NEUTRALITY

Public expenditure should not worsen the production-distribution-exchange relationship instead of improving it. Public expenditure should result in increased production and productivity, reduced inequality of income and wealth and increased economic activity and exchange relationship.

CANON OF CERTAINTY

The public authorities should clearly know the purposes and extent of public expenditure to be incurred. This anon explains the preparation of public budgets.

EFFECTS OF PUBLIC EXPENDITURE

The traditional economists held the view that the state should least interfere in economic activities and the government is merely an agent for the people to keep political organization intact. During the time of Adam Smith the government that interfered least in the economic activities of the state was considered the bestgovernment. Till the beginning of the 20^{th} century, state performed only limited functions-the maintenance of law and order and protection of the country from the external attack. Therefore, the state had to collect only small revenue andspend little. Recently, in almost all countries of the world there has been a phenomenal increase in the magnitude and the variety of governmental activities. The acceptance the principle of welfare state, the necessity of maintaining full employment and economic development etc. the significant role of the government has been increased. All these show the need for an ever increasing public expenditure. In the following few paragraphs we can explain the important effects of public expenditure.

EFFECTS OF PUBLIC EXPENDITURE ON PRODUCTION

"Just as taxation, other things being equal, should reduce production as little as possible so the public expenditure should increase it as much as possible."---Prof.Dalton. The effects of public expenditure on production can be evaluated by examining its effects on the following.

a) Effects upon ability to work, save and invest.

b) Effects upon willingness to work, save and invest.

c) Effects upon diversion of economic resources as between different uses and localities.

Ability to work, save and invest

Public expenditure may tend to influence the ability of the people to work, save and invest. This is described as 'efficiency effect'. Public expenditure designed to increase the efficiency of the people will certainly improve their ability to work. When a person's ability to work is increased, his earnings will also increase. As a consequence his ability to save also improves. For example, expenditure on education, health services, and cheap housing facilities, subsidised food, free education means of transportation, communication etc. will increase the efficiency of the people to work. Similarly, public expenditure incurred for maintaining law and order build up the confidence in the minds of the people which will in turn encourages them to invest in production activities. Public expenditure may have adverse effects also. If public expenditure is spent on wasteful social functions or on the production of intoxicants and drugs which are detrimental to health, the ability to work, save and invest of the people may adversely be affected. Hence, public expenditure should be incurred in such a way that it is most beneficial to entire society

B) WILLINGNESS TO WORK SAVE AND INVEST

Public expenditure may tend to affect the willingness of the people to work, save and invest which is described as 'incentive effect'.As far as the will to, save and invest is concerned, it depends to great extent on the character of public expenditure and public policy of the governments. For example, old age pension, provident fund benefit, insurance against sickness and unemployment allowances etc., have an adverse effect on the willingness of the people to work, save and invest. This is because people will have a feeling that the governments will look after them, when they are unable to earn an income. Therefore, public expenditure should be incurred in such a way that it may not adversely affect the incentive to work of the people. If, however, the benefit increases with the increase in work and the volume of savings, the willingness to work, save and invest will increase and vice-versa. Similarly, the willingness to work can be increased by making the benefits conditional, i.e., the people may be required to contribute something in order to avail the benefits of social security measures. In brief, public expenditure should be incurred systematically and in a planned manner in order to provide social security measures to the maximum extent. Public expenditure should also provide opportunities under which savings and investments are properly rewarded and do not enlarge inequalities.

DIVERSION OF RESOURCES BETWEEN DIFFERENT USES AND AREAS

Public expenditure can significantly influence the level and pattern of production through the diversion of economic resources between different uses and areas. Therefore, the government has to incur public expenditure in those areas and regions which would secure maximum national production and maximum social advantage.

For example, the public expenditure on projects like roads, railways, irrigation energy etc. helps in accelerating the tempo of economic development. Creation of such essential projects through diversion of economic resources from private use to public use is very essential in developing countries. Similarly, concessions and subsidies by governmentsmay help many industries and agricultural activities. According to Dalton the role of public expenditure in the diversion of economic resources from private use to government use and as among different regions is important only when the area of economic activities of the government is limited i.e. in a capitalistic economy.

The forms of public expenditure which increase the productive power and are socially very much desirable for the transfer of resources are generally of the following nature. a) Debt redemption b) Developmental projects like irrigation, power and transport, roads, railways etc. c) Promotion of education, research, inventions training etc. d) Provision of public health and e) Social security etc.

Public expenditure also results in the diversion of resources among different regions. This will reduce the regional inequality- one of the important objectives of Indian economic panning. In order to bring about regional balanced growth the government has to provide special expenditure programmes to economically backward regions. Such diversion of resources among regions is made possible by setting up a federal system of government. Grants-in-aid from Central government to state governments and from state governments to local governments are examples of diversion of resources.

In short, the public expenditure does have many favourable effects on production. To conclude the effect of public expenditure on production we can quote Dalton once again.**“Whereas taxation, taken alone, may check production, public expenditure, taken alone, should almost certainly increase it.**

EFFECTS OF PUBLIC EXPENDITURE ON DISTRIBUTION

One of the important modern state policies, especially in developing countries and socialistic countries, is reduction of inequalities in the distribution of income and wealth. Public expenditure plays vital role in realising this objective. According to Dalton, **"The system of public expenditure is the best, which has the strongest tendency to reduce inequality of income."** Public expenditure which is in the form of money grants, supply of social goods and services, social security measures, subsidies etc. certainly affects the distribution of income in a country in socially desirable way. Expenditures carried out for benefiting the poor people such as those on social services like free medical treatment, free education, unemployment benefit etc. will enhance the benefit of the poor section than the rich. This will help in reducing the gulf between the rich and the poor in the distribution of income and wealth, thus bringing about justice in the economy.

PUBLIC EXPENDITURE AND STABILITY

Economic stability refers to a fairly stable level of national income, employment, prices, savings and investments in the economy. The economy may face cyclical fluctuations on account of imperfections in the market (Depression and Inflation). Public expenditure can be used to check the fluctuations. According to Lord J.M.Keynes economic instability implies departure from full employment at stable price level. It is the deficiency of the effective demand caused by a low marginal propensity to consume coupled with low marginal efficiency of investment in developed countries. (**"The General Theory of Employment, Interest and Money-1936"**)

During depression the effective demand falls short of what is required. Deficiency in effective demand leads tounemployment which in turn reduces consumption and finally to fall in production.In order to solve the situation public expenditure is to be enhanced to compensate the deficiency in effective demand. The increased public expenditure during the time of depression is described as **compensatory public expenditure**. In a period of depression the suitable public expenditure policy will be **Deficit Budgeting. (i.e.,** Current expenditure should be inexcess of current revenue.)

Similarly, during the time of inflation-rising prices- the public expenditure has an entirely different role to play. The government has to adopt **Surplus Budgeting** policy. That is, the government should spend less than its revenue.During inflation that part of the public expenditure which reduces the funds going to the people with higher propensity to consume is reduces. After full employment, public expenditure is likely to add to inflationary pressure, for public expenditure will further increase the purchasing power of the people without any corresponding increase in production.

MODEL QUESTIONS

1) What is the importance of public expenditure?
2) Explain developmental and non-developmental expenditure.
3) What are the canons of public expenditure?
4) Explain Wagner's hypothesis of public expenditure.
5) Explain Peacock-Wiseman hypothesis of public expenditure.
6) How does public expenditure affect the economy?
7) What are the causes for increasing public expenditure?
8) Distinguish between revenue expenditure and capital expenditure.

MODULE III

PUBLIC REVENUE

PUBLIC REVENUE ---Sources of Public Revenue-Taxes-Classification of Taxes-Canons of Taxation-Principles of Taxation: Ability, Benefit and Cost of Service-Impact, Incidence and Shifting of Tax Burden-Effects of Taxation-Major Taxes in India-Value Added Tax in India, The Concept of Good and Services Tax(GST)

PUBLIC REVENUE

In the last module we have seen that in recent time, public expenditure has been increased enormously. The main reason is that the functions of governments have been increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, a German economist presented his famous 'Law of Increase of State Activities.' He states that 'comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments.' This increase is both intensive and extensive.

Professor R.A Musgrave, the twentieth century economist, advocated public expenditure since a government is forced to do many activities such as 1) activities to secure a reallocation of resources 2) redistribution activities, 3) stabilizing activities and 4) commercial activities.

Governments constantly undertake new functions while they perform both old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a satisfactory fashion are satisfied by the central and local governments.

The governments need income for the performance of their variety of functions and meeting their expenditure. We can discuss in detail the meaning of public revenue—income of the governments—the sources of public revenue and related concepts in the following paragraphs.

PUBLIC REVENUE

This is one of the branches of public finance. It deals with the various sources from which the state might derive its income. These sources include incomes from taxes, commercial revenues in the form of prices of goods and services supplied by public enterprises, administrative revenues in the form of fees, fines etc. and gifts and grants.

The income of government through all sources is known as public revenue or public income. Prof. Dalton defined public revenue in two senses – Narrow sense and broader sense.

a) Narrow sense: In the narrow sense, it includes income from taxes, prices of goods and services supplied by public sector under takings, revenue from administrative activities, such as fees, finesetc. **b) Wider sense:** It includes all the incomes of the governments during a given period of time, including public borrowing from individuals and banks and income from public enterprise it is known as public receipts.

Difference between Public revenue and Public receipts

Public revenue includes that income which is not subject to repayment by the government. Public receipts include all the income of the government including public borrowing and issue of new currency. In this way public revenue is a part of public receipts.

Public Receipts = Public revenue + Public borrowing + issue of new currency

SOURCES OF PUBLIC REVENUE

The sources of public revenue can be broadly classified in to two – Tax -source and non- tax source.

Taxes: Taxes are imposed by the government on the people and it is compulsory on the part of the citizens to pay taxes, without expecting a return.

Some definitions

Economists	Definitions
Professor Seligman	Tax is compulsory contribution from a person to the government to defray the expenses incurred in the common interests of all without reference to special benefits conferred
Professor Taylor	Taxes are compulsory payments to the governments without expectation of direct return to or benefit to the tax payer
Professor Charles F. Bastable	Tax is compulsory contribution of the wealth of a person for the service of public power
Professor Taussig	The essence of a tax, as distinguished from other charges by government, is the absence of a direct quid pro quo between the tax payer and the public authority

The revenue from taxes came from three main sources. viz; a) **Taxes on income** b) **Taxes on wealth and property** and c) **Taxes on commodities.**

Characteristics of a Tax

1. It is compulsory payments to the government from the citizen. Each individual irrespective of caste, colour or creed, of age or sex has to pay it. Refusal to pay it or delay in payment brings punishment.

2. It is imposes a personal obligation. It means that it is duty of tax payer to pay it and he should in no case think to evade it.

3. Absence of direct benefit or quid pro quo between the State and people. The tax payer do get many advantages from the public authorities but no tax payer can claim direct benefit as a matter of right on the ground that he is paying a tax.

4. It is payments for meeting the expenses in the common interest of all citizens. The governments have to provide public utility goods. For this the governments have to incur huge amounts of expenditure. Therefore, taxes are imposed on all citizens so that all may share a common burden.

5. Certain taxes are imposed on specific objectives for example, tax on petrol to reduce consumption and tax on luxuries so as to divert resources for the production of essential commodities.

6. There is no tax without representation. This means that proposals regarding taxes are to be sanctioned in respective assembly of elected representatives.

Non - Tax Revenue

a) Commercial Revenue. (Income from public property and enterprises)

b) Administrative Revenue (Fee, Fine, Special assessment)

c) Gifts and grants and

d) Others

Commercial Revenue: - Income earned by public enterprises by selling their goods and services. For example, Payments for postage, tolls, interest on borrowed funds etc. They are also known as prices because they come in the form of prices and goods and services provided by government.

Administrative Revenue

The receipts of incomes accrued on account of performing administrative functions by the government are called administrative revenue. The important items of administrative revenue are listed below.

Fees:"Fee is a payment to defray the cost of each recurring service under taken by the government in the public interest" – Prof.**Seligman.** Fees are payments imposed by the government. For Example, Court Fee, License Fee, Passport, Fee etc.

Fines and Penalties – Fines penalties are imposed on persons as a punishment for infringement of laws. They are imposed to prevent crime. Fines and penalties are arbitrarily determined.

Special assessments: -According to Prof. Seligman **"A special assessment is a compulsory contribution levied in proportion to the special benefit derived to defray the cost of specific improvement to property under taken in the public interest".** For example, when the government constructs a highway, the prices of plots on either side of it will naturally go up. There for, the land owners may be required to bear a part of expenses incurred by the government. Such charges are called as special assessments.

Gifts and grants: - In general gifts and grants are the payments made by one government to another for some specific functions for example, central grant to state government. Gifts are voluntary contribution made by the people to the government for some special purposes.

Other sources of Revenue:-Other sources of revenue are Forfeitures, Escheat, Issuing of currency and Borrowings

Forfeitures:-It is penalty imposed by the court for failure of individual to appear in the court to complete certain contract as stipulated.

Escheat: - Properties having no legal heirs or without will, that go to government are called Escheats.

Issue of Currency: - The printing of paper money yields income to the government.It is mean to create extra resources by the printing of paper money. It is normally avoided because if once this method of financing is started it becomes difficult to stop it. This further leads to inflation.

Borrowings: - This is another source of public revenue. That is through borrowings from the public in the shape of deposits bonds etc. It also includes external borrowings.

Objectives of Taxes

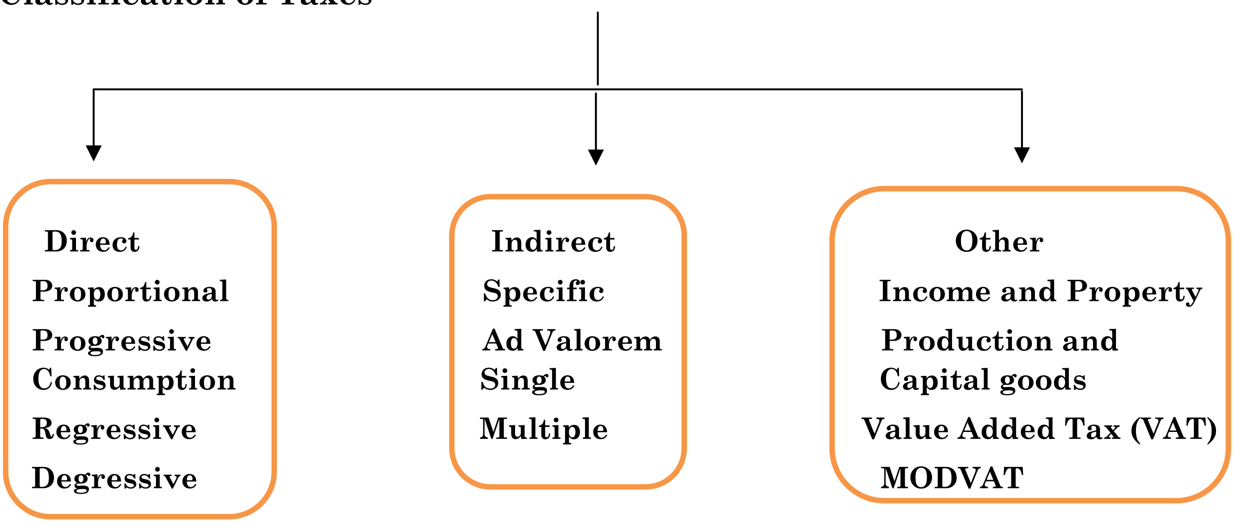
- **Raising Revenue**
- **Regulation of Consumption and Production**

- **Encouraging Domestic Industries**
- **Stimulating Investment**
- **Reducing Income Inequalities**
- **Promoting Economic Growth**
- **Development of Backward Regions**
- **Ensuring Price Stability**

Classification Taxation

Taxes are classified on different bases. Different bases adopted by the economists to classify taxes are the forms, nature, aims and methods of taxation. The various taxes may be classified under following major heads.

Classification of Taxes



Direct Taxes and Indirect Taxes

According to Dalton **' A direct Tax is really paid by a person on whom it is legally imposed, while an indirect tax is imposed on one person, but paid partially or wholly by another, owing to consequential change in the terms of some contract or bargaining between them.'**

According to J S Mill, **'A direct tax is one, demanded from the very person who is intended or desired should pay it. Indirect taxes are those which are demanded from the one person in the expectation and intention that we shall identify him at the expenses of another'.**

According to Prest, **"The distinction between direct and indirect taxes is more commonly drawn by reference to the basis of assessment rather than the point of assessment."**

Professor Antonio defines direct taxes as, **"Direct taxes strikes a citizen's income at the moment of its production."**

In the words of Gladstone, **"The direct and indirect taxes are like two attractive sisters between whom an exchequer should be perfectly impartial."**

According to P.E. Taylor, an authority on public finance, distinguished direct taxes and indirect taxes as follows," **The terms direct and indirect taxes are finally distinguishable in meaning only in terms of shiftability. Direct taxes are not shifted while indirect taxes are."**

From the above we can reach in a conclusion that direct taxes are those which are paid by persons on whom these are imposed and the real burden is also borne by them.The burden of such taxes cannot be transferred or shifted to some other persons. That is, **in the case ofdirect taxesboth impact and incidence fall upon the same person.**

Indirect taxes are imposed on one person but are paid either partly or wholly by another. The person who pays the tax in the first instance, transfers its burden on the shoulders of another person. In other words,**an in the case of indirect tax, the impact and incidence of the tax fall on different persons.**

Examples of **direct taxes are income tax, wealth tax, corporation tax, gift tax etc. And examples of Indirect taxes are Sales tax, excise duty, VAT etc.**

MERITS OF DIRECT TAXES:

Following are the main merits of direct taxes.

1) Equity: direct taxes such as income taxes, taxes on property, capital gain taxes etc. are progressive in their nature. That is, higher incomes are taxed heavily and lower incomes are taxed lightly. Hence, direct taxes are based on ability to pay of the tax payer and they ensure the canon of equity.

2) Economy: The administrative cost of collecting the direct taxes is low. The tax payers directly pay the tax to the state. So there is not much waste of resources and time. That is, direct taxes satisfy the canon of economy.

3) Certainty: Another merit of direct tax is that it is certain. The tax payers know how much tax is to be paid, on what basis tax is paid to the government etc.

Thus, the tax payer is able to make adequate provision the payment of tax in advance. The government can also plan development activities since they can estimate the amount of revenue they receives in the form of taxes.

4) Elasticity and revenue generation: the yield from direct taxes increases as the country economically advances. The government gets more revenue through direct taxes automatically at higher rates.

5) Distributive justice: Since direct taxes are progressive in rates, tax rate increases as the income of individuals rises. The tax burden will heavily be on the richer sections of the society. The increased revenue through taxes is allocated for providing subsidized food, clothing and housing to the poor and needy people. This will bring about distributive justice in the country.

6) Civic consciousness: Direct taxes create civic consciousness among the tax payers. The tax payers will be vigilant in the utilization of the tax revenue and will see whether the resources are efficiently used and wastage is avoided.

7) Absence of leakages: since there is direct payment of taxes by tax payers to the government, there is no room for any wastage. The whole amount of direct taxes such as income taxes, property taxes, and taxes on capital gains etc., reaches the treasury without any middlemen.

DEMERITS OF DIRECT TAXES

The important demerits of the direct taxes are explained below.

1) Uncertainty: The precise degree on needed progression cannot be estimated on account of the difficulties of measuring the ability to pay and the subjective nature of the marginal utility of income.

2) Unpopularity: the direct taxes are directly imposed on individuals. They have to bear both the impact and incidence of these taxes. Thus they experience their pinch directly. Consequently, direct taxes are not as popular as indirect taxes.

3) Violation of the principle of equity: the burden of direct taxes falls almost exclusively on the richer sections of the society while the poorer section are totally exempted from these taxes. This is unjustified and improper because the burden of state expenditure should be borne by individuals at all levels of society according to their ability to pay.

4) Large scale evasion: direct tax is based on honesty. The tax is not evaded only when the tax payer is honest. It is a fact that the people in the higher income groups do not reveal their full income. It is remarked that “direct taxes are a premium on honesty.”

MERITS OF INDIRECT TAXES

The following are the important merits of indirect taxes.

1) Convenience: Indirect taxes are more convenient to pay. It is paid at the time of purchase of a commodity. Hence, the tax payer does not feel the burden of tax. The tax is hidden in the price of the commodity bought. It is paid in small amount. The government can also collect it conveniently.

2) Indirect taxes lead to social welfare: indirect taxes on narcotics and intoxicants reduce the consumption of them which are harmful to health. Reduction in the consumption of such goods will indirectly increase the welfare of the people.

3) Indirect taxes are justified: indirect taxes are justifiable and equitable. They are paid by all the individuals and when they purchase goods and services.

4) Indirect taxes help production and investment: Another advantage of indirect taxes is that they perform as powerful tool in moulding the production and investment activities of the economy.

5) No evasion: Indirect taxes are generally difficult to be evaded as they are included in the price of the commodity. A person can evade an indirect tax only when he decides not to purchase the taxed commodity.

6) Highly revenue yielding in developing countries: direct taxes do not yield much income in developing countries, as the income of the people is very less. Since indirect taxes cover a large number of essential commodities to be consumed by both the rich and the poor in the country, large revenue could be collected.

DEMERITS OF INDIRECT TAXES

1) Indirect taxes promote inequality: Indirect taxes are generally imposed on the consumption goods. The poor people have to pay as much by way of indirect taxes on commodities as the rich people. This is unjust and equitable. They are regressive in nature which will promote economic inequality in society by imposing larger burden of taxes on the poor people.

2) Uneconomical: Indirect taxes involve high costs of collecting them. To raise desired levels of public revenue, taxes should be collected from millions of people.

3) Element of uncertainty: Indirect taxes are extremely uncertain. The revenue accrued to the government from indirect taxes cannot be estimated accurately. As soon as the tax is imposed, the price of the commodity is raised. This will in turn reduce the demand for the commodity. It cannot be estimated with certainty as to what extent the demand falls.

4) Lack of civic consciousness: Indirect taxes do not create civicconsciousness as the tax payers in most cases do not feel the burden of the tax they pay.
5) Indirect taxes promote inflation: another demerit of indirect taxes is that it promotes inflationary tendency in the economy, as they would increase the prices of the taxed goods.
6) Discourage saving: Indirect taxes discourage savings because they are included in the prices of commodities. Therefore, people have to spend more on the purchase of commodities. This will reduces the disposable income of the people and hence the savings.

Progressive, Proportional, Regressive and Degressive Taxes

A tax may be progressive, proportional, regressive or degressive according to the relationship between tax rate structure and tax revenue.

Progressive Tax:

A progressive tax is that in which the rate of the tax depends on change in income. That is, the rate of tax increases with the increase in the income. The higher the level of income, the higher the tax will be and vice- versa. (Table-1)

Table1. Progressive Tax Rates

Taxable income	Tax Rate%	Amount of tax
3000	10	300
4000	15	600
5000	20	1000
6000	25	1500

Proportional Taxes

A proportional tax is one in which the rate of tax remains the same irrespective of the level of income. Here, the same percentage of tax is levied on all income groups. The tax amount is simply calculated by multiplying the tax base with the tax rate. This is illustrated in Table 2.

Table 2

Proportional Tax Rates

Tax Base	Tax Rate %	Amount of tax
1000	10	100
2000	10	200
3000	10	300

Regressive Taxes

In regressive taxation,the higher the income of the tax payer, the smaller is the proportion of income he contributes to the government in the form of taxes. That is, in the regressive taxation, the tax rate declines as income increases. This type of taxation is against the objective of welfare state in modern time. (Table 3)

Table 3.Regressive Tax Rates

Tax Base in Rs.	Tax Rate %	Amount of tax in Rs.
1000	10	100
2000	8	160
3000	6	180

Degressive Taxes

Under this tax system, the tax is mildly progressive up to a certain limit. After that the tax may be charged at a flat rate. In other words, degressive tax system is a mixture of proportional as well as progressive tax system. In this, the higher income group people have to make little sacrifice in comparison with lower income group. (Table 4)

Table 4Degressive Tax Rates

Tax Base in Rs.	Tax Rate %	Amount of Tax in Rs.
1000	10	100
2000	12	240
3000	13	390
4000	13	520

SINGLE AND MULTIPLE TAXATION

Single tax refers to a system in which the taxes are levied only on one item or head of tax. It is only one kind of tax. It implies a tax on one thing. That is, one class of things or one class of people. This type of tax was advocated by economists from 17^{th} to 19^{th} century. Such a tax is collected at regular intervals, may be monthly or annually or any other shorter or longer duration. A single tax may be progressive, proportional or regressive.

First of all, thephysiocrats during the 17th and 18th century strongly advocated a single tax on land, for according to them agriculture was the only productive sector yielding surplus. Issac Sherman proposed a single tax on all real estates—on land—because it was convenient in administration and payments. Henry George also advocated a single tax on land mainly because he thought that it was not possible to shift the tax.

Merits of Single tax System

1) It is a very simple tax as it simplifies the work of the government.
2) It is less costly as lesser amount is spent to collect the revenue.
3) It is based social justice.
4) It does not discriminate against any particular work or industry.

Demerits

1) It cannot bring adequate revenue to meet the needs of the modern governments.
2) Single tax system violates the principle of ability to pay.
3) The burden of taxation is not equally distributed.
4) The tax system is not effective during the period of emergency or crisis.
5) Tax evasion is much possible.
6) It lacks elasticity.

MULTIPLE TAXATION

The multiple taxes imply that there should be all types of taxes so that every citizen can contribute to the state revenue. Similarly, modern economy has to fulfil many objectives like those of economic growth, equitable distribution of income and wealth, economic stability, full employment and so on. Since no single tax can realise all these objectives simultaneously, a multiple tax system is preferred. But at the same time, too many taxes will yield only a small amount of revenue. The cost of collection will be very high. According to Dalton, "It is better to rely on few substantial taxes for the bulk of revenue." Thus, the burden of taxation should be widely distributed. Multiple tax system is a mixture of proportional, progressive, direct and indirect taxes.

MERITS

1) It leads to equitable distribution of tax burden as it includes proportional, progressive, direct, and indirect taxes.
2) Tax evasion is very difficult under this system.
3) It is more flexible than single tax system.
4) It is based on the principle of equity.
5) It enhances the income of the governments.

DEMERITS

1) It is more complicated than single tax system.
2) Too much multiplicity leads to inconvenience to both the taxing authority and the tax payer.
3) It is not based on the principle of ability to pay.
4) It checks the productive process of the economy.

SPECIFIC AND AD VALOREM TAXES

According to the assessment, taxes on commodities can be divided in to two types—Specific tax and Ad Valorem tax.

Specific Tax

Taxes which are based on specific qualities or attributes of goods are called Specific tax. This tax is imposed on commodities according to their weights, size or volume. It is a per unit tax on commodity. For example, specific excise duty may be levied on the cloth in the length units and tax on sugar is based according to the units of weight.

Advantages

1) It is quite easy to calculate and administer.
2) The collection of the tax is very convenient.
3) It does not add to inflation, since it is fixed in amount.
4) It confirms to the canon of certainty.
5) It is difficult to evade as the tax is imposed on the basis of weight, size or measure.

Disadvantages

1) It is regressive in nature. It falls heavily on the cheaper varieties of products which the lower income groups consume.
2) It is less equitable as compared to the ad valorem tax.
3) They are less productive and less elastic.
4) They are also less economical during the period of inflation.

AD VALOREM TAX

When a tax is imposed on a commodity on the basis of its value, it is called ad valorem tax. This type of tax is levied after assessing the value of the taxable possession of a person. For example, several imported articles are taxed in terms of value and they have nothing to do with the weight, length, and size of the commodity.

Advantages

1) It imposes greater burden on the rich section of the society.
2) It is more equitable as it is imposed on the value of goods and thus the canon of ability to pay is fulfilled.
3) It is highly productive and elastic.
4) It is economical.

Disadvantages

1) It is quite difficult to administer as it is difficult to assess the value of commodities.
2) It increases inflationary pressures when there is rise in price level
3) There is wide scope for tax evasion as people may show smaller value of a particular commodity only for the sake of saving the tax amount.

CANONS OF TAXATION

Canons of taxation refer to the administrative aspect of the tax. They relate to the rate, amount method of levy, and collection of a tax. In other words, the qualities or attributes of a good tax are called canons of taxation. It was none other than Adam Smith who gave first a detailed and comprehensive statement of the principles of taxation. According to Findlay Shirras, “No genius, however, has succeeded in condensing the principles into such clear and simple canons as has Adam Smith.”

Adam Smith has given the following four canons of taxation.

1) Canon of Equality 2) Canon of Economy 3) Canon of Certainty and 4) Canon of Convenience. **(2 Es& 2Cs).**

CANON OF EQUALITY

Canon of equity or equality is the most important and basic Canon of taxation. It is based on the principle of social justice and ability to pay. Tax burden should be equally distributed among the tax payers according to their ability to pay. That is, the rich people should bear a heavy burden and the poor a less burden. Hence, the tax system should be progressive. According to Adam Smith, **"The subject 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."**

CANON OF ECONOMY

Canon of economy explains that taxes should be collected at minimum cost. The tax laws and procedures should be simple. The administrative machinery should not be elaborate and costly. According to Adam Smith, **"Every tax ought to be so contrived as little to take out and to keep out of the pockets of the people as possible over and above what it brings in to public treasury of the state."**

Adam Smith argued that lack of economy would result when:

1) Tax administration is costly on account of complicated taxes.
2) Taxes are unduly heavy which would discourage investment, so that the income level reduces, hence the relative tax yields.
3) Taxes are having elaborate and complicated administrative supervision and
4) Taxes are unproductive in yielding sufficient revenue.

CANON OF CERTAINTY

Taxation must have an element of certainty. That is, there must be certainty about the tax which an individual has to pay. Things like the time of payment, the manner of payment, and the quantity to be paid etc. should be plain and clear to the tax payer. It should not be arbitrary. According to Adam Smith, **"The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought to be clear and plain to the contributor and to every other person."**

CANON OF CONVENIENCE

It explains that a tax should be levied in such manneror in such a time that it is convenient for the tax payer to pay it. In the words of Adam Smith, **"Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."**

OTHER CANONS OF TAXATION

Besides the four canons put forward by Adam Smith, there are some other canons given by writers like Charles F.Bastable. They are canon of productivity, canon of elasticity or flexibility, canon of simplicity, canon of diversity, canon of co-ordination etc.

CANON OF PRODUCTIVITY

Tax should be productive of large revenue. According to this canon it is desirable to have a few taxes yielding large revenue rather than having a large number of taxes yielding small revenue.It also implies that instead of imposing large number of unproductive taxes, it is advisable to have a few productive taxes.

CANON OF ELASTICITY

It means that taxation should be flexible or elastic. That is, it should be capable of increasing or decreasing the tax revenue depending on the need of the government. In other words, the tax revenue may increase automatically whenever needed by an upward revision of tax rates or by extension of its coverage.

CANON OF DIVERSITY

This implies that there should be a number of different taxes in the country. This will make every citizen of a country to pay something to the national exchequer. As the number of taxes increases it will increase the administrative costs, reducing the revenue. Hence, too many taxes are to be avoided.

CANON OF SIMPLICITY

This canon implies that the tax should be simple to understand even to a layman. It should be free from all ambiguities and provisions to avoid differences in interpretation and legal disputes.

CANON OF CO-ORDINATION

There should be co-ordination among different layers of governments in imposing taxes. Especially, in a federal country like India there should be co-ordination among the central, state and local governments regarding taxes, since each of these is having legal right to impose taxes.

PRINCIPLES OF TAXATION

The criteria used for constructing a good tax structure are called principles of taxation. The principles of taxation relate to the distribution of taxation or allocation of tax burden to different categories of tax payers. Some important principles are explained below.

Principle of equity:

This principle implies the fairness or justice in the distribution of burden of taxation. In other words, equity in taxation means all tax payers should bear an equal sacrifice in the payment of taxes. There are two types of equity---Horizontal equity and Vertical equity.

Horizontal equity: It implies the treatment of like people in a like manner. That is, persons who are equally well-off should be treated equally. To secure horizontal equity, persons with same income should pay equal amount of taxes.

Vertical equity: This implies that unlike people should be treated in an unlike manner. That is, the persons who are well-off should pay higher taxes than the worse-off people. The theory is very difficult to practise, though it looks to be pretty.

To establish both horizontal equity and vertical equity there are some other principles of taxation. They are the benefit principle, the ability to pay principle and the cost of service principle.

THE BENEFIT OR QUID PRO QUO PRINCIPLE

This principle explains that tax should be paid in accordance with benefits each would receive from expenditure programmes to be financed by tax revenues by the governments. According to this principle people receiving equal benefits should pay equal amounts of taxes and those who receive greater benefits should pay higher taxes.

Merits of Benefit Approach:

1) Justification for taxes- taxes are imposed only when benefits are conferred on tax payers out of the tax revenue.
2) Equity principle satisfied- It is equitable that individuals receiving benefits from the state expenditure should contribute in proportion with the benefits enjoyed by them.
3) No discouragement to work and invest-As taxes are imposed on the basis of benefits, they do not discourage the willingness to work and invest.
4) Basis for allocation of taxes- Taxes are allocated to the extent of benefits received.
5) It combines both the income and expenditure sides of the budget process.

Demerits:

1) Injustice to poor: since modern governments are aiming at welfare states, more benefits will be provided for the poorer people. When taxes are imposed on the basis of benefits, tax burden will heavily be upon the poor. J.S.Mill rejected the theory as it is regressive in nature.
2) Non –applicability of market principle: The market principle of demand and supply is not applicable to social goods like education, defence, public health etc. They are supplied equally by governments for collective consumption. Now that, nobody will reveal their preferences, it is difficult to estimate the benefits.
3) Satisfaction of merit wants: The benefit principle of taxation is not applicable to merit wants since they result in interference in consumers' sovereignty.
4) Benefits are community based or group based: Benefits from social goods are enjoyed by community than by individuals. So beneficiaries cannot be individually identified.
5) Certain benefits are immeasurable: Some benefits of public expenditure cannot be quantified. For example, benefits from public parks, recreation, museums, research centres etc.
6) Violation of tax definition: The very definition of tax is violated as per the benefit principle. Tax is defined as a compulsory contribution without direct benefits.

ABILITY TO PAY PRINCIPLE OR SACRIFICE THEORY

This theory states that those people who possess income or wealth should contribute to the state in proportion to their ability to pay. According to J.S Mill, "Equality in taxation means equality in sacrifice." According to Dalton, "The burden of taxation should be so distributed that the direct real burden on all tax payers is equal." Professor Seligman quoted that "The basic point of the ability to pay principle is that the burden of taxation should be shared amongst the members of the society so as to conform to the principle of justice and equity…….and this equity criterion will be satisfied if the tax burden is determined according to the relative ability of the tax payers." In short, the ability to pay theory explains the fairness or justice in the distribution of tax burden.

IMPLICATIONS OF THE THEORY

1) Tax is a compulsory contribution.
2) Public expenditure and public revenue are two distinct entities. Public expenditure is provided for the common goods and the public revenue is raised through taxation from the individuals according to their ability.

3) Taxes should be imposed by the state in an equitable or just manner.
4) Taxes should be imposed to minimize the total sacrifice involved.
5) It emphasises welfare aspect not only of tax shares but also of expenditure.

Limitations of Ability to Pay Theory

1) Income is main determinant of ability.
2) The theory is based on some unrealistic assumptions like utility is quantifiable and interpersonal comparison of utility is possible.
3) Marginal utility of income is known and declines as income increases.
4) The theory is a vague theory. It does not have a comprehensive definition. The theory has three interpretations of equal sacrifice. One does not know which of the three equity rule is to be followed.

INDICES OF ABILITY TO PAY

To measure ability to pay, two important approaches are used by economists: (i) the subjective (equal sacrifice) approach and (ii) the objective (faculty) approach.

The Subjective Approach

This approach is based on the psychological or mental reactions of the tax payers. Each tax payer should make equal sacrifice, if tax burden is equally distributed. The equal sacrifice interpretation of ability to pay was originally put forward by J.S.Mill. According to him “Equality in taxation means equality in sacrifice.” There are three concepts of equal sacrifice principle. They are (i) Equal Absolute Sacrifice (ii) Equal Proportionate Sacrifice and (iii) Equal Marginal Sacrifice.

Equal Absolute Sacrifice:

As per this principle, loss of utility should be equal to all tax payers. It means that rich people should pay higher taxes than the poor.

Equal Proportionate Sacrifice:

This implies that the loss of utility should be proportional to the total income of the tax payers. That is, higher income people should be taxed at a higher level than that of the poor. For each individual the ratio of utility lost to total utility should be equal.

Rate of tax= Sacrifice of A/Income of A =sacrifice of B/Income of B

Equal Marginal Sacrifice:

This is otherwise known as least aggregate sacrifice. According to this principle, total sacrifice made by all the tax payers should be the lowest.

All the three principles can mathematically be expressed as follows.

Equal Absolute Sacrifice:

$[U(Y)-U(Y-T)]_A = [U(Y)-U(Y-T)]_B$

Equal Proportionate Sacrifice:

$[U(Y)-U(Y-T)/U(Y)]_A = [U(Y)-U(Y-T)/U(Y)]_B$

Equal Marginal Sacrifice:

$[dU(Y-T)/d(Y-T)]_A = [dU(Y-T)/d(Y-T)]_B$

OBJECTIVE APPROACH

This approach explains three criteria to measure ability to pay viz., income, property and consumption.

INCOME: Income is considered to be the best index of ability to pay. Income from all sources- property, investment in shares etc. - in a given period is to be calculated.

PROPERTY: Formerly property or wealth was considered as the index of ability to pay. This was due to the fact that the standard of living of the people was not only influenced by income but also by the accumulated property and wealth. However, this criterion suffers from many limitations and conceptual difficulties. For example, properties of the same size and description may not yield same income.

CONSUMPTION: Many economists have suggested consumption expenditure as the basis of ability to pay. According to Professor Kaldor, "Consumption rather than income should be the basis of taxation." The major difficulty of this measure is that person with large dependents have to spend more and hence to pay larger taxes. This is against the equity principle of taxation.

THE COST OF SERVICE THEORY

According to this theory each tax payer should pay tax equal to the cost rendered by the government to provide a service. For example, if an individual received 0.3% of total services, he has to pay 0.3% of total cost involved in providing such services. If the cost is higher, the tax will also be higher. Taxes are like prices paid for services rendered to each person by the governments according to the cost incurred.

Limitations

1) It is difficult to estimate the cost of all services. For example, defence.
2) It is against the welfare object of the governments. If cost is taken the basis of tax, the governments may not perform many functions which are very much desirable for the welfare of the society as a whole. E.g. Relief works during time of emergency, free medical and educational facilities etc.
3) It is against the very definition of tax. Tax is a compulsory contribution and there is no direct quid-pro-quo.
4) The cost of services rendered by governments to individuals is fixed arbitrarily which is not just.

IMPACT, INCIDENCE, AND SHIFTING OF TAXATION

In modern time there is large number of taxes. In order to understand the various social and economic effects of taxes it is very essential to discuss terms like impact, incidence and shifting.

When government imposes taxes, the amount should be paid by someone. In all the cases the tax burden should not be borne by the same persons on whom the taxes are imposed. To understand this in a better way we have to know two things—a) who pays the tax initially and b) who actually bears the tax burden. In short, a tax may be imposed on one person; the burden of the same may be transferred to a second person or transferred to others who ultimately bear the burden. This is explained in the theory of incidence. In order to understand the theory of incidence, it is very much essential to distinguish between impact, shifting and incidence.

IMPACT

According to Professor Seligman, "Impact is the initial phenomenon, shifting is the intermediate process and incidence is the result." Impact is otherwise called statutory tax incidence. It implies the burden of a tax borne by the person on whom it is imposed. (De jure tax payer- De Viti). In other words, impact refers to the immediate burden of a tax or the person who first bears the legal obligation of a tax.

SHIFTING

The process of transferring the burden of a tax from one person to another is called shifting. The producer may shift the tax burden to the wholesaler, the wholesaler to the retailers, and the retailers to the consumers etc. This is done through the changes in prices. This is a case of forward shifting. Forward shifting may be multi point or single point. The case explained above is an example of multi point shifting. When the tax burden is shifted by a producer to consumers directly it is a case of single point shifting. Shifting may also be backward. Backward shifting refers to shifting of tax burden to sellers by buyers. **Tax capitalization** is a particular case of backward shifting.

INCIDENCE

The final or ultimate money burden of a tax is called incidence. It is the money burden of a tax which is borne by the last person. That is, the incidence of a tax is the final resting place of it (De Facto tax payer- Di viti).

DISTINCTION BETWEEN IMPACT AND INCIDENCE

1) Impact refers to the initial burden of the tax, while the incidence is the ultimate burden of the tax.

2) Impact is at the point of imposition, while incidence is at the point of settlement.

3) The impact of a tax falls upon the person from whom the tax is collected and the incidence rests on the person who pays it eventually.

4) The impact may be shifted but the incidence cannot be shifted.

Effects and Incidence of Taxation

In economic analysis, incidence and effects are used to denote different connotations. As we have already discussed, incidence is the final money burden of a tax whereas effects of tax refer to the economic consequences of a tax on production, consumption, distribution, and exchange. The study of effects is broader than the study of incidence as taxes affect production, consumption, savings, investments, growth, regional balance, distribution of income and wealth and so on.

CONCEPTS OF TAX INCIDENCE

There are different concepts of tax incidence. The three important views on the concept of tax incidence are the following.

1) Dalton's Concept (Traditional Concept)

2) Mrs. Hicks' Concepts of Formal and Effective Incidence and

3) Musgrave's Concept of Incidence.

Dalton's Concept of Incidence

Prof. Hugh Dalton has distinguished between the direct and indirect burden as well as the money burden and real burden of the tax. According to him, "The incidence of a tax is upon those who bear the direct money burden of the tax." The total direct money burden of a tax is the total tax revenue. The total direct real burden of tax refers to the loss of economic welfare due to payment of tax. The indirect real burden is the reduction of consumption or a fall in savings. The direct real burden and indirect real burden together constitute the effects of taxation.

Hence, the incidence of taxation is the direct money burden of a tax. That is, the actual initial payments of tax which may either fall upon a person on whom it is initially imposed or if shifting is possible, upon some other persons by whom the tax money is finally paid.

Mrs. Hicks' Concept of Incidence

Mrs. Ursula Hicks has classified incidence of taxation in to—Formal incidence and Effective incidence. Formal incidence means the direct money burden of a tax. According to Mrs. Hicks the formal incidence is "the proportion of people's income which is collected by the persons who provide them with goods and services, but paid over to governing bodies to finance collective satisfactions."

Effective incidence refers to the difference between economic order relating to income distribution, consumption pattern, and allocation of resources before taxation and after taxation. Mrs. Hicks says," In order to discover the full economic consequences of a tax, we have to draw and compare two pictures- one of the economic set up(distribution of consumers' wants and incomes, and allocation of factors) as it is with the tax in question; the other of a similar economic set up, but without the tax. It is convenient to call for differences between these two pictures the effective incidence of the two." In short, the effective incidence is nothing but the economic effects of the tax.

Musgrave's Concept of Incidence

According to Musgrave "A change in the distribution of income available for private use which arises as a result of changes in budget policy is called incidence." That is, the distributional change caused by changes in budgetary policies that involve resource transfer is incidence. The budgetary policy may either be tax policy or expenditure policy bringing about distributional changes. According to him there are five forms of incidence viz., (i) Specific tax incidence (ii) Differential tax incidence (iii) Specific expenditure incidence

(iv)Differential expenditure incidence and (v) Balanced budget incidence.

Specific tax incidence:

The distributional change in income brought about by a change in tax policy, when there is no change in expenditure policy is called specific tax incidence.

Differential tax incidence:

Here also expenditure policy is kept unchanged. One tax is substituted for another, money income (yield) is the same, the resulting distributional change is called differential tax incidence. Musgrave says, “Thedifference in the distributional results of two tax policies that provided for equal yield in real terms” is called differential tax incidence.

Specific expenditure incidence:

The distributional effects as a result of a change in public expenditure, the tax policy remaining the same, are called specific expenditure incidence. The specific expenditure incidence is associated with the effects of inflation and deflation.

Differential expenditure incidence:

Differential expenditure incidence refers to the resultant change in the distribution of income when public expenditure policy is changed under conditions of balanced budget so as to avoid inflation and deflation. When the budget is balanced, an increase in public expenditure in one direction is compensated by a decrease in public expenditure in another direction.

Balanced budget incidence:

The resulting change in distribution when tax-expenditure policy is changed under conditions of balanced budget is referred to as balanced budget Incidence. For example, if the government wants to increase its expenditure, its tax function should be changed to obtain additional revenue. This will bring about changes in distribution.

THEORIES OF TAX SHIFTING AND INCIDENCE

There are different theories to explain the shifting and incidence of taxation. They are classified into three categories viz. (i) The concentration theory (ii) The diffusion theory, and (iii) The modern theory.

The concentration theory:

This theory was developed by the Physiocrats in the 18th century. They believed that all taxes ultimately concentrate on a particular kind of people. They regarded agriculture as the only productive activity which alone yielded a surplus. They advocated a single tax on the net income of land. According to them diversity of taxes should be avoided. The major criticism against the theory is that all activities are productive and a single tax on land is not suitable for modern welfare states. Similarly the burden should not be concentrated on a single section of the society but instead there should be equal distribution of tax burden on the entire society. The major advantage of the theory is that it stresses that all taxes are paid out of surplus. If there is no surplus the burden of the tax is shifted to others.

The diffusion theory:

The diffusion theory explains that a tax is shifted and re-shifted till its burden eventually gets scattered throughout the entire society in such a way that each individual tax payer bears only a small portion of the tax –a portion which ought to bear and is capable of bearing it. This theory was explained by some French writers like Mansfield and Canard. According to Mansfield, “Tax is like a stone falling into a lake and making a circle till one circle produces and gives motion to another and the whole circumference is agitated from the centre.”

When a tax is imposed it gets diffused so that no one escapes from its burden. The diffusion occurs through the process of shifting. Equilibrium is reached when the tax burden is equally distributed among all the tax payers. N.F. Canard compared the imposition of tax to extracting blood from one of the veins of a human being; although it is taken from a single vein, the loss is spread over the whole body and the body remains in equilibrium. Canard believed that old taxes are preferable to new taxes, as new taxes would upset equilibrium till it got diffused. He quoted that, “Every tax is good, every new tax is bad.”

Limitations of the Diffusion theory

(1) The burden of all taxes does not get diffused. If it is the case, it is not needed to distinguish between direct taxes and indirect taxes.

(2) The theory is based on perfect competition. It is unrealistic.

(3) The principle of equity is neglected in the theory.

THE MODERN THEORY OF INCIDENCE (Demand & Supply Theory)

The modern theory of tax incidence was developed byProfessor Dalton and was supported by modern economists like Seligman and Edgeworth. The theory possesses all the virtues of the earlier theories. It states that tax should be imposed on surplus. It also believes that tax is a part of cost of production and therefore, it enters into price. Shifting of tax burden is thus done through price changes. If there is no price transaction, shifting of tax burden is impossible. So shifting is common in commodity taxation. In short, shifting and incidence depend on pricing. Pricing in turn depends on the interaction of the market forces of demand and supply.The factors influencing the demand and supply are therefore having paramount importance in understanding the nature of tax shifting and as well as to determine the incidence of a tax. The most important factors which affect demand and supply are the elasticity of demand, the elasticity of supply, the laws of returns, and market structure- perfect competition, monopoly, monopolistic competition, and oligopoly.

Elasticity of Demand and Elasticity of Supply

According to Prof.Dalton, "Incidence of a tax is divided between buyers and sellers in the ratio of the elasticity of supply to elasticity of demand." That is, Es/Ed where Es=elasticity of supply and Ed= elasticity of demand. The important propositions of the modern theory of incidence may be summarized as follows:

1) When Ed=∞ or Es=0, the whole incidence is on the sellers. (figure i&ii)
2) When Es=∞ or Ed=0, the whole incidence is on the buyers. (figure iii &iv)
3) When Ed=Es, the burden is equally divided between the buyers and sellers. (figure v)
4) When Es> Ed, more incidence is on the buyers (figure vi) and
5) When Ed>Es, more incidence is on the sellers (figure vii).

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

Figure (i)

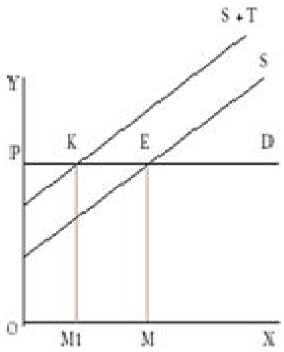


Figure (ii)

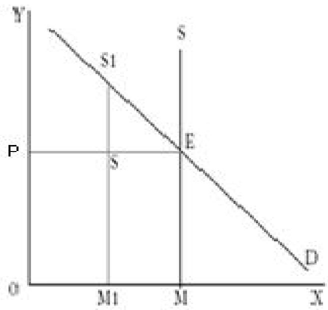


Figure (iii)

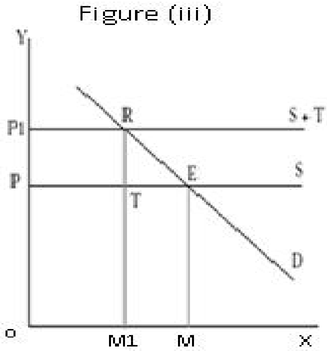


Figure (iv)

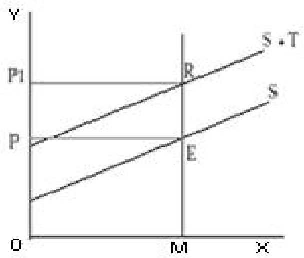


figure (v)

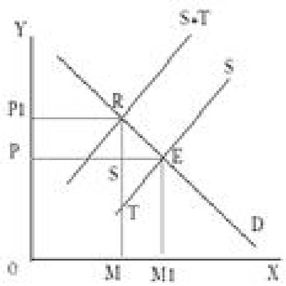


Figure (vi)

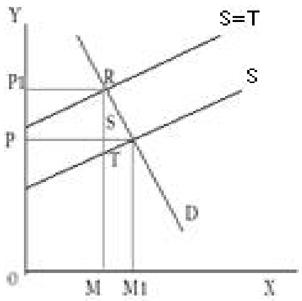
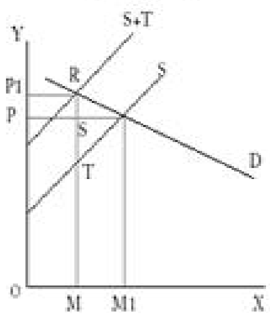


Figure (vii)



Cost Conditions (Laws of Returns) and Tax Shifting

Different cost conditions will divide tax incidence between buyers and sellers differently.

a) Increasing cost (Diminishing returns)

   This is a case where per unit cost rises as more output is produced. That is, supply can be increased only at a higher per unit cost. Here, incidence is partly on the seller and partly on the buyer. If demand is less elastic, incidence will be more on the buyer. Similarly, when demand is more elastic, larger incidence is on the seller.

b) Constant Cost (Constant Returns)

   Under constant cost conditions, since per unit cost remains the same even if the supply is reduced, the seller will shift the entire incidence to the buyers.

c) Decreasing Cost (Increasing Returns)

   Under decreasing cost conditions, per unit cost falls as more output is produced. The price will increase more than the amount of the tax.

Incidence of tax under various market conditions

Perfect Competition

Shifting of tax incidence under perfect competition depends upon the time element, whether it is market period, short period or long period. During very short period or market period, shifting of the tax depends upon the durability of the good. If the good is perishable, the seller will bear the incidence because if he increases the price, his stock will remain unsold and will be damaged. But if the good is durable, tax is shifted. The extent of shifting will be determined by the elasticity of demand.

The tax is shifted partly to the buyer and partly to the seller in the short period. If the demand is relatively elastic, the larger incidence will be on the seller; if it is relatively inelastic the larger incidence will be on the buyer. In the long run, all costs are included in the price. A tax on a good is treated as cost of production and recovered from the buyer. Thus, in the long period, the tax is treated as cost of production and the whole tax is shifted to the buyers.

Monopoly Market and Tax Shifting

Monopoly is a market situation where a single seller is controlling the entire supply of a commodity which has no close substitutes. The seller is a price maker and he maximises profit where MC=MR. A tax increases the cost of production. Monopoly taxes are of two types-lumpsum tax and ad valorem or specific. In the former case, the monopolist would bear the whole incidence and in the latter case, the monopolist will shift the tax burden partly to the buyer depending on the elasticity of demand for the good.

Monopolistic Competition and Tax Shifting

In monopolistic competition, there are many competing firms but with product differentiation. Each firm has its own demand curve, elasticity of which depends upon the extent of product differentiation. If the product is highly differentiated, the demand curve is less elastic; the firm can easily shift a large part of the tax to the buyers through an increased price. If product differentiation is not much, the demand curve will be highly elastic and therefore the larger incidence will be on the sellers.

Factors Influencing the Process of Shifting of a Tax

It has already been discussed that the elasticity of demand and the elasticity of supply are the two important factors determining the shifting of tax burden. Besides these two factors, the following factors also influence the shifting of a tax:

1) Form of quoting the price
2) Rate of tax and Type of the market
3) Availability of substitutes
4) Geographical coverage
5) Time allowed for tax shifting
6) General economic conditions
7) Familiarity of consumers with a particular set of prices
8) Public policy etc.

TAXABLE CAPACITY

In recent time, public expenditure has been increased enormously. The main reason is that the functions of governments have been increased manifold. The modern states are no more police states but welfare states.For meeting this huge amount of revenue is needed. Taxation is the major source of revenue. Taxation, however, reduces the purchasing power of the people and adversely affects their ability and willingness to work, save and invest. So the capacity of the people to pay taxes should be taken in to account while increasing the tax rates or imposing new taxes. Taxable capacity has been defined differently by different writers. We can see some important definitions below.

AUTHOR/ AGENCY	DEFINITION
Professor Dalton	Taxable capacity is a common phrase but a dim and confused concept.
Joshiah Stamp	Taxable capacity is the minimum amount which the citizen can pay to the public authoritieswithout having a really unhappy and downtrodden existence and without dislocating the economic organizations too much.
Findlay Shirras	Taxable capacity is the limit of squeezability. It is the total surplus of production over the minimum consumption required to produce that level of production, the standard of living remaining unchanged.
Indian Taxation Enquiry Commission-1954	Taxable capacity of the different sections of the community may be said to refer to the degree of taxation, broadly speaking, beyond which productive efforts and efficiency as a whole begin to suffer.

Determinant of Taxable Capacity

- National income and wealth
- Size of population
- Standard of living of the people
- Nature of public expenditure
- Psychological attitude of the people
- Stage of economic growth
- Trade cycles
- Political conditions
- Tax structure
- Fiscal, monetary and income policies of the governments
- Favourable balance of trade
- Inflow of foreign capital
- Technological progress
- Modernization of production pattern etc.

SOME CONCEPTS RELATED WITH TAXATION

1. **Tax Neutrality**: Tax should be imposed in such a manner that it should not influence the market decision of either satisfaction motivated consumers or profit motivated producers.
2. **Tax Rate Structure:** it describes the relationship between the tax collected during a given accounting period and the tax base.
3. **Tax Base:** The item or economic activity on which tax is imposed. For example, income, consumption, wealth etc.
4. **Excess Burden:** Excess burden or dead weight loss refers to the reduction in economic efficiency, below the level attainable with an optimal tax with no distorting effect.
5. **Buoyancy of Tax:** Buoyancy or administrative flexibility of tax refers to the total response of tax revenue to changes in tax base.
6. **Elasticity of taxation:** Elasticity of taxation refers to the ratio of percentage change in tax yield to percentage change in coverage or rate of taxation.
7. **LafferCurve or Revenue Rate Curve**: Laffer Curve or Revenue Rate Curve refers to the curve describing the relationship between tax revenue and tax rates. It is a graphical representation of the disincentives created by tax rate. It explains the inverse relationship between tax revenue and tax rates. It has an **Inverted U-Shape.**

EFFECTS OF TAXATION

We have already understood the meaning of incidence of taxation. It refers to the direct money burden of a tax. The ultimate influence of taxation on economic entities like production, consumption, distribution etc. is referred to as effects of taxation. In a wider perspective, taxation can serve as an instrument of fiscal policy in realizing socio-economic goals like price stabilization, regulation of consumption and production, checking fluctuations of booms and depression, promoting economic growth etc. However, the economic effects of taxation need not be always good, they can be bad also. Therefore, while formulating a tax policy, the government should take into consideration not only the revenue but also the economic consequences of taxation as well. According toProfessor Dalton **"The best system of taxation from the economic point of view is that which has the best or the least bad economic effects."** He discussed three types of economic effects of taxation. They are: i) The effects of taxation on production ii) Effects of taxation on distribution and iii) Other effects of taxation.

EFFECTS OF TXATION ON PRODUCTION

According to Dalton the effects of taxation on production can be in the following three ways.

a) Effects on ability to work, save and invest.

b) Effects on willingness to work, save and invest.

c) Effects on diversion of resources between industries and places.

Effects on ability to work, save and invest:

Being transfer of purchasing power from individuals to governments, taxation leads to the reduction of purchasing power of the individual tax payers. This will lead to the reduction of income, consumption, saving etc. of the people. This will adversely affect the efficiency and ability to work of the tax payers. This effect is mostly felt by the poorer sections of the society, since their propensity to consume is reduced. This will in turn lower their standard of living and as a result their efficiency and ability to work also. On the hand, the efficiency and ability to work of the richer people is not affected by taxation, as taxation will results in the reduction of their conspicuous and luxurious consumption. On this ground heavy taxation on the poorer people is objected by most of the economists.

The effect of taxation on ability to work depends on the nature tax. There are some taxes which will promote the ability and willingness to work of the people, like taxes on commodities such as tobacco, intoxicating drugs etc. Taxes will reduce the consumption of such goods, which are detrimental to health and efficiency. Saving depends on income. So when there is a fall in income as result of taxation, saving is reduced which will affect investment. The ability to work, save and invest is affected by all types of taxes. However, it should be noted that we have discussed only the effects of taxation on the ability to work, save and invest. The beneficial effects of public expenditure which is raised through taxation on the ability to work, save and invest are also to be taken into account while evaluating the effects of taxation on the same.

Effects on willingness to work, save and invest:

The effects of taxation on the willingness, save and invest is partly determined by the monetary burden of tax and partly by the psychological state of the tax payer. That is, (a) nature of taxes and (b) psychological reaction of the tax payers.

Nature of Taxes: Some taxes like tax on windfall gains, inheritance tax, tax on monopoly profit etc. will have no bad effects at all on the willingness to work, save and invest. Similarly, reasonable commodity taxes like excise duty, sales tax etc. will not affect willingness to work, save and invest adversely. Direct taxes like personal income tax will influence the willingness to work, save and invest adversely but indirect taxes being included in the prices may not have such disincentive effects.

Psychology of the Tax-payer: The immediate effect on the mind of the tax payer on the announcement of a new measure of taxation is called the psychological reaction. A.C.Pigou called this as **"announcement effect of taxation."**It implies a change in the mental state of tax payer by the imposition of a new tax or by the withdrawal of an old tax or by variations in the existing tax rates. The psychology of the tax payer depends on the elasticity of demand for income. If the demand for income is inelastic, the tax payer will work more to maintain the pre-tax level of income. The incentive to work, save and invest of such tax payers will not be adversely affected but instead be accelerated. If a person has an elastic demand, his incentive to work, save and invest may be retarded with the imposition of taxes. Similarly, if the demand is unity, the desire to work remains constant whatever the level of income.

Effects of Taxation on Diversion of resources: After the publication of 'The General Theory' by J.M.Keynes, the taxation policy has assumed great importance in influencing the economic welfare of the people. A rational allocation of resources is essential for ensuring the economic welfare of the people. There are beneficial diversions of resources as well as harmful diversion of resources through taxation.

BENEFICIAL DIVERSION

Taxation is a powerful instrument to achieve rational allocation of resources through beneficial diversion of resources from undesirable uses to the most desirable ones from the social welfare point of view. For example, tax on luxuries, liquors, tobacco etc. Similarly, tax on luxury items and comforts can divert resources from their production to the production of necessities. Another way of resource diversion is done through differential tax system.

HARMFUL DIVERSION

Taxation on necessaries or articles of mass consumption may not be socially desirable. As a result of increase in prices of such articles, the demand will be decreased which will in turn reduce the production. Similarly, taxes on industries will harm rural and backward areas. Taxes on domestic industries will bring about shifting of domestic resources to foreign countries where the burden of tax is minimal or to such industries which are exempted from taxation. In short, resources are shifted from high taxed countries to low taxed countries.

EFFECTS OF TXATION ON DISTRIBUTION

Distributive justice is one of the macroeconomic goals of the government. Distributive justice implies that growth in the economy should be shared equally by all sections of the people. It also implies that inequalities of wealth and income should be greatly reduced through a proper, equitable distribution of income produced in the country. Taxation is regarded as an important means to reduce the inequality in income and wealth distribution.

As Dalton pointed out, “Other things being equal, one tax system is preferable to another if it has a stronger tendency to check inequality.” Taxation is essential not only to collect surplus income from the rich but also to perform social welfare functions and to provide funds for uplifting the poorer sections of the community. In general all direct taxes, falling heavily on the people getting higher income and possessing large amount of wealth, do have favourable effect on equalizing income and wealth. Progressive taxes on income and wealth found to be of immense use in bringing justice in the distribution of income and wealth.

On the other hand, indirect taxes such as sales tax, excise duties etc. are imposed at higher rates, the lower and middle income groups will adversely be affected. However, even in the case of indirect taxes equality can be maintained by resorting to higher rates of taxation on luxuries and semi-luxuries.

While achieving favourable distributional effects through progressive taxation, care must be taken to ensure that the goose (rich people) that lays golden eggs (of savings and capital formation) does not die. In other words, taxes should not be severely progressive so that the savings and investment by the rich are reduced, because it is only the rich who save and invest.

EFFECTS OF TXATION ON ECONOMIC STABILITY

Economic stability refers to the control of economic fluctuations of inflation and deflation. It also implies stability in the economic activity, output, income and employment. That is, taxation can be used as anti-inflationary and anti –deflationary measure. According to A.P.Lerner, “Taxation is important only as a means of reducing the purchasing power in the hands of the people and cutting their spending.”

Anti-inflationary Role of Taxation

During an inflationary period, prices of consumer goods keep on rising on account of a rise in money income of the people. Direct taxes on income and profits can reduce a substantial part of income of the people, particularly in the higher income groups, thereby reducing their disposable income. This will result in greatly reducing consumption expenditure and hence the demand for consumer goods. This will help in reducing or curbing the inflationary pressure in the economy.

Similarly, the purchasing power of the poor people can be controlled by imposing higher indirect taxes like sales tax, excise duty etc. The impact of these types of indirect taxes will be a steady fall in the demand for consumer goods. Since the marginal propensity to consume is very high in the case of the poorer people, the effect of a tax will be reducing the demand considerably. So we can understand that taxation is a very good measure in checking inflation.

Anti-deflationary Role of Taxation

During a deflationary period the purchasing power of the people has to be enhanced. During deflation the demand for consumer goods will fall as result of deficiency of effective demand. In order to boost up the level of demand in the economy, taxes are to be reduced or avoided if possible. This will increase the disposable income of the people. This will raise the demand for goods and services which will eventually increase the prices and production will also be increased. Thus, stability in prices will be maintained in the economy.

MAJOR TAXES IN INDIA

The taxes of the government may be classified into three categories: 1) Taxes on income and expenditure 2) Taxes on properties and capital and 3) Taxes on commodities. First two types of taxes are direct taxes and the third type of taxes is indirect taxes.

INCOME TAX

Income tax has become the most important type of direct tax in India. The period of assessment of income tax is one year. Money income is taken as the basis of income tax in almost all countries of the world. In India income tax was introduced in 1860 by Sir James Wilson to meet the heavy expenses incurred during the Sepoy Mutiny of 1857. Though it was introduced to meet only the temporary needs of the government, it became a permanent feature of our tax system due to its revenue yield. In 1939, the rate structure was designed o n a slab System.

After Independence, the government appointed Income Tax Investigation Commission in 1947, to investigate all matters relating to taxation of income so as prevent its evasion and avoidance. The Commission recommended in its report in 1948 that all loop holes in income tax system was to be plugged. The Income Tax (Amendment) Act, 1953 incorporated a number of recommendations of the commission. The Income Tax Act, 1961,as amended from time to time through Annual Finance Acts, is the basis of Income Tax in India.

A notable feature of income taxation in India is that the whole proceeds of income tax do not go to the central government. According to the recommendations of various Finance Commissions, a large share of the total proceeds is distributed among state governments.

Merits of Income Tax

1) Income tax is based on the principle of ability to pay.
2) It is one of the most important instruments for reducing inequalities in the distribution of income, because it can be made easily progressive.

3) Income tax is one of the important tools for maintaining price stability.

4) It cannot be easily evaded.

5) A tax on income prevents the consumption of least useful items.

6) It conforms to the canons of productivity and elasticity.

DEMERITS

1) The main drawback of income tax is that it will tend to reduce the ability and willingness to work, save and invest.

2) Direct taxes are inconvenient because complete records and files are to be maintained up to date by each individual tax payer.

3) There is great scope for tax evasion by concealing actual income.

4) As the poor section of the community remains untouched under income tax, it fails to achieve the objective of creating civic consciousness among the people.

COPORATION TAX

A corporation tax is a tax on net income of business corporations or companies. In India, it was introduced after the First World War and since then it has become an integral part of Indian tax structure. This tax is paid by companies and is distinct from the taxes paid by shareholders on their dividends. That is, corporation tax is paid out of the taxable profits (net profit) after meeting all costs i.e., interest charges, wages and depreciation costs etc. earned by the corporation during an assessment year and the remaining is distributed among the shareholders in the form of dividends.The main feature of Corporation tax is that the entire proceeds of this form the revenue of the Union Government and no share is divided among states.

Advantages of corporation tax

1) Since the governments confer special benefits upon the companies and corporations like perpetual legal existence, limited liability and easy capital issue, they are liable to be taxed.

2) The income of the corporations constitutes an important source of accumulation of ideal income and wealth, thus it is appropriate to tax such income and wealth in order to ensure equity in the economy.

3) The undistributed income of the corporations is mainly used as reserves or for expansion of the company. All these will enhance the capital gains, which are to be taxed.

4) It is not only that the corporations have independent ability to pay, but also that their incomes are earned from supplying services. Hence, corporation incomes should be more heavily taxed than the personal incomes.

DISADVANTAGES

1) It is argued that the imposition of a corporate income tax and a personal income tax will bring about a double taxation. This is because of the fact that shareholders of corporations are also subjected to personal income tax.
2) It discourages investment in risky enterprises.
3) The burden of such a tax falls entirely upon the ordinary shareholders and not on the preference shareholders.
4) The tax does not facilitate equitable distribution of income.
5) The ultimate burden of corporation tax is to be borne by the consumers. The corporation will deem the tax as cost of production and will include this in the prices. Hence, the final burden is rested on the consumers.

EXPENDITURE TAX

Expenditure tax is a tax on expenditure. It is levied when the income is spent. In India it was first imposed in 1958 following to the recommendations of Professor. Nicholas Kaldor. He had suggested the imposition ofthis tax to prevent the possibility of tax evasion and to discourage superfluous consumption. According to Kaldor the major advantages of expenditure tax are the following

a. It is more easily definable than income tax.
b. Expenditure is better index of taxable capacity.

The expenditure tax was abolished in 1962. It was again introduced in 1964 and was abolished in 1966. In 1987, it was again introduced under the Expenditure Tax Act,1987.

Taxes on Capital Transactions and Property

The important taxes in this group are: (i) Estate duty (ii) Wealth tax (iii) Gift tax and,(iv) Capital gains tax

Estate Duty

Article 269 of the Indian constitution provides for the imposition and collection of the estate duty in respect of property other than agricultural land, by the Centre. The whole proceeds of this duty except those which are attributable to the Union

Territories are assigned to the States with in which this duty is liveable and distributed among them in accordance with the law made by the Parliament, on the recommendations of the Finance Commission.

An estate duty is levied when any movable and immovable property or interest there in passes or is deemed to pass at death of its owner. The tax is payable by legal heirs on the estate of a deceased person inherited by them. It is also known as death duty or inheritance tax or succession tax. This tax came in to force with effect from October 15,1953 and was abolished from the middle of March 1985.

Wealth Tax

Wealth tax is a tax which is levied on the net wealth of individual. It is also known as a tax on capital or property taxation. Wealth tax is different from income tax which is a tax on income and paid out of income. Wealth is a stock variable whereas income is flow variable. This tax was imposed on the recommendation of Professor NicholasKaldor in 1957. He justified the imposition of an annual tax on wealth on the ground of equity, economic effect and administrative efficiency.

Not all wealth holders where taxed. Wealth below rupees 2.5 lakh was exempted. Initially the tax rate was very high (15%). Consequently it led to wide scale evasion and avoidance. Subsequently the rate was reduced to a very moderate level ranging from 0.5 % to 2%. In 1992-93 the finance minister withdrew the wealth tax on productive assets such as guest houses, residential houses, jewellery etc. With effect from April 1993,wealth tax is chargeable in respect of the net wealth exceeding RS 15 lakh at 1% only. As a consequence of these changes, the revenue from this tax has gone down considerably. Recently the wealth tax has been recommended to be abolished.

Gift Tax

The Gift tax was also introduced in April 1958 on the recommendation of Professor Nicholas Kaldor. It covered the Gifts made by individuals, Hindu Undivided Families, companies, firms and association of persons. Initially, it was levied on the donor and not on the donee. All gifts made by a donorduring a particular year where liable for Gift tax. However, the liability of paying the tax was shifted from the donor to the done who receives the gift under the new Gift Tax Act of 1990. Thus the Gift tax was made donee-based. The reason for the major change in the taxation on the Gifts is that the mechanism of Gifts was used to split up capital and launder black money. The Gift tax was also abolished in October, 1998.

Capital Gain Tax

Capital gain implies gain arising from the sale of a capital asset.Capital gains occur if the selling price of land, buildings, capital equipment, stock exchange securities,happen to be more than the amount invested in them. One of the most important characteristics of capital gains is that it is an irregular or unusual gain, unlike a person's normal income which is regular.

Capital gains can be divided into two categories: a) Short- term capital gains and b) Long-term capital gains. Capital gains from sale of capital assets held for not more than 36 months are called Short- term capital gains. Similarly, capital gains from sale of capital assets held for more than 36 months are considered long-term capital gains.

Securities Transactions Tax(STT)

This tax was introduced in 2004-05. STT is levied on the sale and purchase of securities at the dealing/ strike price in addition to service tax and stamp duties collected for registration and transfer of securities.

Banking Cash Transaction Tax

This tax was imposed for the first time in India during 2005-06. It was on withdrawals of cash from a current account in a bank in excess of a specified amount on any single day. The objective of this tax is to track the black money transactions.

COMMODITY TAXATION IN INDIA

The Central Government of India levies two types of commodity taxes –Excise Duty and Customs Duty.

UNION EXCISE DUTY

The Constitution of India, under Articles 269 (taxes levied and collected by the Union and assigned to States) and 270 (Taxes levied and collected by the Union and distributed between Union and States), has made a provision for levying Union Excise Duties on all commodities produced anywhere in India except alcoholic liquors and opium, narcotics and narcotic drugs (these are within the jurisdiction of the State governments.) There are three types of excise duties which are imposed by the governments. They are: a) Basic Excise Duties b) Earmarked cesses and c) Additional Excise Duties

Basic Excise Duties are levied and collected by the Union Government. The proceeds are shared with the state governments under Article 272 of the Indian Constitution.

Earmarked cesses are levied under Special Act and are earmarked for special purposes. The entire proceeds of earmarked cesses are assigned to the Union Government.

Additional Duties of Excise Act, 1975 provides for the levy and collection of additional duties on sugar, tobacco, cotton fabrics, woollen fabrics and man-made fabrics. These are in addition to the basic duties. The entire proceeds of these duties, excluding those attributable to the Union Territories, are distributed among the states on the basis of recommendations of the Finance Commission. These duties are levied in lieu of sales tax.

CANONS OF EXCISE DUTIES

Indian Fiscal Commission, 1921-22 had laid down the following canons of excise duties:

1) Excise duties should ordinarily be confined to industries which are concentrated in large factories or small areas.
2) The duties are imposed for the purpose of checking the consumption of injurious articles and especially on luxuries coming under this category.
3) Otherwise they should be imposed for revenue purpose only.
4) While permissible on commodities of general consumption, they should not press too heavily on the poorer class.

ARGUMENTS IN FAVOUR OF EXCISE DUTIES

1) The burden of excise duty is not troublesome. The excise duties are paid in small instalments along with prices by the consumers at convenient times. So the burden is not felt by the consumers.
2) It helps in discriminating the rich and the poor in the society, if excise duties are levied on luxuries.
3) It checks detrimental consumption. The imposition of excise duties on injurious commodities may reduce the consumption.
4) The duties are productive and elastic.
5) The indigenous industries contribute to the public exchequer, since the excise duties are imposed on indigenous industries.

ARGUMENTS AGAINST EXCISE DUTIES

1) Equity considerations: Excise duties do not provide any exemption or deduction to individuals as in the case of other taxes. Thus, the distribution of burden of excise duties is very often, though not always, regressive in nature.

2) Distortions of Resources Allocations: There may be distortions in the allocation of resources as the excise duties tend to cause distortions in consumer preferences on account of changes in relative prices of goods and services.

3) Inflationary Potential: The excise duties have a great inflationary potential. The prices of goods will tend to rise as the burden of excise duties is shifted to the wholesalers, retailers, and ultimately to the consumers by the manufacturers. The manufacturers will include the excise duties in the cost of production and will meet this by increasing the prices for the products.

4) Conflict between Equity and Elasticity: For raising more revenue the excise duties may be elastic. In order to get more revenue by way of excise duties, the demand for the taxed commodities is relatively inelastic. Otherwise, the demand will be contracted and consequently the revenue to the governments will also decline. Generally, the demand is inelastic for such commodities which are necessaries of life and are chiefly consumed by the poorer sections of the society. Thus, the excise duties violate the principle of equity for the sake of raising revenue to the states.

5) Excess Burden: The excise duties put an excess burden on the community through a loss of consumer's satisfaction due to higher prices and reduced availability of goods coupled with misallocation of resources.

CUSTOM DUTIES

Taxes on international trade, particularly known as custom duties, are levied and collected by the Central Government and entirely owned by it as per Constitutional provision. Custom duties usually take the form of import duties and export duties. That is, custom duties are levied on goods imported to India (import duties) from foreign countries and goods exported from India (export duties) to foreign countries.

Objectives of Custom Duties

1) For raising revenue: custom duties are one of the important sources of revenue. For this aim, it is better to levy on goods which are largely imported rather than those which are produced at home.

2) For protecting domestic industries: Tariffs or duties may be imposed for protecting domestic industries. Protection is justified on the basis of infant industry argument. Infant industries may not be able to compete with well-developed industries. Therefore, it is argued that infant industries are to be protected till they become strong and can stand on their own legs.

3) For attaining equal status: to ensure an equal status to domestic industries and foreign industries, a countervailing duty is advocated. The imposition of an excise duty on the domestic goods will raise the price of domestic goods. This will be advantageous for the foreign goods and harmful for the indigenous goods. For attaining an equal status for both goods, a countervailing duty on imported goods, which is equal to the excise duty in amount, is to be imposed.

4) For achieving Price stability: price stability is obtained by imposing import and export duties. A reduction in import duties may increase imports bringing about a fall in prices. Similarly, an exemption of export duties will be enlarging exports which will in turn raise prices.

Service Tax

Taxation of services was introduced in 1994-95 initially by levying the tax on stock brokers, general insurance and telephone services. The number of services has been increased from time to time. At present there are more than 100 services liable to be taxed. In 2011-12 the service tax rate was 10% and in 2012-13 it was 12%. The Union Budget 2012-13 introduced a negative listwith effect from July 1, 2012.

VALUE ADDED TAX (VAT)

VAT is a multi-point tax levied at each stage of value addition chain with a provision to allow input tax credit on tax paid at an earlier stage. It is a general consumption tax assessed on the value added to goods. In the case of sales tax, there are problems of double taxation of commodities and multiplicity of taxes, resulting in cascading of tax burden. This results in double taxation with cascading effects. Under VAT set off is given for input tax as well as tax paid on previous purchases. Multiplicity of taxes with overlapping nature like the turn over taxes, Octroi, the CST and surcharges is another feature of the present indirect tax regime. VAT is unanimously acknowledged to be a major reform in the indirect taxation system.

VAT was first proposed by Germany but first implemented by France in 1954. The European Economic Community introduced VAT in 1967. In India 'The Indirect Taxation Enquiry Committee' (L.K.Jha Committee), 1976 suggested to adopt VAT applied to the manufacturing stage combined with a reformed system of sales taxation. In pursuance of the proposal made in the Long Term Fiscal Policy, the government introduced a modified system of value added or MODVAT in the budget for 1986-87. It came in to force with effect from March 1, 1986. The government has introduced the new Central Value Added Tax (CENVAT) scheme by replacing the MODVAT scheme, with effect from April 1, 2000.

STATE LEVEL VAT

Following the June 18, 2004 decision of the Empowered Committee (convenor: Asim Das Gupta) of state finance ministers to implement State-level VAT from April 1,2005, all 28 states and Union Territories had introduced VAT. The first state to introduce VAT was Haryana in 2003 and the last state was Utter Pradesh in 2008.

FEATURES OF VAT

- ✓ It eliminates the cascading effects of taxes.
- ✓ It promotes competitiveness of exports.
- ✓ This is tax one pays when they buy goods or services.
- ✓ The shopkeeper or service provider adds it to the cost of the goods or services.
- ✓ This is a known as a consumer tax in some countries.
- ✓ In some countries, goods are priced in the shop minus this type of tax, but when the customer comes to the checkout they will be asked for the cost price plus the consumer tax.
- ✓ The shop collects this tax on behalf of the government.
- ✓ The difference between the amount of VAT the producer, wholesaler or retailer charged the shopkeeper and the amount the shopkeeper charged the customer must be paid to the government.
- ✓ If the amount of VAT paid by the business exceeds the VAT charged by business, the government will repay the excess.
- ✓ This ensures that VAT is paid by the ultimate customer, not by the business.
- ✓ A value-added tax is an indirect national tax levied on the value added in production of a good or service.
- ✓ In many European and Latin American countries the VAT has become a major source of taxation on private citizens.
- ✓ Many economists prefer a VAT to an income tax because the incentive effects of the two taxes differ sharply.

CUATION:

- ➢ VAT is complex to administer.
- ➢ Co-operation from tax payers is essential for revenue collection.
- ➢ Sophisticated business record book keeping is a pre-requisite for the success of VAT.

- In a federal set up like India, VAT is to be modified substantially to accommodate the concerns of the states.
- Stability and continuity of the already introduced VAT regime is to be ensured with sufficient follow up mechanism.

GOODS AND SERVICES TAX (GST)

The Goods and Services Tax (GST) is an indirect tax reform measure. It is a tax on goods and services, which is leviable at each point of sale or provision of service, in which at the time of sale of goods or providing the services the seller or service provider can claim the input credit of tax which he has already paid while purchasing the goods or procuring the service. GST is similar to VAT; the only difference is that it takes into account services also. GST is a broad based and a single comprehensive tax levied on goods and services consumed in an economy.

The Finance Minister P.Chidambaram in his Budgetspeech in 2006 had said: "It is my sense that there is a large consensusthat the country should move towards a NationalLevel Goods and Service Tax (GST) that shouldbe shared between the Centre and the states. Ipropose that we set April 1, 2010 as the date ofintroducing GST. World over, Goods and Services attract the same rate of Tax. This is the foundationof GST. People must get used to the idea of a GST.We must converge progressively the service tax rate and CENVAT rate. I propose to take one stepthis year and increase the service tax rate from10 per cent to 12 per cent. Let me hasten to add that since service tax paid can be credited againstservice tax payable or excise duty payable, the ne impact will be very small."

The GST can be divided into followingsections to understand it better:

1. Charging Tax: The dealers registered under GST (Manufacturers, Wholesalers and Retailers and Service Providers) are requiredto charge GST at the specified rate of taxon goods and services that they supply tocustomers. The GST payable is included inthe price paid by the recipient of the goodsand services. The supplier must deposit this amount of GST with the Government.

2. Getting Credit of GST: If the recipient ofgoods or services is a registered dealer(Manufacturers, Wholesalers and Retailers and Service Providers), he will normally beable to claim a credit for the amount of GSThe has paid, provided he holds a proper tax invoice. This "input tax credit" is setoffagainst any GST (Out Put), which the dealercharges on goods and services, which he supplies, to his customers.

3. Ultimate Burden of Tax on Last Customer:

The net effect is that dealers charge GST but do not keep it, and pay GST but get a credit for it. This means that they act essentially as collecting agents for the

Government. The ultimate burden of the tax falls on the last and final consumer of the goods and services, as this person gets no credit for the GST paid by him to his sellers or service providers.

4. Registration: Dealers will have to register for GST. These dealers will include the suppliers, manufacturers, service providers wholesalers and retailers. If a dealer is not registered, he normally cannot charge GST and cannot claim credit for the GST he pays and further cannot issue a tax invoice.

5. Tax Period: The tax period will have to be decided by the respective law and normally it is monthly and/or quarterly. On a particular tax period, which is applicable to the dealer concerned, the dealer has to deposit the tax if his output credit is more than the input credit after considering the opening balance, if any, of the input credit.

6. Refunds: If for a tax period the input credit of a dealer is more than the output credit then he is eligible for refund subject to the provisions of law applicable in this respect. The excess may be carried forward to next period or may be refunded immediately depending upon the provision of law.

7. Exempted Goods and Services: Certain goods and services may be declared as exempted goods and services and in that case the input credit cannot be claimed on the GST paid for purchasing the raw material in this respect or GST paid on services used for providing such goods and services.

8. Zero Rated Goods and Services: Generally, export of goods and services are zero-rated and in that case the GST paid by the exporters of these goods and services is refunded. Thisis the basic difference between Zero ratedgoods and services and exempted goods and services.

9. Tax Invoice: Tax invoice is the basic and important document in the GST and a dealer registered under GST can issue a tax invoice and on the basis of this invoice the credit (Input) can be claimed. Normally a tax invoice must bear the name of supplying dealer, his tax identification nos., address and tax invoice nos. coupled with the name and address of the purchasing dealer, his tax identification nos., address and description of goods sold or service provided.

The idea of GST was first proposed in the budget speech of 2006-07 which had set out the deadline of 2010 for its introduction in the country. To implement such a tax regime a constitutional amendment would be needed as the Centre as well as States is involved in this issue. To operationalize the GST, the Constitution (115th Amendment) Bill 2011 was introduced in the Parliament. The Finance Minister has expressed the hope that the two tax reforms the GST and the Direct Tax Code (DTC) will be implemented soon.

GST paid on the procurement of goods and services can be set off against that payable on the supply of goods or services. But being the last person in the supply chain, the end consumer has to bear this tax and so, in many respects, GST is like a last-point retail tax. The proposed rate of GST in India is **16%.** The GST will subsume most indirect taxes like Value Added Tax, Service Tax, Central Excise, Entertainment Tax, Luxury Tax, Octroi, Lottery tax etc. India will have a '**dual GST'** system where states and Centre both would have powers to levy taxes on goods and services. In short, the **GST** is**:**

- ❖ An indirect tax on final consumption of goods and services.
- ❖ Levied on businesses and recovered by them on supplies.
- ❖ Collected at each stage in the commercial and production chain by producers and suppliers.
- ❖ GST is typically charged on registered businesses.
- ❖ Input GST incurred in relation to taxable output of goods and services is available as an offset.
- ❖ GST thus operates as a pure Value Added Tax (VAT).

Objectives of GST

- To lower tax rates due to broadening of the tax base and minimizing exemptions & exclusions.
- Creation of a common market across the country.
- Redistribution of the burden of taxation equitably between manufacturing and services.
- Reduction in transaction and compliance costs.
- Facilitation of business decisions on purely economic considerations.
- Enhanced efficiencies & productivity through the supply chain.

Recommendations of Thirteenth Finance Commission on GST

1) Single 12% rate on all goods and services. (5% for Central GST and 7% for State GST).
2) All indirect taxes and cess to be subsumed in GST.
3) Railways fares and freight, electricity to attract GST.
4) Only possible services by governments, service transactions between employer and employee and health and education should be exempted from GST.

5) Petrol, diesel, alcohol, tobacco may be changed to GST with additional levies by centre and states.
6) Exports to be zero rated.

MAJOR ISSUES TO BE SOLVED

- Agreement on GST rates among states and Centre.;
- Constitutional amendments empowering states to levy tax on services & empowering Centre to levy tax on sales;
- Compensation to be given by the Centre to States incurring revenue losses on implementation of GST;
- Drafting & implementation of Centre GST and State GST laws are lagging behind;
- Final approval and support of industry is a must;
- It is also a formidable challenge that we have only limited time left for GST to become a reality and
- Success of GST would depend upon implementation of IT resources in every nook and corner of the country.

MAJOR TAXES OF THE STATES IN INDIA

1) Land Revenue. 2) Agricultural Income Tax 3) State excise duties 4) Stamp Duties, Court Fee and Registration. 5) Taxes on Urban Immovable Property. 6) Taxes on Trade, Professional and Employment. 7) Motor Vehicle Taxation. 8) Entertainment Tax 9) Electricity duties. 10) Sales Tax and 11) State VAT.

MAJOR TAXES OF THE LOCAL SELF GOVERNMENTS IN INDIA

1) Taxes on Land and Buildings.
2) Octroi and terminal taxes.
3) Taxes on Animals and Boats.
4) Taxes on Vehicles.
5) Taxes on Professions, Trades and Employment.
6) Taxes on advertisement other than those published in newspapers.
7) Other miscellaneous taxes like theatre or show tax, duty on transfer of property, taxes on goods, passengers carried by roads, railways or tolls etc.

MODEL QUESTIONS

1) What are the major sources of revenue of the governments?
2) What are the qualities of a good tax system?
3) Explain the canons of taxation.
4) Distinguish between impact and incidence of taxation.
5) What are the main principles of taxation?
6) Explain the theories of incidence of taxation.
7) Distinguish between direct taxes and indirect taxes.
8) What are the major taxes of central government in India?
9) Explain the concept of equity in taxation. 10) Write short notes on:
   a) Progressive taxes and proportional taxes.
   b) Regressive taxes and degressive taxes.
   c) Tax shifting and elasticity of demand and supply.
   d) Subjective approach of ability to pay.
   e) Value Added Tax (VAT)and Goods and Services Tax (GST).

MODULE IV

PUBLIC DEBT AND BUDGET

Public Debt and Budget- Public Debt: Meaning, Types of public debts, Debt Redemption, Budget: Meaning, Types of Budget: Revenue and Capital Budget, Revenue Expenditure and Capital Expenditure, Revenue Deficit, Fiscal Deficit, Primary Deficit-Budget Deficit -Fiscal Policy-Contra Cyclical Fiscal policy-Deficit financing- Preparation of Budget in India-(Introduce the latest Central and State Budgets to the Students.)

Public Debt and Budget

Among the non-tax sources, the major source of revenue of the government is public debt. That is, borrowing. It may either be internal or external debts. When the government raises revenue by borrowing from within the country, it is called internal debt. Similarly, if the government is borrowing from the rest of the world, it is a case of external debt. According to Philip E. Taylor, **"The debt is the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on the principal. Borrowing is resorted to provide funds for financing a current deficit."**

Causes for Public Debt

Till the beginning of the 20th century, state performed onlyvery limited functions- maintenance of law and order, protection of the country from external attack etc. Therefore, the state had to collect only small revenue and little debt. Recently, in almost all countries of the world there has been a great increase in the magnitude and variety of governmental activities. The acceptance of the principle of the welfare state increases the role of state participation in economic activity. This has necessitated the need to find out additional sources of finance. Hence, modern governments have come to rely on public borrowings.

Objectives of public debt: The objectives of public debt are the following.

1)To bridge the budget deficit (Deficit Financing)

2) To fight against depression.

3) To check inflation.

4) To finance economic development.

5) To meet unforeseen contingencies.

6) An alternate source of income when taxable capacity is reached.

7) To finance wars.

8) To finance public enterprises.

9) To carry out welfare programmes.

10) To create infrastructure.

11) For creation of productive assets.

12) For creation of essential non-income yielding assets (provision of public goods) etc.

Important Sources of Public Debt

Every government has two major sources of borrowing—internal and external. Internally the government can borrow from individuals, financial institutions, commercial banks and from the central bank. Externally, the governments borrow from individuals and banks, international institutions like IMF, IBRD, ADB etc. and from foreign governments. They can be briefly summarized as follows.

1) Borrowing from individuals.
2) Borrowing from Non-Banking Financial Institutions (Insurance companies, investment trusts, mutual funds etc.)
3) Borrowing from commercial banks.
4) Borrowing from central banks.
5) Borrowing from External sources (IMF, IBRD, ADB, Foreign Governments or countries)

Classification of Public Debt

1) **Voluntary and compulsory** (On the basis of legal enhancement): Voluntary debt is the debt which is paid any legal enforcement. Whereas compulsory debt is legally forced in nature. Here people have no option but repay the debt.

2) **Funded and unfunded debt** (Provision for repayment):

   Funded debt is long term or 'definite period' debt. A proper agreement and terms and conditions of repayment with the percentage of interest payable are declared. They are used for creation of permanent assets.

Unfunded debt is for a short term and for indefinite period. It is paid through the income received from other sources. These are used for meeting current needs.

3) **Internal and external debt:** When the government raises revenue by borrowing from within the country, it is call internal debt. Whereas if the government is borrowing from the rest of the world, it is case of external debt.

4) **Productive and Unproductive**(Purpose of loans): Loans on Projects yielding income (Construction of plants, railways, power schemes etc.) are called productive debt. Loans on loan non income yielding projects are called unproductive loans (war, famine relief etc.)

5) **Redeemable and Irredeemable loans** (Promise to repay): Redeemable debts refers to the loan which the government promises to pay off at some future date. (principal plus interest) Irredeemable debts are those, principal amount of which are never returned by the government but pays interest regularly.

6) **Short / Medium/ Long term loans** (Time duration): Short term loans are usually incurred for a period varying from three months to one year. Usually governments get such loans from the central bank by using treasury bills. These loans are calls **'ways and means advances.'**

   Medium Term loans are those which are obtain for more than one year but less than ten years.

Long term loans are those which are obtain for more than ten years. These are used to finance developmental activities.

Redemption of Public Debt

Redemption of public debt means repayment of a loan and it is an important responsibility of the government. All government loans should be repaid promptly. It is, therefore, necessary that the provision of repayment should be inherent in the scheme itself.

Advantages of debt redemption

1) It saves the government from going into bankruptcy.
2) It checks extravagance on the part of the governments.
3) It preserves the confidence of the lenders.
4) It makes easy for the government to float future loans.
5) It reduces the cost of management of public debt.

6) It saves the future generations from the pressure of public debt.
7) The resources obtained after redemption of the debt would be diverted towards private investments and therefore a favorable climate for investment could be created.
8) Redemption of debt may act as a useful tool to curb deflation.

METHODS OF REPAYMENT OF DEBT

1) **Repudiation:**It means refusal to pay a debt by governments. This method was followed by the USA after the civil war and by the USSR after the 1917 Revolution. This method is undesirable and has not been used recently anywhere in the world. Repudiation shakes the confidence of the people in public debt and many provoke retaliation from creditor countries.
2) **Refunding:** Refunding is the process of replacing maturing securities with new securities. In some cases the bonds may be redeemed before the maturing date when the government intends to rearrange the maturity of outstanding debts or when current rate of interest is low. Generally, short-term borrowings are made in anticipation of tax collections for meeting current expenditure. However, excessive burden of new expenditure does not permit the retirement of the debt by means of revenue newly raised or by means of long term borrowing. Thus, there is necessity of refunding the loans by old lenders and renewing the loans at lower rate of interest for future period. The drawback of this method is that government is tempted to postpone its obligation of debt redemption. This leads to a continuous increase in the burden of public debt in future.
3) **Conversion of Loans:** It is a special type of refunding. Conversion of existing securities into new securities before maturity. It is generally resorted to reduce the burden of debt by converting high interest loans into low interest loans. According to Professor Dalton, the conversion does not reduce the burden of public debt on the state; because a reduction in interest rates reduces the ability of the creditors to pay taxes which may mean a loss of income to the governments there by reducing its capacity to repay loans.
4) **Sinking Fund:** Sinking fund is a special fund created for the repayment of public debt. There is a theoretical justification for creating this fund because it imposes a requirement on the government to pay the old debts regularly. According to this method, the government sets aside a certain amount out of the budget every year for this fund. The balances in the funds are also invested and the interest accruing on them is also credited in the fund.

    Sinking fund is of two types: (i) certain sinking fund—here, the governments credit a fixed sum of money annually. (ii)Uncertain sinking fund—

the amount is credited when government secures a surplus in the budget.The one danger of this method is that the government may not wait till the end of the period of maturity and utilize the fund for some other purpose than the one for which the fund was created originally.

The practice of sinking fund inspires confidence among the lenders and the enhancement of the creditworthiness of governments.

5) **Capital levy:** Capital levy is a special type of **"once for all"** tax on capital imposed to repay war debts. All capital goods are taxed above a minimum level of assets possessed by residents of the country. Simply, capital levy refers to a very heavy tax on property and wealth. This tax was levied immediately after the First World War. This method has been advocated by economists like David Ricardo, Pigou and Dalton.Professor Dalton has suggested that capital levy as a method of debt redemption with least real burden on the society. It is useful on account of its deflationary character.

6) **Surplus budget:** Quite often, surplus budget may be used to clear public debt. But in recent times due to the ever increasing public expenditure, surplus budget is a rare phenomenon.

7) **Buying up of Loans:** Governments redeems debt through buying up loans from the market.

BUDGET

The term budget has been derived from a French word 'bougette' which means a leather bag or purse. The term 'budget' is commonly understood as a document presented by a government containing an estimate of proposed expenditure for a given period and proposed means of financing them for the approval of legislation. As per **Article 112 of Indian Constitution** the Government has to present in the Parliament an annual financial statement showing estimates of revenue and expenditure. This is called the Annual Financial Statement or Budget. Hence, government budget is a schedule of all revenues and expenditures that the Government expects to receive and plan to spend during the following year. A Budget includes a) financial actions of the previous year b) budget and revised estimates of the current year and c) the budget estimates for the following year. For example, in the budget 2013-14 there will be the actual estimates of 2011-12, the budget estimates and revised estimates for the year 2012-13 and the budget estimates for the year 2013-14.

The budget is presented in the parliament by the Union Finance Minister. Similarly, the State Governments have also to present the budget in the State Legislatures as per **Article 202 of the Indian Constitution.**

Definitions of Budget

"It is a document containing a preliminary approved plan of public revenue and expenditure."------Prof. Rene Stourn.

"A budget is at once a report on estimates and proposals, that it is the instrument by which all the processes of financial administration are correlated and coordinated."-----Bastables.

"A budget is a pre-determined statement of management policy during a given period which provides a standard for comparison with the results actually achieved."-----Crown and Howard.

B.E Buck defines budget as, "(a) finance plan, (b) a procedure formulating, authorizing, executing and controlling this plan and (c) some government authority responsible for each successive step in this procedure."

Government Accounts

1) **Consolidated Fund**: - All sums of money, all revenues of the governments, the loans raised by it, receipts by way of repayment of

2) Loans constitute the consolidated fund. All expenditures are also incurred out of this fund. No amount can be withdrawn from this fund without the sanction of the parliament. [**Article 266 (1)]**

2) **The Contingency fund**:- The fund is placed at disposal of the President to enable the government to meet the unforeseen emergencies. Prior sanction of the parliament is not required to spend from the fund.**[Article 267]**

3)Public Account:-Certain transactions are not included in the contingency fund. They include transactions relating to provident funds, small savings collections, other deposits etc. The money thus received is kept in public account. This money does not belong to the government. It has to be paid back to the persons and authorities who have deposited it. Hence, parliamentary approval is not required for payments.**[Article 266(2)]**

Features of Budget

1) It is a statement of expected revenue and proposed expenditure.

2)It is sanctioned by some authority.

3) It is periodicity, generally annual and

4) It prescribes the manner in which revenue is collected and expenditure is incurred.

5) Budget is prepared on cash basis.

6) Rule of lapse- All unutilized funds within the year 'lapse' at the end of the financial year.

7) Realistic Estimation.

8) Budget is on Gross/ Net basis.

9) Form of Estimate is to Correspond to Accounts.

10) Estimates to be on Departmental Basis.

Objectives of a Budget

Budget is an important tool of financial administration and an effective means of enforcing fiscal policies. The main objectives of a budget are the following.

- Re-allocation of resources
- Re-distribution of resources
- Stabilization of resources
- Sources of information to the public of the past, present and future activities, plans and programmes of the relevant governments.
- Tool of government policy
- To estimate income and expenditure
- An instrument of fiscal policies
- Basis of public welfare
- To ensure financial and legal accountability
- To serve as a tool of management for controlling administrative efficiency.

Components of a Budget

The government budget is divided into Revenue Budget and Capital Budget.

Revenue Budget or Revenue Account is related to current financial transactions of the government which are of recurring in nature. Revenue Budget consists of the revenue receipts of the government and the expenditure is met from this revenues.Revenue Account deals with Taxes, duties, fees, fines and penalties, revenue from Government estates, receipts from Government commercial concerns and other miscellaneous items, and the expenditure therefrom.

Revenue Receipts include receipts from taxation, profits of enterprise, other non-tax receipts like administrative revenue (fees, fines, special assessment etc.), gifts grants etc. Revenue expenditure includes interest-payments, defense expenditure, major subsidies, pensions etc.

The Capital Account is related to the acquisition and disposal of capital assets. Capital budget is a statement of estimated capital receipts and payments of the government over fiscal year. It consists of capital receipts and capital expenditure. The capital account deals with expenditure usually met from borrowed funds with the object of increasing concrete assets of a material character or of reducing recurring liabilities such as construction of buildings, irrigation projects etc.

Capital Receipts include a) Borrowings b) Recovery of loans and advancesc) Disinvestments and d) Small savings.

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

Types of Budgets

Based on the balancing of revenue and expenditure, budgets are divided into Balanced Budget and Unbalanced Budget.

Balanced Budget: - A balanced budget is that over a period of time, revenue does not fall short of expenditure. i.e., revenue is equal to expenditure (Revenue= Expenditure).

Unbalanced Budget

The Budget imbalance may be due to an excess of expenditure over income or an excess of income over expenditure. In other words, budget may either be surplus or deficit. A budget is said to be surplus when public revenue exceeds public outlay (R>E.)

A deficit budget means a budget when expenditure exceeds revenue (R<E.)

Different Concepts of Deficits

There are different types of deficits depending on the types of receipts and expenditure. The important types of deficits are (i) Budgetary deficit (ii) Revenue deficit (iii) Fiscal deficit (iv) Primary deficit and (V) Monetized deficit.

BUDGETARY DEFICIT

The budgetary deficit shows the gap between total receipts and total expenditures of the government. The budgetary gap is financed by issuing 91-days treasury bills and running down on the government's cash balances with treasuries and Reserve Bank of India.**Budgetary deficit=Total Revenue-Total Expenditure.** This concept **has been discontinued** from 1996-97 onwards.

REVENUE DEFICIT

Revenue deficit is the excess of revenue expenditure over revenue receipts.

Revenue Deficit= Revenue Receipts-Revenue Expenditure.

EFFECTIVE REVENUE DEFICIT

It is the difference between revenue deficit and grants for the creation of capital asset. This was **first** introduced in India in theUnion Budget**2009-10**.**Effective Revenue Deficit=Revenue Deficit-Grants for creation of capital asset.**

FISCAL DEFICIT

Fiscal Deficit is the excess of total budget expenditures over the total budget revenue excluding borrowings. In other words, fiscal deficit is budgetary deficit plus borrowings and other liabilities. The gross fiscal deficit is the excess of total expenditure over revenue receipts and non-debt capital receipts.

Fiscal Deficit= Total expenditure - (revenue receipts + non-debt capital receipts).

Net Fiscal Deficit= Gross Fiscal Deficit-Net loans and advances.

The significance of fiscal deficit is that it is a measure of total borrowing requirements of the government. It shows the extent of dependence of the government on borrowings to meet its budget expenditure.

Consequences of Fiscal Deficit

a) **Accumulation of Public Debt:** It encourages non-plan, non-productive and inflationary public expenditure.

b) **Increase in the burden of interest payments:** There is enormous rise in the cost of servicing the public debt. The whole expenditure constitutes, non-plan, non- productive and non-developmental expenditure.

c) **Generation of inflationary pressure:** Accumulated fiscal deficits over years have been responsible for growing non-plan expenditure and add to inflationary pressure.

d) **Adverse effect on Developmental expenditure:** Besides the rising defense expenditure and civil expenditure on ministries and their employment, the increased interest payments due to the past borrowings is a major cause of growing non-plan, non-developmental government expenditure which takes a largesize of total expenditure, restricting the scope to raise the developmental expenditure especially on capital formation.

In short, the fiscal deficit shows how far the exchequer is running beyond its means. The larger the fiscal deficit, the larger the borrowings will be.

PRIMARY DEFICIT

Primary Deficit is the excess of fiscal deficit over interest payments.

Primary Deficit = Fiscal deficit-- Interest payments.

Primary Deficit explains how much government borrowing is going to meet expenses other than interest payments. It reveals the extent of burdens in future resulting from current government policy. It is a basic measure of fiscal irresponsibility. A low or zero primary deficits is a pointer to financial discipline of a government.

MONETIZED DEFICIT

It refers to the sum of the net increase in holdings of treasury bills of the Reserve Bank of India and its contributions to the market borrowings of the government. It creates equivalent increase in high powered money or reserve money in the economy. In other words, it denotes government borrowing from the Reserve Bank of India.

Types of Deficits	**Concept/ Meaning**
Budgetary deficit	Total Revenue-Total Expenditure
Revenue Deficit	Revenue Receipts-Revenue Expenditure
Effective Revenue Deficit	Revenue Deficit-Grants for creation of capital asset
Fiscal Deficit	Total expenditure - (revenue receipts + non-debt capital receipts
Primary Deficit	Fiscal deficit-- Interest payments
Monetized Deficit	Government borrowing from the Reserve Bank of India

FISCAL POLICY

Fiscal policy refers to the policy of the governments with relation to taxation, public expenditure and management of public debt. According to Arthur Smithies Fiscal policy is “A policy under which the government uses its expenditure and revenue programmes to produce desirable effect and avoid undesirable effect on the national income, production and employment.”

Fiscal policy is:

- Budgetary policy of the government;
- It uses public expenditure and taxation as instruments ; and
- Its objective is to influence production and employment favorably.

Definitions of Fiscal Policy

NAME /Agency	DEFINITION
American Economic Association	The policy which concerns itself with aggregate effects of government expenditure and taxation on income, production and employment.
Otto Eckstien	Changes in taxes and expenditure which aims at short run goals of full employment, price level and stability
Arthur Smithies	A policy under which the government uses its expenditure and revenue programmes to produce desirable effect and avoid undesirable effect on the national income, production and employment
Harvey and Johnson M	Changes in government expenditure and taxation designed to influence the pattern and level of activity.
UN Report on Taxes and Fiscal policy	The central task of wrestling with the pitifully low output of under developed countries, sufficient savings to finance economic development programmes and to set the stage for more vigorous public investment activity.

The significance of fiscal policy was first emphasized by **J.M. Keynes**, in mid-1930s in his **"General Theory of Employment, Interest and Money"** published in **1936**. Fiscal policy refers to the policy of government with relation to taxation, public expenditure and management of public debt. In other words fiscal policy refers to the financial activities under taken to correct either inflation or deflation. **The classical concept of fiscal policy**

The classical believed in laissez – faire policy, Say's law of market, full employment equilibrium, optimum allocation of resources etc. According to them full employment is a common phenomenon and is supposed to reach automatically. There is no necessity of any governmental interference. The concept of fiscal policy held by the classical is known as '**Principle of sound finance**' according to them "That government is the best which spends the least and imposes lowest amount of taxes." A "balanced budget"was supposed to be the orthodox ideal of the traditional public finance policy or the classical concept of fiscal policy, known as **"Sound Finance."**

Therationale behind or justification for a balanced budget was based on the following grounds.

1) A balanced budget was considered an effective check upon any extravagance of the authorities.
2) An unbalanced budget leads to inflationary or deflationary pressures.
3) Any attempt to raise taxes would be resisted by the public.
4) A balanced budget was supposed to be neutral in effect on the working of the economy. It was thought that the additional purchasing power through increased public expenditure by the government would be neutralized by the equivalent reduction in private expenditure by way of taxation.

Modern concept of fiscal policy

The modern concept of fiscal policy is called **"Functional Finance"**. This was first stated by J.M. Keynes and was developed by Abba P. Lerner. According to the policy of functional Finance "Government has to play a positive role so as to regulate and control the economy by means of taxes and expenditure". The financial activities that are under taken by the government to correct deflation or inflation refer to the functional finance. The various tools of functional finance according to Abba.P.Lerner are 1) Taxing and spending 2) Borrowing and lending and 3) Buying and selling.

Rules for Functional Finance by AP.Lerner

1) The financial responsibility of the government or state is to regulate spending in such a way that the supply of goods and services may be absorbed at the current prices.
2) The purpose of borrowing is not to raise money but to make the public hold more bonds and less money.
3) The purpose of taxation is never to raise money but to leave less money in the hands of the tax payer. Taxation is governed entirely by whether the effect on spending is desirable or not.
4) Deficit financing can be adopted when the government money outlay exceeds the current money revenue of the government especially in periods of deflation.

Objectives of fiscal policy in developed countries

- Full employment
- Price stability and
- High and stable rate of growth

Objectives of fiscal policy in less developed centuries

The following are the important objectives of fiscal policy in developing countries:

- Full employment.
- Price stability.
- Accelerated rate of economic development.
- Optimum allocation of resources.
- Equitable distribution income and wealth.
- Economics stability and
- Capital formation and growth.

Contra Cyclical Fiscal policy (Compensatory Fiscal Policy)

The policy taken by the government to check business fluctuations or trade cycles – or to curb the effects of booms and depressions are known as contra (counter) cyclical fiscal policy. A contra cyclical fiscal policy is adopted for achieving economic stability.At the time of boom or economic prosperity, inflation is resulted. Inflation is the result of the aggregate demand for goods and services being in excess of the aggregate supply. The remedial measure in this juncture is to reduce aggregate demand. For this the government has to reduce the purchasing power with the people. The government can adopt the fiscal tools in fighting against inflation and bring about economic stability.

1. Public borrowing: During the time of inflation, the government has to increase its borrowing. This will in turn reduce the purchasing power with the people. This may done in many ways like provision of higher rate of interest on savings, introducing new compulsory savings scheme, making consumers to purchase saving certificates etc.

2. Government spending: during the time of inflation the government has to adopt surplus budget by reducing its expenditure than its revenue.

3. Taxation: taxation is a very good instrument in the hands of the government to fight against inflation. The government can impose new taxes and increase the existing tax rates as well.

The policy taken by the governments during deflation will be just the reverse of what they did during inflation. That is, public borrowing by the government will be reduced, increased public expenditure so as to increase effective demand, tax concessions and reduction of tax rates etc. The objective of all these measures is to enhance purchasing power of the people which will in turn boost the economy. As a result all economic activities will gradually be accelerated and finally economic stability by all means will be regained.

J.M.Keynes has suggested compensatory fiscal policy to counter recession. During recession, private expenditure in the form of consumption and investment may decline due to the operation of some adverse factors. This decline in aggregate demand will reduce consumption, investment, employment etc. leading to down turn and recession in the economy. In this juncture, efforts by the government through additional expenditure (and reduced taxes) will fill the gap in demand, consumption and investment. The main thrust of compensatory fiscal policy thus is thatthe government should inject extra purchasing power through increased public expenditure to enhance demand in the economy. In effect, the government expenditure is able to compensate for the reduced private expenditure. This fiscal policy is called compensatory fiscal policy.

Compensatory fiscal policy has three versions: a) Built- in – flexibility

b) Formula flexibility and c) Discretionary action.

Built-in-Flexibility: It is a system having automatic adjustment of expenditure and taxes which are made in relation to cyclical upswings and downswings without any deliberate action by the governments. For example, unemployment insurance, relief payments, old age insurance, social security scheme, corporate tax, income tax, excise duty etc.

Formula flexibility: In order to avoid the ineffectiveness of other flexibilities, led to the integration of discretion and automation into a hybrid form of fiscal policy called formula flexibility. Formula flexibility is said to be a stand by authority to the government to change tax rates as soon as the fluctuations in employment and price levels are observed.

Discretionary Action: Deliberate changes in the budget by such action as changing tax rates or government expenditure or both.It has three forms-1) changing taxes with expenditure constant 2) changing expenditure with taxes constant and 3) changing both simultaneously.

Deficit financing

Mc. Graw Hill Dictionary of Modern Economics defines deficit financing **"as a practice by government of spending more than what it receives as revenue. Thus a government is said to be practicing deficit financing when it spends in excess of its current revenue".**

According to the Planning Commission of India "Deficit financing is used to denote the direct addition to Gross National Expenditure through budget deficit whether the deficit are on the revenue account or capital account. The essence of such a policy lies there for in government spending in excess of the revenue it receives in the shape of taxes, earning of state enterprises, loan from public deposits and funds and other miscellaneous sources. The government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system".

In Indian context deficit financing takes place; when a budgetary deficit financed by using any one of the following methods.

- The government may withdraw its cash balances from the central bank or
- Government may borrow fund from the central bank or
- Government may resort to printing of additional currency

Advantage of deficit financing

- Best use of resources.
- Helpful to developing countries where it is difficult to create resources through taxation.
- Additional purchasing power.
- Helpful despite inflationary nature.

Limitations

1) Rise in prices
2) Increase in money supply
3) Speculative activities
4) Adverse effect on savings.
5) Less investment.
6) Unequal distribution of income and wealth

Budgetary procedure in India

The constitution of every country lays down a budget procedure and thus the budget of every country is framed; passed and executed in accordance with that specified procedure. In almost all democratic countries including India follow the following budgetary procedures:

1. Preparation of the Budget
2. Presentation and enactment of the budget and
3. Execution of the Budget.

BUDGET PREPARATION:

The Budget Cycle normally starts towards the end of September of the current year and lasts till May of the next financial year. On the presumption that Budget shall be presented at 11:00 hours on the28th/29th of February of a year (last working Day of February), the Budget Division prepares a comprehensive Schedule for carrying out the budget preparation activities. In the year in which General Elections to the LokSabha are held, the interim Budget is presented to Parliament on any given day convenient to Government. After the General Elections are over and assumption of office by the new Government, the Regular Budget is presented to Parliament on any date convenient to Government or as decided by the new Government. The Budget Schedule is constantly reviewed by the senior officers to watch the progress since budget span leaves no scope for slippages. The Schedule clearly indicates the Division/Organization/ Ministry/Department responsible for various tasks/activities along with the timeframe there in. Budget for a year is prepared by the Budget Division in the Ministry of Finance broadly on the basis of detailed estimates of expenditure and receipts received from various Departments/Ministries of Government of India and its own subordinate estimating authorities. The General Financial Rules also prescribe the broad guidelines, procedures and forms for the preparation of budget estimates of receipts and expenditure by the Ministries. The estimates of expenditure are prepared separately for Capital and Revenue as a constitutional requirement and Plan and Non Plan inkeeping with the existing classification system. Theestimates of Plan expenditure are made on the basisof the approved plan allocations intimated by thePlanning Commission.The detailed estimates of expenditure areprepared by the estimating authorities according totheir assessments of requirements for the ensuingyear, keeping in view the actual requirements in the past, current year's trends of expenditure, thedecisions taken by the Government which will have abearing on the funding requirements etc.

Administrative Ministers and heads of the respective Departments are supplied with skeleton forms on which they are asked to prepare the estimates. The prescribed form has four different columns:

a) Actuals of the previous year.
b) Sanctioned estimates for the current year.
c) The revised estimates for the current year and

d) The budget estimates for the next year. For example, the Budget for 2013-14 contains the following:

1) The actuals of 2011-12
2) The budget estimates for 2012-13
3) The revised estimates for 2012-13 and
4) The budget estimates for 2013-14.

These estimates are prepared on the prescribed form and in the prescribed manner. These estimates are then consolidated by the head of each department. Further, these estimates are then consolidated by the Ministries concerned and passed on to the Finance Ministry for scrutiny. Finally, the Finance Ministry consolidates all these estimates and prepares the budget for presenting before the Parliament.

PRESENTATION AND ENACTMENT OF THE BUDGET

As soon as the budget is ready, it is placed before the LokSabha and RajyaSabha for necessary approval in the case of Central government and before the respective assemblies of the states in the case of state budgets. According to the Indian Constitution, all money bills must be initiated in the lower house, so they are first introduced in the LokSabha at the Centre. The central government budget undergoes the following stages:

1) **Presentation of Budget in Parliament:** the budget is presented in the parliament by the government in the case of Central government and before the respective assemblies of the states in the case of state budgets. The budget is presented by the Finance Minister in the LokSabha and by a Junior Minister in the RajyaSabha. The Finance Minister makes a detailed budget speech at the time of presenting the budget before the LokSabha.

2) **General Discussion:** A general discussion takes place in both houses of the Parliament after the presentation of the budget. During the general discussion, the members of the parliament have a right to criticize the various proposals and estimates as shown in the budget. As soon as the general discussions are the over, the Finance Minister replies to all the criticisms, objections, doubts, etc. raised against the budget. The state of general discussion is over after the reply of the Finance Minister.

3) **Voting:** As soon as the general discussion on the budget is over along with the reply of the Finance Minister, the question arises of voting on the budget. The LokSabha starts examining the the estimates or the demands for grants ministry wise. After the discussion, the demands of each ministry are voted.

4) **Passing of the Appropriation Bill:**In the Constitution of India, it has been laid down that no money can be appropriated out of the Consolidated Fund, except in accordance with the law. Hence, appropriation bill has to be passed by the Parliament.
5) **Passing of the Finance Bill**: The finance bill is presented before the Parliament after passing the money bill. The finance bill when passed becomes the Act which authorizes the government to collect the required money through taxation or the provisions that have been made in the budget.

The budget is said to be passed when appropriation Bill and Finance Bill are passed by the LokSabha. After the budget is passed in the LokSabha, it goes to the RajyaSbha. The RajyaSabha does not enjoy the power of amending or rejecting the budget. The RajyaSabha can make only recommendations to the LokSabha but within 14 days only. The LokSabha may either accept or reject the recommendations of the RajyaSabha. After passing the budget in both houses, it goes to President for assent. Generally, the President gives his assent on account of his limited powers.

EXECUTION OF THE BUDGET

After passing the budget, the question of its execution arises. The responsibility to execute the budget lies with the respective governments. That is, Central government and State governments. The execution of the budget has three aspects:

1) Collection of Revenue;
2) Proper custody of collected funds and
3) Distribution of grants to different administrative ministries or departments.

Each administrative ministries or departments are required to submit periodical returns to the Finance Ministry so as to enable them to exercise full control over it throughout the whole financial year.

Glossary

- **'Annual financial statement'** – Also referred to as Budget means the statement of estimated receipts and expenditure of the Central Government for each financial year, laid before the Parliament.
- **'Budget'** – It is the statement of estimated receipts and expenditure of the Central Government as per its policy for each financial year and placed before the Parliament.
- **'Budget Division'**- means Budget Division in the Department of Economic Affairs of the Ministry of Finance in the CentralGovernment.

- **'Budget Estimates' -** are the detailed estimates of receipts and expenditure of a financial year.
- **'Accounts' or 'actuals' of a year.**- are theamounts of receipts and disbursements for thefinancial year beginning on April 1st and ending onMarch 31st following, as finally recorded in theAccounting authority's books (as audited by C&AG).Provisional Accounts refers to the unauditedaccounts compiled by CGA.
- **'Appropriation'**- means the amount authorized by the Parliament for expenditure under different primary unit of appropriation or parthere of placed at the disposal of a disbursing officer.
- **'Appropriation Accounts'**- are the accounts prepared by the

  Controller General of Accounts for each grant or appropriation in which it is indicated the amount of the grant/appropriation sanctioned and the amount spent under the grant/appropriation as a whole. Important variations in the expenditure and allotments, whether voted or charged, are briefly explained therein with the comments of audit.
- **'Appropriation' (Charged) -** means sums required to meet charged expenditure asspecified in the Constitution during thefinancial year concerned, on the services and purposes covered by 'Charged
- **Appropriation.'** It does not include provisions for voted expenditure.
- **'Charged Expenditure' or 'Charged on theConsolidated Fund of India' -** means such expenditure as is not to be submitted to the vote of the Parliament under the provisions of the Constitution.
- **'Consolidated Fund of India-** under Article 266 (1) of the Constitution all revenues of the Union Government, loans raised by it and all moneys received in repayment of loans form one consolidated fund called the Consolidated Fund of India. No moneys out of this Fund can be appropriated except in accordance with the law and for the purpose and in the manner provided in the Constitution.
- **'Constitution'** - means the Constitution of India.
- **'Contingency Fund' –** means the Contingency Fund of India established under the Contingency Fund of India Act, 1950, interms of Article 267 (1) of the Constitution. Contingency Fund is in the nature of an imprest the corpus of which is ` 500 crore at present. The Contingency Fund is intended to provide advances to the executive /Government to meet unforeseen expenditure arising

in the course of a year pending its authorization by the Parliament. The amounts drawn from the Contingency Fund are recouped after the Parliament approves it through the Supplementary Demands.

- **'Department of the Central Government'**- means a Ministry or Department of the Central Government as notified from time totime and listed in the Allocation of Business Rules. It includes the Planning Commission, the Department of Parliamentary Affairs, thePresident's Secretariat, the Vice-President's Secretariat, and the Cabinet Secretariat.
- **'Departmental Estimate'** - is an estimate of income and expenditure of a department in respect of any year submitted by the head ofa department or other estimating officer to the Finance Ministry as the material on which to base its estimates.
- **'Finance Ministry'**- means the Ministry of Finance in the Union Government.
- **'Revised Estimate' -** is an estimate of the probable receipts or expenditure for a financial year, framed in the course of thatyear, with reference to the transactions already recorded and anticipation for the remainder of the year in the light of the orders already issued of.
- **Vote on Account' -** means a grant made in advance by the Parliament, in respect of the estimated expenditure for a part of newfinancial year, pending the completion of the procedure relating to the voting of the demand for grants and the passing of the Appropriation Act.
- **'Voted' expenditure -** means expenditure which is subject to the vote of the LokSabha. It is to be distinguished from 'charged'expenditure, which is not subject to voting, even though can be discussed in the Parliament.
- **'Charged Expenditure' or 'Charged on theConsolidated Fund of India' -** means such expenditure as is not to be submitted to thevote of the Parliament under the provisions of the Constitution.
- **Appropriation Bill:** money bill which includes all the grants for the year whether votable or non-votable
- **Finance bill:** the bill which authorizes the government to collect the required money through taxation, or the provisions that have been made in the budget.

UNION BUDGET 2012-13 AT A GLANCE

(In Crore of Rupees)	2010-11 Actuals	2011-12 Budget Estimates	2011-12 Revised Estimates	2012-13 Budget Estimates
1. Revenue Receipts	788,471	789,892	766,989	935,685
2. Tax Revenue (net to centre)	569,602	664,457	642,252	771,071
3. Non-Tax Revenue	218,602	125,435	124,737	164,614
4. Capital Receipts (5+6+7)$	408,857	467,837	551,730	555,241
5. Recoveries of Loans	12,420	15,020	14,258	11,650
6. Other Receipts	22,846	40,000	15,493	30,000
7. Borrowings and other liabilities*	373,591	412,817	521,980	513,590
8. Total Receipts (1+4)$	1,197,328	1,257,729	1,318,720	1,490,925
9. Non-Plan Expenditure	818,299	816,182	896,116	969,900
10.On Revenue Account of which,	726,491	733,558	815,740	865,596
11. Interest Payments	234,022	267,986	275,618	319,759
12.On Capital Account	91,808	82,624	76,376	104,304
13. Plan Expenditure	379,029	441,547	426,604	521,025
14.On Revenue Account	314,232	363,604	346,201	420,513
15.On Capital Account	64,797	77,943	80,404	1,00,512
16. Total Expenditure (9+13)	1,197,328	1,257,729	1,318,720	1,490,925
17.Revenue Expenditure (10+14)	1,040,723	1,097,162	1,161,940	1,286,109
18.Of Which, Grants for creation of Capital Assets	87,487	146,853	137,505	164,672
19.Capital Expenditure (12+15)	156,605	160,567	156,780	204,816
20. Revenue Deficit (17-1)	252,252	307,270	394,951	350,424
21. Effective Revenue Deficit (20-18)	164,765	160,417	257,446	185,752
22. Fiscal Deficit {16-(1+5+6)}	373,591	412,817	521,980	513,,590
23. Primary Deficit (22-11)	139,569	144,831	246,362	193,831

UNION BUDGET 2013-14 AT A GLANCE

(In Crore of Rupees)	2011-12 Actuals	2012-13 Budget Estimates	2012-13 Revised Estimates	2013-14 Budget Estimates
1. Revenue Receipts	751437	935685	871828	1056331
2. Tax Revenue (net to centre)	629765	771071	742115	884078
3. Non-Tax Revenue	121672	164614	129713	172252
4. Capital Receipts (5+6+7)$	552928	555241	558998	608967
5. Recoveries of Loans	18850	11650	14073	10654
6. Other Receipts	18088	30000	24000	55814
7. Borrowings and other liabilities*	515990	513590	520925	542499
8. Total Receipts (1+4)$	1304365	1490925	1430825	1665297
9. Non-Plan Expenditure	891990	969900	1001638	1109975
10.On Revenue Account of which,	812049	865596	919699	992908
11. Interest Payments	273150	319759	316674	370684
12.On Capital Account	79941	104304	81939	117067
13. Plan Expenditure	412375	521025	429187	555322
14.On Revenue Account	333737	420513	343373	443260
15.On Capital Account	78639	100512	85814	112062
16. Total Expenditure (9+13)	1304365	1490925	1430825	1665297
17.Revenue Expenditure (10+14)	1145785	1286109	1263072	1436169
18.Of Which, Grants for creation of Capital Assets	132582	164672	124275	174656
19.Capital Expenditure (12+15)	158580	204816	167753	229129
20. Revenue Deficit (17-1)	394348	350424	391245	379838
21. Effective Revenue Deficit (20-18)	261766	185752	266970	205182
22. Fiscal Deficit {16-(1+5+6)}	515990	513590	520925	542499
23. Primary Deficit (22-11)	242840	193831	204251	171814

THE STATE BUDGET: The budget is presented in the parliament by the Union Finance Minister. Similarly, the State Governments have also to present the budget in the State Legislatures as per **Article 202 of the Indian Constitution.**

BUDGET AT A GLANCE

(₹ crore)

Items	2010-11 Accounts	2011-12 Accounts	2012-13 B. E.	2012-13 R. E.	2013-14 B. E.
1	2	3	4	5	6
A. Revenue Receipts	**30990.95**	**38010.36**	**48141.59**	**48269.21**	**58057.88**
1. State Tax Revenue	21721.69	25718.60	32122.21	31702.44	38771.10
2. State Non-Tax Revenue	1930.79	2592.18	3495.41	4458.37	4921.57
3. Central Govt. Transfers	**7338.47**	**9699.58**	**12523.97**	**12108.40**	**14365.21**
i) Share of Central Taxes	5141.85	5990.36	7103.46	6840.65	8143.79
ii) Grant-in- Aid	2196.62	3709.22	5420.51	5267.75	6221.42
B. Capital Receipts	**7807.42**	**12284.48**	**11099.85**	**11356.04**	**12460.26**
1. Recoveries of Loans	44.23	54.90	87.81	98.79	123.80
2. Other Receipts	24.61	16.05	20.02	21.03	22.03
3. Borrowings and Other Liabilities	7738.58	12213.54	10992.02	11236.23	12314.42
a. Public Debt (Net)	5213.87	6905.90	10815.76	10753.94	11844.38
b. Public Account (Net)	2524.71	5307.63	176.26	482.29	470.04
C.Total Receipts (A+B)	**38798.37**	**50294.85**	**59241.44**	**59625.25**	**70518.13**
D. Non Plan Expenditure	**31509.53**	**41754.09**	**47101.62**	**47470.01**	**55536.10**
1. On Revenue Account	30469.07	40717.41	43118.18	44183.60	50565.27
a. Of which Interest Payments	5689.66	6293.60	7234.33	7045.40	7673.48
2. On Capital Account	598.03	454.82	3679.87	2743.18	4386.55
3.On Loan Disbursements	442.43	581.86	303.57	543.23	584.28
E.Plan Expenditure (including CSS)	**7280.71**	**9141.99**	**11874.59**	**12264.34**	**14540.25**
1. On Revenue Account	4195.74	5327.21	8487.18	7492.05	9762.58
2. On Capital Account	2765.66	3398.10	2875.03	4160.04	4248.48
3. On Loan Disbursements	319.31	416.68	512.38	612.25	529.19
F.Total Expenditure (D+E)	**38790.24**	**50896.08**	**58976.21**	**59734.35**	**70076.34**
1. Revenue Expenditure	34664.81	46044.62	51605.36	51675.65	60327.84
2. Capital Expenditure	3363.69	3852.92	6554.90	6903.23	8635.03
3. On Loan Disbursements	761.74	998.54	815.95	1155.47	1113.47
G. Revenue surplus/deficit (A-F(1))	**-3673.86**	**-8034.26**	**-3463.77**	**-3406.44**	**-2269.97**
H. Effective Revenue Deficit/ Surplus *	**-1325.64**	**-5262.71**	**-189.51**	**-609.14**	**1202.09**
I. Fiscal Deficit (A+B(1)+B(2))-F	**-7730.45**	**-12814.77**	**-10726.79**	**-11345.33**	**-11872.63**
J. Primary Deficit (H)-D(1a)	**-2040.79**	**-6521.18**	**-3492.46**	**-4299.92**	**-4199.15**

* Revenue deficit minus Grants for Asset Creation

MODEL QUESTIONS

1) What is public debt? What are the reasons for incurring public debt?
2) What are the types of public debt?
3) What are the methods of redemption of public debt?
4) What do you mean by a budget? Explain the objectives of budget.
5) Explain different concepts of budget deficits? What are the implications different deficits?
6) Distinguish between sound finance and functional finance.
7) How far is deficit financing beneficial for an economy?
8) What do youmean by fiscal policy? Explain the major fiscal tools used to check depression and boom.
9) Explain the different stages of central government budget in India.

MODULE V

FEDERAL FINANCE

FEDERAL FINANCE—Meaning—Principles of Federalism—Finance Commission (Finance Commission Report—Latest)—Importance of Local Finance in India.

FEDERAL FINANCE

MEANING: Federation may be defined as a form of political association in which two or more states constitute a political unity with a common government but in which the member states retain a measure of internal autonomy. We can notice some important definitions of federal finance by experts.

Author	Definition
Sir Robert Gorson	Federation is a form of government in which sovereignty or political power is divided between the Central and Local Governments so that each of them within its own sphere is independent of the other
Kenneth C. Wheare	Federal principle is the method of dividing the powers so that the general and regional governments are each within its own sphere, co-ordinate and independent.
Wallace E.Oates	Federalism is a special kind of decentralization where the division of powers ensuring safeguards of the units of federation is constitutionally protected. Thus, the decision making at a particular level of government is based on delegation or constitutionally guaranteed authority.
R.N.Bhargava	Federal finance refers to the finance of the federal as well as of the state governments and the relationship between the two.

Principles of Federal Finance

In a federation there is a division of legislative, executive and financial powers between the Centre and state governments. The duty of the federal government is to fulfill its responsibilities towards the states while utilizing its own financial powers within its own jurisdiction. To preserve federal principles Professor B.P.Adarker, in his celebrated book on 'Principlesand Problems of Federal Finance' lays down three principles for the smooth functioning of a federation. These principles of determining the financial policy in a federal set up are explained below.

1) **Principle of Independence and Responsibility:** the first principle for the efficient and smooth functioning of the federal financial system is that each government should have independent financial resources and should be responsible for raising resources for meeting its obligations. Financial independence and responsibility are two fundamental requisites for the success of fiscal federalism. According to Professor. Adarker,"full freedom of financial operations must be extended to both Federal as well as State Governments in order that they may not suffer from a feeling of cramp in the discharge of their normal activities and in the achievement of their legitimate aspirations for the promotion of social and economic advancement." In other words, national and sub-national governments should be financially independent within their own sphere. Besides, each government should take the responsibilities of taxing, borrowing and raising resources in their spheres for performing their functions. The authority which has the pleasing job of spending money should also do the unpleasant job of taxing it. Thus, "taxing autonomy and spending autonomy go hand in hand."

   However, it is very difficult to put in to practice the financial independence. This is because of the problem like uniformity in tax rates throughout the federation, promotion of economic growth, maintenance of internal and external stability, balancing social and economic development in all regions etc. cannot be ignored. Professor Adarker points out, "the cardinal principle to be followed in a financial settlement is that, as far as practicable, the federal government and the states should be endowed with independent sources of revenue free from mutual interference and that the balancing factors should come in only marginally, so as to fill the gaps."

2) **Principle of Adequacy and Elasticity:**the principle of adequacy means that the resources of the federal government and local governments should be adequate so that each layer of government can discharge its obligations laid upon it. Principle of elasticity means that there must be feasibility to expand its resources in response to its requirements especially during the period of internal and external crisis.

3) **Administrative Economy and Efficiency:**the administrative cost of finances should be at minimum and there should be no tax evasion. Administrative efficiency can be achieved, if the resources are allocated properly between the Centre and the state governments.

Other Principles

1) **Principle of Uniformity and Equity:** Principle of Uniformity means that there should not be any discrimination among different units in a federation,

while distributing resources among various states. Thus, the contribution of each state in federal taxes should be according to ability or economic considerations. Similarly, in order to achieve equity in taxation, a proper balance between direct and indirect taxes should be maintained. Therefore, there should be a proper adjustment between federal and state taxation to make the tax burden on all the citizens equitable as far as possible.

2) **Principle of Accountability:** freedom and democracy are interwoven in a federal system. Therefore, the government in a federation should be accountable to its own legislature for its spending and collecting revenue decisions.

3) **Principle of Fiscal Access:** this implies that there should not be bar on federal and state governments in tapping new sources of revenue within their own prescribed areas to meet the growing financial needs. That is, resources should grow with the expansion of responsibilities.

4) **Principle of Transfer of Resources:** this means that there should be provisions for transferring the resources from one state to the other. The ideal allocation of resources between federation and states should be in accordance with the principle of national minimum which can be achieved through the transfer of resources from rich countries to poor regions in a federal set-up.

5) **Principle of Federal Supervision:**there should be supervision by the federal government to ensure whether state governments follow the rules and regulations with regard to taxation and expenditure laid down by it from time to time.

6) **Principle of Integration and Co-ordination:** according to this principle, the whole financial system of a federation should be well-integrated and coordinated. Integration of financial systems of federal government and state governments is essential in contemporary federations. Similarly, coordination is essential for smooth and efficient functioning of federal financial system.

Social Principle of Federal Finance

The social principle of an effective system of federal finance is fiscal equity. Fiscal equity requires that individuals in similar economic circumstances should receive equal net fiscal benefits where they reside in the nation. For achieving fiscal equity in a federal country there are two ways. Firstly, through introduction of equalizing transfers that provide additional revenue to areas with relatively low revenue capacities and / or relatively high expenditure needs, and secondly, through the imposition of basic minimum national standards with respect to certain public goods.

Types of Fiscal Imbalances

There are two types of fiscal imbalances in a federal nation. They are 1) Vertical Fiscal Imbalance and 2) Horizontal Fiscal Imbalance.

Vertical Fiscal Imbalance:

The important characteristic of federation is the co-existence of two main levels of governments having the capacity to raise revenues and responsibility to carry out various functions. The ideal situation a federation is to have a state of vertical balance. That is, a matching of expenditure responsibilities and taxing powers, enabling each level of government to be financially sufficient. The imbalance in this regard is termed to as vertical fiscal imbalance. That is, vertical fiscal imbalancerefers to the difference between expenditures and revenues at different levels of governments. Vertical fiscal imbalance arises when one level of government financial resources exceeding its needs, whilst the other lacks sufficient resources to carry out its functions. This is a common feature of all multi-level governments.A common solution to tackle this type of imbalance is a scheme of intergovernmental grants as a corollary to the allocation of taxing powers.

Horizontal Fiscal Imbalance: Horizontal Fiscal Imbalance is referred to as the existence of economic inequalities among the states such that, if they were all to have equal standards to public expenditure from their own revenue sources, some of them would have to set their taxes and other charges at a higher overall level to severity than others- a state of affair which is convenient to describe as inequalities of fiscal capacity. In other words, horizontal fiscal imbalance refers to the mismatch between revenues and expenditures of governmental units within a level of governments. Such an imbalance is related to horizontal economic imbalance. It refers to inter-state economic disparities resulting from differences in area, climate, topography, soil and mineral resources, factor endowments etc.That is why, horizontal fiscal imbalances are not exogenous to the States' fiscal management and do not, by themselves, provide a rationale for intergovernmental transfers.

Finance Commission

Under the provisions of the constitution, the president is required under **Article 280 (1)** to constitute within two years from the commencement of the constitution and there after the expiration of every fifth year or at such early year time as he may consider necessary. The commission is charged with tremendous responsibilities of making requisite recommendations to the president of India. The Finance Commission consists of a chairman and four members to be appointed by the president.

Functions of Finance Commission

There are two important functions – Suggestive functions and making recommendations – to be performed by the Finance Commission.

Suggestive Functions

1. To suggest the criteria of distribution between union and States of net proceeds which are to be, or may be divided between them.
2. It determines the allocation of net proceeds between different states according to their respective shares of proceeds.
3. Any modification or continuance of the term of any agreement entered in to by the union government with the government of any State in part B of the First schedule under clause (v) of Article 178 or Article 306
4. The principle which should govern the grants – in –aid of the revenue of different states out of the consolidated fund of India.
5. Any other matter referred to the commission by the President of India.

Making Recommendations

1. The percentage of net proceeds of the Taxes which may be divided between Centre and States.
2. The allocation of shares of the proceeds of such taxes in percentages between different States.
3. To determine the principle to govern the grants – in aid of the revenue out of the consolidated fund of government of India between States.
4. The modification of continuances of the term of agreement regarding the levy of International customs and duties with part B States.
5. Grants- in- aids in tribal areas and
6. Special grants for any particular state.

Finance Commissions in India.

Year	Chairman	Operational Duration	Year of Report Submission
Nov. 1951	K.C. Neogi	1952-57	December 1952
June 1956	K. Santhanam	1957-62	September 1957
December 1960	A.K. Chanda	1962-66	December 1961
May1964	Dr P.V. Rajmannar	1966-69	August 1965
February 1968	MahavirTyagi	1969-74	July 1969
June 1972	Brahmananda Reddy	1974-79	November 1973
June 1977	J.M. Shelat	1979-84	October 1978
June 1982	Y.B. Chavan	1984-89	November 1983
June 1987	N.K.P. Salve	1989-95	March 1990
June 1992	K.C. Pant	1995-2000	November 1994
July 1998	Prof. A.M. Khusro	2000-2005	June 2000
July 2002	C. Rangarajan	2005-10	November 2004
October 2007	Vijay Khelkar	2010-15	DEC-2009
2012	Y.V.Reddy	2015-20	Constituted on 2nd January, 2013.

Criteria and Relative Weights for Tax Devolution According to Latest Commissions

Criterion	Weight (Per cent) 11th FC	12^{th} FC	13^{th} FC
1. Population	10	25	25
2. Income (Distance Method)*/Fiscal Capacity Distance	62.5	50	47.5
3. Area	7.5	10	10
4. Index of Infrastructure	7.5	-	
5. Tax Effort**	5.0	7.5	
6. Fiscal Discipline***	7.5	7.5	17.5

Report of the Thirteenth Finance Commission: 2010 – 2015

Background

The Finance Commission is constituted by the President under Article 280 of the Constitution. Its main work is to give recommendations on distribution of central tax revenues between the Union and the States. The Thirteenth Finance Commission submitted its report in Parliament on February 25, 2010.

Terms of Reference

The Commission was asked to make recommendations on the following matters:

- ➢ The distribution of taxes collected between the centre and the states.
- ➢ The principles determining the grants-in-aid to states out of the Consolidated Fund of India and the sums to be paid to states.
- ➢ The measures needed to augment the Consolidated Fund of a state to supplement the resources of Panchayats and Municipalities.
- ➢ To review the state of the finances of the centre and the states in light of the operation of the States' Debt Consolidation and Relief Facility that was introduced on the basis of the recommendations of the previous Finance Commission.
- ➢ To review the present arrangements regarding financing of disaster management.
- ➢ To suggest a new roadmap for fiscal consolidation in the period between 2010 and 2015.

Findings and Recommendations

Sharing of Union tax revenues

- ✓ The share of states in net proceeds of shareable central taxes shall be 32 per cent in each of the financial years from 2010-11 to 2014-15.
- ✓ The share of each state in the proceeds of all shareable central taxes in each of the financial years from 2010-11 to 2014-15 shall be as specified.

Finances of Union and States

1. **Actual share in the tax revenue of the Centre which is devolved to states:** The Eleventh and Twelfth Commissions had recommended that the share of states be fixed at 29.5% and 30.5% respectively, of central taxes. However, the actual shares devolved to states have been lower than recommended by previous finance commissions. The government has explained that when cesses and surcharges are taken into account, the release to states is in keeping with the recommendations.

Recommendation: The Ministry of Finance should ensure that the accounts reflect all collections so that there are no inconsistencies in the amounts released to states.

2. **Losses in the power sector:** Subsidy for the power sector is the largest component of state government subsidies. The power sector in most states is beset with high losses, and inefficient infrastructure, resulting in huge losses.

   Recommendation: Losses in the power sector are expected to be a major drag on the finances of State Governments, and therefore, the problems confronting this sector need to be addressed in a time-bound manner.

3. **Reduction of centrally sponsored schemes:** Initiatives should be taken to reduce the number of Centrally Sponsored Schemes and to restore the predominance of fund-transfers based on Planning Commission recommendations.

Goods and Services Tax (GST)

The Commission has recommended the adoption of the GST and formulated a model GST. The main features of the model GST are:

- The central portion of the GST would include (a) central excise duties, (b) service tax, (c) additional customs duties, (d) all surcharges and cesses.
- The state GST would include (a) VAT, (b) central sales tax, (c) cesses and surcharges, and others such as luxury tax, lottery tax, stamp duties, etc.
- There would be special provisions for certain goods such as petroleum, and exemptions would be allowed only on the basis of a common list applicable to all states and the centre.

Union Finances

The central government has recently decided that proceeds from disinvestment shall be used fully as capital expenditure for social sector programmes. This policy needs to be liberalised and proceeds should also be used for augmenting critical infrastructure and environment related projects.

State Finances

The practice of diverting plan assistance to meet non-plan needs of special category states should be discontinued.

For PSUs: – All accounts and backlogs of PSU accounts should be cleared by states.

– States need to draw a roadmap for closure of non-working PSUs by March 2011. Divestment and privatisation of PSUs should be considered and actively pursued.

Power Sector:

- Reduction of Transmission and Distribution (T&D) losses should be attempted.
- Unbundling needs to be carried out on priority basis and open access to transmission strengthened.
- Proper systems should be put in place to avoid delays in completion of hydro projects.
- Regulatory institutions should be strengthened through capacity building, consumer education and tariff reforms.

Regarding reforms in the area of pensions, a switch to the New Pension Scheme needs to be completed at the earliest.

Revised roadmap for fiscal consolidation

Central government

- The revenue deficit of the Centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15.
- A target of 68 percentage of GDP for the combined debt of the centre and states should be achieved by 2014-15.
- The Medium Term Fiscal Plan should be reformed and made a statement of commitment rather than a statement of intent.
- A number of disclosures including detailed break-up of grants to states, systematised statement on tax expenditure, compliance costs of major tax proposals, fiscal impact of major policy changes, should be made with the annual budget.
- The government should list all public sector enterprises that yield a lower rate of return on assets than a norm which should be decided by an expert committee.
- An independent review mechanism should be set-up by the Centre to evaluate its fiscal reform process.

State governments:

- States should be able to get back to the path of fiscal consolidation after the disruption caused in 2008-09, and 2009-10. States with zero revenue deficit or revenue surpluses in 2007-08 should eliminate revenue deficit by 2011-12. Other states should do so by 2014-15.

− General category states with zero revenue deficits in 2007-08 should achieve a fiscal deficit of 3 percent of GDP by 2011-12. Other states should do so by 2013-14.

− States should amend/enact Fiscal Responsibility and Budget Management Acts to build on the fiscal reform path worked out.

− State-specific grants recommended for a state should be released upon compliance.

− Borrowing limits for states to be worked out by Finance Ministry using the fiscal reform path, thus acting as an enforcement mechanism for fiscal correction by states.

− Loans from the central government to states and administered by ministries/departments other than Ministry of Finance, outstanding as at the end of 2009-10, should be written off.

Local Bodies

Local bodies should be transferred 2.28% of the divisible pool of taxes (over and above the share of the states), after converting this share to grant-in-aid under Article 275. This amount adds up to Rs 87519 crores.

Article 280 (3) (bb) & (c) of the Constitution should be amended to make the recommendations of the State Finance Commissions less binding on state governments.

Article 243(I) of the Constitution should be amended to empower states governments to constitute and direct state Finance Commissions to give their report before the National Finance Commission finalises its report.

- ❖ State governments should strengthen their local audit departments through capacity building.
- ❖ Bodies similar to the SFC should be set up in states which are not covered by Part IX of the Constitution (Panchayats).
- ❖ Local Bodies should be associated with city planning functions wherever other development authorities are mandated for this function.
- ❖ State governments will be eligible for the general performance grant and the special areas performance grant only if they comply with the prescribed stipulations.

Disaster Relief

- ➢ Assistance of Rs 250 crore to be given to the National Disaster Response Force (NDRF) to maintain an inventory of items required for immediate relief.

- Provisions relating to the District Disaster Response Fund in the Disaster Management Act may be reviewed and setting up of these funds left to the discretion of the individual states.
- The list of disasters to be covered under the scheme financed through FC grants should remain as it exists. However, man-made disasters of high-intensity may be considered for NDRF funding.

Grants-in-aid to States

For augmenting the resources of rural local bodies, the Commission has recommended award of grant based on certain principles. The grant has two main components.

Basic Grant – For 5 years (2010-11 to 2014-15)

Performance Grant – For 4 years (2011-12 to 2014-15)

A small portion of grants is allocated to Special Area covered by the V & VI Schedules and areas exempted from the purview of Part X and XI (A) of the constitution.

This grant is called **"Special Area Basic Grant"**, and accessible for all the five years to meet some of the development needs of these areas.

GRANTS RECOMMENDED BY THE 13th FINANCE COMMISSION

(in Crore)							
	Components	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**Total**
1	**General Basic Grant**	**241.29**	**279.78**	**326.99**	**387.43**	**458.71**	**1694.20**
2	**General Performance**	**0.00**	**95.66**	**224.41**	**264.70**	**312.23**	**897.00**
3	**Special Area Grant**	**19.39**					**19.39**
Total		**260.68**	**375.44**	**551.40**	**652.13**	**770.94**	**2610.59**

The Commission has specially recommended usingthe above grants on the following components:

- Drinking water supply
- Sewage, solid waste management (rural sanitation)
- Operational Expenses (Maintenance of Accounts, Conducting of Audits, Creation of Database etc.)
- **Non-Plan Revenue Deficit:** Eight special category states (Arunachal Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Tripura) have non-plan revenue deficits. For these states grant of Rs 51,800 crore is recommended.
- **Elementary Education:** A grant of Rs 24,068 crore is recommended for elementary education over the award period. The education grant will be additional to the normal expenditure of the states for elementary education.
- **Environment:**

– An amount of Rs 5000 crore is recommended as forest grant for the award period.

– Twenty five per cent of the grants in the last three years are for preservation of forest wealth.

– An incentive grant of Rs 5000 crore is recommended for developing grid-connected renewable energy based on the states' achievement in renewable energy capacity addition from 1 April 2010 to 31 March 2014.

– An amount of Rs 5000 crore is recommended as water sector management grant for four years.

- **Improving Outcomes**

– States should be incentivised to enrol residents who participate in welfare schemes within the Unique Identification (UID) programme. A grant of Rs 2989 crore is proposed to be given to State Governments.

– A grant of Rs 5000 crore is recommended for reducing their Infant Mortality Rates.

– A grant of Rs 5000 crore is proposed to support improvement in a number of facets in the administration of justice.

– A grant of Rs 10 crore will be provided to each general category state and Rs. 5 crore to each special category state to set up an employees' and pensioners' data base.

- **Maintenances of Roads and Bridges**

  -An amount of Rs 19,930 crore has been recommended as grant for maintenance of roads and bridges for four years. This is additional to the normal expenditure incurred by states.

- **State-specific needs**

  --A total grant of Rs 27,945 crore is recommended for state-specific needs. Release of this grant and expenditure will be subject to certain conditions.

IMPORTANCE OF LOCAL GOVERNMENTS IN INDIA

"Independence must begin at the bottom. Thus, every village will be a republic or panchayathaving full powers."Gandhiji

India has the distinction of being a unique federal country. Ordinarily, federalism involves a two tier system – central/union government at the first level and the state/provincial government at the second level. But the Indian constitution provides for a three tier federal structure as below: -

Union Government at the top,

State Government in the Middle and LocalGovernment, i.e.,Panchayats and Municipalities at Grass Root.

As such, in India, Local Government is the third stratum of the Government, the first two being the central and state Governments. India is known to be the world's largest democracy. In constitutional sense, democracy is the system of Government, in the administration of which, every adult citizen of the country enjoys some direct or indirect share. Keeping in view the real spirit and high ideas of democracy, Local Government forms an indispensable part of governance and administration in India. The Local Government's jurisdiction is limited to a specific area and its functions relate to the provision of civic amenities to the population being within its jurisdiction. A Local Government functions within the provisions of the statute which has created it. It is subordinate to the state or provincial government which exercises control and supervision over it. But the activities of the Local Government are not less numerous. Some important functions are explained below.

- **Local Government has been undertaking new activities:**

  - They regulate the conduct of the citizens.

-They are in the nature of service such as provision of mass transport, construction of houses for the poor, supply of electricity, health centres, parks, play grounds etc.

- **Local Government is today much more important in the daily life of a citizen than the state or central government:** The importance of Local government can hardly be over emphasized when we consider the range, the character and the impact upon the daily life of the citizen of the functions which local authorities carry out.
- **Local Government provides public amenities and services:** They are necessary for the convenience, healthful living and welfare of the individual and the community. If these services were suddenly to cease, we should relapse into chaos.
- **The Local Government institutions are based on the principle of division of labour:** They are indispensable because the aggregate duties of government and local authorities can thus be shared.

Need for the Study

Town and villages are two distinct entities in India. They have different needs and problems. The main requirements **of towns are the provisions of housing, transport, communications, water supply,sanitary conditions, community canters, slum clearance and town planning** while main emphasis **in the village has to be on improvement of agriculture, irrigation facilities, animal husbandry, village industries and the like.** The personnel of Urban Local Government and Panchayati Raj institutions would thus require specialised training to cater the specific needs of urban and rural areas respectively. The study therefore, emphasises the need for two distinct set of personnel requirement for the urban and rural local bodies.

MEANING OF LOCAL GOVERNMENTS

It is not easy to answer the question "what is local government"? Local Government may be described as government by popularly elected bodies charged with administrative and executive duties in matters concerning the inhabitants of a particular district or place and vested with powers to make bye-laws for their guidance. Local Government has been defined from various angles. It has been defined as "an authority to determine and execute measures with in restricted area inside and smaller than the whole state." The term "Local Government" literally means management of the local affairs by the people of the locality. It is based on the principle that the local problems and needs can be looked by the people of the locality better than by central or state governments. Theadministration of local affair is entrusted to the representatives elected by the people of the locality on regular intervals. Though local government institutions enjoy autonomy of operations, it does not mean that there are no legal restrictions upon them. The central and state governments are free to prescribe the limits within which a local government has to operate and also reserve the right to issue directions from time to time. The term "Local Government" or "Local-self-government' means the government by freely elected local bodies which are endowed with power, discretion and responsibility to be exercised and discharged by them, without control over their decisions by any other higher authority. Their actions are, however, subjected to the supremacy of the national government. Defining local self-government, it has been observed that: Local inhabitants representing local body possessing autonomy within its limited spheres, raising revenue through local taxation and spending its income on local services constitute the local-self-government. For a better understanding of the concept of Local Government and its meaning, scope and nature, it shall be desirableto study a few important definitions and interpretations from various sources. As per the General Clauses Act, 1897 "Local Government shall mean the person authorized by law to administer executive K. VenkataRangiah"Local Government in India", Bombay (1969), p. 1. Government in the part of British India in which the Act or Regulation containing the expression operates and shall include a Chief

Commissioner.The word Local Government also finds mention in the Government of India Act, 1935. According to eminent scholar and political scientist *Clarke,* "Local Government is that part of the Government of a nation or state which deals mainly with such matters as concern the inhabitants of the particular district of places, together with those matters which parliament has deemed it desirable should be administered by local bodies, subordinate to the Central Government.According to *D. Lockard*Opines that local government may be loosely defined as a public organization, authorized to decide and administer a limited range of public policies within relatively small territory which is a sub division of a regional or national government. According to *M. Goetz* "Self-Government implies merelya form of communal administration".

Thus, the essential characteristics of Local Government are (i) its statutory status (ii) its power to raise finance by taxation in the area under its jurisdiction, (iii) participation of local community in decision making in specified subjects and their administration (iv) the freedom to act independently of central control and (v) its general purpose, in contrast to single purpose, character.

"The greater the power of the panchayats the better for the people…"- M.K.Gandhi.

MAJOR TAXES OF THE LOCAL SELF GOVERNMENTS IN INDIA

1) Taxes on Land and Buildings.

2) Octroi and terminal taxes.

3) Taxes on Animals and Boats.

4) Taxes on Vehicles.
5) Taxes on Professions, Trades and Employment.
6) Taxes on advertisement other than those published in newspapers.
7) Other miscellaneous taxes like theatre or show tax, duty on transfer of property, taxes on goods, passengers carried by roads, railways or tolls etc.

MODEL QUESTIONS

1) Explain the concept of federal finance.
2) What are the important principles of federal finance?
3) What is finance commission? State the functions of finance commission.
4) Distinguish between vertical and horizontal fiscal imbalance.
5) Explain the important recommendations of the Thirteenth Finance Commission.
6) What is importance of local finance?
7) What are the important sources of revenue to local governments in India?

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