M.A (ECONOMICS)
MAEC24102T -PUBLIC FINANCE

SEMESTER-I

MAX. MARKS: 100
PASS: 40%
INTERNAL: 30
EXTERNAL: 70
TOTAL CREDITS: 6

OBJECTIVE

This course introduces the basic principles of public expenditure and revenue. It acquaints the students with the needs and effects of public debt and deficit financing and how a fiscal policy works under the conditions of deflation and inflation.

INSTRUCTIONS FOR THE PAPER SETTER/EXAMINER:

1. The syllabus prescribed should be strictly adhered to.
2. The question paper will consist of three sections: A, B, and C. Sections A and B will have four questions from the respective sections of the syllabus and will carry 10 marks each. The candidates will attempt two questions from each section.
3. Section C will have fifteen short answer questions covering the entire syllabus. Each question will carry 3 marks. Candidates will attempt any ten questions from this section.
   4. The examiner shall give a clear instruction to the candidates to attempt questions only at one place and only once. Second or subsequent attempts, unless the earlier ones have been crossed out, shall not be evaluated.
4. The duration of each paper will be three hours.

INSTRUCTIONS FOR THE CANDIDATES: Candidates are required to attempt any two questions each from the sections A and B of the question paper and any ten short questions from Section C. They have to attempt questions only at one place and only once. Second or subsequent attempts, unless the earlier ones have been crossed out, shall not be evaluated.

SECTION – A

Unit 1: Introduction to Public Finance: Nature, Scope and its Importance.

Unit 2: Theory of Social Goods**,** Theory of Public Finance

Unit 3: Theory of Public Revenue: Theories of Taxation-Benefits, Principles: Cost of Service Principle, Ability to pay. Theory, Principle of Equity. Effects of Taxation.

Unit 4: Analysis of major taxes: income tax, expenditure tax, (GST) corporation tax, custom duties. Theories of tax shifting; concepts of incidence, measurement of incidence.

Section -B

Unit 5: Public Debt: Its Types and Role. Burden and Methods of Redemption of Public Debt. Debt Management. Budgetary Policies: Functional and Economic

Unit 6: Classification of budgets and their uses. Balanced and unbalanced budgets, Performance budgets, Budgets as an instrument of mobilisation and channelization of resources and redistribution of income and wealth.

Unit 7: Deficit Financing: Objectives and Limitations. Fiscal Federalism: Principles of Federal Finance.

Unit 8: **Development Finance**: Functional Finance vs. Development Finance. Development Financial Institution Effectiveness of fiscal policy in periods of inflation and deflation.

Suggested Readings

1. A.R. Musgrave and P.B.Musgrave : Public Finance in Theory and Practice, McGraw Hill, International Student's Edition, 1976.

2. H. Dalton : Principles of Public Finance, London, Routeledge and Kegan Paul, 1936.

3. John Cullis and Philip Jones, Public Finance and Public Choice, Oxford University Press, 1st edition, 1998.

4. Ulbrich, H. (2003), Pubic Finance in Theory and Practice. Thomson.

Aronson,J.R. (1985). Public Finance. New York: McGraw-Hill International.

Houghton, R. W. (1973). Public finance. London: Penguin Education.

M.A (ECONOMICS)

SEMESTER-1

PUBLIC FINANCE

COURSE COORDINATOR AND EDITOR: DR. KULDEEP WAILA

SECTION A

UNIT NO:	UNIT NAME
Unit 1	Introduction to Public Finance: Nature, Scope and Its Importance.
Unit 2	Social Goods, Theory of Public Finance
Unit 3	xation and Effects of Taxation
Unit 4	is of Major Taxes and Theories of Tax Shifting

SECTION B

UNIT NO:	UNIT NAME
Unit 5	Public Debt: Its Types and Role. Burden And Methods of Redemption OfPublic Debt, Debt Management And Budgetary Policies
Unit 6	fications Of Budgets and Their Uses
Unit 7	Deficit Financing: Objectives and Limitations. Fiscal Federalism: Principles Of Federal Finance.
Unit 8	Development Finance: Functional Finance Vs. Development Finance and Development Financial Institution, Effectiveness Of Fiscal Policy in Periods Of Inflation And Deflation

M.A (ECONOMICS)

SEMESTER-1

COURSE: PUBLIC FINANCE

UNIT 1: INTRODUCTION TO PUBLIC FINANCE: NATURE, SCOPE AND ITSIMPORTANCE

STRUCTURE

1.0 Learning Objectives

1.1 Introduction

1.2 Meaning and Definition of Public Finance

1.3 Nature of Public Finance

1.4 Scope of Public Finance

1.5 Importance of Public Finance

1.6 Summary

1.7 Questions for Practices

1.8 Suggested Readings

1.0 Learning Objectives

After reading this unit, learner will be able to:

- Know the meaning and a few important definitions of public finance
- Discuss the nature and scope of public finance
- Differentiate between public finance and private finance
- Describe the importance of public finance.

1.1 Introduction

Just like we individuals earn and spend money, the Government also has to earn and spend money. As individuals, to earn our living, we do a job, run a business or sale our labour in factories, business establishments or households. The money so earned we spend on our food, shelter, clothing, education, health, entertainment etc. Some portion of our income may also go to savings or investment. Similarly, we often hear that Government collects taxes from salaried persons, traders, companies or from consumers also. And there are so many various sources of its income. Again, we also have seen that Government also spends money in the construction of roads, schools, hospitals and also in providing us defense and many such other activities. The branch of Economics that studies the theoretical as well as many empirical dimensions of such earning and spending activities of the Government is known as *Public Finance*. Thus, this entire course deals with the discussion of various important theories and concepts in public finance. Here, you will get to know many important day-to-day concepts relating to taxation, public expenditure, public debt, government budgets etc.

1.2 Meaning and Definition of Public Finance

The term "public finance" clearly is a combination of two meaningful words, viz., public and finance. Public means, the public authority, i.e., Government and finance means financial resources. In this way, loosely speaking, public finance studies how Government collects and utilizes the resources. The subject *public finance* (also termed as public economics) describes and analyses government services, subsidies, welfare payments as well as the methods by which the expenditures to these ends are covered through taxation, borrowing, foreign aid and the creation of money.

Please note that traditionally, the subject public finance has been conceived as that branch of Economics basically devoted to the study of the principles that govern the spending and raising of funds by the public authorities. The classical economists, being the proponent of the 'laissez-faire' doctrine, advocated minimal role for the Government. For example, J. B. Say (b.1767-d.1832) said: *"The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount"*. Among the early Classical economists, Adam Smith (b.1723- d. 1790) (who is also known as the Father of Economics) offered a detail account of the various

problems encompassing this subject. Significantly, Smith also recognized the close inter-connection between science of finance (i.e., public finance, as is known today) with political economy (Economics was earlier known as Political Economy). Following Adam Smith, other economists also had discussed many issues on this subject. Some lateral classical economists also advocated public debt as a component of public finance. However, it was C. F. Bastable who for the first time offered a systematic discussion on the subject Public Finance. In his book Public Finance (1892), Bastable writes, "Public Finance deals with expenditure and income of public authorities of the State and their mutual relation as also with the financial administration and control."

In 1902, in the book Introduction to Public Finance, Carl C. Plehn wrote: "Public Finance may be defined as the science which deals with the activity of the statesman in obtaining and applyingthe material means necessary for fulfilling the proper functions of the State."

One of the prominent definitions of the subject was put forward by Hugh Dalton. According to him, *"Public Finance is concerned with the income and expenditure of public authorities and the adjustments of one to the other."* (*Principles of Public Finance,* 1922).

Findlay Shirras defined the subject as *"the study of the principles underlying the spending and raising of funds by the public authorities"*. (*The Science of Finance,* 1936).

In a nutshell, the Classical economists viewed Public Finance only as the subject of dealing with revenue and expenditure of the Government, though some of them also talked about public debts. However, in the recent times, Public Finance has come to be considered as a branch of study more than merely the study of public revenue and expenditure. Particularly, in the aftermath of Great Depression of the 1930s and with the emergence of Keynesian Economics, the role of public finance got a higher level of attention. Keynes for the first time pointed out that the financial or fiscal instruments of the Government can be used correct the macroeconomic distortions in the economy. In fact, Keynes demonstrated that it was possible through fiscal activities of the State to increase employment and to maintain it at high level. Thus, the emphasis on the State participation in economic life is continuously increasing. Following such advancement, the subject Public Finance is today recognized as that branch of study which is more concerned with the attainment of

(a) optimum allocation of resources,

(b) economic stability with an acceptable level of growth and employment,

(c) an equitable distribution of income and wealth and

(d) Economic growth.

Significantly, four major instruments of Public Finance have emerged, i.e., public revenue, public expenditure, public borrowing and financial administration. However, these four divisions of public finance are not ends in themselves. Rather, they are the means to achieving critical economic objectives like optimal allocation, economic stability with high growth and employment, and a more equitable distribution of income and wealth.

Acknowledging this broader perspective, post-Keynesian economists have tried to define the subject in a different way. For example, Harold Groves writes: *"Public finance is a field of enquiry that treats the income and expenditure of Government. In modern times, this includes four major divisions: public revenue, public expenditure, public debt and certain problems of the fiscal system as a whole such as fiscal administration and fiscal policy."* (*Financing Government,* 1964).

Mrs. Ursula Hicks put forward a very comprehensive definition of the subject. She writes: *"The main content of Public Finance consists of the examination and appraisal of the methods by which Government bodies provide for the collective satisfaction of wants and secure the necessary funds to carry on their purposes."* (*Public Finance,* 1948).

Some other important definitions of Public Finance include:

E. R. Rolph and G. F. Break defines the subject in these words: *"It may be defined as the discovery and the appraisal of the effects of government financial policies."* (*Public Finance,* 1961).

To sum up, public finance is the subject, which studies the income and expenditure of the government as a means to achieving the economic objectives of stabilization, growth and welfare of the people.

1.3 Nature of Public Finance

Nature of public finance deals with the discussion of whether public finance is science or art or both. However, before discussing whether public finance is art or science, let us briefly discuss what is meant by science or art. Science is defined as a branch of knowledge dealing with a body of facts or truths systematically arranged and showing the operation of general laws. Science is of two types: positive and normative. Positive science analyses factual situation or facts as they are. It describes "what is". Branch of studies like Physics, Chemistry, Mathematics etc. are examples of positive sciences. On the other hand, normative science presents norms or ideals. It describes "what ought to be" or what is right or wrong i.e., value judgement. Subjects like Political science, economics are considered as normative science. Again, art is defined as any branch of study devoted to achieving definite objectives.

1. **Public Finance as a Positive Science:** Many economists have argued public finance as a science. Earlier economist in the subject like Carl C. Plehn has put forward the following arguments in favour of considering Public Finance as a science. Plehn put forward the following arguments:
    - Public finance is not a complete knowledge about human rather it is concerned with definite and limited field of human knowledge.
    - Public finance is a systematic study of the facts and principles relating to government revenue and expenditure.
    - Scientific methods are used to study public finance.
    - Principles of public finance are empirical.

It is to be noted here that as we have already mentioned, classical economists including Adam Smith, David Ricardo being the advocates of the *'laissez faire'* policy, did not favour large-scale intervention of the government in the individual decision-making process. Thus, they viewed the role of public finance is very limiting cases of simple fiscal problems. Social and economic policies were considered to be outside its purview. Even modern economist like Bastable, who is credited to have written down the first comprehensive text in the subject of Public Finance, and also established it as a separate branch of study from the general economics continued to view the subject as a study of the "funds raised by government to meet the cost of

government" or as "a field of enquiry that treats of income and outgo of the government" or it "deals only with the finances of the government". Thus, according to these economists, (mostly, they belonged to the pre-Keynesian era), public finance is a positive science, because (a) it deals with the facts as they are, (b) it enquires into the expenditure-income process and (c) it does not deal with good or bad consequences or with the welfare aspect of taxation, expenditure or any budgetary provisions.

2. **Public Finance as a Normative Science**: The normative aspect of public finance got due weightage after the publication of Keynes' *General Theory* in 1936. Here, Keynes argued that the fiscal operations of the Government can be effectively used to influence the general level of economic activity in the economy. With such advocacy, the post-Keynesian

   economists later came up with the concepts of 'compensatory finance', 'functional finance' etc. Significantly, economists like Musgrave, Brownlee, Allen Harber and many subsequent economists therefore have argued the inclusion of "principles of public economy" within the scope of public finance. According to Herber, "In addition to the allocation function, public finance is also concerned with the three major areas of economic activity – distribution, stabilization and economic growth."

   Thus, this change in the perspective towards the role of the Government clearly indicates that public finance is not merely the study of revenue and expenditure process. It is also concerned with the distribution and stabilization affects, only through which the overall economic growth can be attained. On such grounds, public finance can definitely be seen as a normative science.

3. **Public Finance as an Art:** J. M. Keynes defined Art as "the application of knowledge for achieving definite objectives." When we evaluate the different aspects of public finance, we can see that fiscal policy which is an important instrument of public finance makes use of the knowledge of the government's revenue and expenditure to achieve the objectives of full employment, economic equality, economic development and price stability, etc. We all know that to achieve the objective of economic equality, taxes are levied at progressive rate. Since every tax is likely to be opposed, it becomes essential to plan their timing and volume. The process of levying tax is certainly an art. Similarly, there is no denying the fact that the budget making is an art in itself. Study of public finance is helpful in solving many practical problems. Public finance is therefore also an art.

Thus, to sum up, we can say that certain aspects of public finance like revenue, tax collection etc. may be viewed as positive science to a great extent. However, at the same time, public finance is also concerned with the welfare of the people. Hence, it also a branch of normative science. Finally, public finance is also considered an Art as various instruments like budgeting, delivering social equity etc. are matter of great practical deliberations.

Check Your Progress-I

Q1. Define public finance?

Ans: ....

Q2. Is pubic finance an art? Justify your view.

Ans: ....

1.4 Scope of Public Finance

The scope (subject matter) of public finance may be discussed under the broad heads like:

1. **Public Revenue:** The subject matter of public revenue consists of the methods of raising public revenue, the principles of taxation and the various problems associated with this. In other words, all kinds of income from taxes and receipts and all other public deposit are included in public revenue. It also includes the methods of raising funds. Besides, it also studies the classification of various resources of public revenue into taxes, fees and assessment etc.
2. **Public Expenditure:** Here, we study the principles and problems relating to the expenditure of public funds. This part of public finance deals with the fundamental principles that govern the flow of Government funds into various streams.
3. **Public Debt:** In this section of public finance, the problems associated with raising of loans

are studied. Please note that the public authority or the Government can raise income through loans to meet the short-fall in its traditional income. The loan raised by the government in a particular year is the part of receipts of the public authority.

4. **Financial Administration:** Proper organization and administration of the financial mechanism of the Government is another important branch of study of public finance. Under financial or fiscal administration, studies are undertaken on various aspects of the Government machinery which is responsible for performing various functions of the state.
5. **Economic Stabilization:** Now–a-days, economic stabilization and growth have become twin major objectives of any Government economic policy. Along with that, equitable distribution of resources and growth also has become one of the major economic objectives

   Of the Government. Thus, public fiancé also studies the various economic polices and other measures of the government to bring about economic stability, equality and equity in the country.

   Therefore, the subject-matter of public finance is not static, but dynamic which is continuously widening with the change in the concept of state and functions of the state as well as changing need of the time. As the economic and social responsibilities of the state are evolving each day, the methods and techniques of raising public income, public expenditure and public borrowings are also changing. In view of the changed circumstances, public finance only has gained greater importance as a tool of achieving desired socio-economic goals.

1.5 Importance of Public Finance

From the above discussion, we can see that public finance is not just about money. Its subject matter includes not only all aspects of public sector finances but also the structure of the public sector and fiscal institutions as well as the broad objectives and rationale for government activity. Again, as we have already discussed, there is no denying the fact that the importance of public finance was not so recognized in the 19th century as the Government' role was thought to be very limited only to the maintenance of law and order situation as well as to prove adequate defense of the country from external aggression. Thus, in those days, it was generally believed that the Government has no role to intervene in economic activities of the market. However, later, in the 20th century, particularly with the Great Depression of the 1930s, there were marked

changes on the role of Government. Subsequently, discussion came up on how the Government ensures 'Social Welfare' to its citizens and therefore, the scope of governmental activities has been expanding day by day. Today, Governments simply do not confine themselves to law and order situation, rather, they also actively intervene in economic matters to justify themselves as, 'Welfare States'. Consequently, the Governments has to devote its resources for the overall welfare of citizens. Thus, essentially, the importance of public finance has also tremendously increased in the recent times.

We can discuss the importance of public finance under the following broad heads:

1. **Planned Economic Development:** Public finance plays a pivotal role in the planned economic development of the country. The planning authorities fix the priorities of expenditure for the plan period. To achieve the stated goals, the Government raises the Necessary funds to through direct and indirect taxation. It also utilizes many other fiscal instruments, different control measures (say, to control inflation, unemployment etc.) to achieve the plan objectives. Budgeting is another important fiscal tool to translate the national development objectives into realities.
2. **Regulating Consumption Habits:** Public finance also can be instrumental in regulating the consumption habits of the people. For example, Government can impose higher taxes on items of certain socially undesirable commodities, like: wine, cigarettes, tobacco and bidi, and allows concessions and rebates on taxes on certain commodities which it finds socially desirable, like milk and milk products, health drinks, vitamins etc. Thus, we can see that through the effective use of various tax instruments and taxation policy, Government can regulate the consumption habits of the people, i.e., it can either encourage or discourage the demand of various commodities.
3. **Reducing Inequalities:** Various instruments of public finance, for example, the fiscal policies can play an instrumental role in reducing social inequalities in the society. For example, the Government can adopt progressive taxation policy; here, it can levy progressively higher rates of taxation on higher brackets of income. On the contrary, it can reduce the rates of taxation on the lower income bracket people. Further, the Government can also offer various subsidy/free schemes to the people earning below certain level of income, say the BPL (below poverty line) families. This is the reason why the Government offers various facilities to poorer sections of the society such as providing free medical facilities,

educational facilities, cheap/free housing, cheap/free rations through fair price shops etc. Thus, through the effective use various fiscal instruments, the Government, on one hand, can reduce the purchasing power of the richer sections and on the other hand, increases the purchasing power of the poorer sections of the society.

4. **Maintaining Balance or Trade:** The Government in most of the times seeks to limit the imports only to the essential items. As a result, it imposes heavy import tariffs/import duty of non-essential items. On the other hand, the Government encourages the exports of its surplus production. It reduces the burden on export items and also supports them with subsidies and grants. These operations of restricting imports and encouraging exports of the Government maintain the balance of trade.

5. **Protection of Infant Industries:** The Government of an underdeveloped country seeks to protect its infant Industries against foreign competition through the use of various public instruments like imposition of heavy tariff duties on imports, putting restrictions on imports, giving subsidies to domestic industries to keep the cost low etc. The objective of such operations is to enable these industries to stand on their legs against competition from foreign giant companies.

6. **Development of Particular Sector of the Economy:** The Government can use different tools of public fiancé to help certain sectors of the economy, say, agriculture, industry, service etc. Based on its priorities, the Government can provide grants, subsidies, tax rebates etc. to certain target sectors/industries. Further, to help those particular sectors to grow, the Government can also set up certain ancillary industries of its own. For example, to help the industrial sector grow, India, during its initial planning years, set up a huge public sector in the basic industries like steel, oil and natural gas, telecom, railways, airways etc.

Similarly, to help the rural and agricultural sector, the Government set up the institutions like the Food Corporation of India, Indian Council of Agricultural Research, National Bank for Rural Development (under the control of the Reserve Bank of India) etc. Various other policies like the Minimum Support Price, Lead Bank Scheme, Public Distribution System, various rural development and employment generation schemes were also adopted by the Government to support the rural and agricultural sector of the country.

Thus, from the above discussion, we can conclude that the Government of a country can push up the different sectors of the economy to achieve the objective of economic development as well as

to provide employment opportunities, encourage investments and savings in the desired direction and increase social benefits through public expenditure. On the reverse, it can have an influential check over infrastructure economic and social activities, mitigate the inflationary and deflationary trends in the economy regulates the consumption and production of unwanted items, and can regulate the flow of imports to protect its own industries and so on. It therefore, affects the overall economic and social system of the country. In a nutshell, public finance plays a very crucial role in the modern times, both in developed and developing countries.

Check Your Progress-II

Q1. Mention the major subject maters of public finance.

Ans: ....

Q2. How can public finance regulate consumption habits of people?

Ans: ....

1.6 Summary

The term "public finance" clearly is a combination of two meaningful words, viz., public and finance. Public means, the public authority, i.e., Government and finance means financial resources. In this way, loosely speaking, public finance studies how Government collects and utilizes the resources. The subject public finance (also termed as public economics) describes and analyses government services, subsidies, welfare payments as well as the methods by which the expenditures to these ends are covered through taxation, borrowing, foreign aid and the creation of money. The classical economists viewed Public Finance only as the subject of dealing with revenue and expenditure of the Government, though some of them also talked about public debts.

In the recent times, Public Finance has come to be considered as a branch of study more than merely the study of public revenue and expenditure. Particularly, in the aftermath of Great Depression of the 1930s and with the emergence of Keynesian Economics, the role of public finance got a higher level of attention. Thus, public finance is the subject, which studies the income and expenditure of the government as a means to achieving the economic objectives of stabilization, growth and welfare of the people. The classical economists including Adam Smith, David Ricardo being the advocates of the 'laissez faire' policy, did not favour large-scale intervention of the government in the individual decision-making process. Thus, they viewed the role of public finance is very limiting cases of simple fiscal problems. Social and economic policies were considered to be outside its purview. The normative aspect of public finance got due weightage after the publication of Keynes' General Theory in 1936. Here, Keynes argued that the fiscal operations of the Government can be effectively used to influence the general level

Of economic activity in the economy. The change in the perspective towards the role of the Government in the modern times clearly indicates that public finance is not merely the study of revenue and expenditure process. It is also concerned with the distribution and stabilization affects, only through which the overall economic growth can be attained. On such grounds, public finance can definitely be seen as a normative science. Study of public finance is helpful in solving many practical problems. Public finance is therefore also an art. The scope (or, subject matter) of public finance may be discussed under the broad heads like: (a) public revenue, (b) public expenditure, (c) public debt, (d) financial administration and (e) economic stabilization. In a nutshell, public finance plays a very crucial role in the modern times, both in developed and developing countries.

1.7 Questions For Practices

A. Short Answer Type Questions

Q1. Why Plehn considered public finance as a Science?

Q2. Mention the important aspects of public finance as discussed by the pre-Keynesian economists.

Q3. How does Keynes influence the subject public finance?

Q4. Trace out the major changes in the subject public finance in the post-Keynesian period.

Q5.Put forward a comprehensive definition of the subject public finance.

Q6.Mention the major contributions of Bastable to the subject public finance.

B. Long Answer Type Questions

Q1.Discuss the nature and scope of public finance.

Q2. Discuss the scope of public finance.

Q3.Discuss the subject matter of public finance.

1.8 Suggested Readings

- Bhatia, H.L. (2005), "Public Finance", New Delhi, Vikas Publishing House Pvt. Ltd.
- Lekhi, R.K. (2001), "Public Finance and Fiscal Policy", Ludhiana, Kalyani Publishers.
- Menkar, V.G. and Sarma, L.S. (2001), "Public Finance: Theory and Practice", Mumbai, Himalaya Publishing House.
- Prakash, O. (2008), "Public Economics: Theory and Practice", Jalandhar, Vishal Publishing House.

M.A (ECONOMICS)

SEMESTER-I

COURSE: PUBLIC FINANCE

UNIT 2: THEORY OF SOCIAL GOODS STRUCTURE

2.0 Learning Objectives

2.1 Introduction

2.2 Evolution of the Theory of Social Goods

2.3 Classification of Social Goods

2.4 Characteristics of Social Goods

2.5 Theory of Social Goods

2.5.1 Lindahl's Theory of Social Goods

2.5.2 Samuelson's Theory of Social Goods

2.5.3 Demand and Supply Equilibrium

2.6 Free Rider Problem

2.7 Summary

2.8 Questions for Practices

2.9 Suggested Readings

2.0 Learning Objectives

After reading this unit, learner will be able to:

- Understand the difference between public goods and private goods
- Distinguish between merit goods and demerit goods
- Identify the two main characteristics of public goods

- Describe the two theories of pure public goods
- Know the free rider problem in pure public goods.

2.1 Introduction

The allocation function of public policy is justified by the theory of social goods. Non-excludability and non-rivalry are characteristics of public goods. The private market fails to use resources efficiently in the provision of public goods. Public goods are also linked to the so-called "free-rider" dilemma, in which those who do not pay for a good can continue to use it, resulting in underproduction, over-consumption, and degraded commodities, necessitating government action.

The issue then becomes how the government should decide how much of these things should be produced and distributed. The challenge is determining the type and quality of a public good that should be provided, as well as how much a certain consumer should be charged. Consumers pay for the advantages they obtain when purchasing private goods, but the difficulty with public goods is determining how these benefits are valued. Besides this, there is no need for individual consumers to disclose to the government how much they value the public goods. Let us understand in detail.

It is important to mention here that the market mechanism alone cannot perform all economic functions so there is a need for the public sector. It is needed to guide, correct and supplement the market mechanism in certain respects.

Prof. Musgrave explained the importance of the public sector and the need for government intervention to remove the obstacles to free entry and for providing the full market knowledge to the consumers and producers. Besides this, it is needed to bring high employment, price level stability and the socially desired rate of growth.

2.2 Evolution of the Theory of Social Goods

Classical economists believed in the policy of laissez faire and non-interference by government in economic affairs; however, they had accepted the role of the government sector. For instance, Prof. Adam Smith justified four types of government duties in his book, “The Wealth of Nations” 1776 as (a) the duty of protecting the society from foreign invasion, (b) the duty of

establishing administration of justice, to provide for law and order within the country, (c) the duty of setting up and maintaining beneficial institutions and public works, (d) and the duty of maintaining the sovereign or the executive agency level.

John Stuart Mill, in his "Principles of Political Economy" (1848), accepted government allocation on a much wider basis than Smith. According to him, "there is scarcely anything really important to the general interest, which it may not be desirable, or even necessary, that the government should take itself, not because private individuals cannot effectually perform it, but because they will not." Thus, he believed that the government can enter in any field of economic activity and especially those which are generally not undertaken by private individuals.

Prof. Pigou further supported the case for the public sector in his book, "A Study in Public Finance" in 1928. In the words of Prof. Pigou, "just an individual will get more satisfaction out of his income by maintaining a certain balance between different sorts of expenditure, so also will a community through its government. He believed that resources should be allocated among different uses in such a manner that the marginal utility in each use is the same.

The theory of public goods, social goods and merit goods establishes a rationale for allocating resources to meet social and merit wants. In other words, it emphasizes that the government should be responsible for providing public goods. It indicates that the theory of public goods gives a rationale for the fiscal allocation of resources to meet social and merit needs. It appears in the budget policy's allocative function. The problem is crucial to public-sector economics, just as consumer-household and firm theories are to private-sector economics. Let us now understand public goods, social and merit goods, and show why social and merit desires cannot be met efficiently through market mechanisms.

2.3 Classification of Social Goods

1. Private Goods: Private goods yield utility or satisfaction only to those persons who are consuming that good; it is denied to others, only the person who drinks a cup of coffee, for example, benefits from the consumption of that cup of coffee. And the coffee consumed by one person cannot be consumed by anyone else. Thus, it can be said that private goods are rivals in consumption. Moreover, a private good is priced in the market and only those are allowed the

use of it who pays its stipulated price. Thus, those who do not agree to pay its market price, or those who cannot pay for it, are excluded from the use of the private goods. It means the principle of exclusion is applicable in case of private goods.

2. Public Goods and Services: Pure public goods are those goods in which one person's consumption of the goods does not reduce the amount available to others i.e., the consumption of a public good is non-rival in nature. It means in case of public goods A's partaking of consumption benefits does not reduce the benefits derived by all others. So the total supply available to the community can be made available to each person in the community. For example, a television signal that is available to one person can be made available to all persons in the area within the range of the signal. And one viewer's use of the signal does not reduce the amount of entertainment for others. It is worthwhile to mention here that a good can be public but not be produced by the government, for example, television signals. Similarly, a private good may be produced by the government, for example, public housing or electricity.

Professor Musgrave called public goods as social wants and was of the view that they should be satisfied by the government. Thus, "Private wants are provided far adequately by the market. Social wants must be satisfied through the budget, if they are to be satisfied at all. He pointed out that public wants are of two kinds: i.e. social wants and Merit wants

A. **Social Wants**: According to Prof. Musgrave "*social wants are those wants which are satisfied by services that must be consumed in equal amounts by all."* People who do not pay for the services cannot be excluded from the benefits that result, and since they cannot be excluded from the benefits, they will not engage in voluntary payments. Hence, such wants cannot be satisfied through the mechanism of market because their enjoyment cannot be made subject to price payments, budgetary provision is needed, if they are to be satisfied at all. In case of private wants, if a consumer wishes to satisfy his desire for any particular commodity, he must meet the terms of exchange set by those who happen to possess this particular commodity and vice versa. That is to say, he is excluded from the enjoyment of any particular commodity or services unless he is willing to pay the stipulated price to the owner. This may be referred to as the exclusion principle. Where it applies, the consumer must bid for the commodities he wants. His offer reveals the value he assigns to them and tells the entrepreneurs what to produce under given cost conditions. This is known as a market mechanism. It is worthwhile to mention here that the market mechanism breaks

down in case of social wants, where the satisfaction derived by any individual consumer is independent of his own contribution.

B. **Merit Wants:** Some goods are deemed "worthy," while others are deemed "undesirable". For example, low-cost housing is subsidized because good dwelling is seen as desirable, but liquor is subjected to sumptuary taxes since drinking is deemed undesirable. It is important to note here that the consumption choices which are supported may involve goods which are private (rival in consumption) as well as goods which are social (non-rival in consumption). Merit goods are those for which it is considered that consumption should be promoted; non-merit or demerit goods are those for which it is thought that consumption should be discouraged. Merit wants to become public when they are deemed so important that they are funded through the public budget, in addition to what is available in the market and paid for by private buyers. It includes publicly furnished schools, subsidized low-cost housing and free education. Thus, it can be said that social wants and merit wants are public wants.

Difference between Social Wants and Merit Wants: It should be carefully noted that the satisfaction of merit wants cannot be explained in the same terms as the satisfaction of social wants. While both are public wants in that they are provided for through the public budget, different principles may apply in their satisfaction. Social wants constitute a special problem because the same amount must be consumed by all, with all the difficulties to which this gives rise. The satisfaction of merit wants, by its very nature, involves interference with consumer preferences. Besides, the social wants satisfy the condition of non-excludability, indivisibility and non-rival nature of consumption of goods and services while these are not the necessary conditions for merit wants, i.e., they may apply or may not apply.

Moreover, certain public wants may fall on the border line between private and social wants, where the exclusion principle can be applied to a part of the benefits gained but not to all. Budgetary provisions for free education services or free health measures are examples for this. Such measures are of immediate benefit to a particular pupil or patient, but apart from this, every person stands to gain from living in a more educated or healthier community.

Difference Between Merit Goods and Non-Merit Goods: Merit and non-merit goods are simply those goods that generate external cost or benefits. Certainly goods that are often termed

merit (or non-merit) may also give rise to external costs or benefits, as occurs when an intoxicated person drives a car. However, in the case of merit and non-merit goods, rationale for Interference with individual choices is that consumption of the commodity is either good (merit) or bad (non-merit) for the person who consumes or uses the goods, regardless of whether other persons are also favorably or un favorably affected. It means that the satisfaction of merit goods does not depend upon the costs or benefits of the goods in question. Thus, the motive for interference in the satisfaction of merit wants does not require the existence of external costs or benefits.

Merit goods may also be provided for distributional reasons. People may wish to make minimum levels of necessary goods and services (housing, education and medical care) available to everyone. But, they may not wish to redistribute money incomes so that each person can and will obtain these levels; doing so would involve too much equality in the availability of other less necessary goods and services. It means people may not care that poor people are deprived of movies, television, vacations, and non-basic items of food and clothing. But, they may care very much if the poor are deprived of the basic necessities of life. The freedom to belong may override the freedom to exclude.

2.4 Characteristics of Pure Public Goods

The pure public goods possess the two main characteristics

There are certain things that we are happy to share with others, such as fresh air or sunlight in the open air, swimming in a lake, or watching a TV show together in our living room. This is because my consumption is unaffected or decreased when others eat it at the same time. In terms of consumption, such items are unrivalled. As a result, products may be separated according to consumer rivalry. . For goods whose consumption is rivalrous, like coffee, tea and biscuit, we can write $X = X1 + X2$, where X is total supply and , i = 1, 2 is the amount of consumption by consumer i. On the other side, the goods whose consumption is non-rivalrous, like fresh air, cricket match, street lighting, knowledge, flood control system and national defense, we can write $X = X_1 = X_2$. In this instance, both consumers can consume the entire amount if they so want. Rivalry is defined as the impossibility of other consumers to consume at the same time, and non-rivalry is defined as the capacity to do so. There are non-rival consumption commodities

for which some customers may be excluded from consuming them. In the case of a street light, for example, no one may be excluded from using it. Those who have not purchased a ticket or acquired a pass may be excluded from a cricket match. Producers have the ability to exclude Specific types of consumers. It is worthwhile to mention here that private goods possess both thecharacteristics of rivalry in consumption and excludability from consumption.

Check Your Progress-I

Q1. Define public goods.

Ans...

- -

Q2. What is the difference between private goods and public goods?

Ans...

- -

Q3. Distinguish between merit goods and non-merit goods.

Ans...

- -

2.5 Theory of Social Goods

To calculate the quantity of a public good or its distribution to different users, several approaches have been employed. In this case, we define cost as the price or tax. There are two types of approaches: partial equilibrium and general equilibrium. The first one is linked to Erik Lindahl, while the second is linked to Paul Samuelson. Let's take a closer look at these two models:

2.5.1 <u>Lindahl's Model</u>

In a market, customers pay a fixed price for an item but receive different quantities according to their demand schedules. The total quantity of a good is equal to the sum of its constituent quantities. When it comes to a pure public good, everyone gets the same amount, and the total remains constant. Because various customers' demand schedules for a public commodity are varied, different prices may be expected to be paid by them.

It would be costly since numerous public goods would need to be created. The cost of manufacturing might be distributed to various consumer-citizens on a mandatory basis. However, the allocation rule cannot be uniform. Knut Wicksell advocated that (I) each public good be funded by a distinct identified tax and (ii) the quantity to be given be decided by all members of society unanimously. The Voluntary Exchange Model is what it's called. Eric Lindahl expanded on the concept. The following is how Lindahl's strategy works.

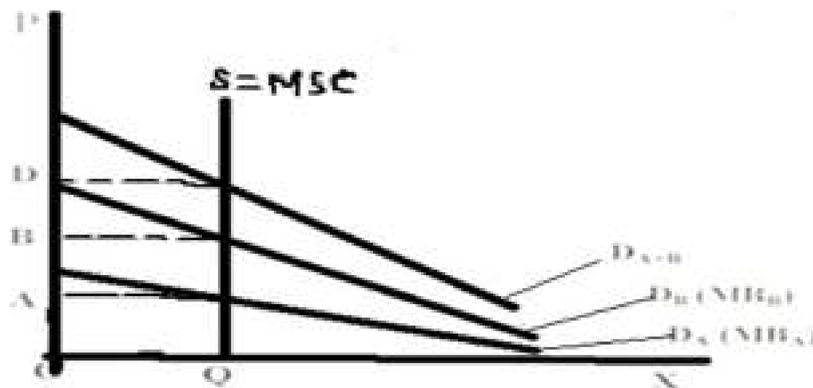


Figure 2.1

It can be seen from the figure 2.4 that there are only two consumers, A and B, of a public good. In Fig. 2.1, we draw DA, DB and DA+B. DA+B is the vertical summation of DA and DB. For clarity, we assume that these are straight lines. The curve S=MSC is the supply curve which represents the marginal social cost. The figure clearly indicates that public good has to be produced in OQ quantity and for this OQ quantity, A and B have to pay OA and OB prices respectively and it represents their marginal benefits (or utilities) MBA and MBB, for a public

good, Thus, in case of public goods:

$$\text{MSC} = MBA + MBB$$

Nature of Demand and Supply Schedule of Private Goods and Social Goods: Let us understand the demand and supply schedule of private goods and social goods through figure a,b

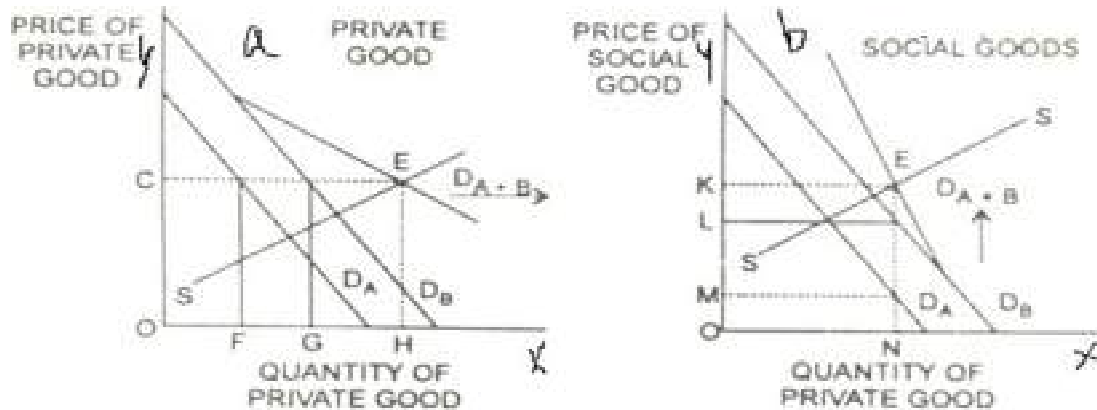


Figure 2.2

Figure 2.2 (a) shows the market for private goods where DA and DB are A's and B', demand curves based on a given distribution of income and prices for other goods. The aggregate market demand curve DA+B is obtained by horizontal addition of DA and DB, adding the quantities which A and B purchase at any given price. SS is the supply schedule, and equilibrium is determined at point E where the market demand curve intersects the supply curve. At this point, price is equal to OC and output is OH. The OF amount of the commodity is purchased by A and OG by B, where OF+ OG=OH.

Figure 2.2 (b) shows corresponding demand and supply curves for a social good. It is assumed that consumers are willing to reveal their evaluation of the social good. As before DA and DB are A's and B', respective demand curves, subject to the same conditions of given incomes and prices for other goods. It is also supposed that consumer preferences are revealed.

The crucial difference from the private good case then arises is that the market demand curve DA + B is obtained by vertical addition of DA and DB with DA+B showing the sum of the prices which A and B are willing to pay for any given amount. This follows because both consume the

same amount and each is assumed to offer a price equal to his or her true evaluation of the unit. The price available to cover the cost of service equals the sum of prices paid by each. SS is again the supply schedule, showing marginal cost for various outputs of the social good.

The level of output corresponding to equilibrium output OH in the private good case now equals ON, which is the total quantity consumed by both A and B. The combined price equals OK, but the price paid by A is OM while that paid by B is OL where OM+OL=OK.

In the case of private goods, it can be seen that the vertical distance under each individual's demand curve reflects the marginal benefit which each individual derives from its consumption. At equilibrium E, both the marginal benefit derived by A in consuming OF and the marginal benefit derived by B in consuming OG equals marginal cost HE. This is an efficient solution because marginal benefit equals marginal cost for each consumer. If the output decreases to OH, the marginal benefit for each individual exceeds the marginal cost and each will be willing to pay more than needed to cover the cost. Net benefits will be gained by expanding the output so long as the marginal benefits exceed marginal cost of doing so, and net benefits are maximized therefore by producing OH units, at what point marginal benefit equals the marginal cost. Welfare losses would occur, if the output is expanded beyond OH, because marginal cost would thereby exceed the marginal benefit. Hence, net benefits are maximized by producing OH units, where the marginal benefit equals the marginal cost.

In figure 2.2 (b), the equilibrium point E shows the equality between the sum of marginal benefits and the marginal cost of the social goods. If the output decreased, the vertical addition short of ON, it will again be advantageous to expand it because the sum of the marginal benefits exceeds cost, while an output in excess of ON, would imply welfare losses, since the marginal cost out-weights the sum of the marginal benefits.

From the above discussion, an important difference arises in the case of public goods and private goods. In case of private goods, efficiency requires equality of marginal benefit derived by each individual with marginal cost. On the other hand, in the case of social goods, the marginal benefits derived by the two consumers differ and it is the sum of marginal benefits that should equal marginal cost. Prof. Musgrave pointed out that the basic doctrine of 'consumer's sovereignty' rests on the assumption of complete market-knowledge and traditional appraisal. In the modern economy, the consumer is subject to advertising, screaming at him through the media of mass communication and designed to sway his choice rather than to give complete

information. The distortions may arise in the preference structure that needs to be counteracted.

According to Prof. P.E. Taylor, "Individual consumption decisions are inferior because of inadequate knowledge, and the market principle results in allocation of resources to other than the best uses". It means that the market economy may fail to achieve efficient allocation of resources due to imperfect conditions of the market, for instance, imperfect knowledge of the market.

2.5.2 Samuelson's Theory of Social Goods

Paul Samuelson defined the notion of public goods in his article "The Pure Theory of Public Expenditure" released in 1954. For this, he developed the phrase "collective consumption goods." It refers to commodities that are inherently non-rival and non-excludable. His paper showed that "no decentralized pricing system can serve to determine optimally these levels of collective consumption".

Let us understand how a market system allocates resources to the government of a public good? And how this market determines supply and how government action affects the welfare of the members of a community. How market supply of public goods is inefficient and how collective supply or government supply of public goods is more efficient.

It is evident from figure 2.2 that on x-axis we take the demand for public goods and on y-axis we take the price. The curve S(MC) is the supply curve for the public good. The demand curves for two individuals, A and B, have been shown in the diagram as dA and dB respectively. If they are only two individuals in the community, what is the community's demand curve?

The community demand curve depicts the marginal value of a public good to the community, or the value of other commodities that community members are prepared to forego in exchange for an additional unit of public good, say X. The marginal value of X to the community is the total of the individual marginal values, since any unit of X may be made accessible to every member of the community without diminishing the quantity available to any other person. A curve ED depicts this. To figure out what the community value of the qth unit is, we need to know what the individual values of A and B are for the qth unit.

Since, the individual A has PA value and the individual B has PB value for qth unit of the commodity. Hence, the value to the community for qth unit is equal to PA+ PB = P.

2.5.3 <u>Demand and Supply Equilibrium</u>

How much public goods (say X) will be provided with the given demands and supply curve. A's marginal value of X exceeds the marginal cost of X for quantities upto qth units, while B's marginal value exceeds the marginal cost for quantities upto qB units. So, the maximum that A would purchase at a price equal to marginal cost is qA while the maximum for B is qB. However, if A should first purchase qA units, then those units will also be available to B, who would then be willing to purchase only qA, qB additional units. Similarly, if B should purchase qB units, then A would purchase nothing. So, each person's purchases of the goods affect the other's willingness to purchase it. It is because of the fact that social goods are provided without exclusion. It can be seen from figure 2.3.

Neither A nor B is willing to bear the full cost of extending output beyond qB although B as an individual would demand and pay for an output of qB. Therefore, we might expect the market determined output of X to be at least as great as qB.

Thus, it can be said that market output of a public good can be at least as great as the maximum output that any one person in the community is willing to purchase unaided by others; it is qB in figure 2.3.

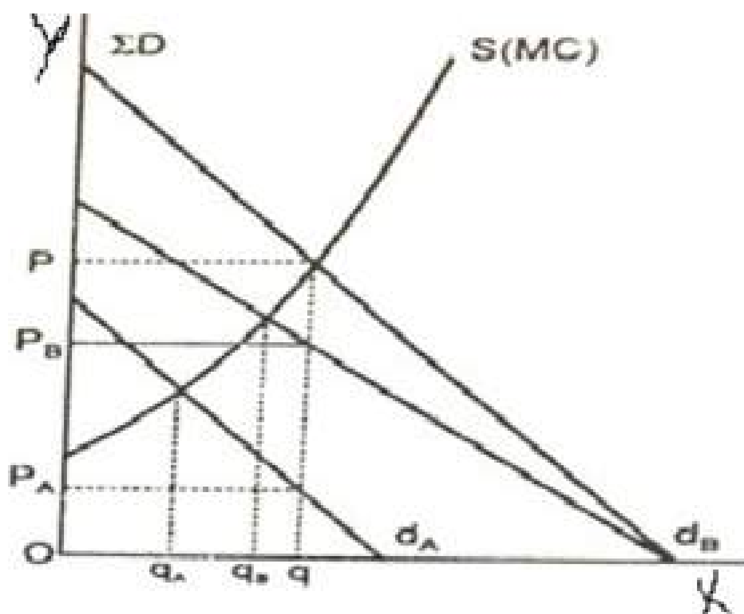


Figure 2.3

The market output may exceed qB and reach to the point q. The price to each buyer must be equal to his or her marginal value of X at q, which is PA for A and PB for B. Such pricing usually means that each person cannot be charged the same price.

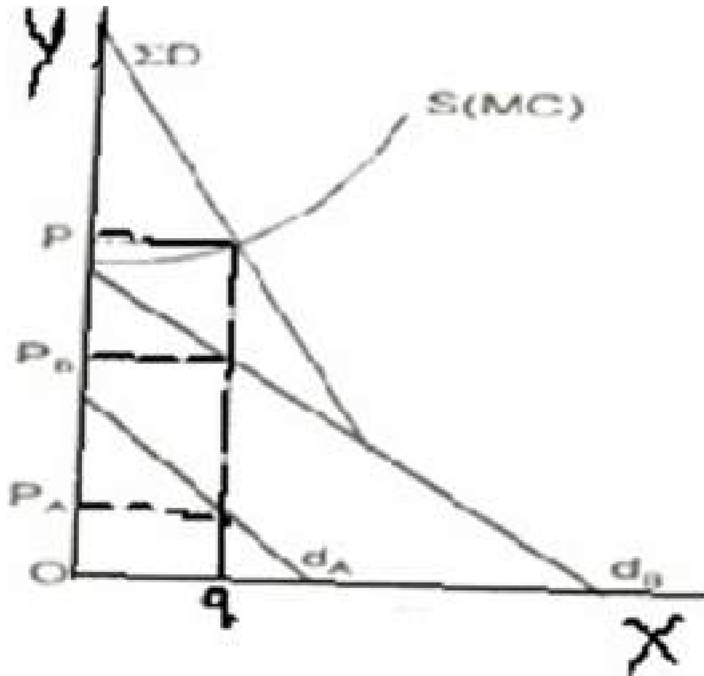


Figure 2.4

It can be seen from figure 2.4 that output could be zero or nearly so in the case of such goods as national defense or television "specials" that are very costly per unit. From the figure 2.4 zero output case is the point where marginal cost exceeds the marginal value of both A and B for the first unit of production.

It should be noted here that extending output beyond qB in figure 2.3, produces a potential welfare gain for both A and B or, more generally, for all members of the community. It means that if the output expands beyond qB, it increases the welfare of all members of the community. It means utility is greater than the cost of the commodity. To put it differently, for outputs less

than q, it can be said that the cost of producing each unit of X is less than what the members of the community are willing to pay. It means that the welfare of each member of the community can be increased by collective action (collective supply of public goods) that expands the output of X to q and distributes the cost of outputs expansion in such a way that no one is made worse off.

Such action is collective in which, the cost of additional X (means public goods) has been shared by members of the community in such a way that no one is made worse off.

For outputs more than q, on the other hand, there is no way to divide the cost of extra X without some persons paying more than they are willing to pay. As a result, increasing output beyond q is incompatible with economic efficiency since it inevitably makes some people worse off.

Prof. Musgrave stated in the context of the cost of collective action and the delivery of public goods that when it has been decided that public needs, whether social or merit, would be met through the budget. It means that the government must provide for the fulfilment of such desires. The government should cover the expense of collective action and budgetary provisions should be made for this purpose.

2.6 Free Rider Problem

The free rider problem is a major issue in economics. It is considered an example of a market failure. That is, it is an inefficient distribution of goods or services that occurs when some individuals are allowed to consume more than their fair share of the shared resource or pay less than their fair share of the costs. It prevents the production and consumption of goods and services through conventional free-market methods. To the free rider, there is little incentive to

Contribute to a collective resource since they can enjoy its benefits even if they don't. As a consequence, the producer of the resource cannot be sufficiently compensated. The shared resource must be subsidized in some other way, or it will not be created.

Why this problem occur:

This problem will occur, when everyone consumes resources in unlimited amounts and when no one can limit anyone else's consumption expenditure. To resolve this problem, the role of government is very important. The government responds by collecting and distributing tax revenue to fund public services. In theory, taxes are proportional to income, allowing for equitable cost-sharing. Besides this, a modest charge can be imposed on everyone in a

community. This will reduce over consumption and, over time, may even encourage altruism.

Check Your Progress-II

Q1 Write a Short note on Samuelson's theory of pure public goods?

Ans...

- -

Q2 What do you understand by the free rider problem?

Ans...

- -

2.7 Summary

In this unit, we have studied that supply of pure public goods should be entrusted in the hands of the public sector. If the task is left in the hands of the private sector, then even a pure public good would have to be priced. This would automatically involve the enforcement of the principle of exclusion to its use. As a result, a section of the society will be deprived of the use of this good. This is highly undesirable in many cases, since a number of needy members of the society would be left out. However, though desirable, the state may not be able to provide all those goods, because the state may not have enough resources to undertake the supply of all goods which are considered public in nature. Besides this, the administrative machinery of the state may not be efficient enough to undertake the provision of all goods which are predominantly public in nature. It is generally considered that the efficiency in public undertakings is low as compared to the private undertakings. The extent to which a government will choose to undertake the

Provision of public goods also depends upon the political and social acceptability of the government policies.

2.8 Questions for Practices

A. Short Answer Type Questions

Q1.What are the two key characteristics of public goods?

Q2.Name two public goods and explain why they are called public goods.

Q3. Elaborate the free rider problem.

Q4. Distinguish between public goods and private goods.

B. Long Answer Type Questions

Q1. Define public goods. Also elaborate how individual demand curves are added to find out the societal demand curves in case of public goods.

Q2. Explain in detail the Lindahl's theory of social goods.

Q3. How Lindahl's theory of social goods is different from Samuelson's theory of pure public goods?

Q4.Define Merit goods.

2.9 Suggested Readings

- B. P. Tyagi, Public Finance
- J. K. Mehta, Public Finance
- J. R. Gupta, Public Economic in India, Theory and Practice
- R. A. Musgrave and P. B. Musgrave, Public Finance in Theory and Practice

M.A (ECONOMICS)

SEMESTER- I

COURSE: PUBLIC FINANCE

UNIT 3: THEORIES OF TAXATION AND EFFECTS OF TAXATIONSTRUCTURE

3.0 Learning Objectives

3.1 Introduction

3.2 Principle of Equity

3.3 The Benefit Approach

3.3.1 Lindhal Model

3.3.1.1 Extent of state activity

3.3.1.2 Allocation of the total expenditure among various goods and services and

3.3.1.3 Allocation of tax burden.

3.3.2 Bowen model

3.4 The Ability to Pay Approach

3.4.1 Subjective Approach

3.4.1.1 The Principle of Equal Absolute Sacrifice;

3.4.1.2 The Principle of Equal Proportional Sacrifice; and

3.4.1.3 The Principle of Equal Marginal Sacrifice (or Minimum Aggregate Sacrifice).

3.4.2 Objective Approach

3.4.2.1 Ownership of Property

3.4.2.2 Tax on the Basis of Expenditure

3.4.2.3 Income as the Basis

3.5 Cost of Service Principle

3.6 Effects of Taxation

3.6.1 Effects of taxation on Production

3.6.2 Effects of taxation on Distribution and

3.6.3 Other effects of Taxation

3.7 Effects of Taxation on Production

3.7.1 Ability to work, Save and Investment

3.7.2 Effects on Willingness to Work, Save and Investment

3.7.3 Effects on Diversion of Resources

3.8 Effects on Distribution

3.9 Summary

3.10 Questions for Practice

3.11 Suggested Readings

3.0 Learning Objectives

After reading this unit, learner will be able to:

- Know Benefit Approach of taxation
- Evaluate limitations of benefit approach
- Differentiate Ability-to-Pay Approach and index of Ability-to-Pay.
- Define Cost of Service Principle
- Examine the effects of taxation
- Describe economic effects of taxation on production, distribution and stabilisation.

3.1 Introduction

In a context where many governments have to cope with less revenue, increasing expenditures and resulting fiscal constraints, raising revenue remains the most

important function of taxes, which serve as the primary means for financing public goods such as maintenance of law and order and public infrastructure. Assuming a certain level of revenue that needs to be raised, which depends on the broader economic and fiscal policies of the country concerned, there are a number of broad tax policy considerations that have traditionally guided the development of taxation systems. These include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility.

Most of the countries are welfare states and the functions and responsibilities of these governments are continuously expanding. The states cannot perform functions in the absence of finance or revenue, which can be raised from various sources such as taxes, loans, creation of money, profits of public undertakings etc. The most important source of revenue in modern times is taxation. It is clearly a desired characteristic of taxes that they should be fair. Apart from the ethical desirability of equity, there is need on practical grounds also, that taxes should be acceptable to tax paying public. An important question widely discussed in public finance is what kind of tax system is fair, just or equitable. As seen above, equity in taxation was the first canon of taxation on which Adam Smith laid a good deal of stress. A fair tax system is not merely an issue in pure economic analysis but also in social philosophy.

3.2 The Principle of Equity in Taxation

The welfare approach to distribution of tax burden grew out of the equity view. The problem of equity has two major aspects: The first is horizontal equity that people in similar circumstances should be treated similarly. The other is vertical equity that people in dis-similar circumstances should be treated differently. There is almost unanimity among economists that persons in the same circumstances should be taxed to the same extent, but the treatment of persons in dissimilar circumstances poses complex problems. While vertical equity has great merit as an ideal but it is very hard to achieve it in practice. This is because there are many views held as to what is the appropriate degree of inequality with which persons in dissimilarcircumstances should be treated.

There are two prominent theories put forward to devise a fair or equitable tax system. They are (1) Benefits Received Theory and

(2) Ability to pay Theory.

There are several approaches to the theory of taxation. The Benefit and Ability to Pay approaches are the subject matter of this lesson.

Check Your Progress-I

Q1. What do you mean by principle of equity?

Ans...

- -

Q2. What is horizontal and vertical equity?

Ans...

- -

3.3 The Benefit Approach or Voluntary Exchange Principle

According to this theory of taxation, citizens should be asked to pay taxes in proportion to the benefits they receive from the services rendered by the Government. This theory is based upon the assumption that there is an exchange relationship or quid pro quo between the tax payer and Government.

The Government confers some benefits on the tax payers by performing various services or providing them what are called social goods. In exchange for these benefits individuals pay taxes to the Government. Further, according to this theory, equity or fairness in taxation demands that an individual should be asked to pay a tax in proportion to the benefits he receivesfrom the services rendered by the Government.

In the Benefit Approach, the relation of taxpayer and government is seen in quid-pro quo term. Since the relation is one of exchange, the benefit approach involves the application of the rules of one sector to the entire government sector. Benefit principle is based on the idea that people should pay taxes based on the benefits they receive from government services. It tries to make public goods similar to private goods. The

more you use, the more you pay. According to this theory, the total tax burden should be so distributed among the people that each of them pays that proportion of the total expenses, which his benefits bear to the total benefits of the society.

That equity is best served if the beneficiaries of the government expenditure pay for these benefits through taxation in proportion to the benefit they enjoy and it is unfair to make some persons pay for what others get. The second advantage of the benefit approach is that it gives simultaneous determination of the tax level and of the level of government expenditure incurred. This happens in the same way as in the market where the prices that people are willingto pay and the amounts that they are willing to buy are determined simultaneously. So, this can be called a willingness to pay theory. In other words, the benefit approach has the advantage of providing a simultaneous determination of public service and the tax shown, thus combining both sides of the budget process.

The benefit approach to taxation was accepted widely among the political theorists of the 17th century. Its modern formulation dates back to Adam Smith and leads up to Voluntary Exchange Theory of Lindahl.

(i) The Classical Version:

The mercantilist writer, Sir William Petty argues that "it is generally allowed by all that men should contribute to the public charge, but according to the share and interest they have in the public peace that is according to their estates and riches".

In the first sentence of his Maxim Smith introduced ability as well as benefit considerations in revenue rising. Smith observes "the subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to the revenue which theyrespectively enjoy under the protection of the state**".**

This raises some doubt whether Smith should be placed in the benefit camp. But towards the end of book No. V of Wealth of Nations there appears a clear-cut rule that the cost of public expenditure should be allocated according to benefit and that general contribution should be used only where expenditure cannot be allocated on a benefit basis.

According to Smith, everyone is benefited from public services and everyone should

contribute to the cost of sustaining them. But the problem is how we can measure individual benefit and cost.

Since there is no practical way of doing this, a general rule of thumb is needed in place of individual imputation. This rule, according to Adam Smith, is provided by taxing individuals "in proportion to their respective abilities". That is the revenue which they respectively enjoy under the protection of the state. Musgrave argues that Smith shrewdly inserted an ability element into the weak link of the benefit rule.

(ii) Modern Views on Benefit Theory – Voluntary Exchange Approach:

3.3.1 Lindahl Solution

A modern approach to the benefit view of taxation comes from the famous Swedish economist Erik Lindahl in his voluntary exchange theory in 1919.

In its simplest form, the theory states that the cost of supplying public service should be covered by taxes voluntarily contributed by the beneficiaries, just as they pay voluntarily for any commodity purchased from private market. Lindahl's theory simultaneously tries to find out solution to allocation and distributive aspect of fiscal problem.

Lindahl tries to solve three problems:

3.3.1.1 Extent of state activity

3.3.1.2 Allocation of the total expenditure among various goods and services and

3.3.1.3 Allocation of tax burden.

This model makes four assumptions:

a) There is one social good.

b) The social good is enjoyed by two tax-payers A and B.

c) The distribution of income is ideal, and

d) The social good is produced under conditions of constant costs.

Lindahl's solution involves taking three set of decisions simultaneously. They are:

a) We must determine the total amount of public expenditure to be incurred and tax resources raised
b) The second decision relate to the allocation of total public expenditure among goodsand services meant for the satisfaction of social wants and
c) The allocation of total taxes among various individuals, who are beneficiaries of theprovision of public service.

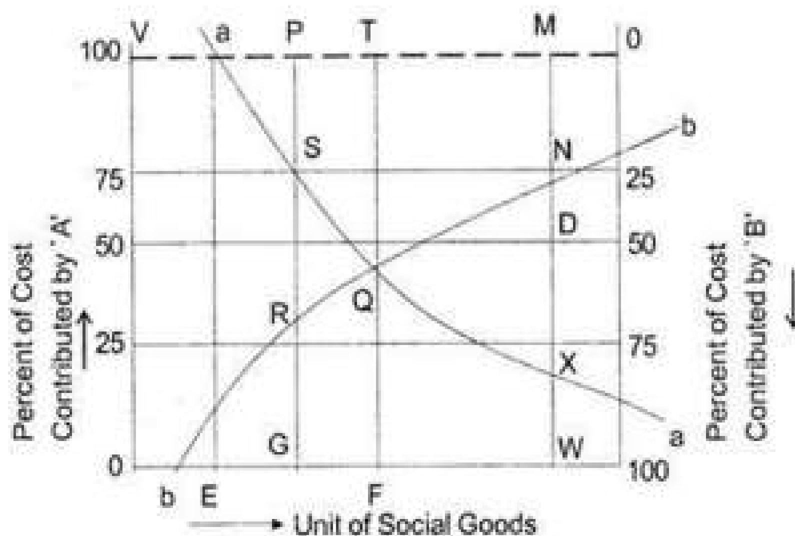
Lindahl states that these decisions are included in the allocation branch and are mutually interdependent and it must be rendered jointly. In a sense Lindahl applies the Marshallian market principle of total cost allocation of two joint products to their respective supply prices.

Lindahl's solution can be explained with the following numerical example. Let us consider a community consisting of two tax payer's 'A' and 'B' and one type of social goods. Both 'A' and 'B' consumes the total amount of social goods supplied. But they receive different amount of satisfaction from it.

Hence, their benefit share may be considered as joint products. So cost of supplying social good is jointly contributed by A and B. Individually, one will have to pay less as the other contributes more

The only way to allocate cost is to do it in accordance with the demand for two products. Thus, if A' is willing to contribute 'X' percent of the total joint cost, then 'B' will be contributing the rest, that is (1 – X) percent of the total cost.

Thus, joint contribution of both A and B covers the total cost of supplying the social



good. It follows that A's offer to contribute certain percentage of total cost may be looked upon as 'B's supply schedule of goods. Likewise, 'B's offer may be similarly seen as the supply schedulefor 'A'.

Quantities of social goods are measured along the horizontal axis. Percentage of total cost contributed by A' along left vertical axis and percentage of total cost contributed by 'B' along right vertical axis.

Total unit cost of supplying social good is OV. The curve 'aa' is the demand schedule of individual A' and 'bb' corresponds to that of 'B'. Taxpayer A' will be willing to contribute100 percent of cost for output OE, which will then be available free to 'B'. At the output level OG, taxpayer A' is willing to contribute GS percent of the cost.

Then the output is available to taxpayer 'B' at PS percent of cost. But taxpayer 'B' willing to contribute 'PR' percent of cost, because 'R' is the point on his demand schedule. Hence the total contribution of taxpayers 'A' and 'B' will exceed the cost of supplying social well by SR percent. This indicates that both taxpayers A and B prefer larger scale of social goods.

The optimum level of social good is given at OF, at which taxpayer 'A' contributes FQ percent of cost and taxpayer 'B' contributes TQ percent of cost. Their combined contribution covers the total cost of supplying OF level of social good

It is not possible to extent the production of social good beyond the quality OF. The reason is that the combined contribution of both taxpayers will fall short of total cost of production.

Let us take the point OW level of output. At this output level, taxpayer 'A' will be willing to contribute WX percent of cost and taxpayer 'B' will be willing to contribute MN percent of cost, because 'N' is the point on his demand schedule. As a result, 'NX' percent of cost will remain uncovered.

Suppose now taxpayer 'A' contributes 'WD' percent of cost, then 'OW' quantity of social goodcan be produced and supplied. But the taxpayers will be paying larger share of cost than the valuation they attach to the social good.

Hence both tax payers 'A' and 'B' will vote for small quantity of social good. Similarly, it can be shown that both the taxpayers will reveal their preference for larger quantity of

social goods, when the supply of social goods falls short of the optimum level at OF.

In this way, the budgetary process for the satisfaction of social wants is determined by a competitive solution, as in the case of a private goods market. Thus, the voluntary exchange model of the benefit approach provides a tool by which the quantity of public goods and the contribution of tax share might be simultaneously determined.

3.3.2 Bowens Model

A better and simple model of benefit principle has been presented by Howard. R. Bowen in his book *"Towards Social Economy"* published in 1948. Prof. Musgrave favours Bowens approach, because it is more realistic and assumes increasing cost conditions in the provisionof social goods.

Bowen's simple model is explained by assuming one social good and two individual tax payers 'A' and 'B'. The figure 2 illustrates the model.

Here we have one social good and tax payers 'A' and 'B'. The demand of taxpayer consumers A' and 'B', respectively for social good are presented by 'a' and 'b'. The total demand forsocial good is given by the schedule (a + b).

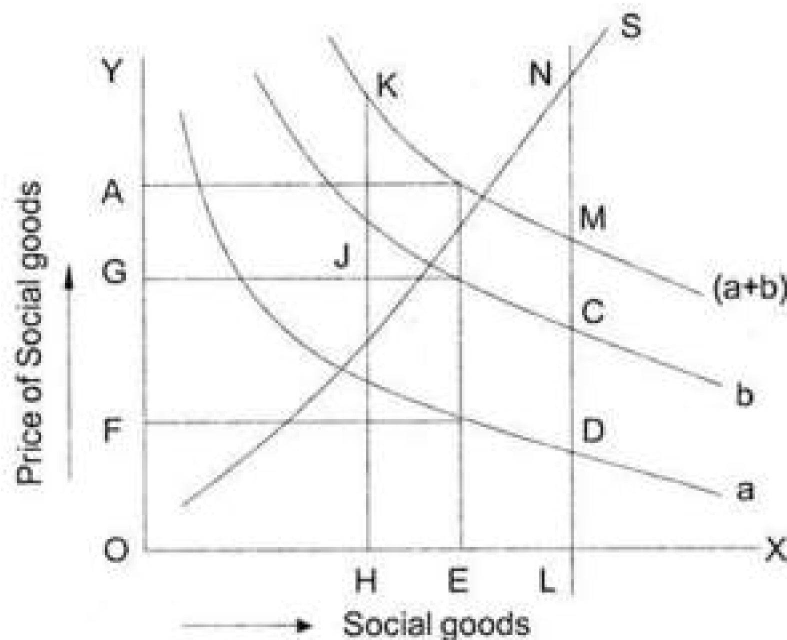


Figure 2: Bowen's Model

The supply curve of social good is represented by ‘S’. It is upward rising, which indicates that social good is produced under conditions of increasing cost. OX axis represent quality of social good and OY axis the price of social goods or tax to be paid by beneficiaries to meet the costof social good. The above figure simultaneously determines the amount of social goods andthe tax share between consumers according to their own valuation of benefits.

The equilibrium quantity of social good is OE, and the total amount of tax revenue to be raised to cover the cost of supplying OE quantity is given by the area OEBA. ED and EC are the marginal benefits expected from OE quantity of social good, by tax paying consumers A andB respectively.

Hence A’ will pay ‘ED’ and ‘B’ will pay ‘EC’ amount of tax per unit, so that the total amountof tax revenue raised comes to OEBA. The tax share of A and B will be OEDF and OECG respectively (OEDF + OECG = OEBA).

Any quantity of social good other than OE level will not be an optimum level of supply. For example, if the public good is at OH output level, the combined contribution of tax per unit will be HK, which is larger than the cost of supplying it that is HJ.

It reveals that more social good is demanded. At OL quantity of social good, the total contribution LM, per unit falls short of its cost, that is LN. Hence OE provides the optimum mix of social goods.

An Assessment of the Benefit Approach:

The benefit approach to tax burden distribution has some advantages. It co-ordinates the revenue and expenditure sides of the budget directly. It involves an approximation of market behaviour in the Allocative procedure of the public sector.

Allocative efficiency and distributional equity considerations are reconciled in this approach. The theory suggests that the benefit conferred by public services justify the imposition of taxes to pay for them. This theory is essentially a cost benefit approach which maintains a balance between income and expenditure of the government.

Moreover, the theory links the provision of public services to the preference pattern of individuals. However, this approach, though simple in application, has little practical

use dueto a number of limitations.

The theory is based on an unrealistic assumption that varied and complex activities of the publicauthorities are calculable and measurable.

According to this theory, this can be assessed on the basis of personal benefit received. But in reality, benefits from public services are indivisible. Moreover, there is no standard yardstick to measure benefit conferred upon the people. How can we measure and divide the benefits of national defence or education, which give rise to externalities.

The benefit approach limits the scope of government activities. Modern state is a welfare state.It provides certain services meant for the common benefit of the society and mostly targetedfor the poorer sections of the community.

In this case, there is no quid-pro-quo basis in the exchange of social goods. Hence, if this theoryis truly followed, government will have to stop many of its welfare oriented expenditure policies targeted towards the socially vulnerable groups in the society. In this sense, the theory seems obsolete.

The Lindahls' solution to benefit approach, assumes optimum distribution of income. However, no precise meaning is given as to what constitute an optimum distribution of income.

At its core, the theory assumes that each consumer reveals his preference for social goods. However, in reality consumers cannot reveal their preferences because of ignorance or with deliberate intension. Hence, authorities cannot judge and take prudent Allocative decisions. Hence, it can be concluded that benefit approach to distribution of tax burden has little operational significance. It is theoretically sound, and is an ideal approach, but lacks of practical applicability.

In practice, state cannot allocate tax burden on the basis of benefit conferred. Many of the budgetary operations of the state are beyond the lines of pure cost-benefit approach. However,it has some limited application, in the case of local authorities.

Local authorities if needed can apply some local taxes on benefit-cost basis. For example, limited application of this principle, in certain taxes such as vehicle tax, for financing improvements in road system is admit able and feasible.

Check Your Progress-II

Q1. Explain Lindhal's model.

Ans...

- -

Q2. Explain Bowen's solution of Benefit approach.

Ans...

- -

3.4 Ability to Pay Theory

The ability to pay is another criterion of equity or fairness in taxation. This theory requires that individuals should be asked to pay taxes according to their ability to pay. The rich have greater ability to pay, therefore they should pay more tax to the Government than the poor.

Essentially, the ability to pay approach to fairness in taxation requires that burden of tax falling on the various persons should be the same. In the discussion of various characteristics of a good tax system, we mentioned about the two concepts of equity, namely horizontal equity and vertical equity based on the principle of ability to pay.

According to the concept of horizontal equity, equals should be treated equally, that is, persons with the same ability to pay should be made to bear the same amount of tax burden. According to the vertical equity, unequal's should be treated unequally, that is, how the tax burden among people with different abilities to pay is divided.

In both these concepts of equity, what exactly do we mean by ability to pay and what are the objective measures of ability to pay are crucial? Some have explained the ability to pay treating it as a subjective concept. Others have treated the ability to pay in terms of some objective bases such as income, wealth, consumption expenditure etc. We shall explain below both theseapproaches to the measurement of ability to pay.

3.4.1 Ability to Pay: Subjective Approach

In the subjective approach to tax paying ability, the concept of sacrifice undergone by a person in paying a tax occupies a crucial place. In paying a tax, a person feels a pinch or suffers from some disutility. This pinch or disutility felt by a tax payer is the sacrifice made by him. In this subjective approach to ability to pay, tax burden is measured in terms of sacrifice of utility made by the tax payers.

The following three principles of sacrifice have been put forward by various authors:

3.4.1.1 The Principle of Equal Absolute Sacrifice;

3.4.1.2 The Principle of Equal Proportional Sacrifice; and

3.4.1.3 The Principle of Equal Marginal Sacrifice (or Minimum Aggregate Sacrifice).

The principle of equal absolute sacrifice implies that the tax burden in terms of utility sacrificed should be the same for all tax payers. If U stands for total utility, Y stands for income and T for the amount of tax paid, then the principle of equal absolute sacrifice requires that $U(Y) – U(Y – T)$ should be the same for all individuals.

The term $U(Y)$ implies that total utility of a given income Y and $U(Y – T)$ implies the total utility of the post-tax income $(Y – T)$. If the equal absolute sacrifice principle is applied, none will be exempted from taxation and everybody will pay same amount of the tax.

Now, the pertinent question is what type of tax, proportional or progressive, follows from this principle. If marginal utility of money income falls, as is generally believed, and if this fall in marginal utility of money income equals the rate of increase in income, then this principle will suggest proportional income tax. However, if the fall in marginal utility of income is greater than the rate of increase in income, then equal absolute sacrifice principle will suggest progressive income tax.

A. **Equal Proportional Sacrifice:** This principle requires that every person should be made to pay so much tax that the sacrifice of utility as a proportion of his income is the same for all tax payers. In terms of the notation used above, this implies that $U(Y) -U(Y- T)/U(Y)$ of all tax payers should be equal. If a person

enjoying higher income is to bear same proportion of sacrifice, then given the falling marginal utility of income, he will have to pay income tax at a higher rate. This means progressive income tax.

B. **Equal Marginal Sacrifice:** According to this principle, tax burden should be so apportioned among various individuals that marginal sacrifice of utility of each person paying the tax should be the same. This approach seeks to minimize the aggregate sacrifice of the society as a whole. When all persons pay so much tax that their marginal sacrifice of utility is the same, the loss of total utility by the society will be minimum. Thus, the principle of equal marginal sacrifice looks at the problem of dividing the tax burden from the point of view of welfare of the whole society. The social philosophy underlying this principle is that the total sacrifice imposed by taxation on the community ought to be minimum. Assuming that marginal utility of income falls, the principle of equality of marginal sacrifice implies very high marginal rates of taxation. Indeed, in the extreme this principle can be used to recommend 100 per cent rate of tax on the people in highest income bracket in the society. Thus, this principle recommends a highly progressive tax structure. This principle of taxation has been recommended among others by Edgeworth, Pigou and Musgrave who consider this as the ultimate principle of taxation.

The whole subjective approach to ability to pay based on the sacrifice of utility has been termed as invalid because utility being a subjective entity cannot be measured in cardinal sense. Further, it is alleged there is no definite evidence that marginal utility of money income falls as income increases.

3.4.2 Ability to Pay: Objective Approach

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

It seems that if the taxes are levied on this principle as stated above, then justice can be achieved. But difficulties do not end here. The fact is that when we put this theory in practice, difficulties actually begin. The trouble arises with the definition of ability to pay. The economists are not unanimous as to what should be the exact measure of a person's ability or faculty to pay. The main viewpoints advanced in this connection are as follows:

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

3.4.2.2 Tax on the Basis of Expenditure: It is also asserted by some economists that the ability or faculty to pay tax should be judged by the expenditure which a person incurs. The greater the expenditure, the higher should be the tax and *vice* versa. The viewpoint is unsound and unfair in every respect. A person having a large family to support has to spend more than a person having a small family. If we make expenditure. as the test of one's ability to pay, the former person who is already burdened with many dependents will have to' pay more taxes than the latter who has a small family. So this is unjustifiable.

3.4.2.3 Income as the Basis: Most of the economists are of the opinion that income should be the basis of measuring a man's ability to pay. It appears very just and fair that if the income of a person is greater than that of another, the former should be asked to pay more towards the support of the government than the latter. That is why in the moderntax system of the countries of the world, income has been accepted as the best test for measuring the ability to pay of a person.

3.5 The Cost of Service Theory

Some economists were of the opinion that if the state charges actual cost of the service renderedfrom the people, it will satisfy the idea of equity or justice in taxation. The cost of service principle can no doubt be applied to some extent in those cases where the

services are rendered out of prices and are a bit easy to determine, e.g., postal, railway services, supply of electricity, etc., etc. But most of the expenditure incurred by the state cannot be fixed for each individual because it cannot be exactly determined. For instance, how can we measure the cost of service of the police, armed forces, judiciary, etc., to different individuals? Dalton has also rejected this theory on the ground that there's no quid pro qua in a tax.

In a democratic country, the policies of the Government should be based on the principle of justice otherwise the people will protest against the unjust policies of the Government. The taxation policy of the Government should be based on justice and equity. How justice can be achieved is a very crucial element of taxation system. A number of theories have been put forward by different economists explaining how justice in taxation can be achieved among which Cost of Service Theory of Taxation is an important theory and is discussed as follows-

This theory implies that the Government should tax the citizens according to the cost of servicerendered by it. The Government renders certain services to citizens and the cost of such servicesshould be collectively met by the citizens The tax, an individual should bear, must be equal to the cost of benefit be receives.

Criticisms of Cost of Service Theory or Taxation

The theory is also subject to several criticisms by many economists.

1. Finding out total cost of services rendered by the Government is very difficult and therefore, the question of distribution of total cost among citizens is not so easy to solve.
2. If we presume that the total cost of services can be determined, the next difficulty is howto divide the cost of the services among individuals.
3. If this theory is followed in the modern welfare state, the poorer will have to pay more taxes because they enjoy more benefits. Hence, it is opposite to the principle of justice.
4. The cost of the services rendered depends very much on the efficiency of the administrator. If the administrator is efficient, the cost would be lower and if the administrator is inefficient, the cost of the benefit would be high.

Check Your Progress- III

Q1. Explain subjective as well as objective approach of Ability to pay approach.

Ans.. ....

Q2. Explain Cost of Service principle

Ans...

3.6 Effects of Taxation

Taxation, these days, is not only used as a means of raising revenues but also it is considered as an important instrument for achieving various socio-economic objectives such as regulation of consumption, production and distribution of income, controlling booms and depressions and thus promoting economic growth with stability in a country. With a view to achieve these objectives we have to analyse in detail the various direct and indirect, favorable and unfavorable effects of taxation on work effort, saving and investment and with reference tothe present and the future generations.

Since the economic effects of taxation may be good as well as bad, the modern government should not keep only the revenue considerations in mind, but the economic effects of taxation should also be considered. Prof. Dalton said that the best system of taxation from the economic point of view is that which has these economic effects under the following three heads:

3.6.1 Effects of taxation on Production

3.6.2 Effects of taxation on Distribution and

3.6.3 Other effects of Taxation

3.7 Effects of Taxation on Production

In line with Dalton, we shall analyse the effects of taxation on production and growth

with reference to (i) ability to work, save and invest (ii) desire or willingness to work, save and invest and (iii) diversion of resources between various employments and localities and influencing pattern and composition of production.

3.7.1 Effects on Ability to Work, Save and Invest

Taxes transfer the purchasing power from the hands of people to government. Hence this transfer implies the reduction of purchasing power of the tax-payer and his ability to obtain the necessary goods, comforts and luxuries of life. This causes adverse effects on the poor people. When the tax burden falls upon the poor, it curbs their income and consumption of necessaries and comforts and lowers their standard of living. Thus, efficiency and ability to work of poor people is adversely affected by taxation. On the other hand, the efficiency and ability to workof richer people is not so much affected by taxation, because taxes on the rich may only curb their consumption of luxuries and that may not affect their efficiency and ability to work. Thatis why heavy taxation on the poor has been strongly objected by one and all. Therefore, taxes on low income and on those articles, which are largely consumed by less well-to-do people, should be avoided in the interest of production and economic growth.

However, there are certain taxes which do not adversely affect people's ability to work. Examples of such taxes are taxes on harmful drugs like opium and liquor. The consumption of these commodities is certainly harmful to the health and efficiency of the people. Hence, taxes on such commodities have good effects on people's health, efficiency and ability to work. Ability to save, on the other hand, depends on income, and when income is reduced by taxation, saving automatically declines. Therefore, using Dalton's words, "Ability to save is reduced by all taxes on those who have any margin of income, out of which saving is possible. The only taxes, therefore, which do not to some extent, reduce ability to save, are those which fall exclusively on people who are so poor that they have no such margin. It is evident that heavy taxes on the rich, though defensible on other grounds (such as equity), substantially reduce their ability to save." The argument is, of course, based upon the presumption that only saving makes an addition to capital and not spending. To most modern economists this argument is fallacious. To them "Capital", in a broad view, includes human capital. Moreover, much "spending" is also required to maintain human capital at its existing

level of efficiency:

Hence, a large proportion of expenditure on its consumption is in short really investment. And, on the other hand, large "Saving" especially in time of trade depression, makes no addition to material capital because it fails to find its way into investment.

Since ability to invest depends on the resources available for investment i.e. savings, any reduction in saving as a result of taxation, is bound to reduce investment and cause adverse effects on production and economic growth.

3.7.2 Effects on Willingness to Work, Save and Investment

Turning from effects of taxation on people's ability to its effects on desire to work, save and invest, we have to take into account, not only the primary effects of actual taxation in the present but also the secondary effects of the expectation that taxation will continue in the future. For it is these secondary effects which are here by far the most important. A tax which is expected to be short-lived as, for example, a special tax to meet some special emergency such as war expenditure or rapid extinction of a war debt, would not produce significant secondary effects of this kind.

Taxation affects the desire or willingness or incentives of the people to work, save and invest and when this happens, the production and growth will automatically be affected. Hence the need arises to analyse the effects of taxes on incentive to work, save and invest. However, the effects of taxation on economic incentives depend upon two types of factors are nature of taxes, and psychological reaction of the tax-payers. We will examine the nature of taxes first.

A. **Nature of Taxes:** From the point of view of production, the aim of taxation is to put people in more work effort, to earn more, save more and invest more. However, the effect of various taxes would differ depending upon the nature of tax. Some taxes have the least or no bad effects at all on the desire or incentive to work, save and invest whereas some have very bad and distorting effects. For instance, taxes on unearned income or windfalls, inheritances, capital gains, abnormal profits etc., all being unexpected will not affect the desire to work and save adversely. Moreover, a reasonable commodity taxation such as sales tax and excise duties may not have

any unfavorable effects on the desire to work, save and invest. But, if a large proportion of the income is taken away by way of taxation of the commodities of wide consumption, the savings are likely to fall due to high marginal propensity to consume.

Similarly, the effect of income tax, wealth tax, inheritance tax and expenditure tax differ in nature. A highly progressive income tax discourages most tax-payers from working hard and saving more and same is the case with wealth tax. But wealth tax has less adverse effects on the desire to work and save of the tax-payer than income tax, since the former does not directly affect the reward for work. Similarly, compared to income tax, inheritance tax is preferable, because the former is paid by the tax-payer out of his present income and the latter will be paid from the wealth and income which he inherits and which is unearned in nature to him. Though, income tax and inheritance tax both affect the desire to work and invest, yet the effects of income tax are more unfavourable on the desire to work and save (and hence on production) as compared to the effect of inheritance tax. An expenditure tax, on the other hand, may have more favourable effect on the desire to work and save than income tax. A progressive expenditure tax will discourage wasteful expenditure on consumption and thus encourage saving and investment.

Thus, it is obvious that, taxes differ in nature and in their effects on the incentives of the people, i.e., on the desire to work, save and invest.

B. Psychological Reaction of the Tax-payers: The psychological reaction of the tax-payers to any tax varies from person to person and is governed by the elasticity of his demand for income. The demand for income is said to be elastic when a person is not so anxious to maintain his given income, and he is not prepared to work hard and secure the same amount of income.

However, the elasticity of demand for income, being more a psychological and subjective factor, and also varying from person to person 'and in different circumstances, is a difficult thing to measure. But, usually, the demand for income, is inelastic i.e. people generally desire to have a certain level of income always and by all means. The factors responsible for the inelasticity of demand - for income may be mentioned as:

1) Some people desire to maintain a certain minimum standard of living for themselves and their families under all circumstances. Such people certainly like to work more, and save more when a tax is imposed.
2) Some people desire to have a definite minimum income from their savings in future, either for themselves or for their dependents. Such people may also like to work more and save more when tax is imposed.
3) Some persons have a strong tendency to accumulate wealth, acquire power and distinction. These, too, are likely to work more and save more on the imposition of tax.
4) Those people who have love for action and enterprise, will also work hard and save more when a tax is imposed.

Check Your Progress-IV

Q1. What are the effects of taxation on ability to work, save and invest?

Ans...

- -

Q2. What are the effects of taxation on willingness to work, save and invest?

Ans...

- -

3.7.3 Effects of Taxation on the Diversion of Economic Resources

While the volume of production in a country depends upon the ability and desire to work, save and invest, the composition pattern of production depends upon the way the economic resources are distributed and allocated between various industries and localities. Taxation can be used as an instrument of fiscal policy for favorable diversion of resources between industries and regions in a country. When the products of certain

industries are taxed, their prices rise, hence the demand for their products falls, and thereby the profits are reduced. This may result in the diversion of resources from these industries to some other industries whose products are either untaxed or are taxed at a lower rate.

The extent to which the diversion of resources takes place - from taxed to non -taxed or low taxed industries - will depend upon the elasticity of demand and supply of the products of such industries. If the demand for taxed commodity is inelastic and its supply is elastic the incidence of tax will be relatively more upon the buyers, and hence, the diversion of resources would not take place. Contrary to this, if the demand for the product is elastic and its supply is inelastic, the incidence of tax will fall upon the producer. If the producer finds it unprofitable or comparatively less profitable to carry on production in taxed industries, the diversion of resources may take place to non-taxed industries.

Beneficial Diversion: Taxation on harmful drugs or injurious articles of consumption may discourage their production, and the labour; capital and other resources employed in these industries may be shifted to other industries. Restriction of consumption and hence of production of harmful goods and the consequent diversion of productive resources to other and more useful industries may be taken as beneficial diversion. A check on the consumption of such articles may also improve the health and efficiency of the consumers. Hence the taxation of such articles is socially desirable. Similarly, a tax on production of luxuries may divert resources (labour capital, etc.) to the production of necessaries. This type of diversion is beneficial, especially, in the under-developed countries where productive resources are generally scarce.

Harmful Diversions: Taxation on necessaries of life or articles of common consumption may not be socially desirable. Taxation on such articles will increase their prices and thus the consumption of these articles may be reduced. This may have an adverse effect upon the health and efficiency of the people. Further, the rise in prices will reduce the demand, and hence, the production of such articles. This may reduce profits and therefore, it is possible that the resources may be diverted from the production of necessaries or the articles of common consumption to that of some less useful goods. Thus, such diversion of resources are harmful and are socially undesirable.

3.8 Effects of Taxation on Distribution

Therefore, one of the major objectives of taxation in modern economies is to use it as an important tool of fiscal policy to reduce the income and wealth inequalities and to bring an equalitarian society. Here the distribution should not be in terms of taxation and distribution; but fiscal policy and distribution. Both taxation and public expenditure are used together to achieve this objective. The effects of taxation on the distribution of income and wealth among the various sections of society, however, depends upon the following two factors:

1. **Nature of Taxes or Tax Rates:** The nature of taxation means whether the taxation is progressive, proportional or regressive. A tax is said to be progressive if the larger the tax- payer's income (or property) the greater is the proportion which he pays as tax. A tax is called proportional if all the tax payers pay the same proportion of their income (or property) as tax. A tax is regressive if the larger is tax payer's income (or property) the smaller is the proportion which he pays as tax.

   If taxation is "regressive", the inequalities in the distribution of wealth and income may increase as the burden of taxation falls more heavily on the poor than on the rich. A toll-tax is regressive, as the amount of tax is the same for the rich and the poor, while the utility of money, which is paid as tax is greater for the poor than for the rich. Hence, the burdenof taxation is higher on the poor than on the rich.

   If taxation is "proportional", inequalities would continue as before, if the income remains the same. But, if the income changes in unequal proportions, the inequalities in income will increase. Therefore, the burden of proportional taxation falls more heavily upon the poor than the rich as the income increases.

   If the tax system is "progressive" the income and wealth inequalities would be reduced, because a higher proportion of the income and wealth of the rich would be taken away by way of taxes than that of the poor. Hence, a sharply progressive tax system tends to reduce inequalities in the distribution of income and wealth and, the sharper the progression, the stronger is the tendency to reduce inequalities.

2. **Kinds of Taxes:** Whether the system of taxation is progressive, proportional or regressive in nature, depends upon the kind of taxes, i.e. whether the tax system is

composed of direct or indirect taxes or both.

A. **Direct Taxes and Distribution:** If taxation is to be used as a tool of reducing inequalities in the distribution of wealth and income in a society, all those taxes which fall heavily upon the rich sections can have favourable distributional effects and hence justified. Therefore, direct taxes like taxes on income, property, wealth, inheritance, gift etc. which are based upon the principle of progression and ability to pay and hence having equitable distributional effect are able to reduce disparity.

B. **Indirect Taxes and Distribution:** The burden of indirect taxes, like taxes on commodities of wide consumption, generally falls on the poor. It is because the poor spend a larger proportion of their income on such commodities than the rich. Since poor people's propensity to consume is higher than that of the rich, the burden of indirect taxes such as taxes on food stuffs, tobacco, cheaper sorts of alcohol etc. falls more heavily upon the poor than the rich. However, the indirect taxes may be made progressive or equitable if the necessaries are exempted from taxation and luxuries are subjected to heavier ad valorem taxes, so that the tax rates would be higher for the highly proved goods of superior quality-which are mainly purchased by the rich. It may, however, be noted that the purchases of luxury goods are optional, and hence the rich can avoid the payment of these taxes by not purchasing such goods or by reducing their demand to some extent.

Further, commodity taxes such as import duties, may have favourable effects on distribution of income. For instance, when duties are levied on imported goods to give protection to those industries in which the wage rates are higher than in other industries there would be tendency for the workers to move from the low wage industries to the high-wage industries. This may help to reduce inequality of incomes. The import duties may also have favourable effect when imposed on those commodities which are imported for the benefits of the rich people. However, indirect taxes are, in general, regressive in nature. Hence, the inequalities of income and wealth cannot be reduced by these taxes.

Other Effects of Taxation:

If taxes produce favorable effects on the ability and the desire to work, save and invest, there will be a favorable effect on the employment situation of a country. Further, if resources collected via taxes are utilized for development projects, it will increase employment in the economy. If taxes affect the volume of savings and investment badly then recession andunemployment problem will be aggravated.

Again, effect of taxes on the price level may be favorable and unfavourable. Sometimes, taxes are imposed to curb inflation. Again, as an imposition of commodity taxes lead to rising costsof production, taxes aggravate the problem of inflation.

Thus, taxation creates both favorable and unfavorable effects on various parameters. Unfavorable effects of taxes can be wiped out by the judicious use of progressive taxation.

3.9 Summary

In this lesson, you have read about some approaches i.e. the Benefit, Ability to-Pay and cost of service approach of taxation. The Benefit Approach is based on the idea that people should pay taxes based on the benefits they receive from government services. Ability to pay approach is defined as one where the sacrifices of utility by all tax payers are equal. There are three principles of sacrifices. Equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice. In the case of last principle, the tax liability is the most on the rich man and the lowest on the poor man.

As compared to incidence of tax, effects of tax are much wider. Effects of tax are incidental results of the tax. Economics effects of taxation are studied under three important heads: Effects of taxation on production, on distribution, and on stabilisation. Taxation influence the ability to work, save and invest; desire to work, save and invest; and diversion of resources between various employments and thus the composition of production. The effects of taxation on the distribution of income and wealth depend on the nature of taxes and kinds of taxes. Stabilisationeffects of taxes on the economy are also important to regulate the level of economic activity.

3.10 Questions for Practice

A. Short Answer Type Questions

Q1. What is significance of Benefit Principle?

Q2. What is the index of ability-to-pay?

Q3. Explain Lindahl Model to distribute tax burden among different people.

Q4. Horizontal and vertical equity.

Q5. What are the elements of a tax?

Q6. Discuss effects of taxation on production.

Q7. Discuss the effects of taxation on ability to work, save and invest.

Q8. Briefly explain the effects of taxation on Economic Stability.

B. Long Answer Type Questions

Q1. Discuss the various approaches of taxation. Which of these explains the principleof taxation most accurately?

Q2. What is meant by ability-to-pay principle of taxation? How it is generally implemented?

Q3. Discuss critically the Benefit Approach to equity in taxation. Also describe the problem evolved in the practical application of this approach.

Q4. Discuss briefly the economic effects of taxation?

Q5. How do taxes affect production in a country?

Q6. How do taxes help to regulate the level of economic activity in a free market developed economy?

Q7. Discuss the favorable and unfavorable effects of taxes with special reference to effects on ability to work, save and invest.

3.11 Suggested Readings

- Otto Eckstein: Public Finance
- Richard A Musgrave: Public Finance in theory and practice
- Harvey S. Rosen: Public Finance
- Gareth D Myles: Public Economics
- David A. Starrett: Foundations of Public Economics
- Francesco Forte: Principles of Public Economics

M.A (ECONOMICS)

SEMESTER-I

COURSE: PUBLIC FINANCE

UNIT 4: ANALYSIS OF MAJOR TAXES AND THEORIES OF TAX SHIFTINGS

STRUCTURE

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4.2 Analysis of Major Taxes in India

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4.0 Learning Objectives

After reading this unit, learner will be able to:

- Analyze the effects and incidence of major taxes in India.
- Explain the concept of tax shifting.
- Understand the various views regarding the concept of tax incidence.
- Measure the incidence of taxation.

4.1 Introduction

The Indian tax structure is divided into two parts i.e. direct taxes and indirect taxes. Thedirect taxes are imposed on taxable income generated by corporate entities as well as individuals. Contrary to it, indirect taxes are imposed on the sale as well as provision of commodities and services. In Indian tax system, taxes are imposed by both the central government as well as the state governments. Some minor taxes are also imposed by the local authorities i.e., local governments and municipality. During the past few years, the various state governments and the central government have introduced several policy reforms and measures to simplify the process in order to achieve automation, transparency and high predictability.

4.2 Alysis of Major Taxes in India

4.2.1 Income Tax: It was for the first time; the modern form of Income Tax was introducedin India in 1860 to remove the financial problems which led to the revenue crisis of 1857.Later on, various Income Tax Acts like 1886, 1916 and 1922 came into existence and was abolished. Currently, the Income Tax Act, 1961 is working in India.

A. Incidence of Income Tax

1. **Incidence of Income Tax on Net Income of the Individuals:** Income tax is imposed on net income when all business costs have been subtracted. Hence, there is no chance of shifting of Income tax. However, there is great contention over the income tax incidence. An individual earns his income in form of rent, dividends, wages and interest. The taxes on the income of individuals are levied on the incomes which are more than the subsistence level. Hence,

individual's taxable income is the surplus over and above such costs. Thus, the taxes imposed on these kinds of incomes cannot be transferred

2. **Incidence of Income Tax on Net Income of Business Firms:** The incidence of income tax on net income of business firms will be borne by its owner(s) when the profit of the firm is at maximum level. If the business firm increases the price of a good to transfer the burden on to customers, the demand for that good will decline. So, the profit of the business firm will also decline. Thus, the business firm will have to bear the tax burden in short run. Hence, there is no chance to transfer the tax. The tax cannot be transferred under normal conditions as it is imposed on profits when all the essential conditions are met. The business firm having marginal income with no profits does not pay the income tax as their cost will be equal to price. Hence, there is no possibility of shifting the tax burden even in long run.

3. **Incidence of Income Tax on Business Profits:** Income tax on net profits are the taxes on surplus, when all costs i.e. entrepreneurial wages, interest on capital and other costs have been deducted. Besides, income tax on income from business or business profit is imposed on taxable profit when entrepreneurial wages and interest on the capital of owner have not been reduced. These taxes are called corporate taxes. The interest on the capital of owner is an essential cost until capital is not acquired without remuneration to the savers, corporate income taxes are collected from super marginal as well as sub marginal firms which generate income for the owners. Similarly, entrepreneurial wages and interest instead of services and capital respectively, are essential payments in larger non-corporate firms. This shows that even marginal firms whether these are corporate and non-corporate, generate income for owners instead of services and capital, as wages and interest respectively. Hence, when a tax is levied on these incomes, it cannot be transferred forward or backward. Contrary to it, there may be some chances of transferring business income taxes in the long run. When heavy income tax is imposed, it reduces the supply of new capital as well as business ability, as a result, it may lead to decline in output and increase in prices. Even in long run, there are no possibilities of tax shifting when there are no non-taxed opportunities are available.

B. Effects of Income Tax:

1. **Effects of Income Tax on Production:** Production depends on the savings and incentive to work. In order to realize the effects of income tax on production, its effects on savings as well as incentive to work have been discussed as below:
2. **Adverse Effect on Savings:** An income tax affects an individual's capacity to save directly by declining his disposable income. If high tax proportion is paid out of consumption expenditure, savings would not be reduced directly rather savings will be affected indirectly. But if tax payment does not affect consumption expenditure, it will have direct impact on the savings which will lead to reduction in savings.
3. **No Adverse Effect on Savings:** Prof. Friedman has said that the proportion of income saved remains constant in long-run. According to Keynes, when income rises, larger portion of it is saved. So, it can be said that savings cannot remain constant as national income rises various times in the long run. Hence, progressive income tax needs not necessarily lead to decline in savings in the long-run.
4. **Effect on Incentive to Work and Ability to Save:** The high- and progressive-income tax reduces the net monetary reward which is to be generated by an extra hour's work; this makes the additional work less attractive. Hence, disposable income of the tax payer is reduced which in turn reduces the savings. But this statement may not alwaysbe true.
5. **Effect on Willingness to Work and Save:** The willingness of people to raise their income may not be affected under any conditions. They must be just as willing to work and save for the smaller rise in income as the larger rise in income. Hence, it can be said that people are not affected by monetary award they get.
6. **Effect on Incentive to Work Hard and Save More:** The income tax induces people to work hard and save more as the tax may compel the people to save more than before as to acquire that level of net income which provides reasonable comfort. But number of such people is less and mostly people belong to less wealthy class and their contribution to savings is likely to constitute small part of the total national income.
7. **Effect on Investment:** If savings and investment are considered to be same

then income tax will reduce savings which in turn declines level of investment. If investments and savings are considered to be separate then effects of income tax on investment has to be studied through financial and non-financial motives. Financial motives are the desire of income, the desire for liquidity, desire to protect purchasing power, expectation of profit through appreciation and the desire for security. Besides, non-financial motives are pride of ownership and the satisfaction of correctly evaluating non speculative risks. The non-financial motives are less important than financial motives.

8. **Effects of Income Tax on Distribution:** Income tax is the most significant instrument of declining inequalities in the distribution of income and wealth in the economy. Contrary to it, some economists are of the view that highly progressive income tax is not very much helpful in reducing the problem of inequalities. Income tax may be levied to avoid concentration of wealth in the hands of few people by higher tax slabsfor the higher incomes; reduce inequalities in the level of consumption through the implementation of progressive income tax system; and to raise the accumulation ofsocially useful forms of wealth by giving income tax exemptions.
9. **Effects of Income Tax on Employment:** Income tax can be considered as an instrument for maintaining as well as achieving economic stability. At the time of increasing prices, taxes on capital gains, incomes and profits may have dis-inflationary effects. Contrary to it, at the time of declining prices, a reduction in burden of income tax on lower income groups may lead to increase in consumption. Hence, it will surely help in solving the problem of depression.

4.2.2 Expenditure Tax

The income has been regarded as the most adequate method of measuring economic welfare of the people; expenditure is also regarded as the basis of taxation as an alternative to income. Fisher, Marshall and Pigou have put forward the fact that expenditure tax is a good direct tax in principle, but it is not considered as a good tax in administrative efficiency. Prof. Kaldorhas said that expenditure of a person is a better measure of a person's tax paying capacity than income. Moreover, some particular amount of consumption expenditure may be exempted and the tax can be progressive or proportional. Expenditure tax has little negative impact on incentive to

work and save than income tax. Moreover, expenditure tax on spending, increases savings rather highly progressive income tax has adverse impact on savings. According to Prof. Kaldor, expenditure tax is justified on the basis of ‘fairness’ and ‘equity’ as this tax would not tax people on the basis of what they contribute to common pool but according to what they take out of it. Expenditure tax is justified at the time of inflationas it reduces consumption and controls prices. On the contrary, expenditure tax has negative impact at the time of deflation as reduction in consumption may reduce investment level which in turn leads to increase in unemployment. Hence, this tax has been recognized as good tax specifically to increase the level of economic development in the economy as it increases savings and capital formation in the economy. The expenditure tax has been criticized on various grounds. Firstly, expenditure is difficult to assess. Secondly, this tax may lead to rise in inequalities in the distribution of wealth as it encourages savings. Third, if expenditure is regarded as the base for taxation, people under different economic situations having same expenditure are bound to pay the same amount of tax. Fourth, this tax treats every one equally without taking into account the temperaments, wishes and habits. Fifth, this tax is not suitable for the times of economic depression and sixth, administration of this tax is very difficult.

4.2.3 Goods and Services Tax (GST)

The GST was implemented in India on 1st July 2017 and it was the most significant policy measure in India since independence. GST has replaced different kinds of indirect taxes at central as well as at state levels to strengthen the spirit of one tax, one market and one nation. Through implementation of GST, manufacturers of goods and services have become liable to make payments of sales tax to the central as well as state governments simultaneously. GST has eliminated all structural inflexibilities and additional burdens on customers as a result of cascading of taxes. The built-in-mechanism of GST credit system is estimated to minimize the problem of tax evasion as well as tax avoidance. India has adopted dual GST system i.e. at central and at state levels like Canada and Brazil. The implementation of GST may have a number of demand and supply side effects. Generally, GST may prove to be beneficial for household sector, business firms and central as well as state governments. The

household sector may reap various benefits like simpler tax system; decline in price of goods and services as a result of removal of tax cascading; uniform prices all over the country; transparency in tax system; and rise in job opportunities. The trade and industry may also get several advantages from GST i.e. reduction in the number of taxes imposed; elimination of double taxation and tax cascading; more effective tax neutralization especially for exports; expansion of common national market; and simpler tax system which includes fewer tax rates and exemptions. The central and state governments may get different benefits from introduction of GST like development of unified common national market to increase foreign investment and strengthen 'Make in India ' drive; encouragement to export/production activity; upgradation of overall investment climate for state development; uniform rates of Integrated Goods and Services Taxes (IGST) and State Goods and Services Taxes (SGST) to decline the chances of tax evasion; and decline in compliance costs as no multiple record keeping is required. The distribution of income has become more equal after the introduction of GST in India. Through GST, increase in output of production sectors may lead to rise in GDP also. Moreover, movement of resources from less productive to more productive sectors has declined. It can be said that introduction of GST has remained positive for investment, growth, consumption, capital formation and employment in Indian economy.

4.2.4 Corporation Tax

1 Incidence of Corporation Tax

a) **Incidence of Corporation Tax and Equity:** The corporation tax declines the real income of three type of individuals i.e., income of shareholders may decline as less dividends are paid out of capital gains, the price of commodities and services manufactured by corporate sector may rise as a result the real income of the purchasers of these commodities and services will decline and the income of raw material and labor supplier to the corporate sector may also decline. If tax burden is borne by shareholders, tax is not transferred. If tax burden is borne by customers, tax has been shifted forward. If tax burden is borne by the supplier, tax has been shifted backward.

b) **Incidence of Corporation Tax in Short Run:** If corporation is generating maximum profits at the time of imposition of corporation tax and continues to do

so, short run tax burden will be entirely borne by the owners of the capital employed in the corporation. If corporation is not getting maximum profits, imposition of corporation tax may resultin increase in prices as tax can help the corporation to maintain the income level as it was before the imposition of tax. Increase in prices means consumer will have to beara part of tax burden. During this time period, if corporation is paying wages more than subsistence level, labor will also have to bear a part of tax payments.

c) **Incidence of Corporation Tax in Long Run**: The tax can be shifted on to other in long run as resources may move among different sectors of the economy. The incidence of imposition of corporate tax may spread over all owners of the capital in tax and non-taxed areas. The imposition of corporate income tax reduces returns on all capital but it is not sure that burden of tax will entirely be borne by the owners of the capital. Moreover, the individual's real income may be influenced by the tax on relative prices of the goods. To conclude, tax can be shifted forward by increasing prices and tax can also be shifted backward through capital movement to other sectors by declining the supply of capital.

d) **Incidence of Corporation Tax and Ability to Pay**: In case of corporate sector, if taxis not transferred and borne by the shareholders then it is vertically and horizontally inequitable as shareholders of corporate sector are taxed twice. Firstly, by corporatetax and secondly by income tax but shareholders of non-corporate sector pay only the income tax. On the other hand, if tax is transferred then shareholders pay only thesingle tax. If tax is shifted forward, it will increase the price of the good which in turn reduces the purchasing power of the customer. Now, it can be said that tax burden is distributed according to ability to pay. But, if tax is shifted backward, the income ofthe employees will decline. So, it cannot be said that tax burden has been distributed according to ability to pay.

2 Effects of Corporation Tax

a) **Effects of Corporation Tax on Savings**: If corporation income tax is paid at the cost of distribution of dividend which in turn declines retained profits, will further lead to reduction in corporate savings. But, if tax rate is less on undistributed

profits, it will be an encouragement to the company savings.

b) **Corporate Income Tax and Investment**: The imposition of corporate income tax may influence corporate investment either by fund availability or by anticipated return. The corporate income tax can affect ability of the corporations to invest in different ways i.e., it influences business cost which further declines profitability of the firm and it may reduce the rate of return on investment that accrues to shareholders.

4.2.5 Custom Duties

Export duties as well as import duties are included in Custom duties. The incidence of custom duties is analyzed by the elasticity of demand of the goods to each country.

4.2.5.1 Incidence of Export Duty: If the good manufactured in Country A is a necessity for B, the demand for the good is inelastic to B, then tax incidence will be mostly on B and vice-versa. If there exists high competition for A's good in B's market, then burden of export duty on A's good will be on the producer's country. If A manufactures only a little portion of the total global supply of a good, then burden of export duty on A's good will be on the producer's country and vice-versa. If country A is a monopolist for the production of a good needed by B, then burden of export dutyon A's good will be on the customers of B and vice-versa.

4.2.5.2 Incidence of Import Duty: if country A's demand for B's good is inelastic, then import duty burden of B's good will be on country A and vice-versa. If country A is a monopolist for the production of a good needed by B, then burden of import duty on A's good will be on the monopolist if the demand for the good is elastic and vice- versa. If a good imported by country A from country B is a necessity for country A, the import duty burden will be on consumers of country A and vice-versa. If country A manufactures only a little portion of the total production of a good exported in exchange of country B's good, an import duty of B's good will be higher on country

A. If the supply of a good, manufactured by country B and needed by

country A, is very elastic, the import duty burden will be on the importing country and vice-versa.

Check Your Progress-I

Q1. Explain the two main effects of income tax.

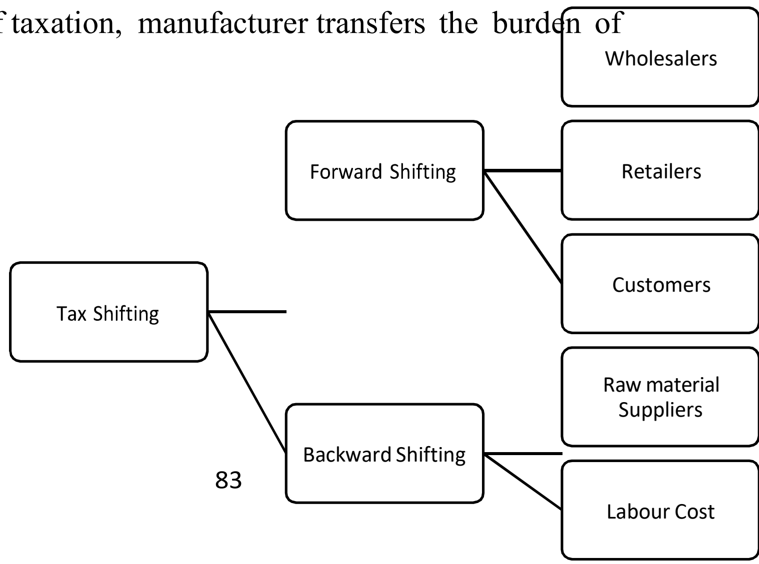
Ans. ....

Q2 Write a short note on the incidence of corporation tax.

Ans. ....

4.3 Shifting of Taxation

The process of tax shifting deals with the important issues of how much burden of a tax is actually borne by the tax payer and how much of it is transferred on to the other persons. Tax shifting is a process through which some or entire money burden of a tax is transferred from the person on whom it is imposed to another person. The burden of taxation is to be transferred through change in price of goods. Exchange of commodities is the pre-requisite for tax shifting. The incidence of taxation falls on that person who cannot shift it on to others. For instance, the government levies excise duty on the production of cloth and collects the amount of tax from producer. The producer will add amount of tax to the production cost and will decide the price accordingly. By deciding price inclusive of taxation, manufacturer transfers the burden of excise duty on to the customers. Thus, by comparing price of a good before and after the imposition of tax, one can ascertain 'shifting of taxation'.



The shifting of taxation
is of two types
i.e. single point and multiple point shifting. In single-point
shifting, the manufacturer transfers tax burden of the

Figure 1: Tax Shifting

Product on to the customer in form of higher prices. In multi-point shifting, the manufacturer transfers the tax burden of the product from single point to different points. In this, if government levies excise duty on cloth, it is paid by the manufacturer in the first instance but manufacturer transfers tax burden to the wholesaler who in turn, transfers burden to the retailer and finally on to the consumer's shoulders. Generally, shifting of taxation is done through three main processes i.e. shifting through price, tax capitalization and forward as well as backward shifting of tax. Tax shifting is done through price by the seller in form of raising the price of the good. There is no other vehicle than price transactions through which process of tax shifting can take place in the free market economy. Sometimes, manufacturer does not transfer money burden of tax in form of increasing prices but by deteriorating the quality of the product. Shifting through tax capitalization takes place when commodities are durable in nature and are subject to a series of annual taxes during its life span. If the complete series ofthe taxes which are to be levied in future are to be transferred backward at the time of buyingof a capital good, the lump-sum amount of these taxes must be calculated to deduct it fromthe price offered for the capital good. This type of tax shifting can be facilitated wholly or partially subject to various conditions. For instance, if somebody is interested to purchase residential building which will be taxed yearly during its life span, the buyer would ask the dealer to deduct the lump-sum amount of future taxes from the price of residential building. This is called tax capitalization. Forward and backward shifting of tax can take place through the price manipulations of taxed good. This kind of tax shifting can take place in two directions: forward and backward shifting as shown in figure 1. The forward tax shifting takes place when a manufacturer of a good transfers the tax money burden on to the wholesaler, retailer and consumers. In this type of shifting, either the price of the good is increased or the quantity and quality of the good is being reduced in order to transfer the entire tax money burden from the original taxpayers to the customers. The backward tax shifting takes place

when manufacturer of a good transfers the tax money burden on to the agents of production. In this type of shifting, price is not changed and the burden of tax is borne by the factors of production or inputs. When a tax is levied on a good, the manufacturer will force the factors of production to accept the lower remuneration. For instance, tax is levied on the wholesaler of a good. The wholesaler cannot increase the price of the commodity but imposition of tax forces him to compel his workers to accept the lower wages or compel other factors of production to accept lower prices.

4.3.1 Theories of Tax Shifting

The process of shifting of taxation determines who will bear the incidence of taxation. Thus, the theories of incidence are the theories of tax shifting.

1. **The Concentration Theory:** The French economists are of the view that Physiocrats have advanced this theory. According to this theory, any tax, eventually is likely to rest upon a single class of taxpayers or landlords without considering who pays it. The physiocrats were of the view that only agriculture and no other occupation, was productive in nature. They put forward the fact that other classes of people did not generate any surplus so they could not pay any kind of tax and they have to pass it on to others. It was only the agriculturist class which could pay taxes out of the surplus generated by them. Thus, the taxes levied on the non-agriculturist class must be transferred to others. The tax levied on the agriculturist class could not be transferred to others. No surplus was created in trade, commerce and other occupations and these occupations were regarded as 'Sterile'. Consequently, it was believed that a tax whether it was levied on a person or a commodity would eventually fall on land through tax shifting. Therefore, physiocrats strongly proposed that agriculturist class must be asked to pay single direct tax on land owners and agricultural land as they are both economical as well as productive. Adam Smith has opposed the view of physiocrats that agriculture alone is productive in nature.

   Merits

   This theory has stressed that all the taxes are paid by taxpayer out of the surplus generated. If there is no surplus, then efforts are made to transfer the tax money burden on to others. Therefore, it would not be right to levy a tax on the one who does not have any kind of surplus.

Criticism

All the economic activities are productive in nature because these activities have utility, demand as well as value in exchange. A single tax on agriculture land is not the right policy decision in modern welfare states. A single tax on agriculture land cannot meet the financial requirements of the present welfare states.

2. **The Diffusion Theory:** The diffusion theory has been given by the French economist N.F. Canard. This theory is also known as 'Absorption Theory'. It proposes that all the taxes are diffused among the members of the society. According to this theory, taxes did not rest on one specific class and has the tendency to reach throughout the community. The taxes were diffused among the members of the community equitably and tax shifting would go on till it spreads throughout the community. The individual taxpayer from whom tax is being collected do not eventually bear the complete burden but transfer it on to others, in order to diffuse it all over the community. According to Prof. Lord Mansfield, "I hold it true that a tax imposed at a place is like a stone thrown in a lake, making circles in it, each circle creating another circle and thus, expanding these." N.F. Canard has compared the tax imposition with operation of veins in the human body. If the blood is being extracted froma vein of the body, the loss is not of that vein only but it reaches throughout the body and the whole body remains in equilibrium. Therefore, if a tax is levied at a specific place, thetax burden does not rest on that specific place only rather it gets infused all over the community. The taxable surplus is generated by employing the land, labour and capital. Through selling and purchasing, all the taxes are infused among the different sections ofthe community and leftover upon the surplus income. The members of the society do not feel the burden of an old tax as they have sufficient time to adjust themselves to it. A new tax creates disequilibrium in the society as it takes time to diffuse all over the community. Therefore, according to this theory, old tax is no tax as it gets infused all over the community. Society does not feel burden of such tax as people gets used to the old tax.

Merits

The principle of equality is the main pillar on which this theory is based. This theory is in favour of imposition of indirect taxes in the society. This theory has put

forward that oldtax burden would not be felt as the community had sufficient time to adjust itself to it. On the other hand, a new tax disturbs the economic equilibrium of the society as it takes timeto get infused all over the society. Prof. Canard has highlighted "Every old tax is good,every new tax is bad." This theory has assumed that burden of tax does not fall on any particular person, but gets infused among the different people of the community.

Demerits

The justice in taxation has been assumed in this theory. According to this theory, tax is neither just nor unjust as all the imposed taxes are get infused among different members of the society and no one can either endure the whole burden of tax or can run away from tax burden completely. There are many taxes i.e. capital gain tax, estate duty etc., which cannot be transferred. This theory is based on several unrealistic assumptions like perfect competition, perfect mobility of factors of production as well as full employment in the economy. This theory has assumed that there is no specific advantage in studying incidence of taxation but the modern critics have opposed this view as the main aim of present government is to obtain maximum social benefit. To achieve this aim, one has to study the tax burden on different sections of society according to their ability to pay. This theory fails to determine the incidence of taxation. This theory is ambiguous in nature as it has assumed that tax payer is only a way of tax paying as far as tax burden is concerned. But tax burden is borne by different people of the society. Therefore, this supposition is baseless.

3. **The Modern Theory:** The Modern Theory has been propounded by Prof. Dalton and many other modern economists like E.R.A. Seligmen and F.Y. Edgeworth have favored this theory. This approach is considered to be the most acceptable in explaining the incidence of taxation and also known as 'Theory of Demand and Supply'. Like other two approaches, this theory has assumed that a tax could be paid out of surplus only and if thereis no surplus, tax money burden will be shifted on to others.

This approach has applied analysis of value and price to the problem of shifting of

taxation and determination of tax incidence. This theory has put forward the fact that all taxesshould be levied upon taxable economic surplus directly, If the tax payer has generated economic surplus, he will bear the tax burden otherwise he will try to transfer it on toothers. According to Prof. Shirras, a tax enters into the price of the commodity by becoming the part of production cost of that good.

According to this theory, all taxes should be levied directly on the economic surplus otherwise it will be transferred on to others. Tax becomes the part of production cost and enters into price of a good. It is by increasing the price of a good that a person shifts tax onto others. If taxes do not have any impact on price, tax money burden cannot be shifted. Moreover, if there are no price transactions, tax shifting is not possible. Critics do not support Stein's view that taxation will be a part of cost of production. Therefore, Hobson has argued that taxes must be levied on economic surplus directly.

It is the price process on which shifting as well as incidence of taxation depends. Tax shifting is based on the behavior of buyers and sellers. All these elements have to be evaluated which have their impact on demand and supply conditions.

Modern economists have taken into consideration the following components of tax shifting:

1. **Nature of Tax:** There are several taxes that can be transferred backward as well asforward. The tax shifting is not possible in case of other taxes.
2. **Surplus:** if economic surplus is not there, tax burden is shifted on to others. The tax isshifted on to a particular place where economic surplus exists.
3. **Amount of Tax:** When tax amount is less, no tax shifting is there and when tax amountis more, seller can go for tax shifting.
4. **Mobility of Labor and Capital:** Tax shifting is possible only in case of mobility oflabor and capital. If both are immobile, no tax shifting will be there.
5. **Condition of Production:** In case of production under monopoly, tax burden will be transferred on to the consumers and in case of perfect competition, tax shifting willdepend on law of returns.
6. **Elasticity of Demand and Supply:** When the demand is inelastic, burden of tax will be entirely on buyers and when demand is elastic, burden of tax will be

partly on buyers and partly on sellers.

4.4 Concepts of Incidence of Taxation

The incidence of taxation refers to a problem who will have to bear the final money burden of tax or who will pay the tax ultimately. In other words, eventual money burden of tax or final payment of the tax is called incidence of taxation. Incidence of taxation rests on the one who cannot transfer it on to others. For instance, the government levies excise duty on the production of cloth and collects the amount of tax from producer. The producer will get it from wholesaler, wholesaler from retailer and retailer from consumer. Hence, incidence of taxation will be on customers.

A. Prof. Dalton's Concept of Tax Incidence

According to Prof. Dalton, "*Whatever tax revenue is collected by the government, it has an ultimate burden on someone or the other. Such a burden is called incidence of taxation.*"

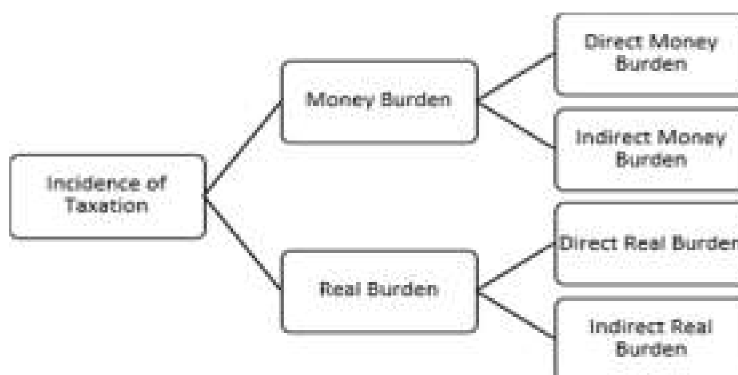


Figure 2: Classification of Incidence of Taxation

Prof. Dalton has classified incidence of taxation into two parts i.e. money burden and real burden. Money burden is the amount of tax money collected by the government. Money burden is of two types: direct money burden and indirect money burden. If tax burden is borne by the person who pays it, is called direct money burden. If tax burden is shifted by the one who pays it onto other persons, then the ultimate tax burden borne by other person is called indirect money burden. Real money burden is the

sacrifice made by taxpayer due to payment of tax. Real money burden is of two types: direct real burden and indirect real burden. Direct real burden is the sacrifice or reduction of economic welfare due to imposition of tax. If there is reduction in consumption of commodities by the tax payer due to tax imposition, it is called indirect real burden.

B. Mrs. Ursula Hicks's Concept of Tax Incidence

It was in 1940; Mrs Ursula Hicks put forward the two concepts of tax incidence i.e., formal incidence and effective incidence. These two concepts are as follows:

Formal Incidence refers to money incidence or the tax money burden. It refers to the amount of taxpayer's income which has been paid to the government. This amount does not provide any direct benefit to the actual taxpayer rather it is used by government to provide collective goods. In other words, formal incidence is the statistical measurement of the mode of distribution of actual tax burden among several income groups during a financial year.

Effective Incidence incorporates all the costs and benefits which an economy gets from a tax system. It refers to the effects of taxation on the economy. The statistical measurement of effective incidence is not possible rather one can only compare the situation before and afterthe imposition of tax.

C. Prof. Musgrave's Concept of Tax Incidence

According to R.A. Musgrave, if there is change in the distribution of income available for private uses, then it is called incidence of taxation. These fluctuations occur due to change in budgetary policy which includes resource transfer. Prof. Musgrave has argued that distributional changes occur either due to change in expenditure policy or tax policy or inboth. He has put forward the five concepts of incidence relating to various types of changesas follows:

a) Specific Tax Incidence is the change in income distribution because of change in tax policy when public expenditure remains constant.
b) Differential Tax Incidence is the difference between the distributional outcomes of two tax policies which give same yield in real terms. It is the outcome of

substitution of onetax for another.

c) Specific Expenditure Incidence is the change in income distribution because of change in rate of public expenditure when tax policy remains constant.

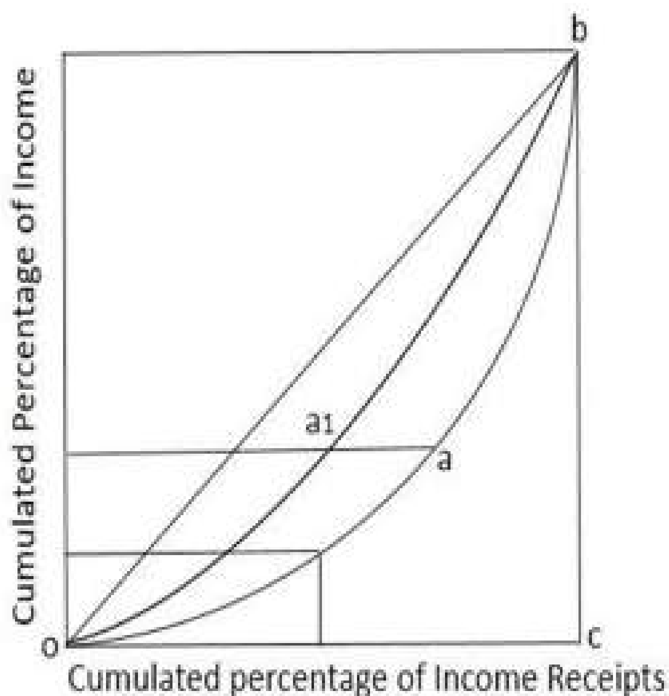
d) Differential Expenditure Incidence is the change in income distribution because of change in type of expenditure when tax function remains constant.

e) Balanced Budget Incidence is the change in income distribution because of change in both the level of real expenditure and policy of taxation.

Prof. Musgrave's concept of incidence is same as that of effects of taxation. According tohim, incidence and effects are the similar concepts. Contrary to it, both are different concepts, incidence is the money burden and effects are the real burden.

Modern economists like Prof. Musgrave, Mrs. Ursula Hicks and several other economists have made substantial efforts to move from traditional approach of tax incidence to its modern approach. Traditional economists have taken into consideration only the direct money burden, other concepts like indirect money burden; direct real burden and indirect real burden have been ignored.

4.4.1 Measurement of Tax Incidence



The incidence has been measured by Prof. Musgrave through cumulative percentage of income and percentage of income corresponding to percentage of income receipts as shown in figure

2. Hence, the Lorenz Curve is plotted. In figure 2, the line of perfect equality is ob which accords with the line of equal distribution. The index of equality is given by oabc/obc. If some reforms occur in budgetary

policy, it results into shifting of
Lorenz curve from oab
to oa1b which is closer to the line of perfect equality. Now, the co-efficient of equality becomes oa1bc/obc. Hence, the ratio of index of equality before and after budgetary reforms measures the incidence or distributional fluctuations. The formula becomes:

Distributional Change = Co-efficient of equality after budgetary change / Co-efficient of equality after budgetary change

(oa1bc/obc) / (oabc/obc) = oa1bc/obc

Hence, incidence or distributional fluctuations can be measured as follows:If R < 1, incidence is regressive

If R = 1, incidence is proportional If R > 1, incidence is progressive

This method has been criticized as it does not comprise the effects which are necessary to be incorporated in incidence to give the final decision. Moreover, it is the aim of analyzing the incidence of the person or the authority on which the definition of incidence would depend.

Check Your Progress-II

Q1. Explain the concept of tax shifting.

Ans. ....

- -

Q2. Mention about merits of diffusion theory of tax shifting.

Ans. ....

- -

Q3. Write a short note on incidence of taxation.

Ans. ....

4.5 Summary

In this unit deals with various topics like analysis of major taxes in India, theories of tax shifting, concept of incidence as well as measurement of incidence. Analysis of major taxes includes income tax, expenditure tax, GST, corporation tax and customs duty. In this part, incidence as well as effects of taxation have been analyzed. The three theories of tax shifting have been included i.e., concentration theory, diffusion theory and modern theory. The views of various economists like Prof. Dalton, Mrs. Ursula Hicks and Prof. Musgrave related to incidence have been analyzed. Moreover, Prof. Musgrave's concept of measurement of incidence has also been included in the unit.

4.6 Questions for Practice

Short Answer Type Questions

4.6.1.1 Expenditure tax

Q1.Write a note on GST.

Q2.Discuss about measurement of tax incidence.

Q3.Explain the terms

Q4. What do you mean by tax shifting?

Q5. Define tax incidence

Q6. Explain income tax incidence

Q7.Explain the effects of income tax

Q8.Explain the measurement of tax incidence

Q9.Evaluate diffusion theory of tax shifting

4.6.2 Long Answer Type Questions

Q1.Explain about incidence and effects of cooperation tax.

Q2.Mention about modern theory of tax shifting.

Q3.Explain the incidence and effects of income tax.

Q4.Define the concept of shifting of taxation in details

Q5. Explain the theories of tax shifting.

Q6. What do you mean by taxes? Evaluate the measurement of tax incidence.

4.7 Suggested Readings

- B.P. Tyagi: Public Finance
- R.K. Lekhi: Public Finance

M.A (ECONOMICS)

SEMESTER- I

COURSE: PUBLIC FINANCE

UNIT: 5 PUBLIC DEBT: ITS TYPES AND ROLE. BURDEN AND METHODS OF REDEMPTION OF PUBLIC DEBT, DEBT MANAGEMENT AND BUDGETARY POLICIES

STRUCTURE

5.0 Learning Objectives

5.1 Introduction

5.2 Meaning and Definition of Public Debt

5.3 Public Debt: Types

5.4 Sources of Public Debt

5.5 Public Debt and Private Debt: Similarities and Differences

5.6 Role of Public Debt

5.7 Economic Effects of Public Debt

5.8 Burden of Public Debt

5.9 Redemption of Public Debt

5.10 Public Debt Management

5.11 Budgetary Policies: Functional and Economic

5.12 Summary

5.13 Questions for Practice

5.14 Suggested Readings

5.0 Learning Objectives

After reading this unit, learner will be able to:

- Understand the meaning, types and roles of public debt
- Know the methods of redemption of public debt
- Describe public debt management
- Evaluate functional and economic classification of budgetary policies.

5.1 Introduction

Public debt is an important component of Public Finance. Public debts are government borrowings of various types. Government can borrow from both internal and external sources. The government redeems these debts using suitable method for overall debt sustainability. Therefore, government takes utmost care in managing its public debt with a focus upon the nature and quantum of borrowings along with the process of its redemption.

Another important component of Public Finance is Budgets, which is a balance of expenditures and receipts of the economy in a given period. It is a financial plan that is used to depict the rationalization of resources amongst the various demand expenditures in the economy. Budgetary transactions of the government are classified into two important types: Functional and Economic with its peculiar features.

5.2 Meaning and Definition of Public Debt

To finance the expenditure, government has two options. It may impose taxes or may borrow from various internal and external sources. To borrow, the government sells government securities to the public, with a promise to pay back with interest in future. The borrowing increases public debt that is owned by the government. Public debt is a very important concept in Public Finance mainly concerning the fiscal policy

The liabilities payable by the government are known as Public Debt. In recent times, countries across the world resort to borrowing along with raising the finance through taxes, fees etc. The consolidated debt of the Central Government and State

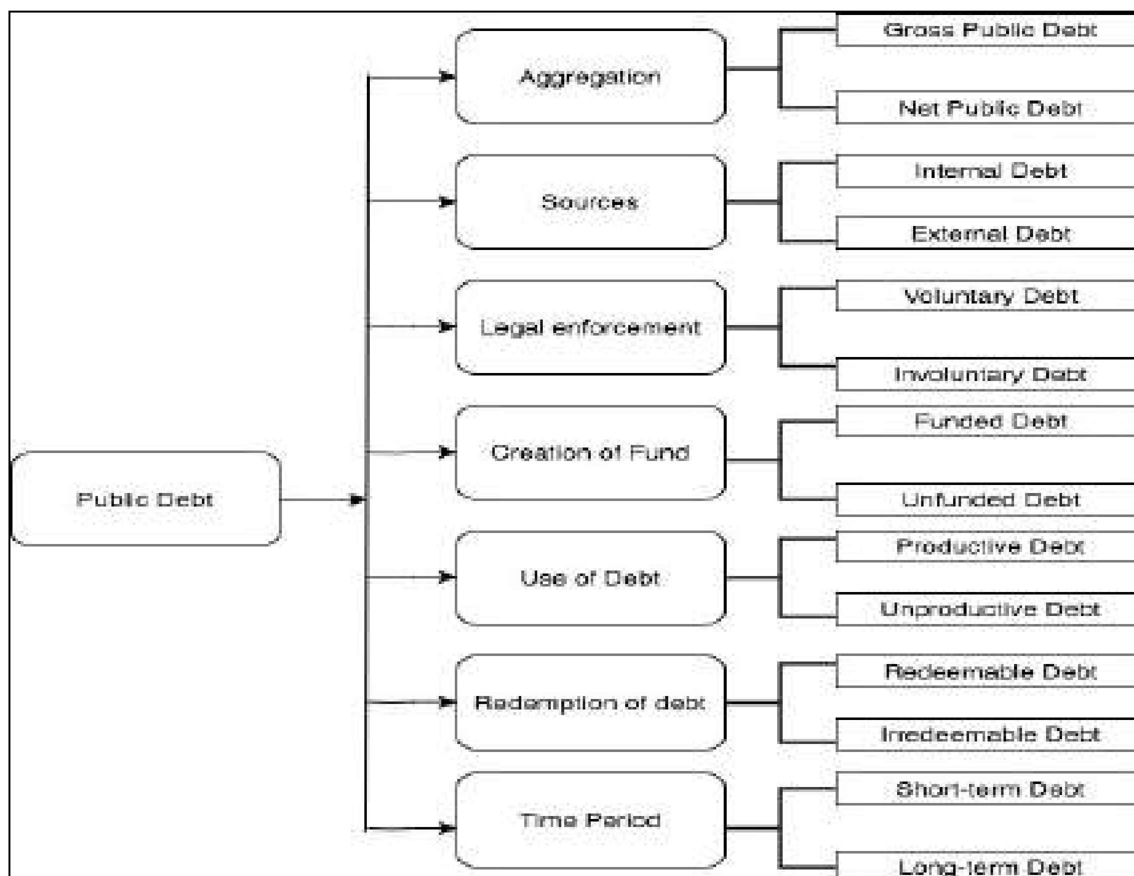
Governments composed General Government Debt. Various economists have defined the concept of public debt.

Prof. J.K Mehta says: "*Public revenue, therefore, consists of the money that the government is not obliged to return to the very individual from whom it is obtained. Public debt, on the other hand, carries with it the obligation on the part of the government to pay money back tothe individuals from whom it has been obtained*."

According to Prof. P.E. Taylor. "*The debt is the form of promises by the treasury to pay tothe holders of these promises a principal sum and, in most instances, interest on that principal. Borrowing is resorted in order to provide funds for financing a current deficit*."

Like all government, Government of India also borrows for various reasons. General Government Debt composed of the borrowing done by Central, State and Union Territories with legislature. Both the Central Government and State Governments can borrow according to the provisions in the Constitution of India. The Central Government Debt includes all the liabilities of Central Government contracted against the Consolidated Fund of India. This provision is stated in Article 292 of the Constitution of India. 'Other liabilities' of the Central Government includes that in the Public Accounts.

The Constitution of India empowers State Governments to borrow only from domestic sources under Article 293 (1). Major source of financing of gross fiscal deficit (GFD) of the State Governments are market borrowings and loans from financial



institutions, provident funds, reserve funds and deposits etc.The government has been publishing the *Annual Status Paper on Government Debt* since 2010-11 that provides a detailed position of Government's debt position. *Public Debt: Types*Public debt is classified into various types depending upon nature of public debt like the level of aggregation, sources of raising funds, nature of legal enforcement, creation of funds for its redemption, use of funds, redemption of debts and time period of the debt as shown in Figure.

Figure 1. Different Types of Public Debt

1) **Gross Public Debt:** Gross public debts include the total financial liability of the government.
2) **Net Public Debt:** These are the gross financial liabilities less the financial assets

of the government. In other words, it means the amount of Public Debt left after exclusion of 'sinking funds' and other assets of the government to be used for repayment of debt.

3) **Internal Debt:** When the government borrows from persons or institutions within its geographical area is called as the loans taken from internal sources or internal debt. An internal loan can be voluntary or involuntary. Internal debt involves the transfer ofwealth from lender to borrower within the territorial area.

4) **External Debt:** The borrowing of the government outside its geographical territory constitutes external debt. These loans are voluntary in nature. In case of external borrowings, the loans are taken from foreign lenders while reverse happens in case of return payments.

5) **Voluntary Debt:** Debts are actually the loans taken by the government. When the lender gives the loan to the government without any legal enforcement, is called as voluntary debt. The lender has a freedom of the quantum of loans given to the government.

6) **Involuntary Debt:** Also known as compulsory loan, people are compelled to pay tothe government. This type of borrowing is very rare in present times due to its inept disadvantages as compared to taxation and voluntary loans. Governments may resorts to these borrowings at the times of war, or other demanding eventualities.

7) **Funded Debt:** These are the debts that are repayable within definite period in conjunction with proper agreements, terms and conditions of repayment of interest,subject to repayment of principal.

8) **Unfunded Debt:** These are short-term debts and are raised in anticipation of public revenue. The borrowings are made for meeting the short-term expenditures.

9) **Productive Debt:** These are also known as reproductive debt. This debt is fully backed by the possession of assets of equal or greater value. Therefore, the interest on productive debts is paid from the returns to the assets possessed by the public authority.

10) **Unproductive Debt:** Also known as 'dead-weight debt". These debts are not backedby corresponding assets. The payment of interest on unproductive debts is

done with some other sources of public income, like taxation, fees etc.

11) **Redeemable Debts:** These are the debts that the government promises to pay off in the future date. Therefore, the government makes the arrangement for the repayment of loans either through tax collections or some more borrowings.
12) **Irredeemable Debts:** For irredeemable debts, the government only pays the interest but never the principal amount. These are long-term loans without any maturity period.
13) **Long-term Debt:** These are the borrowings of the governments that are paid after a long period of time, say 10 years or more. The long-term loans gradually become short- term loan with the approach of repayment date.
14) **Short-term Debt:** These are the short-term loans that are repaid within three months or less. In India, Treasury Bills are redeemed minimum after 91 days. Since, 2010, Cash Management Bill (CMB) was introduced with the maturity of less than 91 days.

Check Your Progress-I

Q1. Explain the meaning and Definition of Public Debt.

Ans. ....

- -

Q2. Discuss the concept of Public Debt in context of India.

Ans. ....

- -

Q3. What are the various types of Public Debt?

Ans ....

- -

5.3 Sources of Public Debt

There are two major sources of Public Debt, namely Internal Sources and External Sources. The government makes choice regarding the major source of taking debt, depending upon the characteristics of the sources.

A. Internal Sources: Internal sources of raising public debts are the one that the government borrows from various sources within the country.

1) **Borrowing from Individuals:** Individuals buys government bonds of various denominations and for varied times, thus diverting the funds from individual consumption to government exchequer. The highly secure and low-risk investments encourage the individuals to buy government bonds. The government further invests the collective funds from individual investors for public projects

2) **Borrowing from Non-Banking Financial Institutions:** Non-banking financial institutions include insurance companies, venture capitalists, investment trusts, mutual saving banks etc. In India, Reserve Bank of India defines "Non Banking Financial Company (NBFC) as a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issues by Government or local authority…." The non-banking financial institutions invest the idle funds available with them in risk free, safe and highly liquid government bonds.
3) **Borrowing from Commercial Banks:** Unlike the individuals and non-banking financial institutions, Commercial Banks has the mechanism of credit creation that is multiple times of the primary deposits. The excess cash reserves are invested in government bonds to earn profits for paying interest to their depositors.
4) **Borrowing from Central Bank:** The Central Bank of the country also subscribes to government loans. The credit is created by the Central Bank by purchasing government bonds and the government pays back the loan from the accounts maintained by the Central Bank. The creditors who receive the cheques from the government, deposit them in their commercial banks that acts as an additional source of loans and advances. Therefore, the borrowings of the government from

commercial banks are most expansionary in nature.

B. External Sources: Borrowings by the government from outside the country constitutes an important component of public debt. These funds are largely borrowed to meet the expenditure on various developmental projects, defense expenditures and other security concerns. Apart from individual countries, the government can also borrow from the international institutions like International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC) etc.

5.4 Public debt and Private Debt: Similarities and Differences

Similarities:

1) Both public debt and private debt is taken to finance the expenditure that are over andabove the revenues generated.
2) In both public and private debt, the resources are diversified from one use to another.
3) In both public and private debt, interest has to be paid on the debt.
4) The borrowing capacity of the borrower is the determining factor of the quantum ofpublic and private debt.

Differences:

1) No private individual or entity can compel any other person or institution to extend him or her loan, whereas government can force people to lend.
2) The loan taken by the government is mainly used for productive purposes, whereas the private debt can be utilized for either productive or unproductive purposes.
3) The government can repudiate the repayment of the public debt under certain circumstances, while the private debt has to be paid under all circumstances.
4) Usually, the rate of interest of the public debt is lower as compared to the private loan due to the higher credit-worthiness of the government.
5) The government can resort to various sources to repay back the public debt. They can either increase the taxes, or can borrow again for repayment and in some cases can also print currency to repay the loan; whereas private debt has to be repaid from the individual resources only.
6) Public debt produces an important impact on the economy, from the

perspective of both borrowings and spending; while the impact of private loan remains confine to the borrower only.

7) The government may also resort to public debt to control inflation as a policy instrument; whereas the private debt does not have any such provisions.
8) The burden of repayment of public debt falls on general public, if more taxes are imposed on the people and/or expenditure on welfare schemes are reduced; whereasthe burden of the private debt remained confined to the borrower only.
9) The public debts are considered to be risk-free and safe with high credit worthiness unlike the case of private debt.

5.5 Role of Public Debt

Public debt had become an important means of revenue generation in modern times. Earlier, the government used to borrow to finance mainly war expenditures. But in present times, the public expenditures exceed the proceeds from taxes. However, the government also prefers not to impose high rate of taxes to avoid any type of discouragement amongst the present generation to produce. Therefore, the government prefers borrowing from the various internal and external sources for current consumption with future promise of payment.

Following are the major reasons for incurring Public Debt:

1) The major reason for raising the public debt is the mismatch between revenue and expenditure of the government. In the lean season, with incurring deficit budget, the government resorts to public borrowings to balance the budget.
2) There may be some sudden events like wars, internal disorders, or natural calamities that also demands expenditures from the government, which it can meet by borrowing from various sources.
3) The government also borrows funds to finance developmental plans like construction of roads, bridges, ports, educational institutes, financial institutes etc.
4) The government also uses public debts as a means to control inflationary trends in the economy by mopping away the excess money available in the economy.
5) The government also resorts to public debt during depression wherein the resources of the government revenue fall along with the fall in employment opportunities and effective demand. Under these circumstances, borrowings from

various internal and external sources provide an important means of expenditure of the government that can have expansionary impact on the economy with multiple times increase in income.

6) There are certain public enterprises and utilities that promote the welfare of the people like railways, water, postal services, power generation etc. Maintenance of these public enterprises for making these utilities available to almost whole population irrespective of the economic stature of the people requires huge resources, which the government raises through loans taken from the public in the form of raising public debts at the case ofdeficit budget.

Check Your Progress-II

Q1. What are the major sources of raising Public Debt?

Ans. ....

Q2. Distinguish between Public and Private Debt.

Ans. ....

Q3. What is the role of public debt in the economy?

Ans. ....

5.6 Economic Effect of Public Debt

The economic effect of public debt can be assessed from the nature of the public debt raised, like the sources of public debt, the duration of public debt, the utility of public debt and its redemption process. The public encounter numerous effects of government decisions to raise public debt that are highlighted as follows:

1) Public debt has an impact on current consumption of the lenders. The government

borrows for various reasons e.g., to curb inflationary trend, to fill the mismatch of public budget etc. Whatever may be the reason, the divergence of funds to government exchequers reduces the funds, otherwise used for consumption purposes with the lenders.

2) The impact of public debts can be understood from two perspectives. If people lends to the government by cutting their consumption expenditures, it would impact demand of the goods negatively and thus produce detrimental impact on the overall private investment. But usually, people lend their idle funds to the government to earn risk-free returns. On the other hand, if the government utilizes the public funds for developmental purposes, it produces positive impact on private investment. Thus, the net results of raising public debt depend upon the comparative impact of raising public debts.
3) The public debt also helps in redistribution of wealth in the economy. Usually, the idle funds are collected mainly from the relatively richer section of the society and are invested for developmental programs keeping in view the relatively poorer sections of the society. Thus the raising the public debt and utilizing its productively helps in decreasing socio-economic inequalities and poverty in the society.
4) The public debts act as a means of increasing employment opportunities and economic growth through making development related investment, mitigating rural-urban divide for inclusive growth in the economy.
5) The public debt also helps in balancing the balance of payment accounts. If with raising the funds, the investment is made on capital goods and other productive activities, it can raise the production and productivity in the economy. This in turn raises exports as compared to imports.
6) Raising public debt instead of addition taxation to meet the current expenditures also helps in controlling the price level of various raw materials and intermediate products. Therefore, public debt is also important means of controlling inflation in the economy.

Therefore, it is important to highlight that public debt is an important component of the government. It is helpful not only in meeting the deficits in the economy, but also helps in controlling inflation along with generating employment opportunities, increasing economic growth and reducing inequalities in the economy.

5.7 Burden of Public Debt

As the personal debts are worrisome for an individual, can we say similarly for the public debt raised by the government at different levels? In this context, it is important to examine the impact of public debt (internal and external sources) on the present and future generations. Dalton has classified the impact of internal and external public debts as (i) real or monetary and (ii) direct or indirect. Therefore, impact of public debts raised an array of possible features:

A. Internal Public Debt

1) **Direct Money Burden:** This involves the sacrifice of the current consumption of the people due to increase in tax payments and other payments to the government.
2) **Indirect Money Burden:** In case the loans are raised for developmental purposes, the income of the people increases multiple times raising the demand for goods and services leading to higher general prices, thus imposing an indirect burden of price riseon people and reducing their overall welfare.
3) **Direct Real Burden:** The collection of taxes by the government for the payment of principal amount and interest thereon, results in the transfer of purchasing power within the geographical boundary of the government. Moreover, the whole society pays the taxes to redeem the loans taken by the government, whose real impact is borne more bythe economically poor people of the society.
4) **Indirect Real Burden:** The additional taxes on different sections of the society can increase the level of poverty and inequality in the economy that has the indirect impact of adverse working possibilities due to tiding away the earned income in taxes.

B. External Public Debt

1) **Direct Money Burden:** The payment of principal amount and the interest thereon to the external creditors has a direct monetary burden on the nationals of the borrower country
2) **Indirect Money Burden:** The payment of loans to external creditors reduces the monetary resources for indigenous developmental projects, which reduce the income of the people and also have an impact on demand of goods and services. This can result in the increase in the prices of the goods and services without the

increase in income, causing economic losses.

3) **Direct Real Burden:** The tax burden on different sections of the society imposes direct real burden on them with the high collection of taxes that also diverts funds from the immediate consumption of goods and services.
4) **Indirect Real Burden:** The high tax collections used for the payment of loans also affects the morale of the people to work more, mainly with the imposition of progressive taxation. These high rates of taxes, collected for repayment of loans can indirectly affect the production and productivity in the economy, leading to some unwarranted impacts on the society.

5.8 Redemption of Public Debt

The repaying of the loan by the government is known as Redemption, whereas refusal to pay back the borrowed funds is known as Repudiation. Repudiation of the loans by the government has numerous social and economic consequences. The creditors who were denied the repayment suffer economic losses and if the creditors composed a large section of society, the social unrest also becomes a possibility. Moreover, the future borrowing also becomes a challenging task.

The redemption of the loan to both the internal and external creditors are important and the authorities are concerned about the timely redemption of the debt for building creditabilityand trust of the creditors. Hence maintaining the pace of redemption is also important. The speed of redemption should not be fast enough to adversely impact the taxpayers, and neither it should slow enough to prolong the debt burdens.

The Following Are the Means of Redemption of Public Debt:

1) **Capital Levy:** This is a special debt redemption levy that is imposed 'all at once' that raises controversies across academic and political spheres. Supported by economist like Ricardo, Pigou and Dalton, the same are opposed by Hicks and Shirras. The capital levy isa very heavy tax imposed on property and wealth. Dalton argued that Capital Levy is important as it avoid the burden on the younger upcoming generation.
2) **Conversion:** Conversions means converting the old debts into new debts in order to reduce the burden of debt by substituting the low interest loans in place of old high

interest loans. The conversion is usually done either before or at the time of maturity of the debt. For the purpose of conversion, it is important to compare the total burden of debt over a given period including the money required to repay the principal amount and the interest, with a further provision of allowances for untaxed capital appreciation.

3) **Refunding:** This is a process where the new bonds and securities are issued by the government to repay the matured loans. Usually, the short-term securities are replaced with long-term securities, mainly to postpone the date of redemption of debt.

4) **Sinking Fund:** The creation and maintenance of debt-redemption fund, called as 'sinking fund' is very important and has been adopted by many countries. In this fund, some part of public revenue is credited continuously during the period of the loan to repay the debt on maturity. Sinking funds are classified broadly into two types, (a) certain sinking funds and
(b) uncertain sinking funds. Whereas in certain sinking fund, government credits a fixed sum of money annually, but in the uncertain sinking funds, the money is credited on account of surplus budget. In present times, governments find it difficult to accumulate sinking funds over time as are used for the repayment of some parts of the debt each yearor to buy the bonds from the market.

5) **Terminal Annuities:** Conceptually similar to 'sinking fund', the government pay off a part of the public debt each year by issuing the terminal annuities. This subsequently eases the burden of debt up till the actual time of its maturity.

6) **Surplus Budget:** A budget is surplus when the spending is less than the public revenues obtained. The excess of the public revenue over the spending is utilized for paying off the public debt. Having surplus budgets in recent times has become a rare plausibility. Usually, governments resort to increasing taxes or fees to increase revenues and reducing the expenditures in the economies that may results in decelerated scenario in the economy.

7) **Surplus Balance of Payment:** The excess of exports earnings over the import expenditures results in the surplus in the balance of payment. These surpluses are used to repay the external debt and internal debt. Therefore, the countries concentrate more on increasing exports.

5.9 Public Debt Management

Public debt management refers to the policies designed and adopted to achieve the objectives of borrowing from internal and external creditors. The public debt management thus concerns about making decisions regarding the optimal source of public borrowings, terms of agreement of taking loans and their redemption process. Conclusively, it is concerned with examining the different characteristics of public debt. The management of public debt is very important for the growth of the economy.

According to Prof. Abbot, "Public Debt Management is concerned with the decisions of the forms of public debt in terms of which new bonds are sold; maturing debts are redeemed or refunded, the proportion in which different forms of public debt should be issued, the pattern of maturities of debt and its ownership etc."

Government of India publishes its 'Debt Management Strategy' (DMS) in its annual 'Status Paper on Government Debt' since Dec 2015. Earlier various documents of the Government of India and RBI publish the various components of public debt management. The DMS document has three components spread in three chapters. This includes Objectives and Scope of DMS, Risk Assessment of Pubic Debt Profile of Central Government, and Medium- Term Debt Strategy (MTDS). The objectives of the DMS revolve around three main pillars of low cost, risk mitigation and market development.

5.10 Budgetary Policies: Functional and Economic

Budget is a statement that contains the forecast of revenue and expenditures of the government during a period of time, usually a year. Whereas, the expenditure of the government is basically meant to increase the public welfare along with economic development; the taxes are the cost imposed on the taxpayers of all these measures taken bythe government by collected the revenues. The concerns of the budget makers are to balance the expenditure and revenue sides of the budget that revolves around the major objectives of the economic planning for growth and development.

Therefore, the classification of expenditure is very important aspect of budgetary policy. Some of the important classification systems include Functional Classification

and Economic Classification

A. Budgetary Policies: Functional Classification: A Functional Classification is very important under the system of budgeting. The expenditures are presented in accordance with the nature of the functions and projects planned for the growth and development of the economy. The targets to be achieved should be financed with respect to the physical targets to be achieved. Therefore, for utility aspects, the functional distribution classifies the government expenditure on the basis of different tasks like education, defense, health, transport, etc. Therefore, the focus of the policy makers get due attention with respect to the different projects to be implemented in the economy for the targeted growth and development.

B. Budgetary Policies: Economic Classification: The budget has a significant impact on the whole economy. It is imperative to understand the impact of revenues and expenditure of the government on different sectors to the economy. Therefore, it is important to group the budget in accordance with the economic criteria. Economic classification categorizes the expenditure into the important heads, like investment, consumption, capital formation etc. India did the economic classification of the budget in the year 1956 by the Economic Division of the Ministry of Finance for the budget of 1957-58. According to Ministry of Finance "*The classification of government transactions is attempted in a manner which makes it possible to link them with a system of a national income and expenditure accounts, it would be possible to indicate the share of government in the generation of the national product and in national expenditure, the breakdown of government expenditure into consumption and capital formation and the impact of government transactions on the level and pattern of expenditure of the rest of the economy*."

Check Your Progress-III

Q1. What are the economic effects of Public Debt?

Ans. ....

Q2. Distinguish between Certain and Uncertain Sinking Fund.

Ans ....

Q3. What do you understand by repudiation and redemption of public fund?

Ans. ....

5.11 Summary

Public debt is an important component of resource generation in different developed and developing economies. Countries, irrespective of their level of development need funds for achieving set targets for the economy. The government raises revenues through taxation; fees etc. and make provisions for various types of expenditures. But it was observed that for most of the times for many countries, the revenues collected through taxes fall short of the needs of expenditures in the economy. Therefore, the governments resort to borrowing to finance its expenditures. Government can raise public debt from internal or external sources at different rate of interest with distinguishing redemption criterion. These loans can be of long-term or short-term, they may accrue a high or low rate of interest, and these may be redeemed with the imposition of new taxes or new borrowings. Hence, it is very important for the Government to manage the debts raised from different sources amicably, with making proper planning and policies for raising the funds, deciding their duration, types and manner of their redemption so that the sustainable economic growth is achieved.

5.12 Questions for Practice

A. Short Answer Type Questions

Q1. Explain the meaning of Public Debt.

Q2. Differentiate between Public Debt and Private Debt.

Q3. What are Sinking Funds? What is their importance?

Q4. Differentiate between redeemable and irredeemable debts.

Q5.How do Surplus Budget and Surplus Balance of Payments help in redemption of public debt?

Q6.What is the importance of economic classification in budgetary policy making?

Q7. Explain the major objectives of Public Debt Management.

Q8. Distinguish between function and economic classification of Budgetary Policies.

B. Long Answer Type Questions

Q1.Explain the meaning, types and importance of Public Debt.

Q2.What is meant by Repudiation and Redemption? Which is better and why?

Q3.What are the various means of redemption of public debt?

Q4.State the meaning and importance of Public Debt management.

Q5.Compare the nature and importance of internal and external sources of raisingpublic debts.

5.13 Suggested Readings

- Chand, S. N., Public Finance, Atlantic Publishers, New Delhi, 2008.
- Eckstein, O., Public Finance, Prentice-Hall of India, New Delhi, 1973.
- Hugh Dalton, Principles of Public Finance, F.A. Praegen, New York. 1955.
- Musgrave, R.A. and Musgrave, P.G., Public Finance in Theory and Practice,McGraw Hill, New Delhi, 2004.

M.A (ECONOMICS)

SEMESTER-I

COURSE: PUBLIC FINANCE

UNIT 6: CLASSIFICATIONS OF BUDGETS AND THEIR USES

STRUCTURE

6.0 Learning Objectives

6.1 Introduction

6.2 Concept of Budget: Meaning and Definition

6.3 Objectives of Public Budget

6.4 Functions and Impact of Budget

6.5 Classification of Budget

6.6 Balanced Budget

6.7 Unbalanced Budget

- **6.7.1 Surplus Budget**
- **6.7.2 Deficit Budget**
  - **6.7.1.1 It accelerates economic growth and development,**
  - **6.7.1.2 Deficit budget enables to undertake welfare programmes of the people**
  - **6.7.1.3 It is a remedy for deflation as it really looks at downward movement of prices.**

6.8 Performance Budget and its Classification

6.9 Budget as an Instrument of Mobilization and Channelization of Resources and Redistribution of Income and Wealth.

6.10 Summary

6.11 Questions for Practice

6.12 Suggested Readings

6.0 Learning Objectives

After studying this unit, learner will be able to:

6.1 Introduction

The word 'budget' is derived from a French word, 'Bougett' which means a leather bag or wallet'that contains financial proposals and recommendations. People are restless to see what the bag contains in the form of economic bill introduced by the finance minister in the Parliament House annually, in order to maximize the welfare of the community in the modern times. In other words, a government budget is an annual financial statement which shows item wise evaluations or estimates of expected revenue and anticipated expenditure during a fiscal year." The budget ina modern state is a forecast and an estimate of all public receipts and expenses and for certain expenses and receipts an authorization to incur them and collect them

6.2 Concept of Budget: Meaning and Definition

The term budget refers to a document which contains estimates of revenue and expenditure of a country, generally for a period of one year. Just as your household financial plan is concerning what you earn and spend, similarly the government budget is a statement of its income and expenditure. In the first quarter of every year, government presents its budget by giving an estimate and evaluation of its receipts and expenditure before the Lok Sabha for the coming financial year. The government plans expenditure as indicated by its objectives and then attempts to raise resources to meet the proposed expenditure. Government earns money broadly from fees and fines, taxes, interest on loans given to states and dividend by public sector enterprises. Government spends mainly on (i) securing and giving goods and services to citizens, (ii) on law and order and (iii) internal security, defence, staff salaries and so on. In India there is constitutional necessity to introduce budget before Parliament for the ensuing financial year. Thefinancial (fiscal) year begins on April 1 and ends on March 31 of next year. For instance, fiscalor budget year 2011-12 is from April 1, 2011 to March 31, 2012. So clearly, the budget is the most important document for the government because government executes its plans and programmes through the proposed financial plan. Some of the definitions of public budget are as follows:

***As per Dimock* "A budget is a financial plan summarizing the financial experience of the past stating a current plan and projecting it over a specified period of time in future."**

According to Harlod R. Bruce "*A budget is a financial statement, prepared in advance of the opening of a fiscal year of the estimated revenues and proposed expenditures of the given organization for the ensuring fiscal year*."

***Munro* "Budget is a plan of financing for the incoming fiscal year. This involves an itemized estimate of all revenues on the one hand and all expenditures on the other."**

Wilne defined as "*Budget is a detail of estimated revenues and expenditures-a comparative chartof revenues and expenditures-and over and above this it is an authority and direction of the competent authority given for the collection of revenues and expenditure of public money."*

***As per S torum* "Budget is a document containing a preliminary approved Plan of Public Revenue and Expenditure."**

Taylor defined "*Budget is a financial plan of government for a definite period*."

From the above definitions, we conclude that the following are the main elements of public budget:

- It is a financial document having expected estimates of revenue and proposedexpenditure;
- It needs some authority to approve it;
- Budget is prepared for a limited period, generally it is annual;
- It additionally sets the procedure and manner in which the collection of revenue and theadministration of expenditures is to be executed.
- Expenditure and sources of finance are arranged in accordance with the objectives of thegovernment.

6.3 Objectives of Public Budget

It should be remembered that rapid and balanced economic growth with equality and social justice has been the overall objective of all the policies and plans. General objectives or uses of apublic budget are as under:

- **Economic Growth:** The first objective is to promote speedy and balanced economic growth in order to improve living standard of individuals. Economic growth refers to a continued increase in real GDP of the economy, i.e., a sustained increase in the volume of goods & services.
- **Reduction of Poverty and Unemployment:** Another aim of public budget is to eradicate mass poverty and unemployment by creating employment opportunities and giving maximum social benefits to the poor. In fact, social welfare is the single most significant objective. Every citizen of our country should be able to meet his fundamental requirements like food, housing, clothing (roti, kapda, makaan) along with decent educational and medical care facilities.
- **Reduction of Inequalities/Redistribution of Income:** In order to minimize the inequalities of wealth and income, government can influence distribution of income through levying taxes and giving subsidies. Government imposes high tax rate on rich people reducing their disposable income and lowers the rate on group having lower income. Again, government gives subsidies and amenities to people whose income level is low. Again, public expenditure can be helpful in reducing inequalities. More focus is laid on equitable distribution of income and wealth. Economic advancement in itself is not a sufficient and complete goal but the goal must be equitable progress.
- **Redistribution of Income:** Equalities in distribution of income mean allocating the incomedistribution in such a way that minimizes income inequalities and also there is no concentration of income among few rich. It basically requires that rate of increase in real income of poor or helpless sections of society should be faster than that of rich segments of society. Fiscal instruments like taxation, subsidies and public expenditure can be utilized to achieve the object.
- **Reallocation of Resources:** Reallocation of resources is another objective of budget in order to accomplish social and economic objectives. Again, government gives more resources into socially productive sectors where private sector initiative is not forthcoming, for example, rural electrification, education, health, public sanitation and so on. Also, government allocates more funds to create socially valuable goods (like Khadi) and draws away resources from some different areas to promote balanced economic growth anddevelopment of regions. Moreover, govt. undertakes production directly when

required.

- **Economic Stability/Price Stability:** Government can bring economic stability by controlling fluctuations in general price level through taxes, subsidies and expenditure. For example, when there is inflation (continuous/persistent rise in prices), government can reduce its expenditure and when there is depression, and government can reduce taxes and grant subsidies to encourage spending by individuals.
- **Financing and Management of Public Enterprises:** Another objective of budget is to finance and manage public enterprises which are of the nature of national monopolies like railways, water lines, power generation and so on.

6.4 Functions of Budget

The following points highlight the functions of budget:

- It guarantees the financial and legal accountability of the executive to the legislature.
- It ensures the responsibility and accountability of subordinates to superiors in the administrative hierarchy.
- It acts as an instrument of social and economic policy in order to serve the functions of allocation, distribution and stabilization.
- Budget works with the efficient execution of the functions and services of government.
- Budget facilitates administrative management and coordination as it brings together the different activities of the government departments into a single plan.

A budget impacts the society at the following three levels:

- Budget helps to promote aggregate fiscal discipline by way of controlled expenditure, given the quantum of revenues,
- Resources of the nation are allocated on the basis of social priorities,

- The budget contains effective and efficient programmes for delivery of goods as well as services to achieve its targets and goals.

6.5 Classification of Budget

A budget is defined as an annual statement of the estimated receipts and expenditure of thegovernment over the fiscal year. The types of budgets are as follows:

1. **Revenue and Capital Budget:** The revenue or current budget is associated with current financial transactions of the government which are of recurring nature. It includes revenue receipts i.e. tax and non- tax revenue and expenditure made out of revenue receipts. Capital budget is associated with those transactions which are related to the acquisition and disposition of capital assets. It includes receipts from borrowings from RBI, market loans, loans from foreign institutions and governments, sale of long term securities and treasury bills etc.
2. **Conventional and Administrative Budget:** The administrative budget is a set of accounts prepared within the framework manner i.e. through the imposition of taxes. The flows whichare not owned by government are excluded from this budget. The cash or conventional budget includes all the cash receipts from and payment to the government. The funds whether belong or not belong to government are included in this budget. This budget is more detailed than administrative budget.
3. **Executive and Legislative Budget:** The executive budget is established by the executive ofthe government. This budget is required to be adopted and passed by the legislature but the main initiative has to be taken by the government. The legislative budget is prepared as well as adopted by legislature either directly or indirectly through committees constituted by it.
4. **Multiple and Unified Budget:** When more than one budget is prepared in order to evaluate the fiscal control and performance efficiency of every specialized function of government, then it is called multiple budgeting. This type of budgeting was prevalent in U.S.A. When single and comprehensive budget is made to evaluate budget operations and its total effect on the economy, then it is called unified budgeting.
5. **Federal, State and Local Bodies Budget:** The federal and state government budgets are prepared, passed as well as implemented by the executive of the government. In some cases, local budget is different from executive budget. At state and local level, the process of budget is

less difficult and one can easily evaluate advantages of public expenditure than in the federal budget.

6. **Ordinary and Emergency Budget:** The ordinary budget is associated with the functions which are relatively permanent. On the other hand, emergency budget is associated with the exceptional or unusual situations like war, depression etc.
7. **Deficit, Surplus and Balanced Budget:** If public revenue is more than public expenditure, then it is surplus budget. If public revenue is less than public expenditure, then it is deficit budget. If public revenue is equal to public expenditure, then it is balanced budget.
8. **National Income Accounts Budget:** The data for preparing such type of budget is extracted from national income and product accounts. These accounts show the total resource- absorbing production as well as income generation by public and private sectors of the country. The activities of private sector are presented through investment as well as consumption and that of public sector are presented through federal, state and local components.
9. **Full Employment Budget:** The full employment budgeting is based on revenue and expenditure that would be in existence under full employment conditions. This budget gives secondary importance to the actual revenue and expenditure of the coming year, it gives primary importance to the impact of budget on the economy. This budget must include estimates of revenue and expenditure at full employment level as well as at anticipated levelof employment.
10. **Plan and Non-plan Budget:** The part of budgetary receipts which finance the planned expenditure and the outlays on planned development heads constitute the plan budget while the remaining part of the budgetary resources and expenditures is referred to as normal or non-plan budget.
11. **Development and Non-development Budget:** Budget have two type of heads i.e. development and non-development expenditure. Further, development expenditure includes revenue account and capital account. Revenue account comprises of expenditure on public health, education, industry, agriculture etc. Capital account comprises of civil works, power projects, road construction, railways construction etc. If all these expenditures whether in capital account or in revenue account are added, one can get a complete view of development budget. Non-development expenditure also includes revenue account and capital account. Revenue

account comprises of tax collection, interest payments, administrative services etc. Capital account comprises of repayment of loans, discharge of permanent debt, loans and advances by government etc. If all these expenditures whether in

Capital account or in revenue account are added, one can get a complete view of non-development budget.

12. **Modern Classification of Budget or Economic and Functional Classification of Budget:** Taking into consideration multiple objectives and functions of modern public sector, modern economists have tries to classify budget into two types i.e. economic and functional classification of budget. The classification of the expenditure and mode of its financing in terms of economic category is known as economic classification of budget which would include information regarding consumption, savings, investment, creation of public assets as well as liabilities etc. from several budgeting items. On the other hand, functional classification consists of different type of functions that government performs or services provided i.e., defense, social and economic services etc.

Check Your Progress-I

Q1. Explain the concept of budget.

Ans...

....Q2. Differentiate between plan and non-plan budget.

Ans...

....

Q3. Write a short note on modern classification of budget.

Ans...

....

6.6 Balanced Budget

A government budget is said to be a balanced budget wherein government estimated receipts (revenue and capital) are equal to government estimated expenditure. Let us assume for the sake

of convenience that the only source of revenue is a lump sum tax. A balanced budget will then imply that the tax amount is equal to the expenditure amount. A fair spending will then, at that point infer that the measure of duty is equivalent to the measure of use.

Balanced Budget: Estimated Government Receipts = Estimated Government Expenditure It is always advisable to have a balanced budget for individuals and families. Most of the Classical economists advocated balanced budget, which was based on the approach of 'Live within means'. According to them, revenue of government should not fall short of expenditure. These economists also favoured balanced budget as they believed that government should not interfere in economic activities and should simply focus on the maintenance of internal and external security and provision of essential economic and social overheads. To accomplish this, government must have sufficient fiscal discipline so that its expenditures are equal to revenue.

Merits

i) It guarantees financial stability

ii) The balanced budget avoids wasteful expenditure

iii) This budget helps in fighting the situation of depression.

Demerits

i) This type of budget does not effectively deal with economic evils

ii) The process of economic growth is hindered

iii) Scope of undertaking welfare activities as government assistance is restricted.

As indicated by Adam Smith, public expenditure should never exceed public revenues, i.e., he supported a balanced budget. But Keynes and modern economists disagree with the policy and arrangement of a balanced budget. They argue that in a balanced budget, total expenditure (public and private) falls short of the amount necessary in order to maintain full employment. Thus, government should expand its expenditure to close the gap between the expenditure essential for full employment and expenditure that actually takes place. A balanced budget is ideally a good approach to bring the near full employment economy to a full employment

equilibrium.

6.7 Unbalanced Budget

When government estimated expenditure is either more or less than government estimatedreceipts, the budget is said to be an unbalanced budget. Unbalanced budget may be either surplusbudget or deficit budget.

6.7.2 Surplus Budget

When government receipts are more than government expenditure in the financial plan, the budget is called a surplus budget. In other words, a surplus budget refers to a situation where in Government revenue is in excess of government expenditure. The surplus budget indicates the financial strength and soundness of the government. When there is too much inflation, the government can adopt the approach of surplus budget as it will help to reduce aggregate demand. Increase in revenue by imposing taxes on individuals reduces their disposable incomes, which otherwise could have been spend on consumption or saved and devoted to capital formation. Since government spending will be less than its income, aggregate demand will decrease and help to decrease the price level. However, in modern times, when governments have so many social, financial & political obligations, it is virtually not possible to have a surplus budget.

Symbolically:

Surplus Budget = Estimated Government Receipts > Estimated Government Expenditure

A surplus budget indicates that the government is taking away more money than what it is pumping in the economic framework. Subsequently, aggregate demand tends to fall which helps in diminishing the price level. Hence, in times of extreme inflation, which emerges due to excess demand, a surplus budget is the suitable budget. However, in case of deflation and recession, surplus budget should be avoided. In modern-day world, balanced budget and surplus budget are rarely used by the government.

6.7.3 Deficit Budget

When government estimated expenditure exceeds government receipts in the budget, the budget is said to be a deficit budget. In simple words, in a deficit budget, government estimated revenue is less than the estimated expenditure. Symbolically:

Deficit Budget = Estimated Government Expenditure > Estimated Government Receipts Nowadays' famous democratic governments adopt generally deficit budget in order to meet the growing needs of individuals. It could be mentioned that Keynes had advocated a deficit financial plan to remedy the situation of unemployment and under-employment. Government covers the gap either through public borrowings or through withdrawals from its accumulated reserve surplus. Therefore, a deficit budget suggests increase in government liability and fall in its reserves. At the point when an economy is in under-employment equilibrium due to inadequate demand, a deficit budget is a good solution to combat recession. In developing nations like India, where a large number of resources are needed for the purpose of economic growth & development it is impossible to raise such resources through taxation, deficit budgeting is the only option. In underdeveloped nations, deficit budget is utilized for financing planned development and in advanced countries it is used as stability tool to control economic and business fluctuations. In figure 1, national income is measured on OX axis and public revenue and expenditure on OY axis. At the Point e, budget is balanced. Towards the left of point e, the government budget is in deficit and to the right of point e, the budget is in surplus. At the point when the government incurs a budget deficit it is financed by borrowing. The government borrows from the general public by way of issuing government bonds. This gives rise tothe public debt or government debt.

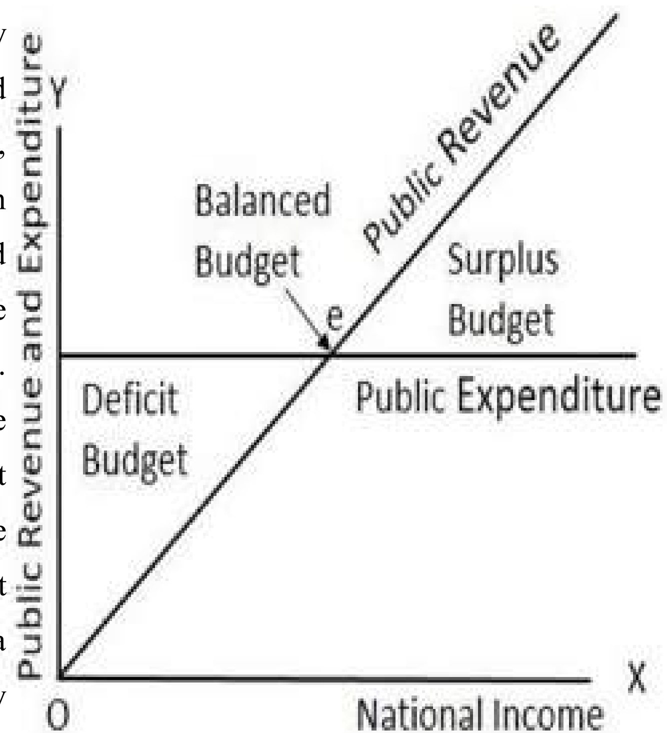


Figure 1: Balanced, Deficit and Surplus Budget

Merits

A deficit budget has the following benefits particularly for developing economy:

It accelerates economic growth and development,

Deficit budget enables to undertake welfare programmes of the people and

It is a remedy for deflation as it really looks at downward movement of prices.

Demerits

At the same time, deficit budget has demerits also as follows:

i) A deficit budget encourages unnecessary and wasteful expenditure by the government,

ii) It might lead to financial and political instability and

iii) It rattles the confidence of the foreign investors.

The situation of excess demand leads to inflation (continuous rise in prices) and the situation of insufficient demand leads to depression (fall in prices, rise in unemployment, etc.) in the economy. A surplus budget is suggested in the situations of inflationary trends in the economy whereas a deficit budget is recommended in the situation of recession.

6.8 Performance Budget

Performance budget is a spending plan which refers to programs and functions which reflects the estimated costs and revenues of the organizations, Government or Statutory bodies. This budget gives the objective and purpose for which funds are being raised and proposed activities and projects to be accomplished. Performance budget is aimed to improve the productivity and efficiency of the people involved in performing the tasks as per the budget requirements. This budget is not just about the performance; it is significantly more than the evaluation of performance or giving the performance information in the financial plans. The primary features of the performance budget are to introduce the performance estimation in the budgeting method

and to incorporate the budget management system with the overall responsibility to compensate for the good performances and punish the terrible or poor performances.

Examples of Performance Budget

i) 80 percent reduction in the patients suffering from Dengue and Malaria by the end of 2020;
ii) 20 percent decline in manufacturing waste by introducing staff training in the process of manufacturing; and
iii) 50 percent decrease in the infant mortality rate through the implementation of vaccination centers in various parts of the country by the year 2021.

Merits

i) Clear Purpose: Performance budget provides a clear purpose of financial planning and gives a reasonable understanding of the performance of the individuals involved. It becomes accessible to review the performances and the deviations and then correct them.

ii) Improvement in Performance: This budget helps to improve the performance, as there will be a constant check on the deviations and performances to eliminate the errors and correct the deviations, and hence this will help in improving the performances.

iii) Sets Accountability: Since the performance budget provides a reasonable understanding of the jobs to be performed and tasks to be completed by the concerned persons, it gives accountability on each individual for their jobs and tasks, and they will be considered responsible for their part of work.

iv) Transparency: The budget succeeds in making transparency in the budget related tasks and their performances, as it is clear to all their roles and responsibility, and they are accountable for their jobs, which will help in giving clear transparency in the entireprocess.

Demerits

i) There can be the chance of data manipulation anywhere in the process;

ii) There is a necessity of a robust accounting system;

iii) Performance budgets are subjective in nature; and

iv) This system has no universal applicability.

Classification of Performance Budget

In the words of Burkhead, performance budget is one which presents the purposes and objectives for which funds are requested, the costs for programmes proposed for achieving these objectives and quantitative data measuring the accomplishments and work performance under each programme. In a mixed economy of developing countries where a part of the budget is concerned with planned development programmes, a time bound achievement of objectives is allnecessary.

(i) Object Classification

The object classification elaborates further each of the heads of expenditure under functional classification. In India, functional classification of budget is made among what are described as 'major' heads of expenditure like those under social services, economic services, general services, community services, etc. Each of these functions is again sub-divided into minor heads and sub-heads against which expenditure is shown separately. This is what is referred to as object classification. The table 1 will help in understanding the classification in a better way:

Table 1: Functional and Objective Classification	
Functional Classification	**Objective Classification**

1. Administrative and general services(Functional head)	Agriculture and Allied services (Major Head)
a) Defence (Major Head)	a) Agriculture Proper (Minor head)
b) Police (”)	b) Soil and water conservation (”)
c) Justice (”)	c) Food and Nutrition (”)
d) General Administration (”)	d) Animal Husbandry (”)
2. Social Services (functional head)	e) Dairy Development (”)
a) Education (Major Head)	
b) Medical and health (”)	
c) Social security (”)	
d) Information & Broadcasting (”)	
3. Economic Services (functional head)	
a) Agriculture and allied services (MajorHead)	a) Agriculture Proper (Minor Head)
b) Fuel and Power (”)	i) Pay of Officers (”)
c) Forest (”)	ii) Travelling Allowance (”)
d) Industries (”)	iii) Stores and Stationery (”)
e) Transport and Communication (”)	iv) iv) Contingencies (”)
4. Community Services (functional head)	
a) Roads (Major Head)	
b) Irrigation and Drainage (”)	
c) Flood Control (”)	
d) d) Sanitation (”)	

From the above table, it is clear that the object classification is a device to facilitate departmental accountability to legislature. The control of public expenditure at the functional level has

necessitated the object classification. Thus, object classification by breaking down the heads of the expenditure into their minutest details serves a very important purpose of budget planning.

(ii) Programme Budgeting Classification

Under this, the budget would frame a programme structure to attain a particular objective and specify spending to attain it. For example, if the objective is to remove the poverty, these expenditures would constitute the poverty removal programme as shown in table 2.

Table 2: General Objective Poverty Removal	
Name of the Objective	**Detail of item**
Specific objective No. 1	**Increase of Earning capacity**
Programmes	a) Elementary and secondary education programme
	b) Teacher's training programme
	c) Adult literacy programme
	d) Skill formation programme
	e) Job placement programme etc.
Specific objective No. 2	**Income Maintenance**
Programmes	a) Employment Insurance programme
	b) social security programme
	c) Consumption subsidy programme
	d) Price support programme etc.
Specific objective No. 3	**Agricultural Improvement Programmes**
Programmes	a) Input supply programme
	b) Irrigation improvement programme
	c) Flood control programme
	d) Land reforms programme etc.

6.9 Budget as an Instrument of Mobilization and Channelization of Resources and Redistribution of Income and Wealth

In modern times, budget is considered as an important instrument of economic policy of the national economy. The budget is not simply proposals of estimates but a comprehensive plan and programme for the future on the basis of past experience, expressing ht economic and social policy of the Government and its ideology. It is prepared by the executive and is approved by the Parliament of the country. In the words of Prof. Taylor, budget is the master plan of the Government. Thus, a budget is a necessary and crucial instrument of economic policy. Budget is not merely an estimate of anticipated revenue and expenditure rather a document of fundamental importance for the as a whole. In the words of Prof. D.T. Lakdawala, budget is an instrument of economic policy meant to guide and regulate the course of the economy in the desired direction at an optimum pace. The following points will make clear to what extent budget is an instrument of economic policy:

- **Revenue Raising Device**: The government requires more revenue to discharge its fiscal responsibility. The modern nations have progressively become welfare states with larger state activities coming under the fold of public sector. Subsequently, resources have to be found in adequate quantity. The budget secures this purpose through a financial arrangement. The receipts side of the budget shows the sources and the extent of funds for the purpose of financing state activities.

- **Incentive to Economic Activity**: Budgetary receipts and expenditures can greatly influence economic activities both in the industrial and the agricultural sectors. Through tax concessions and discriminatory taxes, the budget can influence production and productivity in favour of those sectors which the government likes to promote. Important industries in the priority list of government may be granted tax holiday or tax concessions in order to attract promising entrepreneurs to these ventures. Similarly, agricultural activity and production can be increased through budgetary provisions of free of subsidized supply of agricultural inputs and extension services.

- **Human Capital Formation:** The most important need for a country's economic development is human capital formation. The level of human capital like education, medicaland public health etc. is very poor in the underdeveloped countries. Budgetary provisions can serve this purpose. Since investment on such human capital formation is heavy and subjected to long gestation

period, funds will not come from private sector. It is only the government which can raise the level of general and technical education and of health and productive capacity by providing educational and health facilities through the budgetary outlays.

- **Proper Allocation of Resources:** Most efficient allocation of resources is given by equality between marginal cost and price which is possible only under perfect market conditions.

  Underdeveloped nations are seriously suffering from misallocation of resources. The overall market conditions in private sectors are set by the presence of monopoly, oligopoly and monopolistic competition. To correct this misallocation, the government has to interfere either in the form of production subsidy or supply of goods and services by public authorities so that the gap between average revenue (i.e. price) and the marginal cost is reduced to a greater extent. That is the reason why the heavy instrument public welfare industries which are subjected to decreasing cost conditions are increasingly coming under the fold of public sector.

- **Diversion of Resources to More Useful Production:** Free market mechanism leads to production of those goods which give maximum profit to private enterprises. Hence private investment a generally concentrated on the production of luxury commodities. Thus, it is important to redirect resources to the creation of more valuable goods and services, especially of the kind of mass consumption ones. This could be possible by government interference through the budget. Imposition of heavy tax on less essential and harmful and tax exemption or tax concessions granted to more essential goods as well as services can divert resources to the creation of right kind of services and goods. Moreover, grant of facilities through budgetary expenditure can also help in diversion of resources to useful production.

- **Building of Economic Overheads**: The main cause of the underdevelopment of the poor countries is absence of proper economic infrastructure. Without adequate transport & communication system, establishment of essential and key industries and proper training facilities for entrepreneurs and workers, large scale generation of electric power, industrial development is not possible. Similarly, agricultural production and productivity cannot improve in the absence of proper irrigation facilities, flood control measures, technological improvement with R & D activities etc. The above-mentioned facilities must be given by the government. The expense of supplying these services is heavy and can’t be raised directly from the beneficiaries. Thus, these facilities are provided free of direct charges through the budgetary provisions. Therefore, budget has a great influence on the agricultural and industrial

development.

- **Income and Employment:** Since less developed countries are low-income economies, people live in poverty and hence, saving and investment is very low. The income of individuals can be increased by way of improving productivity and production. The budgetary provisions can go a long way to accomplish this. Setting up of public sector industries in backward regions and improvement of small-scale industries in the rural areas will create employment opportunities in these industries. The budgetary provisions of employment related tax concessions can affect creation of employment opportunities in the private sector also.
- **Reduction of Inequality:** The next important fiscal objective of budget is to achievereduction of inequality. Inequality of income and wealth is acute in most of the underdeveloped countries. Budgetary tax-expenditure programmes can go a long way to reduce inequality. Thus, the provisions of progressive taxes on income and property are aimed at securing this objective.
- **Planning for Economic Purpose:** Programme budgeting is a complete plan with respect to a particular purpose of achievement. It pursues an "overall programme management in the light of long run objectives and seeks to relate planning and programming with budgeting." Thus, to achieve the general objective of poverty removal, for example, the budget will frame as many specific objectives as will be directly and indirectly connected with poverty removal. The specific objectives in this case may be in the form schemes of increase of earning capacity, income maintenance schemes, community improvement programmes,agricultural improvement programmes, etc. which have to be taken up simultaneously so that main purpose is achieved in its fullest form by the targeted period.

Check Your Progress-II

Q1. Explain the concept of balanced budget.

Ans..

....

Q2. Mention about merits of deficit budget.

Ans..

Q3. Write a short note on performance budgeting.

Ans...

6.10 Summary

In modern times, budget is considered as an important instrument of economic policy of the national economy. Just as your household financial plan is concerning what you earn and spend, similarly the government budget is a statement of its income and expenditure. In the first quarter of every year, government presents its budget by giving an estimate and evaluation of its receipts and expenditure before the Lok Sabha for the coming financial year. This chapter highlights the importance of budget as financial document comprising revenue and expenses over a year. Depending on these estimates, budgets are classified into three categories-balanced budget,surplus budget and deficit budget. It contains effective and efficient programmes for delivery of goods as well as services to achieve its targets and goals. The chapter also explains the performance budget that how it reflects the estimated costs and revenues of the organizations, Government or Statutory bodies and aims to improve the efficiency of the people involved in performing the tasks as per the budget requirements. The last part of the chapter explains budget as a comprehensive plan describing the economic and social policy of the government and its ideology. Budget as an instrument helps to guide and regulate the economy in the desired direction at the optimum pace.

6.11 Questions for Practice

A. Short Answer Type Questions

Q1.Write about classification of performance budgeting.

Q2.Discuss two uses of budget.

Q3.Explain unbalanced budget.

Q4.Define the functions and impact of budget

Q5.What do you mean by deficit budget?

B. Long Answer Type Questions

Q1.Differentiate between balanced and unbalanced budget.

Q2.Explain various types of budgets.

Q3.Widely explain the classification of budget

Q4.What is performance budget. Explain its classification

Q5.Explain budget as an instrument of mobilization and channelization of resources and redistribution of income and wealth

6.12 Suggested Readings

i) B.P. Tyagi: Public Finance

ii) R.K. Lekhi: Public Finance

M.A (ECONOMICS)

SEMESTER- I

COURSE: PUBLIC FINANCE

UNIT 7: DEFICIT FINANCING: OBJECTIVES AND LIMITATIONS FISCAL FEDERALISM: PRINCIPLES OF FEDERAL FINANCE

STRUCTURE

7.0 Learning Objectives

7.1 Introduction

7.2 Deficit Financing- Meaning and Definition

7.3 Deficit Financing- Objectives

- 7.3.1 Economic Development
- 7.3.2 Revival of Depressed economy
- 7.3.3 Unprecedented expenditures
- 7.3.4 Optimal Utilization of Natural Resources
- 7.3.5 Mobilization of Idle resources in the economy

7.4 Effects of Deficit Financing

- 7.4.1 Inflation
- 7.4.2 Investment
- 7.4.3 Savings and investment relationship
- 7.4.4 Price Instability
- 7.4.5 Economic Disparities

7.5 Limitation of Deficit Financing

7.6 Fiscal Federalism: Meaning and Features

7.7 Fiscal Federalism and Finance Commission in India

7.8 Allocation of Revenue Resources between the Centre and the States

7.8.1 Taxes

7.8.2 Grants-in-aid

7.8.3 Loans

7.9 Principles of Federal Finance

7.10 Summary

7.11 Questions for Practice

7.12 Suggested Readings

7.0 Learning Objectives

After reading this unit, Learner will be able to:

- Define Deficit Financing: Meaning, Objectives and Limitations
- Know about Fiscal Federalism
- Describe Principles of Federal Finance

7.1 Introduction

Governments of different countries across the world are concerned about economic growthand development with a focus upon increasing the welfare of people, decreasing economic and social inequalities, increasing literacy, decreasing poverty, along with increasing the standard of living of the people. In recent times, governments across the world are getting concerned about environmental issues also. Investments are thus; also needed for attaining sustainable growth that demands a balance between long-run economic growths without environment degradation. Moreover, with the advancements in production technologies, increasing resources are needed for maintaining internal and external securities, creating employment opportunities,

mitigating the rural-urban divide etc. Therefore, the government requires huge resources that are usually over and above the public revenue that is collected through various taxes, fees and borrowings from internal and external sources. In these cases, deficit financing is an important instrument with the government to increase the money supply in the economy. Importantly, government cannot resort to deficit financing all the times due to its certain limitations. Therefore, it is important to understand the concept of deficit financing in details.

7.2 Deficit Financing: Meaning and Definition

Economic development is impacted by and results in public expenditures within the economy. This expenditure may exceed the revenues generated through various means. After the great depression of 1930s, Keynesian model of income and employment depicts the multiple times increase in income with autonomous government expenditures. Therefore, for generating long run income and employment in the economy, the initial investment by the government acts as a motivating factor for private entities to invest further. Henceforth, government collects funds through taxation, fees etc. to begin with and also meet the shortfalls in the required funding through (i) further imposing taxes, (ii) or to finance the 'deficit' (called 'deficit financing') through borrowing from internal and external sources and by printing new notes. But, if government resorts to further increasing taxes, then it may face resentment from the people. Therefore, the second option of financing the excess of expenditure over income is normally adopted by the government, which is known as 'Deficit Financing'.

Deficit Financing in normal parlance connotes all means of raising finance that could help in meeting the planned deficit of the government on both domestic front and in balance of payment. But it is important to highlight the meaning of deficit financing as has been considered in Western world and in India. While the countries in the West, describes 'deficit financing' as financing of a deliberating created gap between public revenue and expenditure that can be filled through government borrowings from various internal and external sources. The idea largely revolves around utilizing all the idle cash in the economy. In Indian context, deficit financing connotes direct addition to

gross national expenditure through issue of new currency or loans from the Central Bank.

In other words, deficit financing are the means of financing the deliberate excess of expenditure over income through printing of currency notes or borrowings. According to Planning Commission, India, "The term Deficit Financing is used to denote the direct addition to the gross national expenditure through budget deficit when the deficit is onrevenue or capital account." Here, capital expenditure includes the money spend for acquiring assets like land, buildings, machinery etc. On the other hand, revenue expenditures are the expenditure of the government for its operational needs like paying salaries, wages, pensions, interest etc. Thus, the capital accounts include capital receipts and payments; and revenue account includes all the revenue receipts and current expenditure of the government.

As defined in Britannica "Deficit financing, practice in which government spends more money than it receives as revenue, the difference being made up by borrowing or mintingnew funds". It further added that "budget deficits may occur for numerous reasons; the term usually refers to a conscious attempt to stimulate the economy by lowering tax rates or increasing government expenditures."

Precisely, deficit is financed through either or a mix of the following sources: (i) Borrowing from the Central Bank, (ii) Withdrawal of cash balances; (iii) withdrawal from the commercial banks and (iv) issue of new currency by the government.

7.3 Deficit Financing: Objectives

Deficit Financing has the following objectives:

7.3.1 **Economic Development**: The major reason of exceeding expenditures as compared to the revenue earned by the government is the need of investment for economic development. The investment for economic development like allocation of funds for construction of roads, bridges, educational institutes, financial institutes, public utilities etc. is done in developed and developing countries. While developed countries needs continuous investment to maintain the higher standard of living, the developing and underdeveloped

countries requires investment for making their economies developed in the years to come. But due to the need of more resources as compared with the revenue generated compel the government to raise funds to meet the deficit. The government can raise funds with imposing additional taxes, which become challenging in developing and underdeveloped economies with low tax base with lower taxable capacity. Also, increasing the rate of taxation has a limited scope in democratic political system. Likewise, borrowings from internal and external sources also have limited scope, mainly in low-income countries with higher marginal propensity to consume. Therefore, deficit financing, i.e. printing new currency is the option with little resentment from the public.

7.3.2 **Revival of Depressed economy:** During the great depression of 1930s, Keynes firmly advocated the increase in investment of the government to multiple the incomes in the economy. Keynes argued that the autonomous investment in the economy induce the private entities to invest that in turn increases income, employment, production and prices in the economy. Deficit financing is thus, regarded by Keynes as an important means to revive the economy from depression.

7.3.3 **Unprecedented expenditures:** In the dynamic world, the economies can witness some unprecedented expenditure like war expenditure, maintaining internal security; natural calamities etc. that requires fund in short notice. Under such circumstances, governments resort to deficit financing as compared to raising taxes and increasing borrowings. Historical evidences show that the governments of different countries resorted to deficit financing during the first and second world wars.

7.3.4 **Optimal Utilization of Natural Resources**: There are many natural resources that are available with different countries. Apart from fossil fuels, petroleum products, some renewable resources like solar energy, wind power etc. has to be exploited optimally with public investment that can generate long-run sustainable economic growth. Generating employment opportunities: Generating employment opportunities are important for the

growth, development and sustainability of the economies. Therefore, the investment by the government in developing new sectors and revival of the existing sectors can create jobs to give boost to effective demand, is based upon Keynesian model of economic growth. But, on the other hand, with economic advancements, government also invests in providing education and necessary skills to improve the capabilities amongst the people for future jobs. Therefore, to meet these expenses government may resort to deficit financing.

7.3.5 **Mobilization of Idle resources in the economy:** Deficit financing acts as an instrument of mobilizing idle recourses in the economy by infusing confidence amongst the wealth holders by doing autonomous investment in the initial stages. The autonomous investment by government pump-prime the private investment andspending in the economy.

7.4 Effects of Deficit Financing

Deficit financing helps in increasing economic growth and development, but it is also having some effects that needs to be looked at in case of resorting to deficit financing for growth and sustainability in the economy.

7.4.1 **Inflation:** Deficit financing is considered to be largely inflationary in nature. The increase in money supply increases the aggregate demand of the goods in the economy that would lead to increase in prices in the short period of time. However, if the deficit financing results in increasing output, income and employment then there is no increase in price level in the economy. Second, it also gives rise to credit creation by commercial banks that also give rise to inflationary tendencies. Keeping in view the inflationary tendency of deficit financing, it should be gradually infused with controlled quantum within the economy to achieve the desired targets.

7.4.2 **Investment:** Deficit financing induces the private investors to invest in the economy. With the increase in price level, private entities perceives increasing profitability in the near future that encourages them to invest in the economy in the short run. However, if in the long run, the rate of inflation remained increasing, the uncertainty of demand from the market discourages further

investment in the economy. Therefore, whereas relatively lower rate of inflation encourages investment, the rather higher rate of inflation discourages investment. Therefore, a careful handing of deficit financing as an instrument of increasing money supply in the economy should be done.

7.4.3 Savings and investment relationship: Deficit financing causes investment to precede savings. Usually, when the voluntary savings are not enough for funds required for investment, the deficit is compensated with increasing the money supply in the economy. Hence, the increase in income in the economy lead to higher savings rather than the other way around. On the other hand, if deficit financing results in rapid increase in prices, the forced savings and decrease in consumption produces deceleration in the economy.

7.4.4 Price Instability: Maintaining price stability is very important for sustainable economic growth. But the infusion of money supply in the economy increases inflation that accentuates with increasing the velocity of money. But exorbitant higher rate of inflation decelerates the economy by impacting the purchasing power and thus rate of employment.

7.4.5 Economic Disparities: The infusion of money in the economy may lead to economic disparities amongst the people belonging to different strata of the economy. The worst suffer of inflation would be the people in the lower strata as compared to the ones in the relatively higher economic stage of the financial hierarchy.

7.5 Limitation of Deficit Financing

Although opting for deficit financing is always a lucrative option before the government to meet the gap between the revenue and expenditure of the government budget, as this does not command opposition from the general public as compared with raising additional taxes. But it is important that even if the government resorts to deficit financing, it must be kept within the limits. Thus, it is important to consider the following points:

It is important to limit the amount of deficit financing according to the precise need of the economy. However, it is a difficult task to estimate precisely the needs of the economy in the dynamic world. But past trends of many indicators and variables can

indicate the quantum of money supply to be increased in the economy to achieve the desired results in a timely manner. Such indicators include examining the past relationship between money supply and rate of inflation, the rate of growth of economy in real terms, the credit creation mechanism of banking system, the relationship between increasing the supply of money and the velocityof money and the relationship between demand and supply factors in the economy.

With deficit financing, a balance should be maintained to wipe out the excess money thorough taxes and saving schemes so as to check the spiral increase of credit creation process leading increasingly inflationary trends in the economy.

The impact of deficit financing on inflation can be checked by regulating the general price levels of the goods in the economy, especially wage-goods through certain formal and informal ways of rationing. Further, taxes should be imposed to reduce inequalities in the economy that may have increased due to increasing money supply.

To reiterate, it is very difficult to setting the precise limit of infusing money supply in the economy to control its probable impacts on inflation. It is important to highlight that inflationat the mild level is considered instrumental for economic growth. But if fiscal deficit lead to higher rate of inflation then, it can have multitude of impacts on economic growth anddevelopment in the economy.

Check Your Progress-I

Q1. Explain the meaning and definition of Deficit Financing.

Ans...

Q2. Discuss the objective of deficit financing?

Ans...

Q3. What are the effects of deficit financing?

Ans...

7.6 Fiscal Federalism : Meaning and Features

N. K. Singh, Chairman of Fifteenth Finance Commission, India regarded that 'India is going through a transition in its intergovernmental relations'. An American economist, Richard Musgrave, introduced the term 'fiscal federalism' in 1959. Financial federalism means the division and coordination of different items of income and expenditure between the central government, state government and local government. The theory of fiscal federalism assumes that the federal system lead to efficient system of distribution of income and thus can lead to economic stability.

Unlike unitary type of government with centrality of the finances, the federal system has layers of government in decentralized pattern. The experts specializing in political science and economics have defined the term 'federalism' differently. Political scientist considers federalism as when the territorial division of power is secured formally by the constitution with some legal protections. On the other hand, economist considers broader view of the term 'federalism' by considering decentralization of fiscal decision –making at the different levels of the government. In nutshell, federal federalism is an institutional arrangement where the fiscal arrangements are decided at multi-layered decision-making framework, based upon the general principle of decentralization and inclusiveness.

Features of Fiscal Federalism: Following the general principle of decentralization, different countries identify the unique characteristics for their countries. The following are some of the essential distinguishing features of fiscal federalism:

1) **Multi-Layered Government:** In Federal form of government, there are two layers of government. Apart from the National government at the center, the individual Statestoo have their governments with the decision-making bodies.
2) **Power distribution:** The decision-making powers and the division of authority is the peculiar feature of federalism.
3) **Constitutional Authority:** The constitutional supremacy exists in the federal setup that commands the faith of the people in the system.

7.7 Finance Commission and Finance Commission in India

India has a federal structure of government. The Constitution of India is supreme law of the land. The Union government at the center and the individual State government have the powers enshrined by the Constitution of India. The Seventh Schedule of the Constitution divides the legislative, administrative and financial powers between Union and State governments according the three List I, II, and III. List I is the Union List that describes the functions and power of the Central Government. In this list the powers to make laws are enumerated with the Parliament. List II is the State List that mentions the functions and powers of State Governments. For matters concerning this list, the legislature of the States has the power to make laws. List III is the Concurrent List that describes the matters on which both the Union Government and the State Government can legislate. The parliament and the legislature of the States specified in the first schedule have to make laws, subject to certain restrictions according to the constitution.

According to the Article 280 of the Constitution of India, the President of India shall, within two years, from the commencement of the Constitution and thereafter at the expiration of every fifth year, or at such earlier times as the President considers necessary, by order can constitute a Finance Commission, consisting of one Chairman and four other members. The provision of Finance Commission in constitution is with respect to obligatory sharing of income tax, the optional or voluntary sharing of excise duties and for making provisions of grant-in-aid. The Finance Commission presents its recommendation to the President of India, which are then (along with explanatory memorandum) places before each house of the parliament. The first Finance Commission was established in 1951 that was operational for the years 1952-57 under the Chairmanship of Sh. K.C. Neogy. Presently, the Fifteenth Finance Commission is established in 2017 under the Chairmanship of Sh. N.K. Singh for the operational years 2020-26.

7.8 Allocation of Revenue Resources Between the Centre and The States

According to the Constitution of India, the functional and financial powers of the

government have been distributed into Central and the States, with some provisions of joint spheres under Concurrent List. There is a clear demarcation of the sources of revenue between Centre andthe States.

According to the Chairman of 15th Finance Commission of India, N.K. Singh, "*The Finance Commission is a constitutionally mandated body that is at the center of fiscal federalism. Setup under Article 280 of the Constitution, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them, lay down the principles determining the distribution of these taxes among States. Its working is characterized by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism. Its recommendations are also geared towards improving the quality of public spending and promoting fiscal stability*."

The 15th Finance Commission under the chairmanship of Sh. N.K. Singh submits its report to the President of India for the years 2020-21 to 2025-26 in November 2020. The four volume report titled as 'Finance Commission in Covid Times' covers wide-ranging issues related to tax devolution, local government grants, disaster management grant etc. The commission also analyzed the finances of State in depth along with the Union Government and examines the departments in greater depth.

The Constitution of India has assigned certain functions exclusive to Union government, States government and concurrent jurisdiction.

7.8.1 **Taxes:** The following is the broader classification of tax revenues between the Union and the States. Taxes levied by the Union but collected and wholly appropriated by the State like stamp duties and excise duties on medicinal and toilet preparations. Taxes levied and collected by the Union Government, but wholly assigned to the States like duties on succession to property other than agricultural land, estate duty on property other than agricultural land, terminal taxes on goods and passengers, taxes on railway fares and freights etc. Taxes levied and collected by the Union and distributed between the Union and the States like taxes on income other than agricultural income. Taxes levied and collected by the Union by may be shared with the States like excise duties.

7.8.2 **Grants-in-aid:** Apart from devolution of revenue from taxes amongst Union and

State governments, the Union also provides grants-in-aids to the States for promoting welfare schemes and specific projects. Grants-in-aid are also used to remove inter-state andintra-state disparities.

7.8.3 **Loans:** The Union government can borrow from both internal and external sources, while the State government can also get short-term and long-term loans from the Central Government that can be for the specific scheme or for general purpose.

Check Your Progress-II

Q1. What are the major features of fiscal federalism?

Ans ....

Q2. Discuss about the nature of fiscal federalism in India.

Ans ....

7.9 Principles of Federal Finance

The division of powers between the Centre and the State governments are based upon certain principles. There are numerous sources of revenue that the Centre and State resorts to for their expenditures. However, it is the aim of the provisions of the federal finance that the resources are allocated between different states according to their needs. The following arethe important principles to be taken into account while determining the financial policy of the federal government.

1) **Uniformity:** This is an important principle of federal finance that depicts no discrimination of any sorts within the States. In other words, uniformity implies that thetax imposed by the Union government should be uniform across the country, while those imposed by the individual states have the uniformity across the region of its jurisdiction. However, taking about uniformity also means that depending

upon the level of development of individual States, the contribution to the common pool should also be uniform. This implies that the economic ability of the States should be the criterion determining their share to the Central government.

2) **Autonomy:** Under the system of federal finance, the individual states should be autonomous in managing the internal financial matters. It means that government in one state should have the ability to raise adequate sources of revenue according to the provisions of the Constitution. The States should also have autonomy in the scope of the expenditure depending upon the unique conditions of their States.

3) **Accountability:** In the matters related to public finance including both revenue generation and expenditures, both the Governments at the Centre and the individual States should be accountable for the optimal utilization of resources that are adequately and equitably collected. Henceforth, the Central government is accountable in the Parliament while the individual States are accountable in State Assembly. This accountability brings transparency and boosts the confidence of the people in the process of managing public finances.

4) **Fiscal Sufficiency and Flexibility:** Federal system of government has its unique characteristics where the States governments are concerned about the growth and development of their own States; the Union government is concerned about the reducing the socio-economic disparities amongst the different States. Therefore, the main concerns of both the Union government and the States government are to increase welfare of the people in their jurisdiction. Therefore, the governments should have sufficiency in the matters of finances to meet their developmental goals. Moreover, in the dynamic world, the principle of flexibility ensures the provisions of raising resources and doing expenditures according to their means and needs, respectively.

5) **Equity:** The principle of Equity is very important in federal finance. The resources should be distributed to each State in such a manner that each State receives the fair share of revenue. Moreover, the concern of the governments at both the Center and the States isto ensure equity in collection of direct and indirect taxes from the people so as to have inter-personal equity in the country across states. Inter-personal equity connotes the provision of collection of taxes and the pattern of

expenditure should be framed in a manner so as to equalize the Marginal Social Benefits and Marginal Social Cost for different individuals across different States under the Union.

6) **Efficiency:** The principle of Efficiency is of utmost importance in Federal Finance. This implies that the Central and the State governments should inculcate 'efficiency' in collection of taxes, fees across its jurisdiction. In other words, the government should ensure that there is no frauds and evasion of taxes at different levels. Moreover, the burden of the taxes is equally distributed. For example, considering the case of collectionof Income Tax by the Government of India, that is imposed at the uniform rate across different Indian States. The provision of collection of this tax should be done in the most efficient manner so that the nationals are taxed according to their taxable capacity. On the other hand, the State governments should ensure efficiency in collection of various taxes.

7) **Administrative Economy:** Another important principle of federal finance is of administrative efficiency. It implies that under the system of federal finance, there shouldbe a close coordination of the Centre and the States for the imposition and collection of taxes to bring maximum welfare to its people. Specifically, administrative economy connotes that there should be minimum cost in collection of taxes across the nation. In the present times, with the development of information and communication technologies (ICT), the possibility of increasing administrative autonomy also get strengthened manifold.

8) **Fiscal Access:** In the fast-changing world, the needs and responsibilities of the government also changes accordingly. Therefore, there should be a possibility for the governments at both the Center and the States to identify and develop new sources of revenue within their constitutional provisions.

9) **Adequacy and Elasticity:** The principle of adequacy means that the allocation of resources between the central government and the state governments should be adequate according to the developmental needs of the latter. On the other hand, the principle of elasticity is also important to meet the challenges of dynamic world. In other worlds, there should be adequate elasticity in the collection of revenues and their expenditures.

10) **Integration and Coordination:** With the basic aim of economic development of the country and to increase the welfare of the people, the principle of integration and coordination amongst different layers of the governments are very important. A closely connected governments of different levels, brings maximum efficiency in the collection of taxes. Moreover, the close interaction between Centre and the States helps in consistent efforts for increasing welfare of the people. The judicious utilization of resources should depend upon an integrated approach to avoid wasteful and redundant expenditures. Apart from the much-needed coordination and integration between the Centre and the States, the coordination and integration should also be strengthened between different departments within the States for the overall development of the people and to avoidwastage of resources.

Check Your Progress-III

Q1. Why is it important for the federal finance to be Uniform, Adequate and Elastic?

Ans...

- -

Q2. Can autonomy and accountability be fix in federal finance?

Ans...

- -

7.10 Summary

Public finance has a broader scope of examining the different sources of generating revenues and the subsequent expenditures. The aim is to increase the welfare of the people with overall economic growth and development. But for economic development, usually the revenue generated through collection of taxes and fees etc. fall short of the requirements in the economy. Therefore, the government resorts to other means like borrowings and minting money to increase funds.

In India, deficit financing connotes the means of increasing money supply in the economy through government borrowings from the Central Banks, printing of new

currency etc. Although, these means of raising funds for expenditure in the economy have its merits of attracting minimum opposition from the public, but it can lead to inflationary tendency in the economy (if remained unchecked). Therefore, increasing the supply of money in the economy without increasing the subsequent output can have a self-distortionary effect in the economy. Therefore, it is imperative that the government should increase the money supply in the economy in a consistent manner so as to avoid the higher rate of inflation in the economy.

Fiscal Federalism is another important component of the public finance. The clear division of administrative and financial powers amongst the Central and the State governments lead to the integrated approach for economic and social development in the national state. The Constitution of India clearly distributes the sources of revenue generation for the Centre government and for the States. The various principles of federal finance including the provisions for autonomy, accountability, equity, uniformity, etc. are paramount for bringing overall development of the economy by increasing welfare of the people.

7.11 Questions for Practice

A. Short Answer Type Questions

Q1. Explain the meaning of Deficit Financing.

Q2. Discuss the need and limitations of deficit financing.

Q3. What does Fiscal Federalism mean?

Q4. Explain the principles of Equity and Accountability for fiscal federalism.

Q5. What is the importance of principle of Elasticity under fiscal federalism?

B. Long Answer Type Questions

Q1. Explain the meaning, importance and limitations of Deficit Financing.

Q2. Discuss in detail the meaning and principles of Fiscal Federalism.

Q3. How the Principle of Integration and Coordination helps in reaping the maximumbenefit of fiscal federalism?

Q4. What are the important principles of Fiscal Federalism?

7.12 Suggested Readings

- Andley, K.K and K.P.M. Sundharam (1972) Public Economics and Public Finance, Ratan Prakashan Mandir, Agra.
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M.A (ECONOMICS)

SEMESTER-I

COURSE: PUBLIC FINANCE

UNIT8: DEVELOPMENT FINANCE: FUNCTIONAL FINANCEVS.DEVELOPMENT FINANCE AND DEVELOPMENT FINANCIAL INSTITUTION.EFFECTIVENESS OF FISCAL POLICY IN PERIODS OF INFLATION AND DEFLATION

STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Concept of Development Finance

8.3.1 Components and Tools of Development Finance

8.4 Functional Finance: Meaning and Definition

8.4.1 Rules of Functional Finance

8.5 Development Finance Vs Functional Finance

8.6 Development Financial Institutions

8.6.1 The Economic Rationale of Development Banks

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8.6.1.2 European Investment Bank (EIB)

8.6.1.3 Islamic Development Bank (IsDB)

8.6.1.4 Asian Development Bank (ADB)

8.6.1.4.1 European Bank for Reconstruction and Development (EBRD)

8.6.1.4.2 CAF - Development Bank of Latin America (CAF)

8.6.1.7 Inter-American Development Bank Group (IDB, IADB)

8.6.2 Major Multilateral Development Finance Institutions

8.6.3 Multilateral Development Finance Institutions: A Critical Assessment

8.6.4 Development Finance Institutions: Indian Context

8.6.5 Development Finance Institutions in India: A Critical Assessment

8.7 Fiscal Policy: Concept, Meaning and Definition

8.8 Objectives and Rules of Fiscal Policy

8.9 Fiscal Policy during Inflation

8.10 Fiscal Policy during Deflation

8.10.1 Effectiveness of Fiscal Policy during Inflation and Deflation

8.10.2 Effectiveness of Contractionary Fiscal Policy during Inflation

8.10.3 Effectiveness of Expansionary Fiscal Policy during Deflation

8.11 Summary

8.12 Questions for Practices

8.13 Suggested Readings

8.1 Learning Objectives

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

- Put forward the meaning and a few important definitions of development finance
- Distinguish between development finance and functional finance
- Describe the objectives, functions and role of a few developments' financialinstitutions.
- Put forward the meaning and a few important definitions of fiscal policy
- Describe the effectiveness of fiscal policy during inflation and deflation

8.2 Introduction

Dear learners, in the earlier units of this course of *Public Finance*, we have discussed different tools the Government utilises for the collection of revenue. In this unit, we shall basically focus on development and functional finance. This unit shall be helpful in getting insights into the concept, evolution, and role of development finance institutions from both international as well as national perspectives.

8.3 Development Finance: Concept

Development finance is one of the important sources for arranging finance for a development project/activity, be it for local, regional, national or global scale (Please refer to box 9.1). Broadly, the term 'development finance' can be defined as the use of public sector resourcesto facilitate private sector investment, primarily undertaken in the low-and middle-income countries. Different tool of development finance not only provides necessary funds for the development activities, but also helps to avoid political risks of attracting purely private capital. Development finance institutions use direct loans, loan guarantees, equity investments, and a variety of other financial products and tools to support and enable these investments by avoiding any significant political and commercial risk.

Let us now discuss two important definitions of the term development finance to properly derive its meaning. In the book entitled "Development Finance: Challenges and Opportunities" edited by Gianluigi Giorgioni (2017, published by Palgrave Macmillan), it has been mentioned:

[Development finance is a very broad area encompassing, in no specific order, overseas development assistance (ODA), foreign direct investment (FDI), remittances frommigrants as well as microfinance. Development finance should also focus on the way capital is being allocated (banks and/ or stock markets) and the way individuals access financial institutions in terms of financial inclusion and financial literacy.] (p.1)

According to the Council of Development Finance Agencies (CDFA):

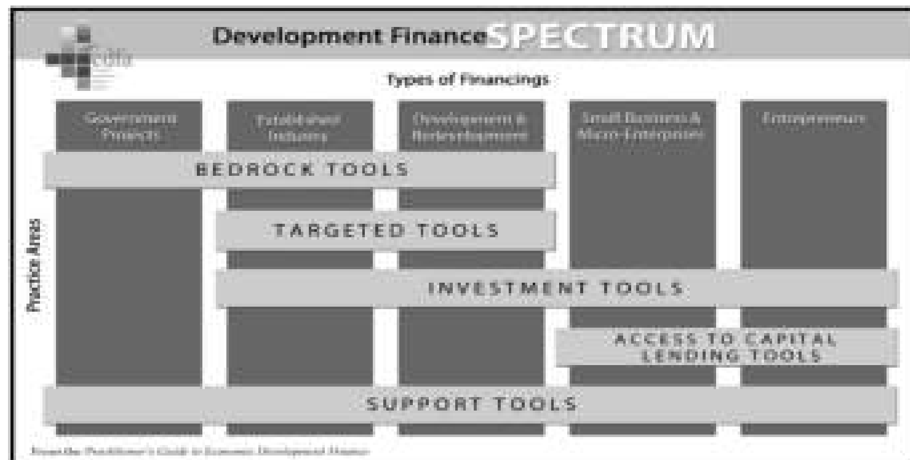
[Development finance is the efforts of local communities to support, encourage and catalyze expansion through public and private investment in physical development, redevelopment and/or business and industry. It is the act of contributing to a project or deal that causes that project or deal to materialize in a manner that benefits the long-term health of the community.](*Source:* https://www.cdfa.net/cdfa/cdfaweb.nsf/pages/df.html)

8.3.1 Components and Tools of Development Finance

The basic objective of Development Finance is to establish proactive approaches that leverage public resources to solve the needs of business, industry, developers

and investors. In the book entitled Practioner's Guide to Economic Development Finance" (2009), Toby Rittner of CDFA as presented the different components (or areas of function) of Development Finance and also has highlighted the different tools that are used in each of these areas. Rittner termed this concept as Development Finance Spectrum in Figure 9.1.

Figure 9.1: Development Finance Spectrum



Source: https://www.cdfa.net/cdfa/cdfaweb.nsf/pages/df.html

The above graphical presentation is useful for development finance agencies to address the needs of established industries, large real estate development projects, small businesses, and individual entrepreneurs. Acknowledgement of the fact that development finance occurs along a continuum is critical to maximizing the resources available in a community. In the above Figure, the dark columns represent, generally speaking, the spectrum of projects that the development finance industry is seeking to finance. Here, we see the different sectors in which development finance is utilized, viz., Government projects, established industry, development and redevelopment activities etc. Again, the different tools of financing that are available under each such sector have also been shown. Let us briefly explain these sectorsand the types of financings.

(1) Government projects include major public activities like: roads, bridges, sewers, water facilities, schools, airports, docks, parking garages, broadband, utilities, etc.
(2) Established industry represents industrial, office and retail sectors (depending on location). Examples such as industrial parks, manufacturing, tech/research hubs and commercial retail centers fall within this category.
(3) Development and redevelopment consist of the projects that require major public

resource commitments to catalyze new private sector development. We see this throughout the country with urban revitalization, rural rejuvenation, adaptive reuse and other transformative projects that require significant public capital.

(4) Small Business and Micro-Enterprises projects represent our economic engine locally. For example, in India, the investment limit for micro enterprises is less than 1 crore INR, for small enterprises, this limit is 1-10 crore INR and for medium enterprises, the investment limit is 10-50 crore INR. Similarly, the turn-over limit for micro enterprises is less than 5 crore INR, for small enterprises, the amount is 1-25 crore INR, and for medium enterprises, the annual turnover limit is 25-250 crore INR.

(5) Entrepreneurs represents our future businesses. These are one-two person companies that are working through the early stages of the business life cycle. Typically, entrepreneurs are not ready for traditional financing and need a unique approach to help them find the working capital needed to expand and grow.

From the above Figure 9.1, different tools available to different sectors have also been shown. These tools can be broadly categorized as Bedrock tools, Targeted tools, Investment tools, Access to Capital Lending Tools and Support Tools. The different components of these broad tools have been briefly shown as follows:

(1) Bedrock Tools: These tools include bonds and the basics of Public Finance.

(2) Targeted Tools: These tools include Tax Increment Finance, Special AssessmentDistricts, Government Districts & Project Specific District Financing.

(3) Investment Tools: Investment tools include Tax Credits, Seed & Venture Capital andAngel Funds.

(4) Access to Capital Lending Tools: These include Revolving Loan Funds, MezzanineFunds, Loan Guarantees and Microenterprise Finance.

(5) Support Tools: These include Federal Economic Development Programs & TaxAbatements.

(Source: https://www.cdfa.net/cdfa/cdfaweb.nsf/ord/cdfatoolboxarticle.html)

From Figure 9.1 and the different tools that we have mentioned in the above para, we can see that the financing types significantly differ with respect to the sector. For example, large- scale industrial development requires a different financing approach compared to small business development. In addition, real estate development does not require the use of innovation capital such as seed or venture capital funding, but an

early-stage entrepreneur is not likely to benefit from bond financing either. Some financing options, such as a revolving loan fund, may address a variety of needs and clients. To be effective, however, most development finance efforts must be tailored to a specific need or project.

By utilizing the toolbox approach, economic development practitioners, public officials and private sector leaders can harness the full spectrum of the development finance industry to support business growth, build public financing capacity, increase investment and secure redevelopment and development projects.

8.4 Functional Finance: Meaning and Definition

Professor Abba P. Lerner introduced the concept of functional finance in the year 1943 in his essay entitled "Functional Finance and the Federal Debt" in the journal *Social Research* published by the John Hopkins University Press. Professor Lerner advocated that fiscal measures should be judged only by their effects. Thus, the way fiscal measures function in an economy is called functional finance. According to him, fiscal policy is an effective instrument in the hands of the government for maintaining full employment and controlling economic fluctuations.

Professor A. P. Lerner states the central idea of functional finance is that government's fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound.

As he argued, the principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism. In the words of Lerner, *"The principle of Judging fiscal measures by the way they work or function in the economy we may call Functional Finance."* Functional Finance entrust the government the meritorious re•sponsibility of keeping a watch over the movements of the economy as a whole.

Whenever and where ever employment sags, income decreases, profitability declines and the economy suffer a severe setback the public authorities are advised to counteract these tendencies by unleashing the opposite force which would rise up the dropping nerves of the system and bring the situation back normally.

The government cannot remain a silent spectator of the dislocations and disturbance in the economy in tune with the non-intervention list policy of the captains of Laissez-

fairism. The object of a stable economy is as much in the interest of the capitalists as in the rest of the society.

Hence maintenance of a high level of demand reason•able prices, a high level of employment and income ought to be the supreme objective of functional finance through the instrument of budgetary manipulations.

Functional Finance is a positive policy in the sense that it advocates a vigorous policy of intense activity on behalf of the community undertaken by the public authority.

8.4.1 Rules of Functional Finance

Concept of functional finance insists on the elimination of the basic causes of inflation and deflation and thereby to maintain economic stability. To achieve this objective, Lerner suggests the following rules for government activity under functional finance:

Rule 1: The first financial responsibility of the government is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current price would buy all goods that it is possible to produce. If total spending is allowed to go above this, there will be inflation. If it is allowed to go below this there will be unemployment. The government can increase total spending by spending more itself or by reducing taxes so that the tax payers have more money left to spend. It can reduce spending by spending less itself or by raising taxes so that tax payers have less money left to spend. By these means total spending can also be kept at the required level, where it will be enough to buy the goods produced.

Rule 2: The second law of functional finance is that the government should borrow money only if it is desirable that the public should have less money and more government bonds. This might be desirable if otherwise the rate of interest would be reduced too low and induce too much investment, thus bringing about inflation. Conversely the government should lend money only if it is desirable to increase the money or to reduce the quantity of government bonds in the hands of the public.

Rule 3: Taxing is never to be undertaken merely because the government needs to make money payments. According to the principle of functional finance, taxation must be judged only by its effect. Taxation should be framed to regulate the spending habit of the people. If private spending is desirable government should reduce the volume of taxation and vice versa.

Rule 4: Lerner was of the view that printing of money (deficit finance) should take place only when it is needed to implement functional finance in spending or lending (repayment of public debt). That is deficit financing should be used when current revenue falls short of expenditure during depression under inflation hoarding or destruction of money should be done.

Functional finance thus rejects completely the traditional doctrines of "sound finance" and the principle of trying to balance the budget. Lerner observes "no budget balancing principle can be used for maintaining full employment and preventing inflation". Thus, functional finance has come to stay, whatever the reactions of the ortho•dox school. It has demolished the basis of the fiscal policy based on sound finance.

Check Your Progress-I

Q 1: Mention the different Rules of development finance.

Ans. ....

- ----------

8.5 Development Finance Vs Functional Finance

Similarities

- Both the concepts evolved after the Great Depression. So, both are post-Keynesian concepts. In fact, in the evolution of both the concepts, Keynes had major role.
- Both development finance and functional finance aims at promoting economic growth. Development finance seeks to promote economic growth through the provision of development institutions. On the other hand, functional finance seeks to control economic situations like business cycles, inflation etc. and thereby promote economic growth.

Distinction

- Development finance is more concerned with funds availability. Functional finance ismore concerned with fund utilization.
- Development finance is more innovative. Newer and newer tools are utilized here. But functional finance primarily lays emphasis on conventional fiscal and budget tools of the Government.
- Development finance is much wider in practice than the concept of functional finance.
- From practical implementation point of view, development finance can be seen as

institutional based, while the practice of functional finance is more Government policyand practice based.

8.6 Development Financial Institutions

In this section, we shall discuss development finance institutions (DFIs) both in international and Indian perspectives.

8.6.1 The Economic Rationale of Development Banks

In the previous section 9.3, we have already discussed the evolution of development finance. In this section, we shall briefly discuss the economic rationale behind the establishment of the DFIs, primarily the development banks in the general international context.

The economic logic of development banks is simple. In the countries which entered late to industrialisation, their capital markets are imperfect. Therefore, to begin the process of industrialization, it was very difficult for the new firms to obtain financefor their initial investment, particularly when it comes to establishing the basic infrastructural facilities. The lumpiness in returns and long-gestation period make private investment in the basic sectors very unattractive. In these circumstances, firms might underinvest, or fail to invest, in the creation of manufacturing capacities that require learning capital.

Another issue here is that as the capital market in these economies are fragmented, most financing is self-financing, so that new entrepreneurs or firms simply do not have access to capital at any price, and even when they do the interest rates may be too high to make the investment worth-while. The problem is particularly worse in case of long-term finance, because, as the industrial set up is not in place, the risks of initial losses are high and the learning period is long. This initial phase of industrialization in a developing country is also to be seen in the context of 'infant industry' argument, following which certain degrees of protection for these industries have been advocated.

To fulfill the financing needs of such a nascent industrial section, the concept of establishment of development banks (or development finance institutions) have come up. The existing commercial banks of the country are unlikely to fulfill needs of this type of financial needs, because the calculated risks in such projects are quite high. It has been argued that to initiate the process of industrialization in these developing countries, the risks of investments have to be borne socially, not individually. As has been argued by Professor Deepak Nayyar,

[In effect, development banks represent a socialisation of risk, where the risks associated with financing industrialisation in its early stages are borne by society rather than by individuals. Insofar as social objectives diverge from private objectives, it is clearly justifiable to accept lower rates of return for development banks in the short run or medium term, because these rates of return are much higher in the long term for patient capital with the benefit of inside information.]

Source: Nayyar, D. (2015). Birth, Life and Death of Development Finance Institutions in India. *Economic and Political Weekly*, L*(33)*

Multilateral Development Finance Institutions: Along with such DFIs established at the country level, certain major multi-lateral DFIs also came up to help the process of industrial development. Major multi-lateral development banks (MDBs) in the world today include:

World Bank.

European Investment Bank (EIB)

Islamic Development Bank (IsDB)

Asian Development Bank (ADB)

European Bank for Reconstruction and Development (EBRD)

CAF - Development Bank of Latin America (CAF)

Inter-American Development Bank Group (IDB, IADB)

It may be noted here that the common objective of these diverse institutions was to finance investment through long-term lending and promote industrial development. In this unit, we shall briefly basically discuss the history, objective, mission, activities of WorldBank, European Investment Bank and Asian Development Bank.

<u>Check Your Progress-II</u>

Q1. Mention any two important distinctions between development finance and functionalfinance.

Ans...

Q2. Mention the names of DFIs that were established between the World Wars I and II.

Ans...-

8.6.2 Major Multilateral Development Finance Institutions

WORLD BANK

Established in 1944, the International Bank for Reconstruction and Development, soon called the World Bank is one of the world's largest sources of funding and knowledge for developing countries. Originally, its loans helped rebuild countries devastated by World WarII.

Basic Mission of the World Bank is: The two basic objectives of World Bank are:

(1) To end extreme poverty: By reducing the share of the global population that lives inextreme poverty to 3 percent by 2030.
(2) To promote shared prosperity: By increasing the incomes of the poorest 40 percent ofpeople in every country.

Presently, with 189 member countries, staff from more than 170 countries, and offices in over 130 locations, the World Bank Group is a unique global partnership: five institutions working for sustainable solutions that reduce poverty and build shared prosperity in developing countries. The five institutions of World Bank are:

8.6.2.1 **IBRD** (International Bank for Reconstruction and Development): IBRD is a global development cooperative owned by 189 member countries. As the largest development bank in the world, it supports the World Bank Group's mission by providing loans, guarantees, risk management products, and advisory services to middle-income and creditworthy low-income countries, as well as by coordinating responses to regional and global challenges.

Created in 1944 to help Europe rebuild after World War II, IBRD joins with IDA, our fund for the poorest countries, to form the World Bank. They work closely with all institutions ofthe World Bank Group and the public and private sectors in developing countries to reduce poverty and build shared prosperity.

8.6.2.2 **IFC** (International Finance Corporation): With the founding of the International Finance Corporation in 1956, the institution became able to lend to private companies and financial institutions in developing countries.

8.6.2.3 **IDA** (The International Development Association): The founding of the International Development Association in 1960 put greater emphasis on the poorest countries, part of a steady shift toward the eradication of poverty becoming the Bank Group's primary goal

8.6.2.4 **ICSID** (International Centre for Settlement of Investment Disputes): Established in 1966, ICSID is the world's leading institution devoted to international investment dispute settlement. It has extensive experience in this field, having administered the majority of all international investment cases. States have agreed on ICSID as a forum for investor- State dispute settlement in most international investment treaties and in numerous investment laws and contracts.

8.6.2.5 **MIGA** (Multilateral Investment Guarantee Agency): Established in 1988, the MIGA was established to promote cross-border investment in developing countries by providing guarantees (political risk insurance and credit enhancement) to investors and lenders.

8.6.2.6 It may be mentioned here that India is a member of four of its five institutions, excluding ICSID.

World Bank's Strategies of Development:

8.6.2.7 Partnering with Governments: Together, IBRD and IDA form the World Bank, which provides financing, policy advice, and technical assistance to governments of developing countries. IDA focuses on the world's poorest countries, while IBRD assists middle- income and creditworthy poorer countries.

8.6.2.8 Partnering with the Private Sector: IFC, MIGA, and ICSID focus on strengthening the private sector in developing countries. Through these institutions, the World Bank Group provides financing, technical assistance, political risk insurance, and settlement of disputes to private enterprises, including financial institutions.

8.6.2.9 One World Bank Group: While our five institutions have their own country membership, governing boards, and articles of agreement, we work as one to serve our partner countries. Today's development challenges can only be met if the private sector is partof the solution. But the public sector sets the groundwork to enable private investment and allow it to thrive. The complementary roles of our institutions give the World Bank Group a unique

ability to connect global financial resources, knowledge, and innovative solutions to the needs of developing countries.

8.6.2.10 Major Activities: Over that time, the World Bank has worked to help more than 100 developing countries and countries in transition adjust to these changes by offering loans and tailored knowledge and advice. The Bank Group works with country governments, the private sector, civil society organizations, regional development banks, think tanks, and other international institutions on issues ranging from climate change, conflict, and food securityto education, agriculture, finance, and trade. All of these efforts support the Bank Group's twin goals of ending extreme poverty by 2030 and boosting shared prosperity of the poorest 40 percent of the population in all countries. As demand for its services has increased over time, the Bank Group has risen to meet them. For perspective, the World Bank made four loans totalling $497 million in 1947, as compared to 302 commitments totalling $60 billionin 2015.

EUROPEAN INVESTMENT BANK (EIB)

Established in 1958, the European Investment Bank is the lending arm of the European Union. EIB is the biggest multilateral financial institution in the world and one of the largest providers of climate finance. The EIB offers four major categories of services: loans, guarantees, equity investments and advisory services. Since its establishment, the EU bank has invested over a trillion euros. While climate action is its core agenda of action, its activities focus on the priority areas like: climate and environment, development, innovation and skills, small and medium-sized businesses, infrastructure and cohesion. The EIB works closely with other EU institutions to foster European integration, promote the development of the EU and support EU policies in over 140 countries around the world.

The EIB has been active in India since 1993. It supports the projects in India relating to climate action, sustainable economic development, the COVID-19 recovery, digitalisation of economy, key infrastructure development, as well as India's small and medium-sized enterprises.

ASIAN DEVELOPMENT BANK (ADB)

The Asian Development Bank (ADB) was established in 1966, with 31 members that came together to serve a predominantly agricultural region. During the 1960s, it focused much of its assistance on food production and rural development. During the 1970s and 1980s, as the oil crises continued ADB increased its support for energy projects, especially those promoting the development of domestic energy sources in member countries. In 1974, ADB established the Asian Development Fund to provide low-interest loans to ADB's poorest members. During the 1980s, ADB also increased its support to social infrastructure, including projects involving microfinance, the environment, education, urban planning, health issues, and helping women and girls. In 1995, ADB became the first multilateral organization to have a Board-approved governance policy to ensure that development assistance fully benefits the poor. Policies on involuntary resettlement and indigenous peoples were also put in place.

In the first decade of the Twentieth century, ADB focused on helping its member countries achieve the Millennium Development Goals (MDGs).

ADB also had to respond to unprecedented natural disasters, committing more than $850 million for recovery in areas of India, Indonesia, Maldives, and Sri Lanka hit by the December 2004 Asian tsunami. In addition, a $1 billion line of assistance to help victims of the October 2005 earthquake in Pakistan was set up.

In 2009, ADB's Board of Governors agreed to triple ADB's capital base from $55 billion to

$165 billion, giving it more resources to respond to the global economic crisis.

Presently, ADB has 68 countries as its members, of which 49 are from within Asia and the Pacific and 19 outside. India was a founding member of the Asian Development Bank (ADB) in 1966. Today, the country is ADB's fourth-largest shareholder and its top borrower since 2010.

8.6.3 Multilateral Development Finance Institutions: A Critical Assessment

The multilateral DFI shave played an instrumental in the successful establishment of many key infrastructural and social projects in its developing

nations in general and the developing world in particular. In this section, we shall not undertake any detail critical evaluation on the activities of the multilateral DFIs, but will briefly mention a few important facts.

When critically evaluated, it comes out to be a mixed bag of both success and failures. For example, as we have already mentioned, since the beginning of the twentieth century, the ADB focused its activities on the achievement of MDGs. A self-study undertaken by ADB mentions that ADB has been able to make significant contributions in Asia and the Pacific region in slashing extreme poverty by more than half. However, even then, the region is still home to 1.2 billion people who live on $3.10 a day or less and almost three-quarters of the world's underweight children. About 600 million people have no access to electricity and 1.7 billion still lack improved sanitation. A huge amount of work still must be done with the new Sustainable Development Goals as important guideposts.

In a web-article published in the eurodad (european network on debt and development: www.eurodad.org) on 05 November 2020, Julia Ravenscroft made some important revelations:

- Only two per cent of investments made by five of the world's largest development finance institutions (DFIs) have reached companies based in the poorest countries since the outbreak of the Covid-19 pandemic.
- Similarly, a report published by the European Network on Debt and Development (eurodad) mentions that despite committing at least US $7 billion in additional investments to tackle the Covid-19 crisis, these DFIs have concentrated on a limited number of sectors that are likely to be financially lucrative. This means that 65 per cent of investments have gone to the financial sector and infrastructure instead of directly to small and medium enterprises (SMEs) based in low-income countries. SMEs employ more than half of the population of the global south.

Further, Jan van de Poel, Advocacy Manager at Eurodad, said: "*As development actors, DFIs have a mandate to fight poverty and contribute to an economy that is sustainable and equitable. Yet this analysis shows that since March they have essentially continued with business as usual, which means relying on the financial sector to channel funds. This raises serious questions about whether the countries, sectors and clients most in need during this pandemic are actually being reached.*"

Some other important findings revealed by Poel include:

- Twelve per cent of DFI investments which were meant largely to support private sector activity have gone to healthcare and education. This raises serious questions about whether that is contributing to further commercialising of these vital public services. Poelwrites: "*The private sector could play a role in supporting the health sector, but DFIs must avoid promoting the privatisation or commercialisation of healthcare. There is sufficient evidence showing that the privatisation of health care is inefficient and risks creating financial barriers to those in need and hampering efforts to reduce inequalities in healthcare access.*"
- The briefing also calls for the institutions to take greater responsibility for the social and environmental outcomes of their activities, including human rights, labour rights, climate and gender impacts. It further demands an improvement in DFI governance and accountability. As has been observed by Poel, "*In the coming days and weeks, institutions and the governments backing them will have an opportunity to embark on an ambitious rethink of the role and place of DFIs in the development finance landscape. They must not squander the opportunity of spaces like the Finance in Common summit to launch thisnew agenda before it is too late.*"

8.6.4 Development Finance Institutions: Indian Context

After Independence, to promote rapid development in the country, India set up a network of financial institutions to bridge the gaps in the supply of long-term finance to industry. In this section, we shall basically discuss four major DFIs in the country, viz., Industrial Finance Corporation of India (IFCI), National Industrial Development Corporation (NIDC), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI). The major such initiatives have been summarised as follows:

- **Industrial Finance Corporation of India and the State Finance Corporations:** The IFCI was set up in 1948. In the next five years of its establishment, a number of state governments, with the encouragement of the central government, also established their own state financial corporations (SFCs). In the initial years, the IFCI was empowered to extend loans above Rs 10 lakh and the SFCs were mandated to extend loans below this threshold. The SFCs were created basically to serve the financial requirements of small- and medium-sized enterprises in the states.
- **National Industrial Development Corporation (NIDC**): The NIDC was set up in 1954as an agency of the central government to provide both entrepreneurship

and finance tothe industrial sector, and it functioned till early 1963.

- **Industrial Credit and Investment Corporation of India (ICICI):**The ICICI was established in 1955 as a public limited company. Other than the Government of India, the World Bankand representatives of Indian industry were its major contributors. The primary objective of the bank was to provide medium-term and long-term project financing to businesses. In the subsequent phases, it emerged as the major source of foreign currency loans to Indian industry, and for underwriting corporate finance. Despite the involvement of the World Bank and the private sector, the central government played a significant role in the establishment of the ICICI.
- **Industrial Development Bank of India (IDBI):**As an apex institution to provide medium- and long-term finance to the industrial sector, IDBI was set up in 1964. It took over the business of the Refinance Corporation for Industry (RCI), which was set up in 1958 for the SFCs. Further, the control of the IFCI was transferred to the IDBI from the central government.

Role of the Reserve Bank of India (RBI): The RBI has played a significant role in establishing institutional mechanisms to facilitate development institutional credit in India, both for the industrial as well as the agricultural sector. In the agricultural sector, it established the important institutions like the National Bank for Agriculture and Rural Development (NABARD) in the year 1982. It also played a significant role in the establishment of a number of Regional Rural Banks in different states of the country. However, prior to that, the RBI also played significant role in the establishment of development banks/finance institutions in the country. For example, the IDBI was constituted as a wholly-owned subsidiary of RBI, which created a new long-term fund known as the National Industrial Credit (Long-term Operations) Fund with an initial contribution of Rs 10 crore. The RBI used to make annual allocations to the fund out of its surplus profits before they are transferred to the government.

Significantly, following the model of "*development central banking*", the RBI built up a three-pronged strategy of developing an institutional framework for industrial financing alongside extending rural credit and designing concessional financing schemes for economic development. The RBI also played key roles in the establishment of the IFCI (1948), RCI (1958), IDBI (1964), and the Industrial Reconstruction Corporation of India (1971) alongsidea network of SFCs to meet the term credit needs of local medium- and small-scale industries (SSI) and for funding

land development banks. The RBI also subscribed 50 per cent of the initial capital of the Unit Trust of India (UTI). As a result of all these developments, by the time the banking system was proceeding towards nationalisation, India already had a networkof specialised institutions that were active in providing industrial finance (Table 9.1).

Table 9.1: Loans Disbursed by Special Industrial Financing Institutions *(In Rs Crores)*

Year	IFCI	SFCs	ICICI	Refinanceto Banks	IDBI (Direct loans)	NIDC	Total
1948	0.7						0.7
1949	1.7						1.7
1950	2.2						2.2
1951	2.1						2.1
1952	2.1						2.1
1953	2.7	0.2					2.9
1954	2.2	1.1					3.3
1955	1.9	1.7	0.1				3.7
1956	6.0	2.7	0.4			0.2	9.3
1957	9.1	3.5	1.4			0.3	14.3
1958	7.9	3.4	1.4			2.2	14.9
1959	8.0	3.8	2.4	0.8		1.9	16.9
1960	7.5	4.5	1.8	1.4		1.7	16.9
1961	8.7	7.3	4.5	4.7		2.3	27.5
1962	12.4	10.5	8.0	8.0		3.2	42.1
1963	15.1	12.3	8.8	15.4		2.6	54.2
1964	17.3	12.7	13.4	18.8			62.2
1965	21.2	15.3	15.4	16.4	1.8		70.1

Source: ParthaRay, (2015). Rise and Fall of Industrial Finance in India. Economic and Political Weekly, L *(5)*, p.63.

Apart from these specialized institutions catering exclusively to industries, investment institutions such as the Life Insurance Corporation (LIC), which had been set up in

1956, played an active role in purchasing industrial securities.

Thus, over the years, many more term-financing institutions were established and these institutions played a significant role in providing long-term finance to Indian industries. By the end of the nineteenth century, the broad structure of development finance institutions that prevailed in India can be broadly categorized as:

(a) All-India development banks, viz., IFCI, ICICI, IDBI, Small Industries Development Bank of India (SIDBI), and Industrial Investment Bank of India (IIBI);

(b) Specialised institutions like: Export-Import Bank of India (EXIM Bank), IFCIVenture Capital Funds (IVCF), ICICI Venture, Tourism Finance Corporation of India (TFCI), and Infrastructure Development Finance Company (IDFC);

(c) Investment institutions like: UTI, LIC, and General Insurance Corporation (GIC) andits subsidiaries; and

(d) Refinance institutions like: National Bank for Agriculture and Rural Development (NABARD) and National Housing Board (NHB). Besides, there were 18 SFCs and 26 state industrial development corporations (SIDCs).

8.6.5 Development Finance Institutions in India: A Critical Assessment

Deepak Nayyar in his article has made a detailed analysis on the performance of DFIs in India (Please refer to section 9.6.2). Similarly, Partha Ray also has deliberated a detail analysis on the similar issues (Please refer to Table 9.1). Learners are encouraged to go through these article for a detail understanding on the different issues on DFIs in India. In this section, we shall make a brief critical assessment of the performance of DFIs in India.

- DFIs made a significant contribution in making industrial finance available in India in the post-independence era. Their total disbursements, financed just 10 percent of the modest gross fixed capital formation in India's manufacturing sector in 1950–51 but this proportion increased by five times (i.e., almost fifty percent) in 2000–01.
- The private sector received the due attention in getting loans from theses DFIs, as loans extended to the public sector was considerably low. Out of the total disbursements, as a proportion of gross fixed capital formation, loans provided to the private sector, increased from approximately 25 percent in 1950–51 to 75 percent in

2000–01. Thus, in the growth of the private industries, the DFIs played a major role. In the absence of these institutions, such levels of private investment would have been difficult to finance from alternative sources.

- Certain DFIs also played an unconventional role of mobilising household savings through government-owned insurance firms, or a mutual fund for small savers. It was a novel method of transforming savings by households into investment by firms without creating problems arising from maturity mismatches. Significantly, their relative importance increased during the 1990s and more so in the 2000s but that was because the term- lending institutions vanished.
- Similarly, the refinancing institutions for agriculture or rural development, housing and small-scale industries performed multiple functions as lenders, catalysts and regulators. They also performed a very effective and considerable impact in the economy.

However, other than such success stories, many other problems were also seen. The DFIs in India followed a very complex structure. The DFIs that were established in the national and state levels though played a crucial role in the development of the industrial sector in the country for more than two decades, yet, after the country moved on the path of liberalisation, their relative importance declined in the 1990s and dropped rapidly in the early 2000s. Some of the issues that the DFIs faced are as follows:

- There was not proper coordination among different DFIs in extending credit to different sectors of the economy. As a result, the DFIs either concentrated on the same sectors, or they ignored certain important sector. Again, this also led to shortfall of funds availability in certain sectors. For example, the pharmaceutical sector of India which is considered asthe pharmacy of the developing world did not receive proper attention from the DFIs. Similarly, the textiles and clothing sectors which had huge export potential did not receive proper preferences. Other such sectors which did not receive proper attention of the DFIs include: mechanised two-wheelers, commercial vehicles, or auto-components.
- Similarly, even when specialised, sector- specific institutions, e.g., Export–Import Bank, were not provide enough finance, resulting in very limited scale of operation.
- Government patronage obviously exercised a significant influence. The rising share of non-performing assets in the portfolio of some institutions was almost an inevitable consequence. In this context, it is also worth noting that the engagement of development finance institutions with the borrowing firms seldom extended beyond

lending.

- DFIs could not exert proper managerial control over the large investors. Even when theDFIs nominated persons in the Board of the Directors of the big lenders, yet they only functioned independently without protecting the interests of the institutions they represented. Which proved ineffective in controlling their state of affairs.

CHECK YOUR PROGRESS III

Q1. Which was the DFI in India that came up after independence?

Ans...

Q2. Mention the role played by the RBI to provide industrial finance in India.

Ans...

Questions for Practices

A Short Answer Type Questions

Q1. Discuss how the concept of development finance evolved.

Q2.Discuss the different components and tools of development finance.

Q3. Briefly discuss the rules of functional finance.

Q4.Discuss the evolution of development finance institutions.

Q5.Write a short note on the evolution of development finance institutions in India.

Q6. Make a critical assessment of the multilateral development finance institutions.

Q7. Briefly discuss the role played by development finance institutions in India.

B. Long Answer Type Questions

Q1. Discuss the concept, Meaning, Definition and Evolution of development finance.

Q2.What is meant by functional Finance? Discuss its major contributions. Make a comparison between functional finance and development finance.

8.7 Fiscal Policy: Concept, Meaning and Definition

Introduction

Fiscal policy basically deals with the taxation and expenditure policies of the Government. Please note, in the previous units, we have already come across the theoretical aspects of relating to taxation and public expenditure. There are some of the empirical aspects of fiscal policy, particularly with reference to the situations of inflation and deflation. Thus, this unit helpful in gaining some insights into the application of fiscal policy in some real situations in the economy, like inflation and deflation. Here, we shall begin with concept, meaning and definition of fiscal policy, broad objectives of fiscal policy, major instruments of fiscal policy and finally shall examine effectiveness of fiscal policy in the situations like inflation and deflation.

The term fiscal policy mainly consists of tax and expenditure policies of the government. Please note, expenditure here also includes public borrowing. This is because; borrowing is an important source of revenue for the government. Thus, how the government operates the instruments of taxation, public expenditure and public borrowing (also called as public debt) broadly constitute the subject matter of fiscal policy.

Public finance got its major thrust only after the Great Depression of the 1930s. There we had discussed that the early economists assigned a very limited role for the Government. They advocated only minor public works for the Government in the time of economic distress.They thought that additional government expenditure can no bring about any improvement in the general economic conditions. But Keynes showed that national income was an important index of economic activity. Further, he also showed the relationship between the level of economic activity and total government spending. Through his analysis, Keynes establishedthe direct and indirect effects of fiscal actions on aggregate spending in the community and its effects on economic activity, which also served as a tool for macroeconomic management. There are few important definitions of theterm fiscal policy, so that we can get a clear idea of what fiscal policy is all about. Arthur Smithies defined fiscal policy as, "*a policy under which the government uses its expenditure and revenue programme to produce desirable effect and avoid undesirable effects on macro variables like income, production and employment*."

Gerhard Colm defines fiscal policy "*as the conduct of the government expenditure, revenues and debt management in such a way as to take fully into account the effect of*

these operations on the allocation of resources and the flow of funds, and thereby their influenceon the levels of income, prices, employment and production".

Ursula Hicks and Gerhard Colm significantly acknowledge a broad perspective of fiscal policy, as they also include public borrowing as one of its instruments.

Thus, fiscal policy may be concisely defined as the policy of the government in regard to taxation, public expenditure and public borrowing in an economy.

Before we proceed further, let us consider the fact that just like the Government resorts to fiscal policy as a means to achieving certain macroeconomic objectives like economic stability, economic growth etc., the monetary authority of the economy (which is usually the central bank of the country. In India, it is the Reserve Bank of India) also resorts to monetary policy to achieve such macroeconomic objectives. And most of the economists suggest that a proper coordination between the two is necessary for achieving such macroeconomic objectives. Both of these policies cannot be highly effective if they function alone. However, it should be noted here that fiscal policy significantly differs from monetary policy in its mode of operation. Fiscal policy has a direct impact on aggregate demand. On the other hand, the monetary policy seeks to function indirectly through the financial institutions (e.g., bank) and instruments (say, rate of interest). As has been pointed out by Gardner Ackley, "…unlike monetary policy these measures involve direct government entrance into the market for goods and services (in case of expenditure) and a direct impact on private demand (in case of taxes)".

8.8 Objectives and Rules of Fiscal Policy

In this section, we shall discuss the major objectives and rules of fiscal policy. This discussion will help in the subsequent discussion on use and effectiveness of fiscal policy in certain macroeconomic situations like inflation and deflation.

A. **Objectives of Fiscal Policy in the Developed Economies:** Fiscal policy is now considered an important instrument in achieving certain macroeconomic objectives. As we have already mentioned, Keynes advocated that fiscal policy should be used to regulate and control the economy with the help of the fiscal tools like taxation, public expenditure and public borrowing. This concept has been further developed by A. P. Lerner and he termed it as functional finance. The concept of functional finance evaluates fiscal policy by its effects on the way it functions in an economy. The principle of functional finance advocates the following:

(a) The foremost aim of fiscal policy should be to remove the causes of inflation and deflation so that economic stability can be attained in the economy.
(b) The instrument of public borrowing should be such utilized that it not only aims at increasing money supply, but also leads people to hold more bonds and less money. This means, public borrowing should aim at controlling purchasing power of the people.
(c) Taxation should also be such used that it not only simply collects revenue, but also controls purchasing power of the people.
(d) Any excess expenditure over its revenue should be covered through public borrowing. If public borrowing is not possible, deficit financing or printing of new currency should be undertaken, particularly if the economy is passing through depression.

In a way, the principles of functional finance significantly establish the role of fiscal policy in controlling cyclical fluctuations, i.e., to help the economy avoid the macroeconomic situations like inflation and deflation.

Another prominent economist in the field of Public Finance, Professor Musgrave has argued that the fiscal policy should aim at certain more specific issues like: (a) in the adjustment of allocation of resources, (b) in the adjustment in distribution of income and wealth and (c) to ensure economic stabilization.

B. Objectives of Fiscal Policy in the Developing Economies: The objectives laid down in the above are more applicable in case of the developed economies. In the developing countries, the fiscal policy should be utilized to attain certain specific economic objectives, which are somewhat different from the developed economies. In general, economic objectives like: full employment, price stability, acceleration of the rate of economic growth, optimum allocation of resources, equitable distribution of resources and wealth, external stability, capital formation and investment, regional imbalance etc. have been prescribed for fiscal policy in the context of a developing economy. These economic objectives of fiscal policy in the developing economy contextcan broadly be classified under the four major heads:

a) Promotion and acceleration of capital formation in the public and private sectors,so that rapid economic development can be attained.
b) Mobilisation of financial and other resources for the public sector in a way thatdoes not adversely affect the private sector.
c) Maintaining a reasonable degree of economic stability, so that economic development is not adversely affected.

d) Redistribution of national income among different sections of the society so thatredistributive justice can be ensured.

Rules of Fiscal Policy:

a) During the period of falling employment and rising unemployment, the Government should act to raise the level of aggregate demand by (a) an increase in expenditure on purchase of goods and services, or (b) increase in government transfer payment, or (c) reduction in taxes, or (d) a combination of these three or (e) a balanced-budget expansion.
b) If the economy is facing the issue of inflation caused by excess demand, the government should aim at curtailing the excess demand by (a) increase in taxes, or (b) by reducing public expenditure on purchase of goods and services, or (c) reduction in transfer payments, (d) a combination of these three measures.
c) If the level of employment and output is quite high, the Government must attempt to achieve at a high rate of economic growth so that continued full employment and price stability can be maintained.

However, the real macroeconomic situation may significantly differ and be much complex, and hence, use of proper fiscal policy may be different from such general prescribed rules.

Check Your Progress-I

Q1. Define fiscal policy.

Ans...

Q2. Mention any three important objectives of fiscal policy.

Ans...

8.9 Fiscal Policy During Inflation

Inflation is characterized by rising prices or declining purchasing power. Here, the phrase rising prices is important. This is because inflation denotes a situation where the prices are rising continuously and not for once only. Thus, a sudden increase in the price

level of the economy will not be termed as inflation; unless it is experienced on a continuous basis over a period of time. The rise in the general level of prices, often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods. In fiscal policy, during inflation (particularly, in case of demand-pull inflation), the Government should aim at curtailing purchasing power (i.e., excess demand) of the people.

This can be achieved by:

(a) increase in taxes, or

(b) by reducing public expenditure on purchase of goods and services, or

(c) reduction in transfer payments,

(d) a combination of these three measures. Let us discuss these in brief.

To curtail the purchasing power (which is also called as disposable income) of the people in case of demand-pull inflation, an appropriate tax policy would aim at increasing the tax rates as well as introduction of new taxes. Increased tax rates as well as new taxes curtail the disposable income of the people. For example, by increasing income tax rates, the salaried peoples' disposable income can be effectively curtailed. Expenditure tax also can be introduced on certain commodities.

Similarly, tax incentives can be offered to the entrepreneurs which will help them to produce more. Appropriate tariff policy measures should be undertaken so that inflow of imported goods is increased, which will ultimately help in meeting the domestic demands.

Along with curtailment of private spending through taxation policy as discussed above, the Government should also reduce public expenditure. Whenever possible, the Government should aim at either withdrawing or postponing public expenditures. It should also attempt to spend less on the social security measures. However, it should be kept in mind that such curtailment in expenditure is done only on the unproductive channels. Public expenditures on productive channels should not be curtailed to the extent possible. Otherwise, there might be long-term adverse impact on the productive channels of the economy.

Among the three instruments of public policy, public borrowing is the other one. During inflation, public borrowing should be increased. This will help in flow of funds from the public to the Government. Ultimately, the purchasing power of the people will be reduced. Again, the Government should present a surplus budget during inflation.

Fiscal Policy in case of Cost-Push Inflation:

Another reason for inflation can be the rise in costs. Changes in costs often caused by rise in wages. Due to the rise in prices of goods and services, organized labours can demand for an increase in their wages. As a result, the costs of production further increase, leading to further increase in the prices of goods and services. This type of cost-push or wage-induced inflation cannot be controlled simply by taxation. In fact, increase in indirect taxation would only increase the prices of goods and services and can worsen the inflationary situation. To fight situations, the Government may provide subsidies to lower the prices of the essential commodities, which can ease the situation to some extent.

Again, when increased taxation adversely affects production, inflationary situation can worsen. To tackle such situations, private investments should be encouraged. Private investments in such situations can have positive impact on increasing production, and in the long-run can also positively contribute towards national income.

To control such cost-push inflations, another effective instrument is encouraging private savings. Government can offer higher interest rates on savings. Increased savings can curtail the excess purchasing power in the hands of people and also curb excess money supply in the economy. Towards meeting this objective, public borrowing is another importantinstrument. The Government can raise public borrowing by offering bonds and other such instruments, which will ultimately reduce the liquidity (i.e., purchasing power) in the hands of the people.

8.10 Fiscal Policy During Deflation

The term ‘Deflation’ refers to a situation when there is a sustained drop in prices in the economy. Deflation is often regarded as the opposite of inflation. Policy-makers are very concerned about a possible deflationary cycle -- when prices start to drop, consumers may believe that prices will drop further. As a result, they delay consumption (i.e., buying stuff), which makes the drop in prices inevitable. A sharp drop in prices also leads to businesses cutting back on investment, production, and employment because they cannot sell goods at profitable prices. This can further exacerbate the downturn in the economy. The Great Depression was characterized by a deflationary cycle, which many believe was partially responsible for the depths of the economic downturn.

During deflation, the main attempt of the Government is to increase the level of aggregate demand, which is simply the opposite to the inflationary situation, that we discussed in the previous section. Thus, in this situation, an increase in public expenditure is likely to increase the aggregate demand for goods and services, which

will lead to a large increase in income via the multiplier process. On the other hand, a reduction in taxes will help in increasing the disposable income in the hands of the people, which will consequently increase the consumption and investment expenditures of the people.

During deflation, the Government should increase its expenditure through deficit budgeting and reduction in taxes. The public expenditure which are generally effective during deflation includes the expenditure on public works such as roads, canals, dams, parks, schools, hospitals and other buildings, etc. Other than those, certain relief measures, such as unemployment insurance, pensions, etc. can also be effective. It should be noted here that the expenditure on public works helps in creating demand for the products of private construction industries and also helps in reviving them. On the other hand, expenditure on relief measures stimulates the demand for consumer goods industries. Along with such measures, the Government can also reduce certain taxes like: corporate profits tax, income tax, and excise taxes, which will ultimately help in increasing the disposable income, leading to increased spending and investment.

As borrowing is one of the fiscal instruments of the government. During deflation, the Government should borrow to finance budget deficits. This helps in utilising the idle money lying with banks and financial institutions for investment purposes. But the effectiveness of public expenditure primarily depends upon the public works programme. The importance of the public works, their volume and nature, as well as, their planning and timing: all these significantly affect the success of public borrowing as a fiscal tool to tackle the situation of deflation.

Check Your Progress-II

Q1. How should the Government handle public expenditure during inflation?

Ans: ....

Q2. How should the Government handle taxation during deflation?

Ans: ....

8.10.1 Effectiveness of Fiscal Policy During Inflation and Deflation

As we have already discussed the different uses of fiscal policy during inflation and deflation, in this section, we shall discuss the effectiveness of fiscal policy to tackle those macroeconomic situations. However, before that we shall briefly discuss the concepts of expansionary and contractionary fiscal policy and the Classical and Keynesian views of fiscal policy.

A. **Contractionary and Expansionary Fiscal Policy:** During inflation, Government should cut in public expenditure. This means contraction of public expenditure. Thus, contractionary fiscal policy is defined as a decrease in government expenditures and/or an increase in taxes that causes the government's budget deficit to decrease or its budget surplus to increase. Similarly, we have also mentioned that during deflation, Government needs to increase public expenditure. This means expansion public expenditure. Thus, expansionary fiscal policy is defined as an increase in government expenditures and/or a decrease in taxes that causes the government's budget deficit to increase or its budget surplus to decrease.

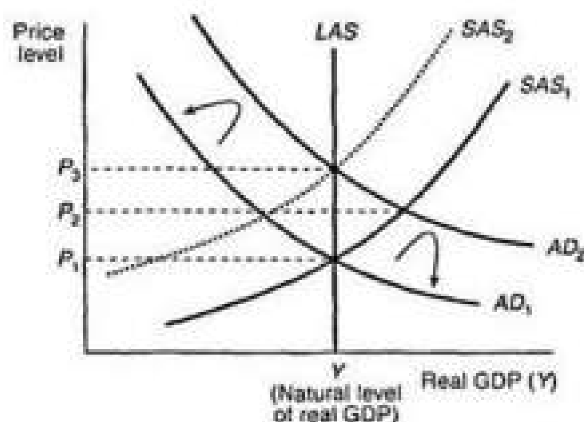
B. **Classical and Keynesian Views of Fiscal Policy:** The belief that contractionary and expansionary fiscal policies can be used to influence macroeconomic performance is most closely associated with Keynes and his followers. As we have already discussed, the classical believed that any such contractionary or expansionary fiscal policies are unnecessary because there are market mechanisms—for example, the flexible adjustmentof prices and wages—which serve to keep the economy at or near the natural level of real GDP at all times. Accordingly, classical economists believed that the government should run a balanced budget each and every year.

Now we shall discuss how the contractionary fiscal policy and expansionary fiscal policy can help the Government to tackle the situations of inflation and deflation respectively.

8.10.2 Effectiveness of Contractionary Fiscal Policy during Inflation

Keynesians also argue that fiscal policy can be used to combat expected increases in the rateof inflation. Suppose that the economy is already at the natural level of real GDP and that aggregate demand is projected to increase further, which will cause the AD curve in Figure to shift from AD_1 to AD_2.

Figure 10.1: Effectiveness of Contractionary Fiscal Policy during Inflation



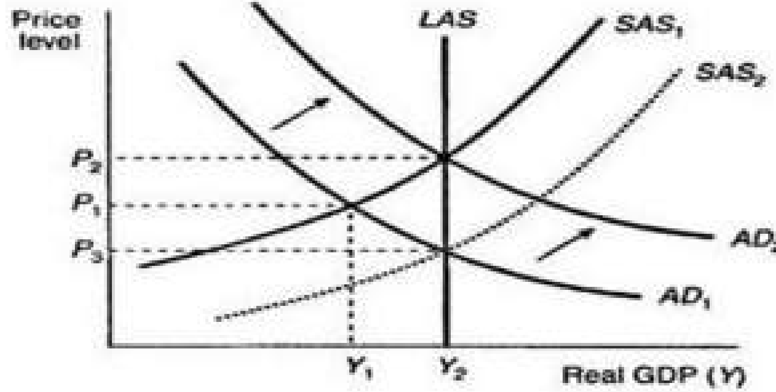
From Figure 10.1, it can be seen that as real GDP rises above its natural level, prices also rise, prompting an increase in wages and other resource prices and causing the short run aggregate supply curve to shift from SAS1 to SAS2. The end result is inflation of the price level from P1 to P3, with no change in real GDP. The government can head off this inflation by engaging in a contractionary fiscal policy designed to reduce aggregate demand by enough to prevent the AD1 curve from shifting out to AD2. Again, the government needs only to decrease expenditures or increase taxes by a small amount because of the multiplier effects that such actions will have.

8.10.3 Meffectiveness of Expansionary Fiscal Policy during Deflation

Keynesian theories of output and employment were developed in the midst of the Great Depression of the 1930s, when unemployment rates in the U.S. and Europe exceeded 25 per cent and the growth rate of real GDP declined steadily for most of the decade. Keynes and his followers believed that the way to combat the prevailing recessionary climate was not to wait for prices and wages to adjust but to engage in expansionary fiscal policy instead. The Keynesians' argument in favour of expansionary fiscal policy is illustrated in Figure 10.2.

Let us assume that the economy is initially in a recession (Please refer to the box item). The equilibrium level of real GDP, Y1, lies below the natural level, Y2, implying that there is less than full employment of the economy's resources. Classical economists believe that the presence of unemployed resources causes wages to fall, reducing costs to suppliers and causing the SAS curve to shift from SAS1 to SAS2, thereby restoring the economy to full employment. Keynesians, however, argue that wages are sticky downward and will not adjust quickly enough to reflect the reality of unemployed resources

Figure 10.2: Effectiveness of Expansionary Fiscal Policy during Deflation



Consequently, the recessionary climate may persist for a long time. The way out of this difficulty, according to the Keynesians, is to run a budget deficit by increasing government expenditures in excess of current tax receipts. The increase in government expenditures

Should be sufficient to cause the aggregate demand curve to shift to the right from AD1 to AD2, restoring the economy to the natural level of real GDP. This increase in government expenditures need not, of course, be equal to the difference between Y1 and Y2. Recall that any increase in autonomous aggregate expenditures, including government expenditures, has a multiplier effect on aggregate demand. Hence, the government needs only to increase its expenditures by a small amount to cause aggregate demand to increase by the amount necessary to achieve the natural level of real GDP.

Keynesians argue that expansionary fiscal policy provides a quick way out of a recession andis to be preferred to waiting for wages and prices to adjust, which can take a long time. As Keynes once said, "In the long run, we are all dead."

Check Your Progress-III

Q1. Explain briefly effectiveness of contractionary fiscal policy during Inflation.

Ans:...

Q2. Define contractionary and expansionary fiscal policy.

Ans: ....

8.11 Summary

Fiscal policy basically deals with the taxation and expenditure policies of the Government. Please note, in the previous units, we have already come across the theoretical aspects of relating to taxation and public expenditure. How the government operates the instruments of taxation, public expenditure and public borrowing (also called as public debt) broadly constitute the subject matter of fiscal policy. According to pre-Keynesian economists thought that additional government expenditure can no bring about any improvement in the general economic conditions. But Keynes showed that national income was an important index of economic activity. Further, he also showed the relationship between the level of economic activity and total government spending. Through his analysis, Keynes advocated that fiscal policy should be used to regulate and control the economy with the help of the fiscal tools like taxation, public expenditure and public borrowing. This concept has been further developed by A. P. Lerner and he termed it as functional finance. The concept of functional finance evaluates fiscal policy by its effects on the way it functions in an economy. During deflation, the main attempt of the Government is to increase the level of aggregate demand, which is simply the opposite to the inflationary situation, that we discussed in the previous section. Thus, during inflation, an increase in public expenditure is likely to increase the aggregate demand for goods and services, which will lead to a large increase in income via the multiplier process. On the other hand, a reduction in taxes will help in increasing the disposable income in the hands of the people, which will consequently increase the consumption and investment expenditures of the people. The term contractionary fiscal policy is defined as a decrease in government expenditures and/or an increase in taxes that causes the government's budget deficit to decrease or its budget surplus to increase. Whereas, expansionary fiscal policy is defined as an increase in government expenditures and/or a decrease in taxes that causes the government's budget deficit to increase or its budget surplus to decrease. Keynesians argue that expansionary fiscal policy provides a quick way out of a recession and is to be preferred to waiting for wages and prices to adjust, which can take a long time. As Keynes once said, “In the long run, we are all dead.” However, Classicaleconomists point out that the Keynesian view of the effectiveness of fiscal policy tends to ignore the secondary effects

that fiscal policy can have on credit market conditions.

8.12 Questions For Practices

A. Short Answer Type Questions

Q1. Discuss the meaning of fiscal policy.

Q2. Mention the different rules of fiscal policy.

Q3.How does taxation policy help in controlling inflation and deflation? Discuss.

Q4. How does public expenditure help in controlling inflation and deflation? Discuss.

Q5.Briefly discusses the secondary effects of expansionary and contractionary fiscalpolicy.

B. Long Answer Type Questions

Q1.Discuss the effectiveness of fiscal policy in tackling inflation.

Q2.Discuss the effectiveness of fiscal policy in tackling deflation.

Q3."During deflation, the main attempt of the Government is to increase the level ofaggregate demand". Discuss the statement.

Q4.Compare the objectives of fiscal policy in developed countries vis-à-vis thedeveloping countries.

Q5.Discuss the objectives of fiscal policy.

8.13 Suggested Readings

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