Public Finance

DECO404

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LOVELY PROFESSIONAL UNIVERSITY

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SYLLABUS

Public Finance

Objectives

- The aims of this course are to introduce basic concepts of public finance, particularly in the context of macroeconomics policies, to the students.
- This course will provide students relevant theoretical methods to analyze government public finance policies.
- The course will emphasize on application of advanced macroeconomic to public finance.

Sr. No.	Topic
1	Meaning and scope of Public Finance; Principles of maximum social advantage; Issues related to economic activities of the public sector.
2	Instrument of public finance: concepts and role of budget; Public revenue: Revenue receipts and capital receipts.
3	Taxation and its cannons; Division of tax burden: Expediency theory.
4	Socio – political theory; Ability to pay theory; objective and subjective indices.
5	Incidence of taxes and the effects of a tax, Forward and backward shifting; Theories of tax shifting: the concentration theory; Diffusion theory.
6	Classification and choice of taxes: Direct and indirect, VAT; Effect of taxation on production and growth.
7	Public Debt: Meaning of public and private debt and its limitations; Public debt, economic growth and inflation.
8	Public expenditure: Meaning and nature of public expenditure, Wagner's law of Increasing of state activities; Effects of public expenditure and economic stabilization; Public budget: Introduction, types.
9	Federal Finance: The rationale and principles; Indian Federal Finance: Historical background, financial federalism under constitution.
10	Finance Commission: Introduction, rationale.

CONTENT

Unit-1: Meaning and Scope of Public Finance

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the importance of Public Finance and its area
- Gain knowledge of the works of Modern States accurately
- Understand the subject-matter of Public Finance
- Explain Public and Private Finance
- Know the importance of Public Finance in National Economy.

Introduction

Public Finance is not a new subject itself and it has been studied till ancient times but scientifically, its study has become possible in current times. In ancient times, the area of this subject was limited but today its area has become more vast. However, the record of income - expenditure in ancient unitary system was kept but its format was limited because the functions of the state were very limited. Against this, the functions of modern state were expending continuously. Specially, after the establishment of Welfare State, the state has entered into economic lives of people that its absence cannot be imagined in current time. Today, the function of state is not only arranging for security and arrangement of law and justice but also it has to perform many welfare works. For example, India and other countries of the world have to perform many tasks such as social security, public security, justice, railway, heavy electrical equipments and atomic power etc. Economic planning and the wave of economic growth

have completely changed the structure of the functions of the state. Naturally, the structure of income and expenditure will increase simultaneously with the increment in the functions of State. In this way, it will be difficult to say that State which was started for life only, it is working for good human life. It is clear that the need of suitable arrangement for income and expenditure of the state was felt as a result of increasing works of the state and its result was that today Public Finance and its problem are studying scientifically.

1.1 Meaning of Public Finance

Public Finance is related with income and expenditure of public authorities. The word 'Public' is used normally for Government or State. All type of Governments can be included in public authorities. That's why it can be said that Public Finance is related with income - expenditure of all type of Governments Centre, State and local and income - expenditure of all type of Governments can be studies under Public Finance Different experts have defined Public Finance. Some important are definitions are as follow:

According to **prof. Dalton "It deals with the income and expenditure of public authorities and with the adjustment of one to another."**[1.]

According to **prof. Findlay Shirras, "The study of the principles underlying the spending and raising of funds public authorities"**[2.]

C.F. Bastable says while defining it, **"Public finance deals with the expenditure and income of public authorities of the state and their mutual relation as also with the financial administration and control,"**[3.]

In the words of **Prof. J.K. Mehta, "Public finance then constitutes a study of the monetary and credit resources of the state."**[4.]

Analysis - It has been clear after studying various definitions of Public Finance given by various scholars that the basic meaning of Public Finance is about income and expenditure of public authorities of centre, states and local. But, in today's context this meaning has become more vast and expand. Now, Public Finance is not related the Governments income and expenditure only but Financial Administration, Accounts Auditing and Financial Control can also be included under this. Therefore, we can define Public Finance this way - It is that science which study the reactions upon society and economy of Fiscal Policy and Fiscal Activities and Public income - expenditure, debt and Financial Administration, basic principles of Accounts Auditing and Financial Control.

Stanford has defined Public Finance in following way, "Public finance is related with fulfillment of group needs specially. We study economic problems in it which arises within State or public sector such as how to divide resources between private and public sectors and how resources are allotted for fulfillment of different sources of Government expenditure under public sector." It is clear that public finance studies the problems related with adjustment and methods of various Government income and expenditure. The ways by which public bodies spend their money and the methods by which they get income and debt, these ways and methods are called the functions of Public Finance.

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1. "It deals with the income and expenditure of public authorities and with the adjustment of one to another." – *Dalton*
2. "The study of the principles underlying the spending and raising of funds public authorities." – *Findlay Shirras*
3. "Public Finance deals with the expenditure and income of public authorities of the State and their mutual relation as also with the financial administration and control." – *C.F. Bastable*
4. "Public Finance then constitutes a study of the monetary and credit resources of the State." – *J.K. Mehta*

Hence, these methods are related with the function of fiscal or public treasury, therefore those are called fiscal operations also. In this way fiscal operations and fiscal policies have become part and parcel of Public Finance. The effect of fiscal operations and fiscal policies can be felt on national production, national income, standard of living, distribution of money and income and money market etc, and they affect the whole economic life of the country. In this way, every person of country is related with the methods of Public Finance.

Notes Fiscal policies are undivided part and parcel of Public Finance.

1.2 Importance and Scope of Public Finance

We will study the importance and area of Public Finance under following three headings -

1. Functions of State
2. The effect of Fiscal operations on economic life, and
3. The subject matter of Public Finance

(1) Functions of the State — Ancient economists believe in laissez faire, therefore they supported that the number of functions of State must be minimum. In 1776 **Adam Smith** wrote about the functions of State in his book "Wealth of Nations" first of all. According to **Adam Smith**, the duties of "a complete sovereign rich nation" can be divided into following three categories -

(a) To provide security to nation against war and injustice of other nations.

(b) To maintain peace, justice and system among citizens, and

(c) To build and conduct such public functions and public institutes, which can be highly beneficial for whole society, but they will not provide profit if started and conducted by some private persons. Their saying was that in such public functions, those functions must be considered main by which public functions of trade and commerce in State must be created. It is clear that these three functions are the primary functions of any Government. We can not imagine and static social system which do not consider basic functions to these functions. In today's time, the Government have to perform functions to achieve the economic and social goals which can be placed into **Adam Smith's** third category of work. Here, this is noticeable that in 18th century in England **Adam Smith** emphasized on the growth of these two branches (i.e., economic and social goals) of Government expenditure also.

But many economists, such as **Robert Owen** and **John Stuard Mill** in England who were the followers of classical school cast the attention of people towards laissez faire and supported Government intervention. **Sisomandi** in France also criticized the principle of laissez faire and suggested for Government control for the prevention of rights of poors. The socialists of many countries therefore suggested for socialization of resources of production in some form or other, by which labour class can be saved from the cruelty of famous capitalist economy. Economic depression of 1930 and the general principle of employment by keens proved valley of death for laissez faire. Keens told that it is possible to rise employment by fiscal operations of state and to maintain it at high level. In this way, Government intervention in economic life and support of admission are increasing continuously and this series is in continuation.

But, the concept of state and format of the functions of the state are changing slowly. This fact has been accepted widely that the objective of state is to provide maximum welfare to whole society. As a

result of this concept of state, the functions of state have expanded and therefore they have to arrange for treatment, education, help to poors and health care and many other public services, by which there can be increment in the welfare of whole society. In today's time, state helps its public by many ways. For example, it increases the production power of country by arranging basic facilities such as railways, roads, electricity and post and telegraph, it takes necessary steps to reduce the inequalities found in the distribution of income, it controls the production and distribution of deficient things, it controls the rates of essential commodities and takes necessary steps to stop inflation and depression. During war time, state controls the whole resources of the country and gives them right direction to move so as war can be faced successfully.

The Government of advanced Countries are duty-bound and promise - bound that they maintain a static and wide level of the employment of the country. Their goal is that the economy of the country becomes active at the level of complete employment. It takes part in these programmes actively by which there must be increment in national income and economy must be moving towards progress. When the question of under developed or developing countries Governments arise, they are committed to the programmes of progressive economic growth. Therefore it can be possible that such countries develop their complete resources systematically. It is clear that the functions of state in all countries developed, under developed or developing have increased concretely and the possibility is that when the duties and responsibilities of the Government will increase, then the functions of state will expand more. The current situations of our country verify this fact. Our country is an under developed country. Therefore, for implementing developing plans, the Government is bearing new responsibilities on it and their admission is expanding and the counting of their works is increasing.

Do You Know? Adam Smith wrote about the functions of state in 1776 in his book ' Wealth of Nation ' first of all.

Self-Assessment

Fill in the blanks:

1. Public Finance is related with the income and ..... of Public - Government.
2. The word ..... is used normally for Government or State.
3. The functions of Public Finance is called the function of .....
4. Adam Smith wrote about function of state in ..... in his book 'Wealth of Nations' first of all.
5. The economic crisis occurred in .....

1.3 Functions of Modern States

The state has to expand its expenditure to fulfill the expanded functions and for fulfilling the expenditure, it has to get money from adopting various means for given methods in Public Finance. Therefore, with the expansion of the functions and responsibilities of the states, the importance and area of study of Public Finance is also expanding continuously these days.

After analyzing the functions of Modern State, we know that the following services are required for welfare —

(a) To arrange expenditure for **Internal and External Security** and soldiers, police and other security services.

(b) **Justice** or solution for controversies.

(c) Organization and control of economic industries and other such services such as coinage, weight and measures, regulation of professional activities and Government ownership and conduction of some **Enterprises**.

(d) To develop social and cultural welfare by education, social help, social insurance, health control and other such activities.

(e) Irregularization of moral levels by controlling on manufacture and sale of medicines, sale of wine, gambling and other anti social activities.

(f) Preservation of natural resources.

(g) To maintain and expand the unity of state by controlling on the means of transport and communication and other such means.

(h) Government administration and aid to Government officials.

(i) Financial arrangement of Government and administration of fiscal control.

(j) Religion related functions from time to time.

Effect of Fiscal Operations— We know that by economic analysis that the activities of Public Finance leave solid impact on investment and usage. Therefore, they are used easily for immobilizing in economy and controlling for total demand. The main base for bringing immobilization in Government expenditure management in fiscal policy and the total expenditure of the country can be controlled by bringing change. But, in this direction, Government expenditure can become active only when Government spends more or less from its income in any definite time period. Therefore, developed countries take shelter in good fiscal policy for bringing stability in their economy and it is considered the best option fulfillment for that objective from all other options of economic planning.

Although there are some limitations for above mentioned statement, but it proved a powerful and only weapon for expanding under ownership in income and production and in some limitations. In advance economy, where per capita income is at good level, the main hurdle in the way of development in national income is that the demand does not increase in comparison with the increment in resources, therefore the chances of investment become less. The reason for demand is that marginal propensity to consume decreases with the increase in income. Therefore, if we bring more similarity in the distribution of income then usage work is enhanced and investment and total production decrease. In this way, industrial country having high income adopts economy having 'high labour and low profit' and by such any fiscal policies, our income and living conditions of people can be raised by bringing maximum similarity in distribution from income by such any fiscal operations. Therefore, for bringing economic stability in developed countries and for equal and justifiable distribution of national income and production, operations of Public Finance are considered important.

In underdeveloped countries too, the main objective of the Government is to develop economy of the country fastly and there must be equitable distribution of national production, and fiscal policy can be an important weapon against achievement of these objectives fiscal policy can effect the economy of the country, on one hand, it can do so by increasing in the quantity of public income and on the other hand, it can do so by quantity in public expenditure and its directional change. Three important fiscal policies, by which Government Treasury or the means of fiscal can be expanded, these are taxation, public debt and debt procurement. It is important that fiscal methods must be used by making suitable coordination between them, so as on the economic lives of people, it can spell best and vast effects as social welfare and economic progress.

This must be understood clearly that taxation is most important among these three methods. If taxes are levied intelligently and if they are implemented cautiously, then taxation can become an effective tool in fiscal policy. As an organ of general programme of growth, taxation can be used for achieving following objectives —

(a) By banning consumption or by subsidizing it, the means of origin must be transferred toward investment of consumption.

(b) To motivate and encourage saving and investment.

(c) To give resources to the hands of state from hands of public, by which public investment can be possible.

(d) To minimize economic inequalities.

In this way, it is clear that all these objectives match with the last objectives for high growth in national income and betterment in its distribution. Therefore, for the view of economic development and social welfare of underdeveloped countries, operations of Public Finance are important.

1.4 Subject - matter of Public Finance

Public Finance is that science which has relation with Governments income and expenditure. But, in modern time, its area and importance has been expanded. Modern political thinkers have divided it into following departments. Public Expenditure, Public Income, Public Debt and problems of Government Treasury in complete sense, such as Financial Administration. The precise details of these departments are as follow—

(1) Public Revenue – In this department, analyze and synthesis of receiving of public income and ideas of its expansion, rules of revenue and its other problems take place.

The following tasks are concluded under this department:

(a) What are the sources of Public Income i.e., categorization of Public Income.

(b) Revenue that is an important source of Public Income, what are the types of revenue i.e., categorization of Revenue.

(c) What things must be kept in mind while imposing Revenue i.e., Rules for Revenue Implementation.

(d) What is meant by the public power of giving revenue and it depends on what conditions i.e., Revenue giving capacity and its imposing factors.

(e) What effects is felt of Public Income on country's production and financial distribution i.e., effects of Public Income.

(f) Which factors are responsible for transfer of revenue from one person to another successfully? i.e, Factors of Revenue Distribution.

(2) Public Expenditure — This department of Public Finance studies the principles of Public Expenditure and its effect on country's financial life such as production distribution and its effect on various categories.

Under this department, study and synthesis of following problems take place —

(a) Categorization of Public Expenditure.

(b) What aspects should be covered in Public Expenditure or what not? i.e., The Area of Public Expenditure.

(c) What should be kept in mind while doing Public Expenditure? i.e., the principles of Public Expenditure.

(d) What effect does Public Expenditure cast on country's production and financial distribution? i.e., effects of Public Expenditure.

(3) Public Debt – Under this department, it is studied that why we bring Public debt, how we bring them, what is their mode of payment and their effect on society.

Under public debt, following aspects are studied –

(a) Under what circumstances, it will be compulsory for the Government to take debt i.e., the area of Public debt.

(b) What are the types of Public Debt i.e., the categorization of Public Debts.

(c) In what conditions, it will be better to take debt and in what condition, it will be better to impose revenue i.e., comparative study of debt and revenue.

(d) In what conditions, it will be better to take debt with in the country and in what condition, it will be better to take debt from foreign country i.e., comparison of internal and external debt.

(e) What is Finance Management of loss? Upto what extent Finance Management of loss can be done and what are its effects i.e., meaning of Finance Management of loss, its limitations and effects.

(f) What are the methods of returning of debt and what are the benefits and the limitations of each i.e., the principles of usage of Public Debt.

(g) What are the effects of Debt?

(4) Financial Administration - In this branch of Public Finance, methods of Administrative Control and the problems related to the preparation of budget is studied and analyzed. Under Financial Administration, following aspects are studied -

(a) How the budget is prepared, cleared and implemented.

(b) How the collection of different taxes is done by the officials and the institutions?

(c) How the conduction of Expenditure Department is done?

(d) Which department and officials are responsible for writing and auditing of Public Accounts and what are their rights and responsibilities?

Bastable has especially emphasized on the need and importance of revenue of this department. According to him, no book of finance can be considered complete unless it studies the problems of Public Administration and Budgeting.

Modern Aspect Regarding Subject - Matter

According to modern economists and thinkers, following two parts can be included in the subject - matter of Public Finance in addition to its four parts described earlier.

(1) Economic Stabilisation - Under this department, it is studied that in current scenario, the main objective of all economic systems is economic stability, how fiscal policy is adopted to maintain it? The Fiscal Policy is considered an important weapon to maintain judicial distribution in national income of the country. With its help, economical stability can be maintained by using production activities of the country.

(2) Economic Growth - According to some experts, the problem of economic stability is basically a problem of developed countries. In developing countries, the main problem is of Economic Growth. In this condition, in these countries, there is a need of growth in income, saving, investment and capital - establishment which can be possible by the usage of National Treasury Apparatus. In this regard, popular economist **Prof. Regnor Nurkse** rightly says, "It is my complete faith that in developing countries to solve the problem of capital - building, Public Finance has taken a place of a hero." In this way, it is clear that in planned growth in fiscal policy, which is a part of the subject - matter of Public Finance, its study is important.

The area of Public Finance and its subject - matter is not constant because it is growing continuously with the changes in concept of state, work of state and the problems of Economy.

Example It was already clear by the serious economic crisis of 1930 and Keen's writing named 'General Principle of Employment' how important are fiscal policies in bringing economic constancy and maintaining it. Nowadays, Government Income, Expenditure and Debt in Public Administration and the economic and social responsibilities of state are growing continuously. New problems are creating in Public Administration and security. Because of all these factors the area of public finance is expanding day by day.

Self-Assessment

State whether the following statements are True or False:

6. The functions of Public Finance lay emphasis on investment and usage.
7. Government Expenditure is the main base of Fiscal Policy bringing inconsistency in economy.
8. Fiscal Policy affects on the economy of the country.
9. Public Finance is that science which has no relation with Government's income and expenditure.
10. The area and subject - matter of Public Finance is not constant.

1.5 Public and Private Finance

On comparing Public and Private Finance, we know that if there are similarities in them, we also find dissimilarities, which is clear by following description :-

1.5.1 Similarities

The similarities found between Public and Private Finance are as follow:-

(1) Maximum Satisfaction – The objective of individual and State is basically same and this is satisfaction of human wants. Private Finance is related with the satisfaction of individual needs whereas public finance is related with the satisfaction of social or group needs.

(2) Balanced Budget – Man and State both get money and use it and each of them try to balance income and expenditure. Both of them try hardly to get maximum satisfaction by expenditure.

(3) Borrowing – When current income becomes less in comparison with current expenditure in both Public and Private Finance, then borrowing becomes important. Not only individual but state also has to payback the debt taken at the time of loss.

(4) Economic Choice - Both Public and Private Finance want to get maximum satisfaction and target by minimum resources, so both have to face the problem of adjustment of income and expenditure and problem of selection of economic choice.

1.5.2 Dissimilarities

Basic difference is found in many ways between Public and Private Finance such as objective, methods for getting Finance and quantity of resources etc. For example, as far as Public Finance believes in

public welfare, whereas the only objective of Private Finance is getting profit. Former fulfills for the loss by imposing new taxes or by any other means, whereas later cannot do so. In the same way, the resources of Public Finance are big and enormous but the resources of Private Finance are limited. We will explain this topic in detail now.

(1) Determination of Expenditure - Public authority decides the amount of expenditure first of all which it has to use on different aspects to fulfill its some responsibilities and after that it searches for the resources to fulfill that expenditure. But, a person first of all considers his income and he decides the amount of expenditure after that which he has to consume on different aspects of consumption. The reason for this is that public finance can increase or decrease its needs of income accordingly, but no such flexibility is found in the income of a person. **Prof. Dalton** has expressed this thought in these words, "A person adjusts his expenses according to his income but Public Finance adjusts its income according to its expenses. **"But this satatement is true with some limitations."** For example, if the expenses and duties of a person increase then he tries to increase his income but on the other hand, any Government or Public authority can not increase their expenses by indefinite limit. They have to watch out how much income they can get without causing any harm to the economy of the country. Therefore, sometimes, Government have to decrease its expenses due to lack of resources.

(2) Compulsory Character - According to **Findlay Shirraj,** "Government expenditure has another characteristic, that is compulsory character found in it. Some expenses are those which cannot be terminated or divide by State, but it is not possible in case of a person. For example, the expenditure on security and Public Finance etc. is of compulsory nature. In the same way, state can force its people that they use a special variety of clothes, grain and other things, they buy those commodities on Government imposed rates and pay them on the installments decided by Government. But private person or professional firm cannot do so. Not only this, situations can also force a person that he spends a special amount on food minimum clothes and housing etc., and he must wear and buy a special kind or sample clothes. In all these matters he motivates only by interest, taste and choice but also he gets affected by the availability of goods and environment of society.

(3) Principle of Equi-marginal Utility - For gaining maximum satisfaction "a person divides his expenses on different commodities and services in such a way that marginal utility of expenses on all heads must be equal and total marginal utility must be maximum by getting complete expenses," There must be a same rule on distribution of Government expenditure between different objectives and heads. But, it has been found that a person is more capable to implement this rule in comparison with Government. The reason for this is that a person is more independent while choosing heads of expense of his will, while Government is not independent like that. Normally, there is a standard for a person for spending or not spending that how much profit, he is getting on a special expense - but Government - cannot make the base of its expenses to this standard, specially on the expenditure on security, establishment of law and order, education, help for poors etc. It is clear that Government is not independent on the matter of these expenses. Sometimes, government is forced for spending money on special aspects only, whereas, in the state of lack of pressure, Government do not like to do so. It is possible only when some same favour group or person in the country come in the position of criticism of Government and pressurizing it by becoming more powerful. The result is that Government expenditures increase on important aspects.

(4) Nature of Budget - A person believes in surplus budget or spending less than income normally and does not believe in deficit budget or spending more than income. But, Government or any other Public - sovereign can consider making deficit budget profitable specially making of surplus budget by person during economic growth and during war time is considered good and this task is considered his personal ability because an individual can collect money by savings only and can become rich, but Governments surplus budget means that taxation of high level and Government expenditure of low level, but in normal conditions, for Government balanced budget is considered good not surplus or deficit budget.

(5) Nature of Resources - The resources of getting income of a person are limited. Government can borrow money from general public and foreign countries when needed, but it is not possible for a person to do normally. The Government can take shelter of deficit financing of laws, it means it can print currency notes to increase its income, but no one can do so. Public authority can make such law by which it can handle profitable business and profession for the objective of increasing income itself, for example, it can nationalize private transport and private whole sale business. The Government can adopt coercive method for getting money from general public.

(6) Motive of Expenditure - In professional dealings, the first objective of private person is to get profit. But, the dealings of public bodies are motivated for the objectives of public - welfare not for the objectives of profit. For example, many services like public health, health service, education, activities of social security and water supply etc. are not considered profitable for professional front but they are considered very important for the welfare view of citizens and for the same reason such facilities and services are arranged by public services.

(7) Long Term Consideration - Private person or companies invest money liberally in those professional areas where there is a need of getting immediate returns but in those areas in which marginal returns are received and it got lately, **Private Capital Shies**, but Government never got affected by these views and thoughts. Therefore, Government handles these projects itself but they must be appropriate for the view of public welfare. The construction of multi purpose Hydroelectric Projects in India are its direct example. In this way, Government uses many expenses for the view of public welfare which are used for future and present. Future is as important as present and Government arranges for the arrangement for expenses for future and present, a person can not do so like that.

(8) Coercive Method - Government or public - sovereign can adopts the methods of force for getting its income. Suppose, a person does not pay due income tax then he can be punished by the court or he can be punished economically for increasing tax - payable on him. In this way, a person can not deny the payment of taxes if it is due on him. Private person or businessman cannot use power in that way for getting his income, the way Government does. That is the reason that in comparison to private persons or businessman, the income of Government is more assured.

(9) Publicity and Audit Test - Lastly another difference between public and private finance is important. A private person likes to conceal all his financial deals but Government publicizes more to its means of distribution of resources in various aspects of five - year plans and budget - proposals. In addition to this, audit - examination and evaluation of accounts of public services are done compulsorily but is not essential in respect to the person always.

Task Differentiate between public and private finance.

1.5.3 Trends in Public Finance

General Economic Theory has always affected the views of public finance and the Government activities. The ancient view of Public Finance was based on Classical Economic Theory but there were many revolutionary changes were seen after that. At last, modern economic theory was implemented which is called **keyne's General Theory of Full Employment**. Because of this theory, the ancient concept of public finance has been changed also.

Notes Keyne is considered the founder of Modern Theory of Public Finance.

As a result, the responsibility of new achievement in economy of public finance and fiscal operations have been developed.

(1) Classical Theory - The demand of ancient economical theory was that supply can developed its demand itself. Therefore, the situation of over production or un-employment never arises. This theory gives emphasis on full employment or full use of resources. If labour is movable and wages are flexible then full use of resources by private enterprises can be achieved and unemployment generates because of immobility of labour and inflexibility of wages. Ancient or classical economist thought that the expenditure of one person is the income of another person, but they also expressed that by decreasing the expenses of a person, we cannot decrease the income of another person, because the money saved by him by reducing expenditure will be invested, it means it will be spent on the expenses of industries of capital commodities. The meaning is that there will not be any reduction in effective demand. Classical theory of public finance is based on ancient general economic theory.

Classical theory of Public Finance is based on classical General Economic Theory. According to this, private enterprises become assure about the subject of full employment and the State is unsuccessful in raising the level of economic operation of state. If government increases its expenses by taxation then its meaning will only be this that the expenditure has come into the hands of Government from the hands of private person but it will not increase total demand in area of production. If Government increases its expenses by borrowing money then the meaning of it will be competition from private persons and dearness will increase. The meaning of this is that classical economists believed in balanced budgeting. Taxes always affect on savings in some way or others, therefore, as a result of reduction in private savings, the level of private investment can also decrease. It is clear that it affects on the moment of money inversely. So, they believed that small budget is the best budget. The most undesirable taxes are those which give more burden on private savings such as death tax, super tax and business tax and direct tax. But, on the other hand, in direct taxes affect on consumption, therefore, they can be considered harmless by economic view although they are undesirable too by social view. Its meaning is that classical economists have supported direct taxes. If the loss of budget is compensated by printing notes or by taking short term Government loan, then it increases inflation. Its reason is that the rate of interest does not increase much during short term period that it can deflate the private investment and this position can mismanage the increment in the expenses of Government. If the loss of budget is compensated by issuing long term Government bond these bonds are considered substitute of business bond on shares and inflation does not occur by them. The loss of budget decreases the rate of progress normally, if the Government does not use the full borrowed money in construction of monetary decorum. The following conclusions can be obtained by above mentioned analysis -

(1) The Government can not increase in the levels of economic operations within the country.
(2) The budget should be balanced.
(3) Small budget is perfect budget.
(4) Those taxes are harmful for the society which lie on savings such as income tax, death tax etc. The taxes which lie on consumption are less harmful.
(5) If we cannot spare ourselves from the loss of budget then this is convenient to issue long term bonds.
(6) Landing must be for productive investment only.

(2) Modern Theory - Keyne's Employment Theory is based on this general principle that the expenditure by one person is the income of another person. If the whole income is spent by a person then as a result of this the income of that person increases as much as that person has spent if a person does not spend a part of his income and this reduction in expenditure is not fulfilled by investment - expenses, then its effect will be that the lesser expense by a person will reduce the income of other persons. The persons will spend less because they will get less income and as a result of this, the income of other person will also decrease. By this either employment will be available as a result, there will be a reduction in national income.

However, Keynes has not accepted a view -

(a) That, the motive of consumption is to increase the movement of money inversely, unemployment increases and national income decreases by the trial of saving.

(b) That employment must be provided at the lowest level of wages. Against this, their view was that by reducing wages, the demand of commodities will decrease and condition of expulsion of labourers will arrive.

(c) The pattern of establishment of such economic system is found which is based on private property and which adjusts the level of full employment in itself.

Now, we will analyze that how the serious change in general theory of economy affect the theory of public finance. It is clear that Keynes has not accepted the classical theory of full employment and told that the balanced budget is not desirable in all conditions but budget is considered a powerful tool in current times such as - (i) Receiving full employment (ii) High level of investment (iii) Deny of inflation i.e., the lack of both inflation and deflation (iv) Best distribution

But practically, it can be difficult that all objectives are achieved simultaneously.

It can be said if inflation has increased more than its solution is surplus budget; and if deflation has increased more then the solution is deficit budget. If we want to bring the state of lack of inflation then it is important that total value of new savings (all Government and non-Government) must be equal to the value of new investment (all Government and non-Government). If the savings are lesser than investment then inflation will occur and costs increase. Inversely, if the savings are more than investment then deflation will occur, the cost will decrease and unemployment will increase. If there is an increment in employment income, new investment increases definitely to bring new savings. But, with the increase of income, the propensity to consume of people does not increase in such a way. As a result, consumption does not increase with the speed of raising income. Its result is that savings increase more and effective demand decrease, and unemployment occurs as a result of increment in effective demand. It is that state in which we know the importance of public finance. In this state, the state can increase effective demand by spending Government money on investment of roads, rails, public utility industries and business. The money invested by Government in such a way can be borrowed by people, and this borrowed money by the people to Government can be a part of that income which was kept by people in cash form instead of spending on commodities of consumption. The Government is in good state of taking money for investment by inflation caused by deficit public system. In this way, it can fulfill that loss of total expenditure which was caused by those savings of people which was not available for investment. Classical economists could not understand this important contribution of government expenditure. They have always objected to Government's invention in economic operations and said that the state cannot raise the level of economic operations. In the same way, classical economists have objected to the deficit financial system and Government lending, whereas modern economists place them into the category of important measures of public finance for increasing economic progress or bringing economic stability.

1.5.4 Taxation and Equitable Distribution

Classical economists do not support this fact that the taxation must be used as a tool for transferring from rich to poor people for income, but under the modern concept of public finance, taxation is considered as an important source for increasing social justice and reducing the inequalities in income. In addition to this, classical economists believed in imposing taxes on poor in comparison to rich and they supported indirect taxes in comparison to direct taxes. But modern economists believe that the taxes must be imposed on those people which are capable to save and not on those people, which are eager to consume goods. In other words, they said that the taxes must be imposed on rich instead of poor. Not only this against to classical economists, modern economists support progressive and direct taxation for this purpose so that they can be used as a tool for collecting Government income and just distribution of income in the country. Unearned income is considered undesirable as social view, therefore, the Government tries that a part of unearned income must be taken away by direct

taxes (death tax and taxes on lotteries), but classical economists did not support it too. Indirect taxes contribute very much in public finance. But, modern economists do not consider this thing right that tax is imposed on every goods of consumption. Inversely they thought that the taxes must be imposed only on those things of consumption which do not create negative impact on general welfare of people, it means the taxes must be imposed on such goods which are used by rich, not poor.

1.6 National Debt

According to the concept of classical economists Government debt should be considered dead weight debt - not in the meaning that debt was tied, but in the meaning that by giving debt to Government useless means dead weight opportunities are provided. But, modern economists consider an important operation of public finance to Government debt. In modern times, Government debts are considered important to face many important situations such as for fulfilling deficit budget and to tackle the situations of lack of food stores and famine etc. The Government debt is considered very important because in modern times, to fulfill the objectives of public welfare is so dear that general income provided by taxation becomes less for it. The many other economists like **Keynes** have the opinion that such raised Government expense which is managed financially not by taxation but borrowing which is an effective measure to reduce economic crisis. For the development of natural resources of under - developed countries, Government borrowings are considered very effective.

1.6.1 Activating Finance

Prof. Baljeet Singh founded the concept of Activating Finance, we examine financial resources and apparatus on the basis of their functional structure and we discuss that what is the usefulness of financial management in economy. Activating financial management tells us about that how different methods of financial management create inflation in economy. Activating financial management believes in this belief that expenditure is incomplete and because of this, coordination is maintained between demand and production.

Such methods are used in activating financial management by which the flow of money is always maintained. If this happened then the levels of national income and employment will raise. The beliefs of **Keynes** and **Lerner** are appropriate for developed countries only where expenditure is more important. Semi developed and developing countries must emphasize on saving and investment. So, in developing countries, the implementation and conduction of fiscal policies must be in such a way that all resources must be used in employment to raise production and increment in income. The best use of resources must be done. Both managements have important place in developing countries. The desirable benefits can be obtained by implementing the belief of Prof. Singh in primary steps of development and the theories of Prof. Lerner in final steps.

New Trends in Public Finance - In modern times, the drastic change has been noticed in the structure and nature of public finance as a result of which its definition has some different type.

There are some important definitions in this regard which are as follow:-

(1) According to **Richard Musgrave**, "An investigation into the principles of public economy, move precisely into those aspects of economic policy that arise in the operations of the public budget."

(2) According to, **Otto Eckstein**, "Public Finance is the study of the affects of budgets on the economy particularly the effect on the achievement of the major economic objectives - growth, equality and efficiency. It is also the study of 'what ought to be'."

It is clear by following definitions that public finance is an ideal science with original science too. It studies the economic aspects of Government budget. These economic aspects are related with economic objectives. These are obtained by economic budget.

These economic objectives are - (1) Economic development, (2) Economic stability, (3) Justice and effectiveness. **Prof. Musgrave** has divided these economic objectives into three parts -

Economic Stabilization, Distribution of Income and Resources Allocation. It is clear that we study following both aspects -

(a) How to fulfill these objectives,

(b) How the economic system of different operations of budget get affected to fulfill these objectives.

In this way, it is clear that Public Finance is not only Positive Science but an Ideal Science also. Therefore, as a result of new emerging trends in Public Finance the area of Public Finance has increased much.

Public Finance in Developed and Under - Developed Countries - In modern times, all countries are progressing fast. There is a problem of economic development in under - developed countries; this problem is found in developed countries also, because they want to keep their economic development in continuous progression. Today, the Government's of nation's interfere in their economic lives, because of which the economic operations of the state got affected. In this way, because of growing influence of Government intervention in economic lives of country, in today's time, the importance of public finance in developed and under developed countries is increasing.

1.6.2 Developed Countries and Public Finance

On speeding up the economic growth of developed countries and on raising the level of lives of their citizen, public finance has sufficient importance there. Public Finance policies appear in the form of financial policies. The economy of developed countries got affected by this. The main problem of developed countries is - to maintain the level of economic life static. Under developed country, the objective of public finance movement is not to get economic development. **Arther Smithies** has expressed his opinion about America, "The main objective of financial policy is to control on total demand and it skips this traditional functions between traditional use for private sector." In developed countries, economic development occurs. Therefore, the Government tries that economic stability should be maintained for purchasing power.

In this way, public finance places an important role in maintaining economic stability in developed countries. Economic stability can be maintained by controlling total demand. Total demand affects by public expenditure consumption and investment. Total demand can be affected directly and indirectly by the policies of public finance. If the Government of the country keeps static the total demand by its budget policy then economic development can be controlled for bringing economic stability in developed countries, public finance is very important.

1.6.3 Under-developed Countries and Public Finance

There are some basic differences between the economies of developed and under developed countries such as the main problem of developed countries is to establish economic stability, whereas the main problem of under-developed countries is economic growth. Belief of **Walter Heller** is that public finance of developed and under developed countries are normally same. The main objective of public finance is to stop income and money, to promote investment and to provide economic stability. The main objective of Government in under developed countries is to speed up economic development in day - to - day basis and operations of public finance are used for this. Here the words of A.R. Prest are mentionable. **"Now it is not only accepted but it is hoped that the government has to work definitely for economic development."**

"For economic growth of developing countries, it is necessary to control and regulate economic life. These tasks are completed by the operations of public finance. Therefore, this fact is true that the policies of public finance in under developed countries perform important and useful work."

The importance of public finance in under - developed countries has been increased due to some other reasons, which are as follow: -

(1) Lack of Public Savings - In developing countries, the rate of savings is very less, because of which economic growth does not take place. For this, there is a need to collect finance, which can be increased by the suitable policy of public savings. In this way, in these countries, the importance of public finance has been increased.

(2) To Achieve Economic Resources - In today's time, it is considered the main task of the state to speed up economic growth in developing countries and to establish balance in it. It is difficult to collect economic resources of these countries forcefully, therefore, it is considered better to collect economic resources indirectly and public finance is considered best for it.

(3) Control on Private Sector - It is different to end private sector completely in under developed countries, because there is a fear of blockage of the speed of economic development by doing so. Therefore, right direction and control is necessary for private sector and this task is only done by the operations of public finance.

1.7 Role of Public Finance in National Economy

In modern times, the importance of public finance is increasing day by day. Although, according to classical economists, State has minimum interference in the tasks of public. Adam Smith considered State interference only in tasks like security, police and peace management. In the same way, the expenses by people are productive and expenses by Government are unproductive. In 19th century famous German Economist **Wagner** implemented the increasing operations of the state and then the tasks of the state in increased vigorously. In the beginning of 20th century, especially due to the economic crisis of 1930, public finance has been given due importance. The state is considered a welfare organization in modern times. Due to the situations like poverty, economic imbalance, professional highness etc. state interference has become compulsory in human life.

Karl Marx, **George Bernard Shaw** and **Sydney Web** have given importance to Government's efforts and intervention in place of individual efforts. The reason for the increase in the study of public finance is that public finance system of the country affects on every part. The function of public finance is not only collect finance - it is considered a powerful tool to encourage economic development providing social justice, maintaining economic stability and providing the state of full employment too. There is an important contribution of public finance in economic development of developing countries. Therefore, it is clear that Government is interfering in economic matters also.

Do You Know? Public finance has been given huge importance due to economic crisis of 1930.

We can study the importance of public finance in brief under following heads —

(1) Importance in Distribution of Resources.

(2) Importance of Public Finance in Distribution of Income and Wealth.

(3) Importance of Economic Stability.

(4) Importance in Collection of Resources for Economic Development.

(1) Importance of Public Finance in Allocation of Resources - The meaning of allocation of resources is their best selection by which it is clear that how to use land, labour, capital goods and other resources of the society - What goods are produced in what quantity and what methods of production must be used etc. Every country has economic resources in definite quantity. In this, natural resources like land, forests, mineral wealth and power source etc. are included also. It is mentionable regarding natural resources that by their availability only cannot raise the level of economic development of the country but their usage is also important for economic development. In addition to this, by natural and human resources of any country economic activities like agriculture, transport and trade etc, are conducted. This is the part of economy of the country. The whole economy depends on it. It is clear that the main objective of economic operations is to use appropriately and wisely. It can be known by following description -

(i) **Development of Economic Structure -** Government can arrange money for the development of economic structure by its budget policy. We can include the development of railway, electricity, road, transport, school, hospital, multipurpose projects etc, under this. In its absence, we cannot get economic growth in an organized way but in these plans, money is needed in large quantity. But, we cannot hope for their quick and direct result. Therefore, individual entrepreneurs do not have interest in investment. Therefore, it is the duty of the state that it can bear the expenses of economic structure, it can speed up the rate of capital formation.

(ii) **Rate of Population Growth -** Economic development is possible only when the opportunities of employment and increment in income must be more than rate of population growth. Therefore, Government can control population by giving more importance on family planning in its fiscal policy.

(iii) **Development of Backward Areas -** If relations and benefits are provided on taxes in backward areas then in highly congested areas, economic resources can be diverted towards the backward areas. By this, the help will be provided in progress and development of backward areas as well as balanced economic development is also possible.

(iv) **Development of Public and Private Industries -** In modern times, the state establishes and develops basic industries by preparing powerful economic structure. In addition to this, the Government can encourage individual investment in its public finance policy, such as (A) To reduce tax weight on individual industries, (B) To provide different industrial facilities to them, (C) To provide cheap loan facilities to individual industries and to open special financial institutes for this purpose etc.

(v) **Social Security Activities -** In many developed countries, public expenditure is used in large quantities on programmes like health insurance, unemployment insurance plan, old age pension, motherhood benefit etc. on serial wise security which has direct and indirect important effects on economy. It is clear by above mentioned discussion that public finance has important contribution in the area of suitable allotment and complete usage of available resources.

(2) Importance of Public Finance in Distribution of Income and Wealth - Today, there are inequalities in the distribution of income and wealth in many countries. On one hand, handful persons are wealthy and they misuse their wealth in many luxurious functions, on the other hand, general public suffer due to lack of wealth. Under free economic system, if economic power are not controlled then the problem of distribution of income and wealth becomes more serious. The inequalities of income is compulsory in all views like moral, social, economic and political etc. By eradicating the inequality of distribution of money, society will get maximum economic welfare. Due to inequality in income the structure of production becomes adoptable according to rich group. Maximum part of production consists of commodities of luxury instead of commodities of essential needs. In addition to this, the inequality in income encourages unemployment at last, as a result, economic insecurity develops

for a large group of population, the balance between savings and investment is not possible and the economic system of the country could not function well in favourable conditions.

Now, we have to study that how useful Public Finance will prove to reduce the inequalities in distribution of income and wealth. Reliable economists considered taxation as a negative thing generally for distribution of wealth. Their saying that the only purpose of taxation is to get income for the state. But, in modern times, this fact is wholly accepted that fiscal policies play an important contribution in reducing inequalities of distribution of money. By public expenditure, the inequalities of distribution can be reduced by raising the level of lives of poor people and by taxation this objective can be achieved by lowering the level of rich people. In this way, there are two main methods to bring equality in distribution of money -

(i) **Public Expenditure -** This can be the source to redistribute income in favour of poor people. If Government spends the maximum part of its income in such a way that it benefits more to poors then there will be less inequality between real incomes. Therefore, the Government have to spend more on people with low income. In this regard, government have to -

(a) do social services like free education health and arrangement of housing etc. for poors.

(b) save poors from unemployment, illness, hardships of old age

(c) provide special economic aid for the increment in the production of essential commodities by Government

(d) start balanced development programmes in different areas of Government economic system then this policy will be more successful to reduce inequalities of income and to raise the level of lives.

(ii) **Taxation -** Taxation is an important source to reduce the inequalities of money also. First of all German economists **Wegner** supported vigorously eradicate the inequalities of money through the medium of taxation. Income tax reduces the inequality of income due to the difference in income and wages, whereas inheritance tax reduces the inequalities due to the difference in wealth specially. Therefore, money can be transferred to the poor group from rich group by progressive and direct taxes, because by extracting tax from rich group people, it can be spent on such social services whose real benefit have to be availed by poor group. Although, public expenditure and taxation run side by side to each other, but taxation is very important in reducing the inequality of distribution of money also because taxation is not necessary for reducing the level of income of only rich person but it is very important to get money for the programmes of Government expenditure. Progressive tax reduces the inequalities of income but the tax increases inequality of income.

It is clear by above mentioned discussion that the efforts in the direction of equal distribution of income and wealth by public finance, they cause favourable effect on saving and investment and it helps in developing economic system of the country and it increases economic and social welfare of the country.

(3) Importance of Economic Stability - Economic stability means changes in production, employment and cost. The increment in production, employment and cost is the symbol of growing up the economy of the country. Inversely, reduction in production, unemployment and dearness are causing dearness in economy of the country. Therefore, for full employment or economic stability, we can discuss the importance of public finance in this way that how production, costs and employment can cause effect by it to fulfill the desired objectives.

Here, it is necessary to understand the meaning of full employment and value - stability. According to **Sir William Beverage**, "The concept of employment symbolizes that special state in which we get more vacant spaces in comparison to the number of unemployed person." According to American

economic union, "The meaning of full employment is that all those able persons who want to work on definite salary rates, without delaying more, the work can be received in productive works." In this way, the stability of cost means lack of alternative changes in general level of costs.

Famous economists believed that the state of full employment is always maintained in the society. Their beliefs were based on "Supply is the mother of demand" laid by J.B. Therefore, there cannot be unemployment in economic system because all that which is produced, its balance is necessary by money because modern economists strongly denied the above mentioned beliefs of famous economists and clarified that the state of full employment is not always found by the efforts of private enterprises of the country. According to **Keynes**, there are always ups and downs in capitalist economy. Sometimes the state of full employment occurs and sometimes the state of incomplete employment occurs. If a state of complete employment is found at a particular time then it is matter of chance.

Full employment and the facts related in this regard means the basic factor affecting production employment and cost inform the cost of total production. Its reason that there is no difference between total cost of national production and sale of goods by industrialists. It means total production is equal to national income. Therefore, it is clear by above mentioned details that economic stability effects the economy of the country to a good level.

(4) Importance in Collection of Resources for Economic Development— What is the importance in collection of resources for economic development? We can clarify this by the following details—

(i) Capital Formation - Capital formation has central importance in economic development of any country. It can be tackled by the point of suitable circle of poverty in semi developed countries and because of which there are chances of favourable changes. Therefore, the objective of the operations of public finance must be the usage of resources from saving and investment means from capital formation for consumption and other non - developing functions. The Government can help in many ways to increase capital formation. According to **Dr. R.N. Tripathi**, because of low rate of savings in capital formation, therefore, for getting increased rate of saving so that investment must be maximum, the Government can adopt following ways -

(a) Direct physical control

(b) Increase in the rate of present taxes

(c) To collect the savings from public enterprises

(d) Public debt

(e) Deficit Budget

(a) Direct Physical Control - This is very effective in reducing consumption and comparative investment. Although, its administration is not comfortable in semi developed countries, however direct physical control is a necessary part of fiscal policy.

(b) Increase in the rate of Present Taxes - To impose taxes and to increase the rate of present taxes, which can be said progressive clearly, place an important place. The structure of tax can be as follow –(i) Those resources of rich group which were lying useless or which are not used profitably - it can be achieved by imposing income tax, wealth tax etc, the tax can be imposed on Government commodities. (ii) To impose tax on increased income of farmer group is necessary. For this purpose, taxation can be imposed on land and other type of wealth.

(c) To Collect the Savings from Public Enterprises - In developing countries, there is less saving in enterprises due to high cost but if the public enterprises are conducted effectively then better results can be achieved by them.

(d) Public Debt - Desirable saving can be achieved in the form of Government debt. To increase the savings of people, Government debt letter is safe source. The institutes can

invest their money in Government debt letters. Although, per capita income is very less in semi - developed countries, therefore the area of public debt is very limited, its meaning is not that there is not any type of saving in country due to sale of public debt letters. Short savings have special importance in these countries. In present times, many international institutes like World Bank and international development union etc. provide sufficient debt to developing countries.

(e) **Deficit Budget -** The state of deficit budget arises when the Government gets enough by taxes and debts received by public and other sources of income, then it spends more than it. The finance system of deficit Government must be used cautiously. The excessive usage of this method brings drastic changes in economy and can destroy the economy.

(ii) Change in the Production Structure - Fiscal policy is motivator in speeding up the resources of public area. By expanding public sector, the Government can expand such enterprises which are considered important by the view of national favour. In addition to this, the objective of public finance related operations is to speed up individual investments in desired directions too.

(iii) To Remove Unemployment - The problems of unemployment and invisible unemployment are becoming complex in under - developed countries. There is a short term problem in fully developed countries which is created by the effects of business circles. But, in developing countries, unemployment is a major problem which can only be solved by long term development policy. Therefore, the chances of employment can be expanded by increasing investment by taxation public expenditure and policies related to debt in the country.

Task What is the importance of public finance in arranging resources for economic development?

Self-Assessment

Multiple Choice Questions:

11. In what public finance believed?
    (a) In public welfare (b) In self welfare
    (c) In profit (d) All of the above
12. What is the only objective of private finance?
    (a) To do public welfare (b) To get profit
    (c) To cause harm (d) All of above
13. Which operation is considered Government borrowing by modern economists?
    (a) Complete (b) Incomplete
    (c) Important (d) Total
14. To which country Wagner belonged?
    (a) India (b) Russia
    (c) America (d) Germany
15. When did economic crisis occur?
    (a) In 1930 (b) In 1830
    (c) In 2001 (d) In 1999

1.8 Summary

- The economy of public finance is related to the fulfillment of group needs specially. In this, we study those economic problems which arise in state or public sector, such as how to divide resources between private and public sectors and how allotment of resources for satisfaction of different resources of Government expenditure under public sector.
- The implementation of General Theory of employment by Keyne and Economic depression of 1930 became the bell of death for the policy. Keyne narrated that it is possible for the state to increase employment by fiscal operations and to maintain it on high level.
- In under-developed countries too, it is the main motive of the Government that the country must progress fastly economically and there must be equitable distribution of national production, and fiscal policy can become an important tool for the fulfillment of these objectives.
- The area and subject - matter of public finance is not static, because it is expanding continuously with the changes in functions of state and problems of economy.
- The basic difference is found between public finance and private finance in many matters such as objective, the methods of receiving finance and the quantity of resources etc.
- The classical view of public finance was based on classical economic theory but there were many revolutionary changes in this theory later. At last, modern economic theory was implemented which is called Keyne's General Theory of Full Employment. Because of this theory, the classical concept of public finance changed.
- Keyne's 'Employment Theory' is based on this basic concept that expenditure by a person is the income of another person.
- The concept of employment symbolizes about that special state in which working persons have more space in comparison to the number of unemployed persons.

1.9 Keywords

- Budget - The account of income and expenditure
- Fiscal operations - The activities of fiscal
- Inflation - The usage of more money than business needs of the country
- Taxation - To impose tax

1.10 Review Questions

1. What do you understand by public finance?
2. Describe briefly about the functions of modern state.
3. What do you understand by taxation?
4. Write down the similarities found between public finance and private finance.
5. Write a short note on the following—

   (a) Taxation (b) Public Expenditure

Answers: Self Assessment

1. Expenditure	2. 'Public'	3. Fiscal	4. 1776
5. 1930	6. True	7. False	8. True

9. False	10. True	11. (a)	12. (b)
13. (c)	14. (d)	15. (a)	

1.11 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
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6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
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Notes

Unit-2: Principles of Maximum Social Advantages

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Theory of Maximum Social Advantage
- Know about the Maximum Social Advantage
- Know about the Conceptual Fact during Imposing Tax
- Know about the Conceptual Fact during Expenditure.

Introduction

'The Principle of Public Finance' means fundamental rule by which financial policy of state must be decided. This fundamental rule is called the principle of maximum social advantage or the principle of maximum net social advantage or the principle of maximum social welfare. **Prof. Pegu** and **Prof. Delton** were two such famous economists, to which whole credit can be given for implementation of this principle and its famousness.

Classical economists **Adam Smith's** opinion was that operations of state and the quantity of taxation must be minimum. Following Adam Smith, his famous franchise student **J.B.C** told that, **"The best plan in all plans of finance is to reduce expenditure and the best tax in all taxes is that whose amount is minimum." Adam Smith** and **Recordo** thought that non - Government expenditure is productive and Government expenditure is unproductive. That's why those economists thought that, "Every tax is an evil and every Government expenditure is unproductive." Inversely, **Prof. Dalton** told that giving emphasis that, "It is not true to say that every tax is an evil in itself." For example, if we impose tax on narcotic drugs, wine and other objectionable substances, then these products, which are injurious to health, decline is reported in their usage and it brings solid welfare to the society. **Dalton** has also supported Government expenditure and objected this classical concept as it is unproductive. "Blind faith persons, remain biased about government expenditure of all types. But, we have to believe this fact clearly that government expenditure of any type is good." For example, the Government expenditure on agriculture, industries, public health, education and justice etc. is not

considered unproductive because such type of expenditure increases economic and social welfare. But, **Prof. Dalton** has said that also, **"It is not true to say that all type of public expenditure is good. For example, the government expenditure on unnecessary wars is clearly an evil."** Now, this fact is clear that this concept of classical economists that every tax is an evil and every Government expenditure have been rejected forcefully by unproductive, modern economists. They believed that the economic testing of productivity of Government expenditure is that too that expenditure creates how much economic welfare. For example, the Government expenditure on education and health usually is more productive than non - Government expenditure on commodities of luxury. In this way, any operation of public finance if, increases society and economic welfare of society completely, then it will be considered compulsory otherwise not.

2.1 The Principle of Maximum Social Advantage

This principle directs economic welfare of society, as whole, operations of public finance. Public revenue and public expenditure are two important operations of the state. It is necessary that direction or execution of these two financial operations of the state must be done by some basic principle so that maximum social profit can be obtained by those operations. **Prof. Pegu** and **Prof. Dalton** were two such famous economists who were responsible for implementation of this basic principle. According to the principle of maximum social profit, the state has to get its income and to spend its money in such a way that there can be maximum increment in the welfare of public. When the government imposes tax then some uselessness and disutility occur. On the other hand, when the government spends money there is some increment in usefulness and utility. Therefore, the Government has to adjust its income - expenditure in such a way that the maximum surplus of any utility occurs and the quantity of disutility must be minimum. But, here, this mentionable that by doing so, there will be maximum increment in individual welfare of all people; it can be possible that there can be more reduction in the welfare of some of them. If there is an increment in big quantity in number of people then it will be considered that there is maximum net welfare of society completely. **Prof. Delton** has expressed it in these words, "**As a result of operations of public finance, the nature and quantity of money produced and between the categories and different persons there are many changes in the distribution of that money. The question is that do this changes; leave a profitable impact on society? If it is so then it will be considered that the operations of public finance are justified, otherwise not. The best system of public finance is that can obtain maximum social profit by the operation organised by them."**

Notes **Prof. Dalton** called this principle '**The Principle of Maximum Social Advantage**' and **Prof. Pegu** called this principle '**Principle of Maximum Aggregate Welfare**'.

2.1.1 Extent of Public Revenue and Expenditure

Prof. Dalton pointed out to this thing that upto what extent Government expenditure must be increased? How to divide Government expenditure between different uses? How to collect Government income? And how to divide it between different categories? In the words of **Prof. Dalton**, "Government expenditure must be used in every direction upto that extent that equal balance can be maintained in loss caused due to increase in any other source of taxation or any Government income. This rule

Notes

presents an ideal limit for both Government expenditure and Government income." Its meaning is that by every additional unit of imposing tax, the weight of sacrifice by public will increase, but by the expenditure of that tax, the quantity of benefit received by public will decrease continuously. In this way, by imposing tax and regarding spending it, a point will come where profit received by any unit of money spent by state, will be equal to the sacrifice by the public due to any unit of tax imposed by Government. This is that state when the Government has to stop its extending step regarding to income and expenditure because it is that point on which marginal sacrifice is equal to marginal benefit. This is the optimum limit of financial task of Government. In this way, the Government expenditure must be done upto that extent where marginal utility received by Government expenditure must be equal to the marginal disutility due to taxation or Government income.

Maximum social welfare can be understood easily by following example:

Unit of Currency	Sacrifice from the every unit of tax	Satisfaction from every unit of expenditure
1	5	16
2	7	12
3	9	9
4	12	7
5	16	5
6	20	3

It is clear by the above table that marginal sacrifice is increasing due to the increase in every unit weight of tax on society. Inversely, from every additional unit of Government expenditure, its utilities decreasing as comparison to earlier for the society. Here, on third unit of currency, marginal social sacrifice and marginal social advantage are equal i.e., 9 units. Here, the limit of tax and public expenditure will be fixed. This fact has been cleared by the given diagram in which there is curve line of disutility or SS′ sacrifice line and BB′ benefit or utility curve. These two curve lines intersect each other at point P. In addition to this, OX line represents the amount of money spent and slant line OY represents sacrifice or the amount of benefit of money spent.

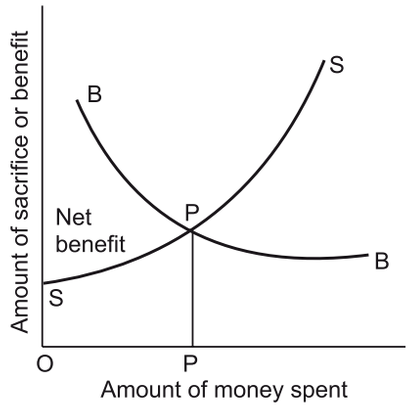

Fig. 1

If the curve line of benefit BB by the area covered is subtracted from the area covered by sacrifice curve SS′ then we get net benefit which we get by spending as equal to OP′. OP′ expenditure is at adoptable state at point P because at this point, utility money spent by last unit of money is equal to

Notes

utility lost by last unit of money. Sacrifice curve SS′ is an upwardly growing curve because with each unit of money received for Government expenditure the amount of sacrifice increases. But, inversely, benefit curve BB′ is a decreasing curve, because as the expenditure increases, the benefit decreases with into every unit. Point P, where two curve lines meet each other, show the adaptable limit of financial operation of state. It is that point where marginal sacrifice is equal to marginal benefit received. The explanation of maximum social benefit can be expressed by total social sacrifices and total social benefit. Maximum social benefit will be achieved at that point where the difference between total social benefit and some social sacrifice is maximum.

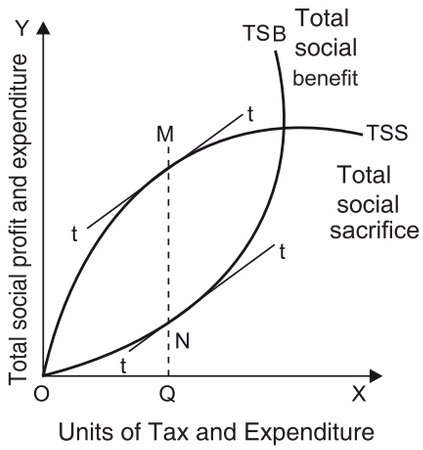

Fig. 2

In fig. 2, TSB curve shows total social benefit received from public expenditure whose curve is in upward direction. This curve shows that as the public expenditure increases total social benefit increases. But, it decreases after a point. Inversely TSS curve shows total social sacrifice produced due to tax which shows that total sacrifice increases with the amount of tax but total sacrifice increases rapidly after a point.

Here, the difference between TSB and TSS will be gotten as net social benefit which has been denoted by MN here. Therefore, the Government has to spend in the quantity OQ so that maximum benefit can be achieved.

Do You Know? The explanation of the principle of maximum social benefit can be given by total social sacrifice and total benefit curve also.

2.1.2 Distribution of Resources

Distribution of resources between different uses must be in such a way that marginal return of satisfaction must be equal in all uses. For example, the distribution of expenditure between aspects of help of poors in such a way that equal return of satisfaction must be achieved from last shiling imposed on every post. From here, there is a principle of Equi-marginal utility or maximum satisfaction which is imposed on public finance. Then, suppose that expenditure on agriculture is more than the marginal utility of expenditure on marginal utility defence then comparison to the expenditure on defence, the expenditure on agriculture is gaining more satisfaction. In this state, it will be better to

Notes

transfer agriculture to defence of resources. This transfer must be on that time, when the marginal utility received from both directions must not become equal.

2.1.3 The Thoughtful Facts While Spending

(1) Marginal utility from every expenditure must be same. If marginal utility on expenditure on education is more than the expenditure on health then the expenditure on education must be more. The expenditure like security education, health, transport etc. must be utilized in such a way that the same marginal utility must be obtained.

(2) The expenditure must increase production. The expenditure on roads, railways, wells the source of entertainment, school and health centres is appropriate. The expenditure on defence is unproductive but is necessary because the society have to be secured, the country must have to be preserved from internal and external quarrels.

Clarification by Diagram

In fig- 3, the marginal social benefit received from public expenditure on agriculture by AA curve has been depicted. In opposition to this, DD curve tells the marginal expenditure social benefit received from public expenditure.

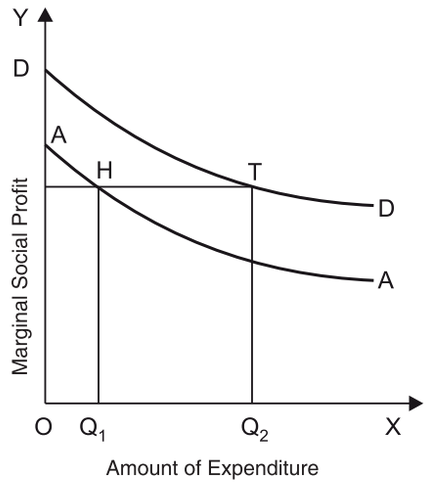

Fig. 3

The maximum social benefit will be received at that point where the marginal social benefit received from both aspects are equal. The position of marginal social benefit received from both in figure will be $HQ_1 = KQ_2$. Therefore, OQ is spent on agriculture and OQ_2 is spent on security then the marginal social benefit from both will be received in equal quantity and it will be maximum social benefit.

2.1.4 The Thoughtful Facts While Imposing Tax

1. The government has to watch while imposing tax that the tax must be imposed on those people who have capacity to pay tax. The weightage of tax must be same on different persons.
2. The production power of the society must not be minimized while imposing tax and there must not be any hinderance in the capital making.

Notes

3. The marginal utility of money decreases when rich persons have more money and they do not have to sacrifice much while paying tax. Therefore, tax must be imposed on rich person with greater rate so that the sacrifice must be same. For example, X, Y, Z are three persons their economic status are different. If the same tax is imposed on these three person then their sacrifice must be the following as shown in the table below:

Unit of Rupees	X	Sacrifice Y	Z
On giving tax of 1 rupee	10	15	20
On giving tax of 2 rupees	15	20	25
On giving tax of 3 rupees	20	25	32
On giving tax of 4 rupees	26	32	40

For making the same sacrifice, the tax imposed on X will be ₹ 3, on Y will be ₹ 3 and on Z, it will be ₹ 1 which become clear in fig. 4.

2.1.5 Distribution of Burden of Taxation

Prof. Pegu said that the distribution of burden of taxation between different sources must be according to the principal of least aggregate sacrifice. In other words, the burden of taxation must be divided between different sources in such a way that the marginal sacrifice of each source must be the same. In the words of **Prof Pegu, "If we want-to bring the state of least aggregate sacrifice then the taxes must be divided in such a way that the marginal utility of money paid as taxes must be same for all taxpayers."**

For example, if the utility of last unit of rupees paid by A is less then the utility of last unit of rupees paid by B, then the burden of tax on B must be lightened and the tax-burden of A must be increased. This process must be in continuation till that time when the marginal sacrifice of last rupee of A and B both must not become equal.

Clarification by Figure

In fig- 4, AA, and BB**,** curves show the marginal social sacrifice paid by the persons A and B. These curves are in upward direction which show that as the amount of tax will be collected, the amount of marginal social sacrifice will increase. Aggregate sacrifice will be least in that condition where the marginal social sacrifice of A and B will be equal. In this condition, the Government must impose tax equal to OQ2 on individual A and OQ1 on individual B because here the marginal social sacrifice by A is equal to the marginal social sacrifice by B i. e., $TQ_2 = HQ_1$.

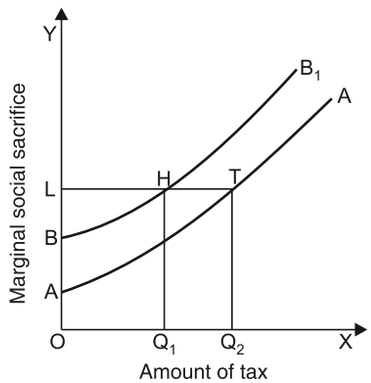

Fig. 4

Notes

Task Show the distribution of burden of taxation on the Map.

Clarification by Musgrave

Prof. Musgrave has tried to explain the principal of maximum social benefit with the help of fig. 5

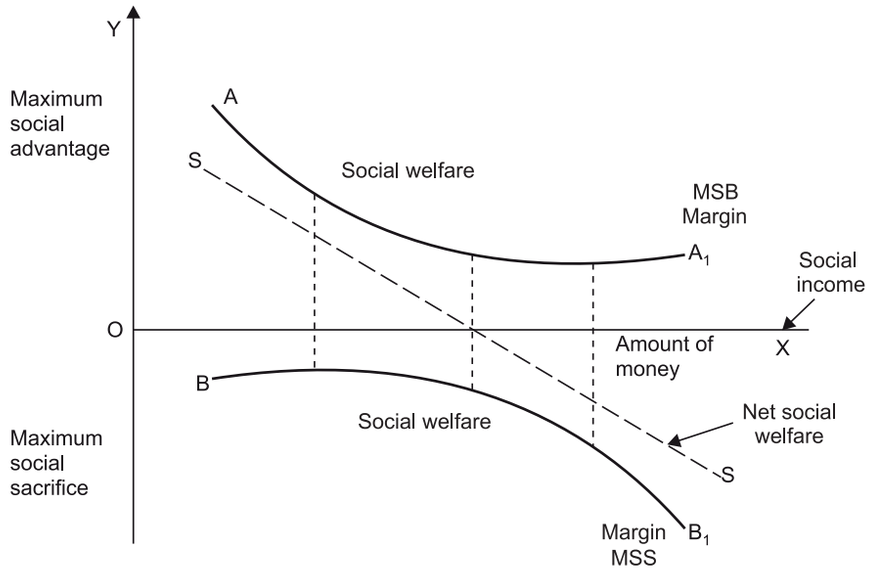

Fig. 5

In fig. 5, OX denotes public income. The upper part of OX shows social welfare and the down part shows social sacrifice. AA_1, depicts marginal social welfare and BB_1, depicts marginal social sacrifice. The bending down of AA_1 shows the fact that the welfare received by the additional amounts of expenditure is decreasing. BB_1, curve shows that as the burden of tax will increase, the amount of sacrifice of taxpayer will also increase. SS_1, curve shows net social welfare which can be known by subtracting AA_1, from BB_1, i.e. from social sacrifice is subtracted from social benefit. M is that point where actual social welfare is maximum and OM is that amount of money which the government has to receive as tax from society and has to spend as public expenditure.

Self-Assessment

Fill in the blanks:

1. The principal of public finance is also called the principal of …….. .
2. Adam Smith was …… .
3. When the Government spends money then there is some increment in …… .
4. …….. utility must be same by each expenditure.
5. The expenditure must be so that it increases ……. .

Notes

2.2 Maximum Social Advantage

As a conclusion it is said that there are three basic principal which guide the Government in financial operations and to achieve the ideal of maximum social benefit, they help the Government –

1. The Limit of Expenditure – The Government expenditure must be up to that extent, where the benefit received by public from the last unit of money spent by state must be equal to the sacrifice on public received by that unit.

2. The Distribution of Resource of the States –The distribution of resources of state between different aspects of adventure must be done in such a way that the marginal result of satisfaction received from each source must be same.

3. Distribution of Tax – The distribution of taxes must be done in such a way that marginal utility of money by people must be paid as taxes that must be same for each taxpayer.

Test of Social Advantage

Prof. Dalton expressed view on some kits of tests of social benefit. He said that some targets must be achieved by the operations of public finance. By which, completely, there must be increase of social benefit of the community. The tests suggested by them are as follow:-

(1) Preservation of Community – It is the duty of every Government that it must defense the society from internal unrest and mismanagement and external attack. The confidence develops in citizens from internal unrest and external security and their economic lives are progressive because of which social benefit increases. Therefore, it is very necessary that army, police and courts etc. must be established so that the country can successfully face the threats of internal and external enemies. It is the duty of state in every situation that it must increase the welfare of its citizens economically and uneconomically both types. It follows the principal of peace and co-existence; otherwise there will be increase in disutility expenditure on army, police, courts etc., which will leave a positive impact on economic life of the country.

(2) Improvement in Production – The other motive of the operations of public finance must be that the level of production in the country must be raised so that economic welfare of the society must be increased. The meaning of increment or reform in production is that- ''(a) The increase in production power, so that more production can be achieved by less efforts by per labourer **,** (b) The reform in the organization of production, so that the wastage of economic resources due to unemployment and other factors, (c) The reform in structure and infrastructure of production, so that such goods must be produced by which the needs of society can be fulfilled in best ways." Therefore, the objective of operations of public finance (Government expenditure, taxation and Government debt etc.) must be that these three objectives must be fulfilled by which there can be increment in production and economic welfare of society.

(3) Improvement in Distribution – While deciding the policy of state, the third fact must be think on that it has been seen that there must be that suitable distribution between different categories of society for production i.e. the distribution must be in such a way that the fluctuations and dissimilarities found in income of different persons and families must be ended. The distribution of income must be according to the needs of family and must be according to their efficiency and efforts. Due to unearned income, the in equalities produced in income cannot be bared whereas efficiency and hard work must be given just respect must be rewarded. In the words of **Delton,** "The meaning of reform in distribution is that – (a) To reduce the inequalities found in income of different individuals and families which are found normally in cultured society, (b) To end heavy fluctuation at different times, some individuals and families, specially in wages of persons of poor category of the society" Therefore, it is very necessary that suitable distribution of income and money for economic welfare must be done.

Notes

(4) Economic Stability and Full Employment – Economic instability (i.e. to create the situation of economic slow down) is an important sign of free economy. Many evils produce from it, such as unemployment and over production can increase the social welfare of people whereas stability remains in commercial direction in the country and fluctuations have to be ended in it. Therefore, the objectives of fiscal operation must be that economic stability have to be maintained at high level of employment. The effects of depression can be controlled by increasing government expenditure on tasks like public construction by fiscal operations and in this way employment and effective demand can be increased. In the same way during the time period of rising in costs, by government debt and heavy taxation, the price level can be brought down.

(5) Provision for Future – The individuals give importance to present as compare to future. As a result their financial activities are motivated by the effort of satisfying their present needs or life long needs. But, the state has double responsibility because it has to care for the favour of both present and future generation. Therefore, it is suitable for the state that it gives importance to large benefits of future generation in comparison to the small benefits of current generation. In the words of **Dalton," The state is the preserver of future as well as present. A person dies but that society remain alive who is the part of person. Therefore, the state has to give preference to the large social benefit of future in comparison to small social benefit of present**."

Notes During the period of influctuation, by government debt and taxation, the price level can be brought down.

Limitations

The principle of maximum social benefit is a basic principle of public finance and it is considered a guiding principle of financial operations of the state. But, in spite of this, when this principle is implemented practically, many problems are faced. The main are as follows:-

(i) Disadjustment between disutility and utility- It will be a very difficult task for the state that it maintains balance between disutility produced due to imposing tax and utility obtained by people from Government expenditure. An individual faces difficulty too in his practical life while doing so and on reaching that point normally where his disutility of sacrifice is equal to the utility of income and there is more difficulty for the state while doing so because the task of imposing tax and spending it of Government is not completed by a single person, but it is completed by lacks of Government servants at different places and in different departments.

(ii) Future Expectation – The state can guess about the future and can watch that what events can happen in future, but on the basic of these guesses and prediction, it is very difficult to assume that the expenditure by the Government which is creating disutility in present will provide more utility in comparison to that in future. Therefore, it is very difficult for the state if not impossible to maintain balance between government expenditure of marginal disutility of taxation and marginal utility of Government expenditure. To maximize net social benefit, the success of the state depends on this facts upto some extant that how much capability it has in assuming correctly about these result of its financial operation and the ability to do can approach now whereas the officials and workers to do this work are very sensitive and intelligent. Therefore, it is very necessary that the construction of Government administration must consists of such planning constructor's experts and official of higher qualifications at each level which are capable of obtaining maximum benefit from Government money spent in a definite time.

Self-Assessment

Notes

Multiple Choice Questions:

6. How many basic principles are there which guide government in financial operations?
   (a) Three (b) Four
   (c) Five (d) Six
7. Which economy has economic un-stability as its important feature ?
   (a) Slave (b) Free
   (c) Slave and free (d) None of these
8. The increment in production means –
   (a) Destruction in production power (b) Equilibrium in production power
   (c) Increment in production power (d) None of these

2.3 Summary

- By the wording "The principal of public finance" means that fundamental rule by which the financial policy of the state can be decided.
- The classical economists like **Adam Smith** thought that the operations of state and the amount of taxation must be minimum.
- The best plan among all plans of finance is to reduce expenditure and the best tax among all taxes is that whose amount is minimum.
- According to the principle of maximum social benefit, the receiving of income of state and expenditure of money must be in such a way so that welfare of public can get maximum increment.
- The Government expenditure must be done up to that level in every direction by which in the benefit received to society from more increment of this expenditure and inversely in the loss due to some increase in any other source of any Government income or taxation, the equal balance must have to be maintained. This rule presents an idea limitation for both Government income and expenditure.
- The distribution of resources between different uses must be in such a way that marginal return of satisfaction must be same in all uses.
- If we have to bring the state of minimum aggregate sacrifice, then the taxes must be distributed in such away that the marginal utility of money paid in the form of taxes must be same for all taxpayers.
- The reform in distribution means- (a) To reduce the inequalities found in income of different individuals and families which are found mostly in cultured societies, (b) To end heavy fluctuation in some individuals and families, especially in incomes of people of poor group of society at different times.

2.4 Keywords

- Revenue –Income of state
- Defence – Protection

Notes

2.5 Review Questions

1. Explain the principle of maximum social benefit.
2. In which ways the resources are distributed?
3. What facts must be kept in mind while imposing tax?
4. Write notes on following –
   - The limitation of expenditure
   - Tax distribution

Answers : Self Assessment

1. maximum social benefit	2. economists	3. utility
4. marginal	5. production	6. (a)
7. (b)	8. (c)	

2.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
3. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*

Unit–3: Issues Related to Economic Activities of Public Finance (Exp.)

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know the Economic Effect of Public Expenditure
- Understand the Influence of Public Expenditure on Production
- Know the Influence of Public Expenditure on Distribution

Introduction

The working – ability of public increase when they are provided essential facilities to work. The transfer in special plannings of economic resources by public expenditure increases production many a times. The Government can reduce the ditch of inequality of Government money with the help of tax policy, in the same way, the inequality can be reduced with the help of public expenditure also.

3.1 Economic Effects of Public Expenditure

The result of public expenditure in every modern nation is increasing day by day. Therefore, the analysis of economic effects of such expenditure is very important. By following **Delton,** we can divided these effects proudly in three parts – (i) The effect on production (ii) The effect on distribution and (iii) other effects

3.1.1 Effect of Public Expenditure on Production

Some people believe that public expenditure are totally unproductive and it cannot increase the production of the country. But, this belief is not right. The people forget that many public expenditure are mere **Transference** of money between people only – such as to give interest on public debt by Government or to give pension to elderly people. Here, the government gives money to the other category of people by taking it from one category of people. The public expenditure on education

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and public health increases the working – capacity of people directly. In the same way, canals rail, road transport etc. increases the production power of the country also. The reform of agricultural land and the expenditure on development of forests are production directly. But some public expenditure are those which do not help in production directly, such as expenditure on war. According to many people, this expenditure is definitely unproductive because the expenditure of this type bring the young ones of the country many essential commodities of the country iron, coal, oil, etc. to the area of war from the area of production, where they destroy. This idea seems right but if we examine closely then it will be clear that expenditure prevents economic loss and slavery in the country by protecting from external attack and in this way it is helpful in production work indirectly.

Notes We will surely have to accept that there is very much expenditure on armies these day and there is an urgent need in reduction of it.

The effect of public expenditure on production is as follow:-

(1) Increment in power of working- ability and savings in public – The working ability of public expands when they are provided with essential facilities to work. The expenditure on education, health, transport etc. Government is such expenditure which provides help to people in their work. Therefore, all those expenditure expand the working ability of people production power increases due to increase in working ability and when income is more then the power saving will increase automatically. In brief, it can be understand in such a way that there is a need of economic income for increasing the power of saving and increased income can be obtained when there is an increment in work–ability and to increase work – ability, expansion of education and other many things. Government spends on all these, because Government expenditure increases the work – ability of public and power of saving.

(2) Increment in desire to do work by public and to save –Government expenditure is of two types- one is related to present and other is related to future. By present expenditure, there is an increment in desire to work and to save. By public expenditure many individuals motivate to raise their life standards. It is possible that some individuals may develop bad habits, by denying them, the Government has to help in the form of commodities and service. Individuals have always desire to progress, they can form their desire in work by public expenditure. Therefore, by public expenditure, the desire to produce their own develops in individuals. In this way, if the Government promises to give economic benefit in future then it is possible that the interest to work and to save in individual increases by this, such as illness and unemployment benefit, because of which state gives its contribution instantly, where as benefactor becomes ready to give his contribution if the Government increases the rate of benefit with the increment in amount work then the desire of work will also increase.

(3) Promotion of production resources in country – Transference in special employments of economic resources by public expenditure increases the production some time. The government can tackle this type of transference by giving contribution or economic aid to private enterprises in special business or by bearing loss in those business it self. This type of interference is essential, but, it will produce industries or it will increase the power of production by arranging for future instead of present. This type of interference i.e., economic arrangement for future is very important for the view of increasing production power and by this view, to increase human capital with physical capital is very important. According to this view public expenditure on railways, roads, canals and other means of irrigation, scientific and industrial research, social insurance etc. is very important, economic help to reduce the value of essential food product, education, health is beneficial. In addition to this, Government can increase saving by reducing public debt and this saving will increase production.

Notes

Do You Know? The government can increase total production by utilizing useless resources and running new industries in backward areas by giving economic aid.

(4) **Economic development by plans –** If Government makes new plans for the progress of industries, then this expenditure are considered productive expenditure, because the economic development of the country increases with the increase in production.

Self-Assessment

Fill in The blanks:

1. In every modern nation, the result of ……. expenditure is increasing day by day.
2. …….. of public increases when it is provided with essential facilities.
3. Government can increase the income of poor group in the form of …….. .
4. …….. helps poor group by debt and social expenditure.
5. The fluctuation of employment can be controlled by …… of workers working in government expenditures permanent.

3.1.2 Effect of Public Expenditure on Distribution

With the help of tax policy, the ditch of inequality of money can be reduced, in the same way, with the help of public expenditure, inequality can also be reduced. If the Government spends according to maximum social benefit, then the economic inequality of society can be reduced very early. This inequality can be reduced by following ways –

(1) Spending more for poor groups – The government has received money from rich group by taxes, that must be spent on favour of poor group, then economic inequality of the country will be reduced and country will get maximum favour . If Government wants to reduce the inequality of money then it has to spend on management of education, health, hygiene, gardens and water etc. The work–efficiency of poor- group will increase, their income will increase and their standard of living will increase. The benefit of those facilities will be obtained mostly by poor group by which they can save money on the expenditure of these and can buy other commodities and can consume them. By this, poor person can also raise the level of his living by consuming more and more goods. On the other hand, the rich group has to spend money to get these facilities and there is less money remaining for the consumption of other commodities. In this way, the inequality between the standard of living of both reduces slowly.

(2) To increase the income of poor group directly – Government can increase the income of poor group directly. This increment can be giving aid at the time of unemployment, the buying power of poor group increases by this and they can increase the amount of their consumption.

(3) Aid by debt and social expenditure – The government can help poor group by debt and social expenditures. By which their standard of living can be raised and the inequality between poor and rich can be reduced. The objective of this type of debts or social expenditures is to bring economic equality.

(4) Assistance by progressive contribution – The government tries to bring economic equality in society by providing contribution to poors also. These contributions are also progressive, in ratio and

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good like taxes too. As the income of any poor reduces, so as the amount of contribution given to him increases then it is called progressive contribution. On the other hand, on reduction of income of it the amount of contribution also reduces then it is called unprogressive contribution and when contributions are given according to a definite percentage rate of income then it is called proportional contribution progressive contribution can reduce economic inequality in society. Therefore, Government has to give progressive contribution only.

According to **Pegu –** "Any work by which the original income of poor individuals increase, but national structure does not get reduction in any way by it, economic welfare has to be increased normally."

Task The economic inequalities can be reduced by increasing income of poor group directly. How?

3.1.3 Other Effects of Public Expenditure

With the help of public expenditure, the Government can solve the problem of unemployment by placing the demand of labour permanent. For solving the problem of unemployment, following aid can be taken by public expenditure –

1. **Government can spend its expenditure in running of new business by** which many people can get employment. By this policy, the problem of unemployment can be solved by increasing employment. This policy has been adopting in India these days. Major portion of public revenue of India has been spending on five year plan. Because of this lacs of unemployment labourers have got employment.
2. **The fluctuation of employment can be reduced by making the employment of workers in Government departments permanent.**
3. **The unemployment will also be reduced by spending on individual business to nature of classical Government businesses.** Whenever, there is fluctuation in individual businesses then many labourers become jobless due to this, but on the nature of Government businesses become same as the nature of individual businesses, they get the jobs in Government businesses.
4. **There is a fear of unemployment on depression in trade and industries.** If in that condition government spends on helping industrialists or running new industries, then by policy, the fear of unemployment will be reduced.

Conclusion –The production, distribution and labour problem of country depend actually on public expenditure. Public expenditure will try to run them smoothly, so as the economic condition of the country will improve.

Self–Assessment

State whether the following statements are True or False:

6. If Government spends according to maximum social principle, then economic inequality of society can be removed very early.
7. Government has to spend the money which has been received by taxes from rich group on the favours of rich group.

8. Government can increase the income of rich group directly also.
9. Government tries to bring economic inequality in society by giving grants to poors also.
10. With the help of public expenditure, the Government can solve the problem of unemployment by placing the demand of labour temporarily.

3.2 Summary

- In every modern nation, the result of public expenditure is increasing day by day. Therefore, the analysis of economic effects of the expenditure of this type is very important.
- Some people believe that public expenditures are completely unproductive and they cannot increase the production of the country merely. But, this belief is not true.
- The work–efficiency of the public increases, when it has been provided with essential facilities to work. The expenditure education, health, transportation etc. by government are such expenditure by which the people get much help in their work.
- Public expenditure are of two types – one is about present and another is about future. By public expenditure, the desire to work and to save in individuals increases.
- The government can reduce the ditch of inequality of money with the help of tax policy, in the same way, with the help of public expenditure, inequality can also be reduced.
- Government can increase the income of poor group directly. This increment can be done by helping at the time of unemployment and by helping at the time of old age, the buying capacity of poor group increases by this and it can increase the amount of its consumption.
- By making the employment of the workers working in government departments permanent, the fluctuation of employment can be prevented.
- By spending in making the nature of individual industries same like classical government industries, the unemployment will also reduce.

3.3 Keywords

- Transference – From one hand to another hand
- Contribution – Little charity

3.4 Review Questions

1. What is the effect of production on public expenditure?
2. How public expenditure affects distribution?
3. Describe other effects of public expenditure.

Answers: Self Assessment

1. public	2. Work – efficiency	3. direct	4. Government
5. employment	6. True	7. False	8. True
9. False	10 . True		

Notes

3.5 Futher Readings

Books

1. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking International Trade and Public Finance—*Nee. Thai Somshekhar, Anmol, 2004.*
4. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*

Notes

Unit-4 : Instrument of Public Finance : Concepts and Role of Budget

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Meaning of Budget
- Understand Important Things Related to Budget
- Know some Facts about Budget in India.

Introduction

The first step of public budget is to arrange financial resources by Government and to spend them. The meaning of any budget is limited to this step.

In many countries, there is a belief that public budget must be for one year. In many countries the beginning and closing of 'fiscal year' are found on different dates. According to the belief of many people, the time period of budget must be at least two years. According to them, a big part of the year is spent on implementing budget and preparing next budget. It is important to know for the meaningful information on budget, that what are the provisions and customs in the constitution of our country for receiving and expenditure of Government. All those receiving received to Government of India which come under their ownership, they are kept in those accounts which are called 'fund' collectively.

4.1 Meaning of Budget

The budget of a modern government is a detailed document. In there is social wise content of expenditure and total financial receivings of government with introductory amendments, there are guess of financial flow, and there is description about policies and activities of government related to this.

Therefore, for knowing the suitable meaning of public budget, be aura of its main dimension is compulsory, which is as follow –

Notes

1. The first main dimension of public expenditure is to collect financial resource by Government and to spend them. The meaning of budget was limited to this dimension only.

There are some objectives against each Government, for getting them, it chooses policies and activities. To collect resources and the task of spending them remains connected to these activities. Therefore, one meaning of public expenditure are considered that they area detailed be aura of collecting financial resources by Government and spending them. Proposed receivings for short duration (maximum one year) and proposed expenditure on following heads and are shown in serial wise category in it. The budget of a considerable year is presented to parliament or other concerned member of legislative assembly at appropriate time before starting it that year and in this way, through the medium of budget, each head of receiving and expenditure shows their proposed decision.

2. This is not expected by a modern Government that they decide in an unorganized way about their receivings and expenditure heads. The recourses coming towards Government are the gifts to society basically and it is their moral duty that the overuse of these resources do not happen by any means. In addition to this, all heads of budgets have deep relation to it, due to this, their structure must be according to the structure of goal achievement. Due to this, the beaura of budget cannot be kept limited upto proposed receiving of considerable year (or short term) or proposed expenditure normally essential discussions are kept the serial wise (and categorized in other type) receivings and four set of payments, which are as follow –

(i) Actual data of previous year,

(ii) Budget Estimates of outgoing year,

(iii) Revised Estimates of outgoing year,

(iv) Budget Estimates of incoming year,

Notes In this part, there are two sets of additional receiving of serial-wise proposed expenditure amounts. In one set, those amounts are shown which are proposed keeping same the present tax structure and in another set, the tax structures in budget and other financial resources and policies etc., after proposed amendments, desirable guesses are shown.

3. In this way, the budget shows the evaluation of possibilities of problem, facts, goals of society, country and economy of country and their receiving.

4. It has been in most conditions that 'Budget Expectations' of current year and 'Revised Expectations' are different. The possible explanation is given in these differences in budget.

5. In most cases, for some expenditure matters of public expenditure, the government is committed officially and after arranging resource for them, remaining resources – receiving are earmarked for some instructed expenditure heads.

6. It is possible that, legislative authority will present it in two or more than two parts. It can be possible for many reasons –

(i) When there is multi–level government in country then it is hoped that addition state governments and local governments of central governments budgets must be presented separately.

(ii) Budget can be presented in parts at any level of government. For example, from the budget of central government in India, the part of 'railway budget' can be placed before parliament before 'General Budget (means Main Budget) or separately.

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(iii) Sometimes, due to election or any other reason, public budget comes to legislative authority for general time period (means one year) or less than time period and for remaining portion of year, the number to execute it comes after second portion of budget.

Do You Know? During the year (means during duration of budget) Government has to spend additionally and for additional resources due to some reasons. For this task, government prepares a supplementary budget and execute it. The resource of necessity of supplementary budget can be done by its activities and policy modification or due to the result of external conditions, Government needs a supplementary budget.

7. The distribution in item and item-categories of budget depends on law structure of country and account pattern. With this compulsory categorization some other categorization techniques are adopted for making budget meaningful and assuming its result, which will be discussed later in this unit. In the same way, the explanation of classical categorization of Revenue and Capital Account will be given in 'Type of Budget.'

Self-Assessment

Fill in the blanks :

1. The budget of a modern Government is detailed …….. .
2. ……. can be presented in parts at any level of Government.
3. The distribution of heads and head - categories of budget depends on law structure of country and ..... Pattern.
4. First main dimension of public budget is to collect ..... Resource by Government and to spend them.
5. The basic resources of Government are the ..... of society.

4.2 Some Concepts Associated with Budgets

Duration - There is a custom in many countries that public budget must be for one year. In different countries, the beginning and end of 'fiscal year' is seen on different dates. In some countries only 'fiscal year' matches with their calendar year. The general duration of budget in India is one year which is counted from 1st April to 31st March of next year. In favour of modification of dates in this fiscal year suggestions have been given many a times, but not single suggestion has gained acceptance. The logic of suggestion givers is that India has been an agricultural country which has more importance for Kharif crops; therefore, our fiscal year must be started from October/November.

According to the beliefs of many people, the duration of budget must be two years. According to their logic, a big part of the year is spent on execution of budget and in preparing next budget. Therefore, due to the custom of yearly budget, resources are used extravagantly.

Secrecy - The datas of budget and budgetary proposals in India are kept secret till the last moments of presentation of budget. Due to this, secrecy (excluding Prime Minister or Chief Minister), the whole budget remains secret for other members of ministry.

Many people believed that by the custom of this secrecy, no special benefit is obtained, but loss occurs. Businessman and other people guess about the proposals of budget. Due to this, they become successful in benefiting by other type and increasing costs. For investors, there is difficulty in long term decision

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making. Therefore, it is the idea of those people that the datas of budget and other proposal must be kept secret. Known - government elements get the chance of getting contribution in their selection by discussion only, so that the government can know that what are imagined effects of its budgetary proposals on society and economy and how they can become better.

According to another belief, secrecy can be beneficial about some special matters. Therefore, keeping the secrecy of such matters, public must be aware about the presentation of budget proposals (specially tax related) and other matters and they must be discussed independently.

A 'Good' Budget

Any budget can be considered as good when it is a possible helper in receiving of different chosen objectives of society and economy. But, here, the main problem is that there is always dispute about these objectives. But, in the view of legislative authority also those objectives are appropriate; a 'good' budget must be helpful in its aid.

How to evaluate this fact that how the budget in question will be helpful in receiving the desired goal? For this, there is a need of detailed analysis of datas and proposals of budget. A good budget is that which has this analysis or the analysis of this type can be done smoothly. In this context, we can give emphasis on this fact that government need not to take debt for its current expenditure such as wages of government servants, payments of interest, expenditure on security of country etc.

4.3 Some Facts Concerning Public Budget in India

It is necessary for budget related meaningful knowledge that for the receiving and expenditure of government that what are the provisions in the constitution of our country and what are the customs. In this context, we have to note firstly that the receivings of government can be in its own ownership, or it can be as a form of identity (The main form of these identities is debt). On this base, the receivings received in the form of 'identity' there isn't any need of permission of Parliament (or legislative assembly of state) for returning them to their owners and for some other expenditure heads.

1. Consolidated Fund — All those receivings of government of India which comes under its own jurisdiction, can be kept in those accounts which are called 'Consolidated fund of India'.

(i) Before 80th amendment of constitution, the whole receivings and some partial receivings from taxes debited by government of India go to state governments. Therefore, the arrangement was like that all other tax receivings in addition to the part received to states in receivings of income tax go to the consolidated fund of India and from this consolidated fund, the part of receivings of state (including part of receivings of income tax) can be transferred to them. The budget of union state areas without legislative assembly, are consolidated in the budget of government of India, therefore tax receiving of union state areas also went to consolidated fund of India. Now, the situation is that a predecided part of receivings of all taxes of government of India excluding (a) taxes imposed under Article 268 and 269, (b) surcharge on taxes, and (c) Taxes imposed for special provisions and it is out of bounds of consolidated fund of India.

(ii) Indian government also received different types of taxes and revenue. All these go to the consolidated fund of India. The examples of these receivings include currency, coinage and mint, interest receiving, profit, external Grants-in-Aid and contributions, tax-ratio revenue.

(iii) Some receivings in capital accounts go to consolidated fund. This includes internal debt of different types collected by government of India foreign debt and debts given earlier by government of India and receivings etc. Constitutional state is considered when debt

receivings are placed in consolidated fund, government have debited them on availability in present and guarantee of received amount in future and that Government will pay them from consolidated fund also. All those dues of government of India which are payable from "Consolidated Fund of India", are called "Public Debt of Government of India" or "Public Debt". According to this fund, every state has its consolidated fund.

2. Public Account—By government of India and all other amounts are called 'Public Account of India' collectively. All these amounts remain deposited as identities with government. Therefore, for returning them, government need not have to take permission from parliament. The main examples of other dues are- (a) Small Savings, Deposits and PPF; (b) State Provident Funds; (c) other accounts; and (d) Reserve funds and deposits. The payment of these debts can be done without execution from Parliament. According to this fund, every state has its public account also.

Task What do you understand by consolidated fund?

3. Contingency Fund of India—The country may have to face such situation where government has to spend immediately, but there is no time and opportunity to take permission from parliament. For tackling such situation, it is considered suitable for keeping some amount as advance for the government which is know as **contingency Fund** of India. Expenditure from this fund from time to time is executed by parliament and possible modification is also done from total amount. In this way, there is a '**consolidated fund**' for each state. There are two categories of payments from consolidated fund of India.

In first category, there are those items which are 'charged' payment of this fund, i.e., there isn't any need to implement these payments (expenditure heads and proposed expenditure amounts on them) in parliament. These become a part of expenditure party of that budget without execution. Some examples of these 'charged' payment heads have been mentioned earlier. Accordingly, there are some 'charged' payments also on consolidated fund of each state. The payment of any type cannot be made without prior approval from parliament (and legislative assemblies in matters of states) from consolidated fund.

As the public account is considered, the receivings in them are according to such predetermined conditions that government is bound by law by time table of their payments and other conditions. Therefore, there is no need of prior permission of parliament (or legislative assembly of state) for payments from this account.

Self-Assessment

Multiple Choice Questions:

6. Whose beginning and ending are seen on different dates on different countries?
   (a) Fiscal year (b) Financial year
   (c) Public Finance (d) None of these
7. Which year matches with fiscal year of some countries?
   (a) Financial (b) Calendar
   (c) Hindi (d) Public
8. Some receivings from Capital Accounts go to which fund of India?
   (a) Contigency (b) Public
   (c) Consolidated (d) All of these

Notes

4.4 Summary

- The budget of a modern government is a detailed account. There is serialwise description of all financial receivings and expenditure of government, including proposed modifications; there are possibilities of financial flows; and there is description of policies and activities related to government.
- There is a custom in many countries that public budget must be for one year. The beginning and ending of 'fiscal year' in different countries are seen with different dates**. 'Fiscal Year'** matches with their calendar year in some countries only.
- Many people believed that no special benefit is received from the custom of this secrecy, but Loss occurs. Businessmen and other people guess about the proposals of budget. Due to this, they become successful in increasing costs and benefiting from other type.
- A budget can be said good when it is helpful in receiving of different chosen objectives of society and economy. But, there, the main problem is that there is a dispute regarding these objectives.
- It is necessary to know for meaningful knowledge regarding budget that what are the provisions and customs in the constitution for our country for receiving and expenditure of government. First of all, it must be noted in this regard that the receiving of government may be in their ownership, or can be in the form of identity. (The main objective of these identities is debt)
- All receivings of government of India which are under its ownership, are kept in those accounts which are called 'Consolidated Fund of India' collectively.
- All other amounts received by government of India are kept in those accounts; they are called 'Public Account of India' collectively.
- The country may have to face such situation where government has to spend immediately, but there is no time and opportunity to seek permission from parliament.

4.5 Keywords

- Supplementary - To satisfy
- Charged - Debtful

4.6 Review Questions

1. Whats is the meaning of budget?
2. What is a good budget?
3. Describe some facts related to budget.
4. Write short notes on following:

   (i) Duration (ii) Secrecy

Answers: Self Assessment

1. account	2. Budget	3. accounting	4. financial
5. assets	6. (a)	7. (b)	8. (c)

4.7 Further Readings

Notes

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking International Trade and Public Finance—*Nee.Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Supreet Singh and Anil K.Gupta, Dominant,2012.*
5. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Notes

Unit-5: Public Revenue: Revenue Receipts and Capital Receipts

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Meaning and Importance of Public Revenue
- Know the Source of Public Revenue
- Understand different Element of Tax
- Get Knowledge about Gift and Contribution.

Introduction

In today's age of economic planning, the importance of origin in economy has some importance as public revenue of public finance. In current time, due to the increment in tasks of states, the amount of public expenditure increases. The taxes are those essential payments in source of public revenue which are done by tax payers for government in such hope that they will get direct benefit in return of these.

5.1 Meaning and Significance

There is a need of income for fulfillment of a person's needs, in the same way government needs income for successfully completing its tasks. Income of all types received by government is called public income. In the study of public finance, the government income has the same place which is gained by production in study of economy. The production is necessary for the fulfillment of consumption, in the same way, for the fulfillment of the government expenditure, government income is essential.

Income received from different sources of government is called government income or government revenue. But, **Dalton** has used government income in both meanings - broad and limited. He named

them public receipts in Broad Meanings and named them public income or public revenue in Limited Meaning. In public revenue, taxes, the cost of commodities and services received by government industries, income of administrative operations like fees and penalty and gifts and contributions are included. But, in public receipts, all those incomes of government can be included which they receive during a particular duration. In other words, public receipts = public revenue + income of all other sources such as individuals, debts from banks and issue new money letter.

In the age of economic planning, the importance of origin in economy has same importance as public revenue of public finance. In current time, due to increment in tasks of states, the amount of public expenditure is also increasing. For the fulfillment of this increased expenditure, it has become necessary to increase public income. In modern times the objective of income related sources is not only receive income, but to affect production, employment, planning and other economic operations as a form of an effective fiscal tool. An arrangement of powerful resource for fulfillment of desired objectives by deciding a definite policy in regard of public revenue as well as public expenditure and public debt policy in every economy is done. Therefore, in current age, public income for each economy, whether developed or undeveloped has been proved important. The familiarity and success of government depend on whole public income. In the same way, for both private individuals and government, the practical importance of methods of public revenue and study of its nature has been increased.

Notes Government Receipts = Government Revenue + All other Sources of Income.

Self–Assessment

Fill in the blanks:

1. All type of income received to government is called ..... income.
2. In the public finance, the government income has the same place which is gained by ..... in study of economy.
3. Production is necessary for the fulfillment of..... .
4. Government receipts = government revenue +..... .
5. In today's age of economic planning, the importance of origin in economy has same importance as ..... of public finance.

5.2 Sources of Public Revenue

Now, we will study different sources or forms of government revenue. These resources are following-

(1) Taxes

(2) Commercial Revenues

(3) Administrative Revenues

(4) Gifts and Grants

Now, we will study all these sources separately -

Notes

5.2.1 Taxes

Taxes are those compulsory payments which are used without any such hope towards government by tax payers that they will get direct benefit in return of them. According to **Bartable**, '' Tax is that compulsory contribution of money present with person or individuals which is given in lieu of service in government tasks.'' According to **Prof. Seligman**, '' Tax is that compulsory contribution given to Government by individuals which is paid in the payment of expenses in all general favours and no special benefit is given in lieu of that.'' According to **Trussing**, ''The special thing is that in regard of tax in comparison to all amounts taken by government, quid pro quo is not found directly between taxpayer and government administration in it.''

Characteristics of a Tax

It is clear by above mentioned definitions that some specialties are found in tax which are as follows :-

(1) Compulsory Contribution— Tax is a contribution given to state by people living within the premises of country due to residence and property etc. or by citizens and this contribution is given for general use only. Though it is a compulsory contribution, therefore, no individual can deny from the payment of tax. For example, no person can say that he is not getting benefit from some services provided by that state or he didn't get the right to vote, therefore, he is not bound to pay tax. Therefore, tax must be paid by each individual which is imposed by state, whether he is adult or minor and citizen or foreigner. If a person denies to pay tax, he must be prosecuted.

But, there are some limitations of taxes. For example, if tax is imposed on some special product then he can escape tax by not using that product. Suppose if tax is imposed on wine then government can force some person to pay tax only when he uses wine. But, if he doesn't drink, then he cannot be forced to pay tax imposed on wine. In addition to these limitations, tax is compulsory payment and its speciality separates it from other types of government revenue.

(2) Personal Obligation — Tax casts personal obligation on taxpayer. Its meaning is that if tax has been imposed on some person then it is his duty or obligation to pay it and don't try to avoid it in any condition. For example, tax is imposed on incomes of persons then there can be many sources of income of persons, therefore it is possible that government may not be aware of all sources of income of people. In that condition, it is the duty of taxpayer that he must declare all his income and pay tax according to it.

(3) The Tax is Imposed for the General and Common Benefit — The contribution that is received from taxpayers in the form of taxes, it can be possible that it cannot be spent for their profit only, but it must be spent in favor of common people. It can be possible that a person is not capable to fulfill all his needs specially to fulfill those needs where huge amount is spent there such as construction of hospital. In that condition the state arranges for such services for the benefit of all people. Therefore, for bearing this general burden, the tax is imposed on all those people who are capable to pay it.

(4) No Relation between Taxation and State Services — Payment of taxes not done by state for the payment of any special service given to a person and tax is not paid for this purpose that some special benefit has been given to taxpayer by state. In this way, tax are not paid because taxpayer has received benefit from state or state has provided service for it.

But, there is some limitations also of this speciality. For example, land tax is paid by those individuals only who have land or those who get benefit from land. In the same way, entertainment tax is given by those individuals only who get benefit from entertainment. By highlighting on this condition, **Prof. De Marco** has said about the limitation of tax that the law of taxation in modern state is based on the assumption of an exchange relationship that is the exchange of a payment of the state for the provision

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of public services by the state.[1.] Therefore, according to **De Marco**, "The tax is the price which citizen pays to the state to cover his share of the cost, the general public services which he will consume.[2.]

But, here, this is mentionable that contribution is received in form of land tax by farmers, it can be possible that it is not only use for their benefits only by the state, but also it must be given for the benefit of all society. In the same way, government receives contribution in lieu of the profit received from entertainment by people; it is possible that it must be used for the benefit of whole community instead of the benefit of only those. In this way, the amount paid in the form of tax by individual and benefit received from the government service have no relation between them. Therefore, it is a compulsory contribution and this contribution is for the benefit given to general public and there is no relation between service given by government and tax paid by them.

Do You Know? It is the duty of taxpayer that he must declare his whole income and pay tax accordingly.

Elements of Tax

On the basis of above mentioned analysis, it can be said that the main elements of tax are as follow-

1. Compulsory Contribution —Tax is a compulsory contribution, if the directions instructed by law are imposed at the time of paying tax.

2. Taxes are Imposed by a Government—Taxes are imposed by government only. If the management of any temple or any other organization makes compulsory to give a special amount for one year for each family, then it cannot be said tax in any condition.

3. Involvement of Sacrifice—The emotion of sacrifice lies within the payment of tax because taxpayer pays in the general favour of society.

4. Social Welfare—Tax is imposed for the objective of welfare of whole community, i.e. revenue received from tax, at one hand, it is spent for the welfare of whole society but for special category of society and, on the other hand, the inequalities of revenue remove from this expenditure.

5. The Benefit is not the Condition for the Payment —To receive benefit is not a compulsory condition for the payment of tax. Taxes are not paid merely because taxpayer receives benefit from government expenditure, but they are paid because they are compulsory. If the taxpayer receives any benefit then it is not necessary that it must be in ratio of tax paid.

6. No Relation with the Cost of Service —The benefit which is provided to individuals by government service tax is not imposed to utilize the cost of that benefit, i.e. tax has no relation with the cost of that service which is provided by the Government to individuals. For example, it is possible that poor person gets benefit from government expenditure but he gets very less effect of taxation.

7. Payment from Income—Taxes can be imposed on income and on capital also. But, they are paid from high income only.

1. "The law of taxation in modern state is based on the assumption of an exchange relationship, that is the exchange of a payment of the state for the provision of public services by the state."
2. "The tax is the price which citizen pays to the state to cover his share of the cost the general public services which he will consume."

—4 and 5 Antonio de Viti de Macro, First Principle of Public Finance, pages 112-113.

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8. Individual Payment — Taxes can be imposed on individual's property or any commodity, but they are paid only by individuals.

9. Legal Collection — Tax is a legal collection.

5.2.2 Commercial Revenues

Commercial revenues are those incomes which are received in the form of produced goods by them or cost of services. In other words, that revenue is called commercial revenue which it received by selling goods of public enterprises or services by government. This revenue is called price and it is so because it is received in the form of goods provided by Government and cost of services, payment of postal expenditure, toll tax, interest of money given on debt by government approved corporations, costs paid for the beer of government godowns, costs of electricity distributed by government, payments of rail services etc, are included in commercial revenues. Sometimes, government generates revenue from the production of goods like steel and mineral oil. But, in spite of this, savings or surpluses from commercials enterprises are not considered an important source of revenue in most countries of the world.

Difference between Tax and Price

The main differences between tax and price are as follow:-

1. **Difference in Payment** — Tax is a compulsory contribution which is paid by each individual, who buy goods and services produced by government.
2. **Difference in Benefit** — There is no guarantee of this thing that whether any benefit will be received or not in lieu of that payment, and if benefit is received then what will be the amount and nature of that' but costs are direct payments given in lieu of goods and services and the amounts of their payments depend on amount of services and goods purchased. **Prof. P. E. Taylor** expressed this thinking in these words, "The characteristics which separate revenue of other categories from commercial revenue are : Direct receipts of goods or services in lieu of payment and secondly, adjustment of amount of payment with cost of goods or services broadly."

It is mentionable here that it is not the condition that there can always be a condition of equality between marginal production cost or average and cost of goods produced by government. It can be possible that there can be a state of conflict between general social policy adopted by government enterprises and business policy, such as rates of postal expenditure or about fares of tunnel ways that these rates and fare do not complete the cost of services. In such examples, it is considered desirable that government service for social welfare must be available broadly; if the cost of goods and amount are equal then in that condition it is possible to avoid it. There are some other examples in which for the distribution of total commodities and services, government monopolies are established, and it is so because monopoly benefit can be obtained. The main examples of it are rail service and distribution of electricity in India. French Tobacco monopoly is also a good example and government controlled beer shops also come in this category. It can be possible in these matters that in the establishment of these monopolies, the only objective of government is to get benefit, but have to keep control on distribution of services and commodities by them. **Taylor** said that, "It is possible that monopoly activities for the objective of control in this area is as important as possibilities of benefit."

Government can enter in the area of their sale and production of goods and service for many reasons. It can be possible in some matters that private enterprises are not willing to establish such enterprises because they have very less possibility of benefit, or because the receipt of benefit or results will be obtained by them in long term duration, for example, postal service and construction of dams and canals producing electricity etc. Some other essential services can be taken over by government so that

the rights of consumers of private organizations can be saved, such as city transport service and water supply service. Thirdly, in some other matters, it is considered that the said service can be provided more cheap and best by government in comparison to private individuals, such as production and distribution of electricity. Fourthly, there are some matters in which government can take control of those enterprises which have their basic importance in economy. The production of related goods from such enterprises by government is considered in the favour of whole country. Iron and steel heavy electrical appliances, oil and minerals etc. are some examples of such enterprises. Here, it will be important to mention that the nature of such professional incomes is mainly like those costs which are given to non-governmental producers of goods and services.

5.2.3 Administrative Revenues

Those receipts which are placed in the category of administrative revenue are fees, license, penalty, receipts from mortgaged property and control on property in absence of heir and special assessments. One characteristic of this receipt is that a person gets relaxations that he can pay them or not. Secondly, these receipts give direct benefit to the person or impose fine on him. But, in that state it is not essential that there must be a relation between money paid or cost of benefit and cost of benefit received. There is a special characteristic of administrative income that it is received in the form of by product of administrative works of government. And this is the reason that these are called 'administrative income'.

The short descriptions of these administrative incomes are as follow -

Task Differentiate between tax and cost.

(A) Fees

The definition of **Prof. Seligman** is as follow - "Fee is that amount which is given to pay the cost of each such recurring service provided by government which is mainly in favor of public but which provides such special benefit to fee payer that can be measured." In this way, fee is that payment which is given to government to fulfill the costs of those administrative services which are completed in the favor of whole public but provide special benefit to individuals. Therefore, fee is paid by those individuals only which get special benefit from the services provided by government. For example, if a student wants to get benefit of education by studying in government school, then he must have to pay fees.

Difference between Fees and Price

There are many major differences between fees and price -

1. **Cost Optional, Fees Compulsory -** Costs are always voluntary payment, but fees can be compulsory contribution also, if both are paid in lieu of special services.
2. **Quid Pro Quo -**The element of quid pro quo which is found in tax is also present in fees, but this element lacks in costs.
3. **Professional Operations -**Fees is not the payment for professional service, but it is mere production of administrative operations of government but costs are payments for professional operations by government.

Notes

(B) Licence Fees

The nature of licence fees match with fees up to some extent but there is some difference in it and fees. "Licence fee is paid in that condition when government administration is requested that it must provide permission or privilege instead of providing service of definite kind and more clear." Registration fees of motor vehicles, payment of permit of driving motors and license fee for keeping revolver are such examples. No one can be forced to pay fees in these matters, but any person who wants to use revolver or motorcar then essential fees have to be paid for that. The benefit which a fee payer gets after paying fees, that is in the form of practical facility and law to use motorcar or keeping revolver.

The objective of that fee is sometimes that the implementation or control of activities and operation of different type, for example, responsible individuals must be given licence of revolver for the establishment of law and order. In this way, for controlling the sale of wine, licences are given to run wine shops. In the favor of public-security, motor driver are instructed to get licence for driving and these licences are given only when a person is found fit to drive a vehicle. Therefore, the factor of control which is found in licence fee separates it from fee and tax both.

(C) Special Tax Assessment

In the words of **Prof. Seligman,** "Special assessment is that compulsory contribution which is paid in the ratio of special benefits provided and whose objective is to pay the cost of special reform in property purchased." When government takes the tasks of public reforms like road construction, arrangement of sewer and arrangement of light in roads and streets in its hand, then the whole public get general benefit whose property like shop, house etc. is on that road. As a result of these reforms, the costs and rents of these properties increase. So, it is possible that government may impose some special tax on the people of that area to pay back some part of such expenditure. Such special tax imposition is done in the ratio of increment in the cost of property and it is different from this view.

Characteristics —According to **Seligman** following characteristics are found in the imposition of special tax -

1. It has factor of special purpose.
2. Special benefit received from government service can be measured in it.
3. Special assessments are not progressive, but they are proportional according to the benefits received.
4. They are imposed for special local reforms.

Comparison of Special Assessment with a Tax

Similarities - Following similarities are found in it:-

1. **Objective -** Both of them have element of public purpose, because whether government has been received income in the form of tax or in the form of special assessment' it is spent in the favor of society as well as special individuals as a whole.
2. **Compulsory Contribution -** Special tax decision like tax is a compulsory contribution also. Therefore, the factor of compulsion is found in both of them.

Dissimilarities - Three dissimilarities are found between tax and special tax decision. These are following -

1. **Dissimilarities of Assessment** -The income received in the form of taxes is spent in the fulfillment of general objectives of government, but the income ending in the form of special assessments is spent on special local improvement.

2. **Basis of Assessment -** There can be many basis for imposing tax such as income, expenditure; the cost of property etc. but there is only one base of imposing special assessment, that is benefit. In other words, special assessment is calculated in proportion to the benefits received.
3. **Dissimilarities of Object -** Special assessments are imposed for the objective for getting money for some capital growth plans but taxes are also imposed for financial system of capital growth plans and for the fulfillment of current expenditure.
4. **Dissimilarities of Payment -** Special assessment is different from this point of view to costs because the payment of costs is optional whereas the payment of special assessment is compulsory.

(D) Fines and Penalties

Fines and penalties are not an important source of government revenue. Fine is related to punishment and penalty is given on breaking the law. The objective of both of them is to avoid crimes and to punish for any wrong doing.

(E) Forfeitures

The meaning of bails or bond or forfeitures of property is related to those penalties which are imposed on people by courts so that they failed to appear in court in a definite date or they didn't complete prior contracts. It is clear that the importance of the source of revenue of government is very less.

(F) Escheat

This source of government revenue is the symbol of claim of government on property of such person who died without appointing a successor or without making a will. In this state the amount deposited in bank of that person go in the custody of government. Under escheat, government can take over dissolved educational institutions or unclaimed property of trusts also. It is not an important source of government income.

5.2.4 Gifts and Grants

Gifts are those optional contributions which are given to government for such special tasks by private persons or non-governmental donors such as relief fund at the time of war or defence fund. These contributions are given to freedom fighters, kind hearted and other individuals at war, natural disaster or other such emergency situations. In modern government system, there is no mentionable place for these gifts excluding war time or emergency. It had important place definitely in classical government system but king, Nawab and Jageerdar etc. take gifts from their people. These days the total amount of gifts is so less that it has nominal place in revenue system.

The characteristic of receivings in the form of gifts and grants that are optional in nature and in return of this, it does not hope for any direct benefit. In the state of grants, donor government gives financial help for completing government task at any level. In unitary countries, central government gives grants-in-aid to state governments and state governments give grants-in-aid to local governments so that they can be made capable so that they can do their work successfully or with uniformity or can handle some special tasks such as construction and maintenance of highways. Therefore, these contributions can be unconditional also or can be given to complete some special tasks too.

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Sometimes, government of a country receives contribution from other country which is normally called foreign aid. The good relations must have to be maintained between different plan heads of foreign aid. But, it will be suitable that this categorization must not be touched otherwise answerability towards Parliament which have been received from it that will end. But the government have to do this essentially that there must be such separate system to distribute the expenditure of budget according to plan heads so that the objective of budget making can be completed.

Self-Assessment

State whether the following statements are True or False:

6. Tax is a compulsory contribution by a person to government.
7. Tax doesn't impose personal responsibility on taxpayer.
8. Land revenue is paid only by those individuals which have land.
9. The emotion of sacrifice is not present in the payment of tax.
10. Benefit is given to people by government service.

5.3 Summary

- The popularity and success of government depends on whole public revenue. In the same way practical importance of study of nature and methods of public revenue for both private individuals and government has been increased.
- Taxes are those compulsory payments which are given by taxpayer to government in this hope that they will get direct benefit in lieu of this. According to Bastable, a tax is that compulsory contribution of money with individuals or group of individuals which is given to government tasks in lieu of service.
- Tax is contribution given to state by citizens living in the radius of a country due to residence or property etc, or by citizens that this contribution is given for common use only. It is a compulsory contribution so no person can deny from the payment of tax.
- Payment of tax is not done for the payment of any special service for individual by state and neither paid because the taxpayer got some special benefit by state.
- Tax is the cost given to government by each citizen which he pays in lieu of that part of cost of those public services which are used by him.
- Commercial revenues are those revenues which are received to government as costs of services or goods produced by them.
- Tax is a compulsory contribution which is paid by each such person on which it is imposed but the cost is paid by those individuals who buy goods or services produced by government.
- Tax doesn't give guarantee that benefit will be received in return of that payment and if happens so then what will the amount and nature of that, but costs are direct payments in lieu of goods and services and the amount of those payments depend on amount of services and goods purchased.
- The receipts which are kept in the category of administrative revenue, these are - fee, license, penalty, receipts in forfeitures and escheat etc. and special assessments.
- Special assessment are those compulsory contribution which are paid in proportion to special benefits provided and whose objective is to pay cost of special reform in property seized in view of public favor.

- The feature of receipts in the form of gifts and contributions is that they are of optional in nature and the individual who gives them doesn't hope for any direct benefit.

5.4 Keywords

- Land tax — Tax to be paid for land
- Cost — Expenditure
- Legal — Related to law
- Surplus — In large quantity

5.5 Review Questions

1. How government receipts are decided?
2. Describe briefly about different sources of public revenue.
3. Describe the characteristics of tax.
4. What do you understand by administrative revenue?
5. What is the difference between fee and cost?

Answers: Self Assessment

1. Public	2. Production	3. Consumption
4. Revenue from all other sources	5. Public revenue	6. True
7. False	8. True	9. False
10. True		

5.6 Further Readings

Books

1. Public Finance — *New Royal Book Company.*
2. Indian Public Finance System — *Manjusha Sharma, O.P.Bohra, Ravi Books.*
3. Money Banking: International Trade and Public Finance — *Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance — *Nand Kishore Parsad, ABCD Publication, 2011.*

Notes

Unit-6: Taxation and Its Canons

CONTENTS

Objectives

After studying this unit students will be able to:

- Know about Development related Things of Taxation
- Understand Different Canons of Taxation.

Introduction

In today's time, government expenditure is also increasing with the increment in tasks of government. Today an important problem against each government is that how to get income temperorarily by debt also, but they have to return it after some time. Some government income is received from government enterprises, administrative and judicial tasks and other such sources, but a big part of government income is received from taxation.

6.1 The Development of Taxation

In classical communities, people used to give their optional services to government. But, with the rise of state, for the conduction of government, tax or gifts and income from other enterprises have started receiving classical state hoarded property tax, income tax, commodity tax and collection of heir tax rarely and in small quantities and only in the form of emergency income. There is no need of any detailed system of taxation for brief expenditure for classical states.

If we have to rise tax systems of modern states, such as **Plehn** described, it can be reached more accurately in feudal system instead of classical fiscal system. After the collapse of Rome rulers fulfill their expenses for a long time from their income of own land and from the compulsory contributions for their citizens. At that time the fee of bazaars, fee of security, usage of roads and Ghats, rent of land

etc. which were used as goods and services, were changed in money payment slowly and slowly and when money economy was born by this then these payments changed into taxes.

In the age of handicraft when new goods started to be produced and the enterprises of new types started to be established, so as land tax, production tax, boundary tax, road tax and other taxes were imposed on individuals products. It is mentionable that the change in the form of taxes of classical due amounts is not sudden but in a sequence.

After 1500, when modern state starts to rise then taxation developed an important place. With the increase in government expenditure, it became essential to search for new sources and they were searched in new properties new commercial activities and new goods of consumption, the importance of income tax and heir tax in 19th and 20th century. First World War increased expenditure for the fulfillment of this, the arrangement of taxation was made. Taxes were increased highly in nations engaged in war and new general sale tax and capital levies were imposed. Time after the period of war remained mentionable for the point of view of high taxation. In the end of 1929, long depression ended the usability of some famous taxes and the increment in government expenditure in social aid started the demand of new taxes. But, due to this, taxation didn't prove helpful for total economy in depression. These days, fiscal operations are helpful in the process of reconstruction due to changing economic political and social directions. Therefore, it is necessary to understand that what are the deciding factors of a good tax system, by which that tax system can fulfill the needs of economy of different situations.

Therefore, when this question is discussed in a complete sense and with a broad view, then the question arises that what must be the characteristics in a good tax system? **Firstly**, it must include good taxes because taxes construct tax system. **Adam Smith** was possibly first economist who followed the canons of taxation or rules of taxation. After that, other economist in which **Findlay, Shiraj, Vestable** are main followed the principles of taxation.

Notes After 1500 A.D. modern state rose.

6.2 Adam Smith's Canons of Taxation

Canons of taxation presented by Adam smith's are as follow -

6.2.1 The Canon of Equality

Canon of equality or equity is the first canon presented by **Adam Smith**. According to this, "The citizens of every state must contribute for the aid of government in proportion to their ability, means in proportion of that income whose enjoyment; they receive in security of state. By following this principle, the equality of taxation can be received and by neglecting this, the principle of inequality. Taxation tells clearly that government have to receive accordingly from each citizen for the fulfillment of their expenditure."

Do You Know? The canon of equality is also called the canon of equity.

Criticism - Its meaning is that a person receives income in security of state, the tax must be imposed on it by proportional rates. Although, **Smith** has said at one point that rich people have to pay more

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tax accordingly to their money, its meaning is progressive taxation. But, modern economist are not agree with this statement that proportional taxes are sub equity. Therefore, for implementing the canon of equality, they promoted progressive taxation. In this way, there are differences about the rates of taxation means resources of taxation of Adam Smith, not about the objectives of taxation.

6.2.2 Canon of Certainty

Second canon of Adam Smith is canon of certainty. According to this, "Every individual who pays taxes, must be certain. The time of payment of tax, method of payment and amount of payment etc, must be clear to taxpayer and each other individual. In the matter of tax, the payment which is paid to any individual, its certainty is very important that on the basis of experience of all countries, but my view is that the inequality of large amount is not so dangerous so that the certainty of less amount."

Haidley supported this canon. He says that individual and government both have benefit because a person remains in certainty that what tax they have to pay and at what time. Inversely it helps government to balance its budget.

Criticism — It is said that payment of tax is compulsory. Therefore, it is definite up to some extent. In this state, this canon has no importance. But, this can be true legally. As long as the question of attitude arises, the utility of this canon is no less. For example, tax payers and tax officers know well about the payment of tax, rate of payment and time of payment etc, but disputes arise between them. We have seen many matters in which taxpayers are troubled by tax officers. The fact is that we have to face many practical hurdles while deciding tax so that the income received to Government can be fixed.

6.2.3 Canon of Convenience

The **third** canon of Adam Smith is canon of convenience. According to this canon, "Every tax must be paid at such time and according to such ritual that the payment of this is more convenient for the taxpayer." Its meaning is that the tax must be imposed in such a way and must be imposed at such a time when the taxpayer can pay it more conveniently. For example, the best time to receive land revenue is when the crops is harvested. In the same way, the tax on the rent of house must be received at such a time when taxpayer is more convenient to pay. Direct tax are so comfortable that the person considers them more convenient as cost of goods in comparison to payment of tax. The taxes imposed on goods of comfort in comparison to useful goods are more convenient.

Criticism - Smith has described those taxes also with reasons which can be collected with great convenience. It is tax on goods of luxury. "The taxes imposed on goods of luxury such as consumable goods are very convenient because the forms in which consumers have to pay them are very comfortable." The payment of these taxes is very convenient for consumers because when they buy goods slowly and slowly so as they pay taxes in bit and pieces and they pay when they like, because the purchase of goods at the best convenient depends on their desire.

6.2.4 Canon of Economy

The **fourth** and last canon of **Smith** is canon of economy. According to this, "Every tax must be imposed and received in such a way so that the money which comes by it in the treasure of state, people must have to pay less for it." The objective of this canon is that the administrative cost of tax payment must be kept minimum, means there must be minimum difference between the money coming from the pocket of people and money deposited in treasure. **Adam Smith** also said that the usage of the amount coming from cooperative treasure of tax due by public can be possible in four directions -

(i) **Firstly,** officers are needed in bulk for imposing tax and receiving it; whose salary will be so much that a big part of money will be spent on it received as amount of tax and then

taxpayers have to pay more tax than prior for state works. Therefore, it is essential that the administrative cost for payment of tax must be minimum.

(ii) **Secondly**, taxes can cause hindrance in business of people and can discharge people regarding the subject of starting some such branches of business which can become a source of earning for the people of majority.

(iii) **Thirdly**, some unfortunate people unsuccessfully try to avoid taxes and when penalty is imposed on them on being caught or their property etc. is forfeited then their business is ruined and the benefits received from that business to community by doing this is also ended. In addition to this, a corrupt tax officer becomes a big attraction himself for theft of taxes. Therefore, taxes must not be so heavy that they attract to hide taxes and the taxpayer gets unnecessary burden.

(iv) **Fourthly**, by the frequent visits of tax officers and unnecessary checking of accounts etc. there can be unnecessary burden, pressure etc, on taxpayers. Therefore, tax system must be very simple so that it did not become a cause of difficulty and sensation by tax officers.

Task Explain the canon of convenience.

Self-Assessment

Fill in the blanks:

1. In classical communities, people used to give their ..... services for the aid of government.
2. After the year..... , modern state arose.
3. ..... was the first economist possibly who gave the principle of taxation.
4. ..... supported the canon of convenience.
5. ..... cost of payment of tax must be minimum.

6.3 Criticism of Adam Smith's Canons

It has been found after studying the canons of taxations that all other canons excluding the canon of equality do not prepare a definite base for tax policy. We can say them directions related to administration of tax officers instead of saying them canons.

The canon of equality or equity does not tell any definite measure of tax due to capacity.

Economists have considered the canon of taxation very important while having above mentioned defects in the canons of Adam Smith. According to **Prof. Shirraj, after Adam Smith "No expert could place the rules of taxation so clearly and simply so as Adam Smith did,"**

In the words of **Prof. B.R. Mishra - "The rule of ability is a principle of taxation, there are administrative rules regarding other three taxes."**

6.4 Other Principles of Taxation

The writer like **bastable** has followed some other principles in addition to **Adam Smith**. These principles are as follow -

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6.4.1 Canon of Productivity

Bastable have placed his canons of taxation serial wise. In this series, he has given first place to the canon of productivity. In other words, "Taxation must be productive firstly." It is clear that Bastable has given top most importance to the productivity of tax. The productivity of tax can be achieved in two ways; Firstly, tax must be such that it can yield money for the conduction of government. In the words of Bastable**,** the main objective of revenue system is to get revenue for the expenditure of state, therefore, Finance Minister possibly assumes about its merits from the amount received by tax. Secondly, tax must be such that which doesn't discourage production from both views - short term and long term.

6.4.2 Canon of Elasticity

It is essential to have elasticity in tax system. Bastable has told that canon of elasticity is very important. He said that the taxes must be such that there must be flexibility in them according to the needs of government. The government can need more money for war, development work and other possible reasons for facing feminine or flood. In this state, the speedy increment in the resources of government when its tax system is elastic. For example, taxes imposed on property and goods are not so elastic, so as the income tax.

6.4.3 Canon of Diversity

There has been already big dispute between comparative benefits in single tax system and multiple tax system. One is about imposing tax from time to time by thinkers. For examples, physiocrates suggested about imposing single tax system on economic revenue of land. In the same way, many arguments can be given in regard of imposing single tax system on revenue.

Many defects are found in single tax systems

(i) It is possible that it doesn't provide sufficient revenue,

(ii) It is possible that the distribution of weightage of taxation by it is not satisfactory.

(iii) Its receipt can be difficult and costly.

(iv) There can be more greed to avoid tax.

Inversely, there is very less possibility of finding all these defects in Multiple Taxation**.** Whether arguments are concerned, the balance of scale goes against single tax system. Due to this reason, some writers have given emphasis on diversity of canon.

The meaning of diversity of taxes is that there must be many type of taxes like direct and indirect so that every category of citizens can give their contribution in revenue of state. Multiple tax system is given importance normally in comparison to single tax system. But, multiplicity in taxes is not considered appropriate, because multiplicity goes against the canon of productivity. If the number of taxes is high then its result will be that each tax within them will provide less revenue by which the cost of their collection will increase.

Dalton suggested that we must have to depend on less solid taxes than more. "It will be best that we have to depend on less taxes for a big part of government revenue." **Dalton** thought that if tax is imposed in excessive quantity then the efficiency of administrative system will ruin. Therefore, for maintaining the efficiency of administration it is necessary that the taxes must be imposed for limited time but **Prof. Arthur Young** says that, "If I am told to describe a good tax system is that which exerts

a very low pressure on number of people and high pressure on it." But, it must be in mind that there must not be any regressive effects of such taxes.

In the same way, it is suitable that the weight of taxation must be spread vastly on total economy, so that one part of it doesn't get much damaged. Therefore, it can be said conclusively that a good tax system must be based on the canons of multiple taxation, but by doing so, no damage of any type must be caused by the efforts of productivity.

Do You Know? A good tax system is that which exerts very less pressure on unknown number of people and not a high pressure on any one.

6.4.4 Canon of Simplicity

Tax must be such that the taxpayer can understand it easily. In other words, the nature of tax, its objective, the time of payment, the method of tax - decision and base etc. must be so that every taxpayer can understand it easily and can follow it. It is clear that this canon removes many difficulties of taxpayer but in modern tax system whose nature has become very complex, it is difficult to follow this canon. But, it can be said that administrative efficiency is an important deciding factor of a good tax system and that efficiency can be brought easily when tax system is easy. When there will be tax system then there will not be any difficulty to understand it then the tax pay will not have to face any kind of difficulty or administrative or account related tasks. As a result, the payment of income tax will also become easy for government. Therefore, the efficiency of tax system can be increased by adopting this canon of taxation.

6.4.5 Canon of Expediency

Its meaning is that the government have to impose only those taxes which are suitable and desirable. By this point of view, when the government impose a new tax or increase old taxes then it must be seen that what will be their reaction on taxpayer . Sometime, it seems that some taxes are also desirable and there are some characteristics which are found in a good tax but the government did not consider to impose that tax according to time. For example, a crop income tax is considered very desirable in India but it has not been implemented in that form till today. Therefore, in democratic countries, where the desires of public are respected, this canon has given due importance.

6.4.6 Canon of Co-ordination

In democratic countries, taxes are imposed by centre, state and local governments. Therefore, it is desirable that there must be coordination between taxes imposed by different governments, it is very essential for the benefits of both taxpayer and government, especially in democratic countries.

6.4.7 Canon of Consumer Surplus

According to **Marshal**, while imposing tax, government have to keep two factors in mind-(i) Tax must be imposed on those things by which consumers are getting saving so that the attraction can remain on consumers after imposing tax on those goods (ii) government have to impose tax on those goods only due to the tax from the sacrifice of consumer saving to revenue received to government then there will be maximum welfare. It can be clear easily from the figure given on next page:

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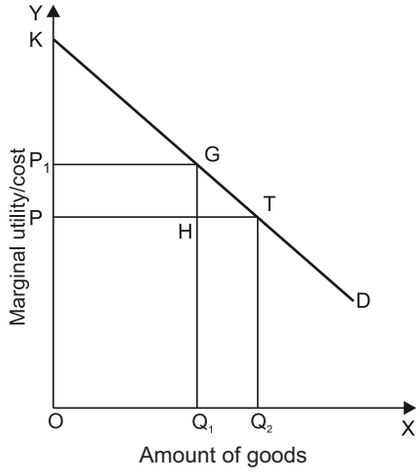

Suppose D is marginal utility curve. Before imposing tax, the taxpayer receives OQ amount OP cost. Suppose the tax would impose on per unit then the cost becomes equalent to amount of tax becomes OQ_1, and amount decreases to OQ. In this state, the income received by tax is $GHPP_1$, which is product of amount of tax and amount of goods. In this state, the revenue of consumer is GP_1PT. Therefore net loss is GHT**.** In brief, we can say that the tax must be imposed in such a way, that there must be minimum loss of consumer saving.

Task Explain the canon of consumer saving by diagram.

Three Aspects of Tax

Describing about the canon of **Adam Smith**, Sir John Stamp has analyzed taxes by three views_

- On the questions of taxation it must be considered on the view of taxpayer.
- They must be considered by the view of government, and
- They must consider from the view of whole community as productive unit or economic society.

In this regard, **Prof. Canon** has rightly said that it is not any fundamental principal but it is the other way for saying this thing that equality and productivity are basic canon of taxation.

Many modern writers, in which **Garnier, Roscher** and **Ricca Salerno** are specially mentionable, has been tried that there must be some rules in regard of characteristics of a good tax system. In this regard, **Prof. Shirraj** has rightly said that, "No intelligent person has not succeeded in keeping in as the form of clear and easy rules of canon of taxation so as Adam Smith. Their fast and huge mind has given a new form to all checking and inventions and its heirs neither improved much in those canons nor they provided high place in those canons."

But, its meaning is not that the writers of later age who contributed in that direction have no importance. **Bastable** and other writers have followed those canons are counted in important deciding factors of a good tax system also. It is sure that whenever it is found that there is direct conflict, between those

canons then in that condition, most important canon used in comparison to less important canon, For example, in comparison to equality and convenience the canon of productivity is considered more important.

In the same way, more amount has to be given more importance than lesser amount or equality of more amount must have to be given more importance than lesser amount. It is main objective of tax system to give success to administration of states, if the equality and convenience of less amount has to be left for productivity then it will not be good to do so.

6.4.8 Characteristics of a Good Tax System

An ideal tax system is that which adopts all type of taxes in it as per need. The discussions which have been given in regard of canons of taxation from **Adam Smith** to modern economist, all these factors construct a good tax system. Some merits and some demerits are possible in every tax system. **Luytes** has to say in this regard, "Neither a tax is completely good nor bad." No system can be defect free practically. Famous philosopher **Admand Burk** has rightly said, "Imposing tax and to keep people happy is as difficult as to get affection and remain intelligent." A tax system can be suitable at any given time and can be unsuitable when time and circumstances change.

What must be the characteristics of a good tax system, it depends on factors like nature of government expenditure, reactions of public about government tasks, economic condition of the country and political condition etc. not only this, the characteristics of a good tax system will be different in comparison to developing economy in developed economy.

According to **Mrs. Hicks,** a good tax system must have following characteristics

- Taxation which is imposed on public must be according to the capability to pay. This capability depends on their income and family condition.
- The objective of tax must be definite for financial systems of public services.
- Tax system must be based on universality. In brief, we can say that a good tax system is that in which tax must be increased slowly and slowly, but on the occasions of emergency situations like war, heavy taxation can be considered practical. In normal condition, heavy taxation which gives un favorable effect on economic lives of people, is not considered desirable. But, we think that we must take shelter from the taxes of both kinds direct and indirect, but the tax system must be such that it does not cause adverse effect on progress.

Notes An ideal tax system is that which includes all type of taxes in it.

A good tax system must have following characteristics _

(1) Taxes are Parts of the Tax System

Taxes of state, it is good if we say taxes of state, must be seen as part of united tax system, otherwise it must be seen as many unrelated taxes, every tax must be viewed from this point of view that what is the appropriate place of them in tax system. Its decision can be taken by comparison between its profit and losses from other taxes of tax system. For example, how a tax can be good or bad separately. But as a part of tax system, its position can be opposite of it, because as a part of tax system, it is possible that it removes the ill effects of other taxes or increases the desirable effects of other taxes. It can

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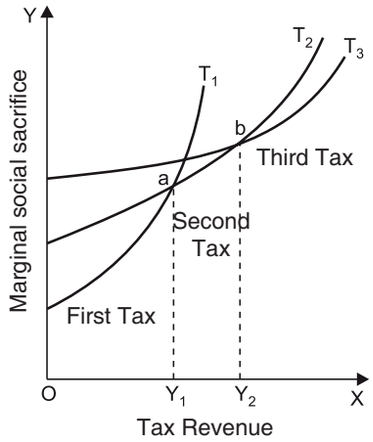
establish essential balance in tax system or it can deform current balance also. In front of leaders and members, this problem remains present that how to form balance, unitary and uniform tax system and the solution of this problem can be done only when in the whole structure of tax system frame of different taxes must be so well knit that it brings symmetry in tax system and its opposition must be less.



In comparison to any single taxation, Government receives more revenue from a complete mixed form. Briefly, it can be said that for gaining more revenue, the government have to provide more widely to the base of tax system. This fact can be clear easily with the help of diagram attached. In diagram, tax revenue has been shown on X-axis and marginal social sacrifice has been shown on Y_ axis. It has been shown here that marginal social sacrifice in first tax is less then second and third tax. Government will seek help from first tax for getting revenue firstly. For getting revenue, there must be increase in amount of tax but after point **a**, the marginal social sacrifice of first tax will be more than second tax. In this state government will seek help from second tax for getting more revenue. For getting more revenue the amount of second tax will be increased but after point **b**, the marginal social sacrifice of second tax will be more than third tax. In this states government will increase third tax for getting more revenue. In this way, it is clear that for getting more revenue to government, we have to locate the wide area of tax.

The usage of income tax and heir taxes are done to put on heavy load on goods used by high income groups. Such taxes can be imposed which can be reached up to in low income groups. Which ever tax is imposed, there selection must be according to organized social policy. In this regard a big problem is that how to find out the ratio of property tax, goods tax, income tax and other taxes in total tax receipts. Therefore, tax system must be such that which can present a suitable solution to all these problems.

(2) Maximum Social Benefit

Taxation must not be considered a source to receive government revenue only but it must also be considered a source for fulfillment of such social objectives such as to redistribution of money and to reduce in equalities of income. Taxation is also considered useful for financial arrangement of government services. It is also used for controlling and regulating consumption, for example, to limit the consumption of wine and other seductive drugs by imposing heavy production tax .By these measures, social welfare of country increases. In this way a good tax system is that which gives guarantee to the country about providing maximum social benefit and does not consider it a source to get only government revenue.

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(3) Just Distribution of Tax Burden

A good tax system is that which guarantees about the matter of just distribution of tax burden. Three main canons are famous in regard of just distribution of tax burden_

(1) **Cost Theory—**Measurement of taxation must be done by cost of service provided by each taxpayer by government.

(2) **Benefit Theory—**Measurement of tax must be done on basic of benefit received from such service to each taxpayer, and

(3) **Ability to Pay Theory—**The decision of taxes must be done according to the ability to give tax by each person.

Cost Theory can not be imposed on those services whose payment is not done as costs, but can be done by other type (which has been told in the definitions of costs and fees of taxes described earlier). The costs in position of taxes can not be determined. Tax is a compulsory contribution which is taken from all citizens and it is not considered that the service provided by government has been used in what quantity by different individuals. In this way, cost theory cannot be implemented practically. Though, the cost of services provided to different taxpayers cannot be determined, therefore, the benefits received from service can not be determined excluding some matters like old-age pension. According to the theory of cost received from service, a pensioner has to return his whole pension to government as a form of taxes. There are some exceptions of this theory it is not clear that they have to be kept according to which rule and for how much time. At last, there is **Ability to pay Theory**, in this regard, this problem arises that how to calculate the ability to pay to each taxpayer, but this theory is considered best in comparison to all others. In reality, a good tax system is that which guarantees about minimum total sacrifice which exerts pressure on rich group more than poor group. Therefore, a good tax system is based on the theory of progression.

(4) Universal Application of Taxes

It is right that every individual have to pay it according to his capability and the people whose capacity to pay tax is uniform and burden of taxes must be same on them. But, in Indian tax system, this merit is not found up to some extent. For example, income tax in India is not imposed widely and uniform because on the revenue received from agricultural, tax is not imposed up to that extent so as it is imposed on revenue of non-agricultural areas. Because of this, dissatisfaction occurs in the mind of people which are engaged in non-agricultural areas. Because of this, there is a fear of developing imbalance in economy. Therefore, a good tax system is that which have to be imposed widely and in uniform manner on taxes on every individuals of society with out any differences.

(5) Revenues should Increase with the Increase in National Income

The structure of tax system must be so that with the increase in national income, its maximum ratio comes to government treasury and government do not have to get it. From this point of view, in comparison to the tax imposed on agriculture revenue or capital cost of land, the amount of land revenue per acre, which was fixed ten years earlier, is less beneficial.

In this way, fixed tax imposed on each shopkeeper is less beneficial in comparison to that tax which is imposed on their net income or total sale .In this way, a good tax system is that under which, with the increase in consumption, production, per person income and national income, the revenue of state also increases.

(6) Co-ordination between Direct and Indirect Taxes

The construction of a good tax system must not be done by mining one type of taxes, but under this, all type of taxes must be imposed in a balanced and coordinated way. Direct and indirect taxes must

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have found a suitable place in tax system so that the result of revenue can be achieved in desirable quantity and there must not be any undesirable effect on production and consumption. Many benefits are those which are found in direct taxes, but not in indirect taxes. But, there is a defect in direct taxes that they are capable to exert tax burden on entire economy. Therefore, to fulfill the increasing expenditure of a modern government, they couldn't give revenue in suitable amount, then one thing is that the payment of indirect tax is suitable for tax payer. Therefore it is suggested that an economy means on distribution of production put any adverse effect, to get maximum government revenue, direct and indirect both types of taxes must be imposed.

In this way, a good tax system must not depend on progressive or only proportional taxes. Both types of taxes have their own merits and demerits. Therefore, for a good tax system, it is essential that the benefits of both type of taxes must be used in favour of economy and whole community.
Therefore, it can be said as a **conclusion** that in a good tax system, emphasis is not given on not only one type of taxes but by a balanced system and with balance of all taxes, taxes are imposed in such a way so that the revenue can be received from whole society and there must not be any adverse effect on economic development of consumption, production and whole country.

(7) Adoptability in Tax Structure

Tax structure must be so that there can be change in situations accordingly. Important objectives like control on economic height, establishment of complete employment, to see the nature of long term motionlessness, control on inflation in emergency etc. can be obtained their tax structures.

(8) Attention on Right of Taxpayers and Their Problems

The construction of good tax system must be done while keeping in mind the rights of taxpayers and their problems. In this regard, following facts are important:

(i) Tax laws related to tax must be more clear and easy so that a common person can also understand them.

(ii) Payment and receipt of taxes must be minimum in nature. There must be such time for tax policy and tax receipt which must be suitable for tax payers.

(iii) The complaints and difficulties of taxpayers must be resolved very quickly by suitable operations. In this regard, active administration can be more helpful. Tax due capacity from loose administration and infamous revenue policies are decreasing.

(9) Effects on Production

A good tax system concerns about speedy economic development of economy. It doesn't become a hindrance in development of business and industry. The structure of a good tax system must be made in such a way which separates additional resources from economy and doesn't create an adverse effect on direct or indirect form on ability to invest and save and work for people. Tax system must be such that which always promotes increase in production means it encourages people to work, to save and to invest. **Dalton** has expressed this thought in very limited words, "Taxation's best method from the economic point of view that it costs best or worst economic effects."

(10) Effects on Distribution

The old objective of taxation was to receive revenue only. In ancient times, the state had to do less works, so taxation was considered a source to receive money only, but this view 'Taxation for revenue

only' is now considered such **Medevial Slogan** which is not imposed in current direction. It is said that in current time, the usage of taxation can be used as a weapon for gaining some social objectives, such as to reduce inequalities of revenue, to bend resources towards productive usages and to increase in social welfare of community. Those taxes which transfer revenue from people towards government which can possibly change non-governmental usage and investment and this situation can prove helpful in raising the level of national income. Therefore, as a conclusion, it can be said that a good tax system is that which guarantees about increment of national income and equal and just distribution of wages.

(11) Size of Revenue and Welfare

Classical economist believe that the last deciding factor of government revenue is the wealth with people of the country and government revenue can only be obtained by imposing tax on that wealth. In this way, they failed to find other sources like business income.

He also thought that non-governmental area receives losses in place of profit from transfer of resources. This principle that the government which imposes minimum tax and has minimum expenses is not good for current time. In modern time, to provide social justice and bring economic equality, The government needs wealth and it is an important source to reduce inequalities of taxation revenue and to bring social justice.

Here, this fact is also mentionable that we mean by the amount of government revenue, nothing else, but, availability of resources. The economic welfare of a country depends on this fact that how to achieve that available resources and how to use them. It is possible that in a country, the abundance of government revenue reduces the amount of economic welfare and it is possible only when the taxation providing huge revenue cast an adverse effect on production and distribution. Inversely, if taxation of a country encourages production and just distribution then the reduction in amount of government revenue, economic welfare can be seen in abundance. Therefore, the huge amount of government revenue casts favorable and mentionable effect only when it is spent intelligently on different aspects of expenditures. In this way, government expenditure is as important as government revenue.

In this way, as a conclusion, we can say that a good tax system is that which not only provide appropriate revenue to government but also reduce inequalities found in distribution of income and wealth and also increases social welfare of the country.

6.4.9 Tax Structure in a Developing Economy

The structure of a tax system in every economy must be such that it can fulfill the basic needs and objectives of an economy. Basic problem of a developed economy like India is to maintain **Economic Stability** so that the state of total employment can be maintained there. Therefore, in developed economy, the structure of tax system must be such that which helps in maintaining economic stability and total employment. But, the tax system of a developed economy is not considered suitable for developing economy. Because the main problem of developing economies is to speed up the speed of economic development. In this state, the structure of tax system in developing economies must be such that which increases the rate of economic progress by increasing rate of capital construction, inflation can be controlled and the inequalities in wealth and distribution of income can be reduced. In this way, it is clear that tax system of developing countries brings dissimilarity in tax system of developed countries.

In regard of tax system of developing countries **Prof. Kindley Berger** has said that there must be two main objectives of tax policies in those countries:-

- Unnecessary consumption increment and control on gambling etc. and
- To increase capital construction

Notes

According to **Meier And Baldwin**, the policy of developing countries can be effective only when it –

- Can increase the capacity of taxation of people
- Can make administration effective and honest, and
- Can establish justice and equality

But in these countries, while constructing a strong tax system, following facts must be kept in mind-

1. **Increase in the Rate of Capital Formation**—The rate of capital construction in developing countries is very low. Therefore, the main objective of taxation in these countries must be to solve these problems. By cutting current consumption by tax policy, saving can be increased. In addition to this, by redistributing resources in different productive and unproductive areas, the rate of capital construction can be increased.

2. **To Accelerate the Economic Development** —The main problem in developing countries is to increase the speed of economic development. In this condition, tax policy must be implemented in such a way so that there can be maximum increment in production of the country. For this, it is necessary to increase the capability of people to work and desire, the capability of saving and investment by taxation. For increase in production, with the help of taxation, resources can be redistributed in different areas.

3. **To Mobilize the Economic Surplus**—In these countries, there is expenditure on unproductive work like additional economic consumption by which capital construction gets damaged. There is expenditure on additional economic consumption. Therefore, tax system must be such that in these countries which can motivate resources to capital construction from personal consumption and can cause continuous growth in the base of capital construction.

4. **To Minimize the Economic Disequalities**—Economic inequalities are found in developing countries. Governments have to do this that it must construct such a tax policy by which economic inequalities of the country reduced. This objective can be fulfilled by taxation. Progressive tax policy can be adopted to bring equality in wealth and revenue means taxes must be imposed by higher rates on rich group and poor group must be given relaxation. In addition to this, the wealth received by taxes from rich group must be spent on services of social benefits.

5. **Control on Inflation**—Taxation is considered best weapon to control inflation. Due to expenditure and inferior management in developing countries, the serious state of inflation is found. In this type of state, on one hand, there is increase in investment and income but on the other hand, the production does not increase with that ratio as a result of this, demand and cost of commodities both increases and the state of inflation occurs. These countries have to seek help of taxation for controlling this. Tax system must be such that which reduces additional purchasing power of people and encourages desirable saving.

6. **Condition According to Ability** - Tax system must be such that in which all people give some contribution to government necessarily and taxation must be received according to capability. By doing this, two benefits will be obtained - firstly, government will receive revenue in high quantity and secondly the distribution of tax-part will be just. In brief, we can say that such type of tax system must be adopted under which all people can pay their taxes according to their ability.

Self-Assessment

Notes

Multiple Choice Questions:

6. Who implemented the canon of taxation?
   (a) Adam Smith (b) Headlay
   (c) Aristotle (d) Bastable
7. What must be the structure of taxation firstly?
   (a) Unproductive (b) Productive
   (c) Consumption (d) All of these
8. Which includes all types of taxes according to needs is called.....?
   (a) Defective Tax System (b) Equitable Tax System
   (c) Ideal Tax System (d) Destructive Tax System

6.5 Summary

- After 1500 A.D., when modern state rose, then slowly and slowly taxation gained an important place. With the increase in government expenditure, it has become necessary to search for new sources of income and they were searched by imposing tax on new business activities and new goods of consumption. In 19th and 20th century, the importance of revenue tax and heir tax increased.
- Depression starting in the end of 1929 and stretching for a long period has ended the utility of some famous taxes and the increment in government expenditure on social aid has produced the demand of new taxes.
- Every citizen of state must contribute for the help of government in ratio of their ability, means in proportion to that income whose pleasure they are getting in security of state. By following this canon, equality of taxation can be achieved and by neglecting it, the canon of inequality of taxation clearly tells that for fulfilling their expenditure, government have to receive tax from every citizen according to their abilities.
- Every tax must be received at such a time and by such a policy so that it must be best suitable for taxpayer to pay it.
- Every tax must be imposed and received in such a way that by it the money which comes in the treasure of state, extra money must extract in less quantity from the pockets of people.
- First of all, taxation must be productive.
- The main objective of revenue system must be to receive income for the expenditure of state, therefore, finance minister assumes about its merits by the amount received from taxes.
- Tax is neither completely good nor completely bad.

6.6 Keywords

- Taxation - To impose tax
- Income Tax - Tax on income

Notes

6.7 Review Questions

1. Highlight the development of taxation.
2. Critically explain the canon of certainty.
3. What is flexible canon?
4. What are the aspects of tax? Write them.
5. "With the increase in national income, government revenue also increases". Upto what extent, are you agree with this statement? Present your views.

Answers : Self Assessment

1. Optional	2. 1500 A.D.	3. Adam Smith	4. Headlay
5. Administrative	6. (a)	7. (b)	8. (c)

6.8 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*

Unit-7: Expediency Theory

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand Evaluation Process Related to Expediency Theory.

Introduction

In Expediency principle, this fact has been given importance that only those taxes can be imposed which can also be received and by which revenue can also be obtained. To impose such type of tax which can also be received, cannot be said nothing except meaningless effort. In this theory, this fact is also hidden that Government needn't have to think about its possible effects to adopt any considerable tax. If suitable amount of tax revenue can be received on being harmful of possible effects then such type of tax must not be acceptable.

7.1 Evaluation of Theory

(1) This theory is definitely based on a bitter truth, but this truth is only negative. On the level of practicability in front of every government and legislative assembly, it is the effort of different group that the burden of taxpayer must be imposed mainly on other groups. For sectarian or vested interests, government is pressurized by all types. Due to this, sometimes government takes decision related to tax due to pressure.

(2) This fact is also mentionable that for any government, it is not considered best to impose tax without viewing about their drawbacks. Governments have to decide to adopt any tax after thinking about various aspects like their administrative defects and cost to receive tax etc. Tax must be imposed in such a way that there must not be any unnecessary difficulty to taxpayers.

(3) Society remains unbenefitted from its many possible benefits on the basis of work-efficiency only for complete construction of a tax system. This fact is considerable that the tax leaves deep effects on economy. In this state, government must try that there must be increase in good-effects and reduction in bad effects. If in the construction of tax system, there must not be any discussions on its possible effects then it can prove harmful for the society.

Notes

Notes The conclusion is that it is not right to impose such tax which cannot be received. We must select the best tax among them by not considering all such 'able' taxes equal by which society and economy can get minimum loss and maximum profit.

Self–Assessment

Fill in the blanks:

1. To impose such tax which cannot be received, can be said a .....effort.
2. This theory is definitely based on bitter truth, but this truth is only .....
3. Society remain un-benefitted from its many possible .....on the basis of work-efficiency only for complete construction of a tax system.
4. We must select from the .....taxes by not considering all able taxes equal.
5. A government must be not impose any .....without not considering its defects.

7.2 Summary

- To impose such a tax which cannot be received is nothing else but a meaningless effort. In this theory, this fact is also hidden in it that government needn't have to consider its possible effects in adopting any considerable tax.
- This theory is definitely based on a bitter truth, but this truth is only negative. On the level of practicability, in front of every government and legislative assembly, it is the effort of different group that the burden of taxpayer must be imposed mainly on other groups.
- This fact is also mentionable that for any government, it is not considered best to impose tax without viewing about their drawbacks.
- Society remains un-benefitted from its many possible benefits on the basis of work-efficiency only for complete construction of a tax system. This fact is considerable that the tax leaves deep effects on economy.

7.3 Keywords

- Expediency - Work-efficiency
- Evaluation - To evaluate

7.4 Review Questions

1. What is importance of Expediency Theory?
2. Evaluate Expediency Theory.

Answers : Self Assessment

Notes

1. Meaningless
2. Negative
3. Benefits
4. Best
5. Tax

7.5 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Finance System—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
3. Money Banking : International Trade and Public Finance—*Nee. Thai : Somshakher, Anmol 2004.*
4. Public Finance—*Nandkishore Parsad, ABD Publication, 2011.*

Notes

Unit-8: Socio-Political Theory

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know Socio-Political Theory
- Understand the Evaluation of Theory

Introduction

Wagner said that existence of private property and presence of heir is only possible by society and security of government. Their existence is not a product of any Divine Order. Therefore, it is the right of government that it must regularize ownership of property and heir by which favours of society can be secured.

8.1 Socio-Political Theory

This theory was given by Germany's **Adolph Wagner**. The basic concept of this theory is that the selection of taxes must be based on their social and political objectives. According to German Philosophy **Wagner** also thought that the solution of a problem must be done on social and political view not on individual view. Society is not a group of individuals only. It has its own existence and there is a logic to maintain it. It is the basic duty of each government that possible steps must be taken to fulfill this objective. Therefore, the objective of tax system is not fulfilling individual needs of member of society, but must be the security of favours of all society. In other words, the construction and implementation of tax policy by Wagner have emphasised on adopting modern favourable philosophy. Specially, Wagner said that we must reduce the inequalities of income through the medium of taxation and for this, small incomes must be tax-free.

Wagner said that existence of private property and presence of heir is possible only by society and security of government. Their existence is not a product of any divine orders. Therefore, it is the right of government that it must regularize ownership of property and heir by which favours of society can

be secured. The thoughts of Wagner were opposed at that time but these thoughts have become base of fiscal policies of modern governments. These days, social and economic problems have become so serious that it has become difficult to even calculate them. No modern government can watch society suffering from problems like a mere spectator. In the solution of these problems, to help the society has become their main duty.

Task Where did Adolph Wagner live?

8.2 Evaluation of Theory

In comparison to expediency theory, the theory of socio-political tax is more acceptable. But, this theory has many drawbacks. In this theory, just equality in allotment of tax burden means morality of tax system is not considered properly. Due to lack of this tax system plays a role of making them capable and complex instead of helping in solving social economic and political problems. According to Royal Commission on Taxation, Canada, the highest objective of any tax system can be just allotment of its burden. Due to lack of this justice, the structure of society can get damaged and it can be destroyed. If tax players believed that tax system lacks justice, then they can think about tax evasion also.

Do You Know? There are many hurdles in adopting justfull system. Firstly, there are not any meaning of 'justfull system'. The second hurdle is that there are conflicts between this objective and other objectives of tax system. In these other objectives include economic development, economic stability, employment-promotion etc. The solution of possible conflict in objectives is possible in ' Tax-due-ability Theory'.

Self–Assessment

State whether the following statements are True or False:

1. Germany's Adolph Wagner gave Socio-Political Theory.
2. According to German Philosophy Wagner told that the solution of any problem must be given by individual view.
3. In comparison to expediency Theory, Socio-Political Theory is more acceptable.

8.3 Summary

- Germany's Adolph Wagner presented Socio-Political Theory. The basic concept of this theory is that the selection of taxes must be based on its social and political objectives.
- The objective of tax system is not to fulfill individual needs of members of society, but have to protect the favours of whole society.

Notes

- No modern government can see the society suffering like a mere spectator in the hands of these problems. To help the society in solving these problems is considered its basic duty.
- In comparison to Expediency Theory, Socio-Political Theory is more acceptable. But, this theory has many defects. In this theory, just equality in allotment of tax burden means morality of tax system is not considered.

8.4 Keywords

- Commission - Authority to perform task
- Taxation - To impose tax

8.5 Review Questions

1. Explain Socio-Political Theory.
2. Evaluate Socio- Political Theory.

Answers: Self Assessment

1. True
2. False
3. True

8.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. Money Making and Public Finance—*Sundaram V, Alpha Public 2009.*
4. Public Finance—*Supreet Singh and Anil K. Gupta, Dominate 2012.*

Notes

Unit-9: Ability to Pay Theory: Objective and Subjective Indices

CONTENTS

Objectives

After studying this unit students will be able to:

- Know about Index of Ability to Pay
- Understand Subjective Approach
- Know about Objective Approach
- Know about Index of Ability in Faculty Theory
- Know about Ability to Pay Theory and Under Developed Countries.

Introduction

Property is considered an important source of revenue in ability to pay theory. The revenue received from it can be from zero to huge amount of wealth. According to subjective approach, Sacrifice Theory is being used to measure ability to pay and in objective approach, Faculty Theory is being used.

Many thinkers believed that Ability to Pay Theory is a universal theory and it can be implemented easily in semi-developed countries.

9.1 Index of Ability to Pay

(A) Property - Ability to pay theory used to be expressed as faculty theory in its primary stage in comparison to revenue. In comparison to revenue, invested money of person and his property was

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considered symbol of his ability to pay tax. The reality is that property is not a main objective of ability to pay, it can be considered an essential supplementary index. It has many reasons:

1. Property is an important source of revenue, but it is not right if we say that all properties provide revenue.
2. The revenue received from property is not received continuously.
3. The revenue is received from property can be of different type from zero to a big amount. It depends on nature state and utility of property. For example, it is possible that the house of a person situated in a village does not provide any tax. But, if the house situated in city then it can become a good source of revenue.
4. The tax which is imposed on property, it is imposed on its capital value. Therefore, if any year, no revenue is received on property then the taxes imposed on that property can not be considered just. In this condition, it can be said that property can not be considered primary or main concern of ability to pay.

Yes, property can be considered supplementary test of ability to tax due to following reasons:

1. **Additional Capacity** - The ownership of property provides its holder such additional capacity to pay tax whose receiving is not from net income.
2. **Ability To Pay -** There is more ability to pay tax in comparison to revenue earned from individual service from revenue received from property. In addition to this, the property received in heir ship provides the ability to pay tax in abundance to its recipients. Its reason is that the revenue which a recipient receives from the properties of unearned types.

(B) Income - The second index of ability to pay is income. Gross income includes factor of cost whereas net income is received by subtracting cost. Therefore, in comparison to some income, net income is considered a good index of measurement of ability to pay. **Adam Smith** was the first thinker who accepted that income is a suitable measurement of ability to pay tax.

(C) Size of the Family - While deciding the ability to pay tax of an individual, the size of the family should also be considered. If the incomes of both are equal than in comparison to small size of family, big size of family have more ability to pay tax. For example, if other things are same then in comparison to married couple having four children, a bachelor or unmarried person has more ability to pay tax.

(D) Consumption - It is also said that consumption that expenditure must be made measurement of ability to pay tax of individual. Sometimes, it is seen that the taxes made on the basis of property and income are not subjudiced. As a result, taxpayer tries to hide them by many ways. Therefore, **Prof. Fisher** and recently **Prof. Caldoor** suggested imposing tax on expenditure. But, the reality is that consumption - standard of ability to pay tax did not get any special place.

How to Measure Ability?

According to Pay Theory, a basic problem occurs that how to measure the ability to pay tax of a person? Two views are adopted for fulfilling this objectives -

(1) Subjective Approach

(2) Objective Approach

According to subjective approach, to measure ability to pay tax, sacrifice theory is being used and in objective approach, faculty theory is used for this task.

9.2 Subjective Approach

Subjective approach is based on psychological or mental activities of taxpayers. In Subjective Approach taxpayer face many type of difficulties like mental imbalance, pain etc. in paying of taxes. In this

way, when taxpayer pays tax then he has to sacrifice. If tax-burden is divided in just way, then each taxpayer has to do same sacrifice.

According to subjective approach, three basis are considered for taxation -

1. Equal Absolute Sacrifice
2. Equal Proportional Sacrifice
3. Equal Marginal Sacrifice or Minimum Aggregate Sacrifice

For implementing this concept, following beliefs are observed -

(i) Cardinal measurement of utility received by revenue is possible.
(ii) With the increase in income, marginal utility decreases.
(iii) No effect occurs on marginal utility of income level. Unit of income of all individuals and marginal utility related to this are same, therefore interpersonal comparison of utility is possible.

9.2.1 Equal Absolute Scarifies

According to this view, taxation can be just only when the amount of sacrifice of each person must be equal. In this regard **Dr. Dalton** said, "The distribution of burden of each factor of taxation must be such a way that directs real burden on all taxpayers must be equal". [1.]

But sacrifice is related to mental direction of a person whose measurement is not possible. Therefore, it is not right to compare the sacrifice of different person. If imposing tax is considered base for revenue then in that condition, three conditions can be imaginal for receiving equal sacrifice -

(i) Speedily Increase In Income - In that condition the utility meeting person with the increment decreases. In that condition, speed of tax will be progressive. In brief, with the increase in income, people will have to pay more tax. Its explanation can be given by diagram easily.

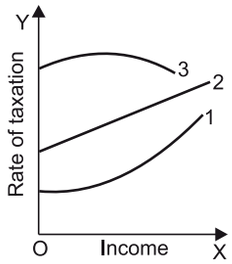

Fig. 1

In fig. 1, income has been measured in X-axis and rate of taxation has been measured in Y-axis. It is clear in figure that the rate of taxes can be made progressive by three types. It has become clear here that as the income increases fastly so as marginal utility decreases. In this way, the sacrifice for all taxpayers will have to pay equal tax on high rate.

Notes Equality in taxation means equality of sacrifice.

1 Dalton, op. cit., page 91.

Notes

Therefore, burden of taxation must be divided in such a way that each taxpayer have to give equal sacrifice. In this way, it is essential for bringing just equality in taxation that individuals living in same conditions must be treated well so that horizontal equity can be achieved and all individual living in un-equal conditions must be treated differently in matter of imposing tax, so that virtual equity can also be achieved.

Therefore, Mill gave this explanation that for bringing equality in real burden of taxation, identical people or person living in identical conditions must be treated in a same way.

(ii) Slow Growth in Income - If there is slow growth in income then marginal utility received by it will be consumed slowly. In this condition, we have to take help by proportional taxation for bringing equality in sacrifice.

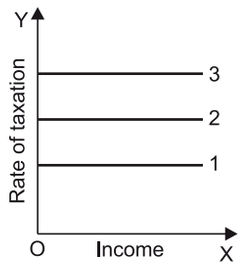

Fig. 2

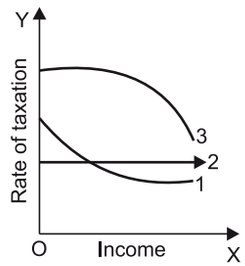

Fig. 3

In this way, the tax will be imposed from equal rate on all person having high and low income. It is clear from fig. 2. It is clear in figure that one of the three rates of taxes can be imposed.

(iii) Reduction of Income - In this state, as a result of fall in income, the marginal utility beginning from marginal units of income. In that condition, regressive taxation is imposed for equal sacrifice, means high income group will pay in high rates. The three rates given in the fig. 3, tax can be imposed on any rate. But, with the increase in income, to correctly measure the reduction of marginal utility of liquid is a very difficult task. As a result, the decision of rates of progression can be adopted freely, which cannot be called just. But, on high levels of income, if the amount of progression is higher than that amount, which is received by curve of marginal utility of liquid of a person, then it can be considered just**. It shows the reduction of rate of marginal utility of liquid with the increase in curve income and it can be stretched on this concept that by it, other social companion of that person remains unaffected".**

9.2.2 Equal Proportional Sacrifice

According to this theory, tax burden does not remain equal on taxpayers but it is definite in ratio of their economic state. In other words, the loss in utility due to imposition of tax must be in ratio of total income of taxpayers. In that condition, high income taxpayer will pay more tax in comparison to low income taxpayers. But the ratio of per sacrifice of income will be equal for all. It can be expressed as following-

$$\frac{\text{Sacrifice by A}}{\text{Income of A}} = \frac{\text{Sacrifice by B}}{\text{Income of B}}$$

In this way, according to this theory, direct real burden on each taxpayer will be in ratio to that economic welfare which he gets from his income. According to this, the construction of progressive tax structure is also possible because marginal utility of liquid decreases with the increase in income

Notes

(in any ratio). In this way, it is clear that in comparison to equal complete sacrifice, taxation imposed according to this theory is more progressive.

9.2.3 Equal Marginal Sacrifice

According to this theory, not the total sacrifice of different taxpayers, but marginal sacrifice (means sacrifice by last unit of wealth of taxpayer) must be equal, so that the whole sacrifice of community will become minimum completely. In the words of **Prof. Pegu, "Such distribution of taxation, which must be according to principle of least aggregate sacrifice, it is possible that it must be equal to marginal sacrifice but not equal to total sacrifice provided by all members"**. The objective of state is to maximize economic welfare and taxation creates disutility for tax payers. Therefore, distribution of taxes must be according to the principle of least aggregate sacrifice, means by taxation, marginal sacrifice provided by each taxpayer must be equal.

According to this principle, decision of tax must be done in such a way that the amount of tax by taxpayer must be minimum and social benefit must be maximum. It is possible only when marginal sacrifice of all taxpayers must be equal. It can be explained by table and figure -

Suppose, there are three taxpayers A,B and C by whom government wants to receive ₹ 8/- as tax. Suppose, one of them has to give rupees then the sacrifice will be as follow -

Units money	Marginal Sacrifice by A	Marginal Sacrifice by B	Marginal Sacrifice by C
1	15	20	42
2	25	30	51
3	38	42	60
4	42	50	65
5	50	58	69

In this condition, sub-marginal sacrifice is 4 unit. Therefore, if government wants to receive ₹ 4/- from A, ₹ 3/- from B, and ₹ 1/- from C.

This condition can be explained easily by fig. 4. Here, the amount of tax and sacrifice by paying tax can be measured on X-axis and Y-axis. AA_1, and BB_1, shows the sacrifice of taxpayer A and B, which tell that whenever the amount of tax increases so as the sacrifice increases. Total sacrifice will be minimum when the marginal sacrifice of A and B, will equal. It will be possible only when government collects amount of tax OQ_1 from A and OQ_2 from B, because in that condition, marginal sacrifice Q_1M of A and marginal sacrifice Q_2N of B are equal.

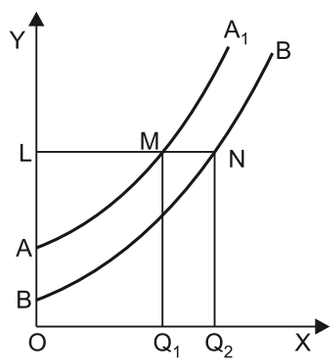

Fig. 4

Notes

For bringing equality, it must be done that taxes must be imposed on wealthy people and small income people from these receipts must be given bounties till that time, unit it doesn't get dead level of equality. But, if state doesn't do so that it doesn't touch low income groups, until high level group doesn't reach upto the level of low income group. Its meaning is that tax must be imposed firstly on that person whose income is maximum and it is so because it has to do minimum sacrifice on imposing tax. In this way, when his income comes to the level of other wealthiest person of society on reduction by taxation, then we have to begin imposing tax on both and it is so because when the sacrifice will be given due to payment of last rupee as tax by both, it will be equal. In this way, while imposing tax on both, they have to bring down the level of third wealthiest person of society. And this process must be continue till that time until the revenue of essential amount doesn't receive.

Task What do you understand by Equal Proportional Sacrifice and Equal Marginal Sacrifice?

Theory of minimum total sacrifice or theory of sub-marginal sacrifice clearly constructs maximum progressive tax structure. Therefore, such as **Prof. Pegu** has said that, **"The excess of all minimum income by taxes must be cut and equal incomes must be left on all inviduals after taxation".** Here, it is essential that low level income group must be kept free from taxation. The income of that minimum level must be such that it can fulfill the expenses done on essential needs of life. While imposing tax on individual, his family size must always be kept on mind.

9.2.4 Musgrave's Utility Model

Equal Absolute sacrifice, Equal Proportional Sacrifice and Equal Marginal Sacrifice can also be presented mathematically each person who sacrifices, its measurement must be done on that power of income which he leaves as tax.[1.] Now, if we assume Y income, T = Amount of tax paid and U = Total utility, then U(Y) = Total Utility Received from Disposable Income after Tax Payment then (subscripts) A and B are indices of different persons. **Three views of subjective sacrifice approach can be presented in mathematical form by following way:**

(a) Equal Absolute Sacrifice -

$$[U(Y) - U(Y\text{-}T)]_A = [U(Y) - U(Y\text{-}T)]_B$$

(b) Equal Proportional Sacrifice -

$$\left[\frac{U(Y) - U(Y - T)}{U(Y)}\right]_A = \left[\frac{U(Y) - U(Y - T)}{U(Y)}\right]_B$$

(c) Equal Marginal Sacrifice -

$$\left[\frac{da(Y - T)}{d(Y - T)}\right]_A = \left[\frac{d(Y - T)}{d(Y - T)}\right]_B$$

1 Musgrave—The Theory of Public Finance. Page 96.

Notes

9.2.5 Diagrammatic Representation

Prof. Musgrave has presented three aspects related to equal sacrifice - equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice by fig. 5.

As shown in figure, income has been measured on Horizontal axis and Total Utility has been measured on Vertical axis on up and down side of D.

In figure, income OZ or DC has been expressed as subsistence income whose utility has not been expressed here. Here CE curve and CF curve show total utility received from income and marginal utility. Now, suppose the income of taxpayer A and taxpayer B increase ZG and ZH from livelihood income. In that condition, taxpayer - A will get Total utility IE and Marginal Utility GF as equivalent. Inversely, taxpayer - B will get Total utility equivalent to KJ and marginal utility equivalent to HL. Now, suppose, Income Tax is imposed equivalent to MG then as a result, the utility of both taxpayers will reduce.

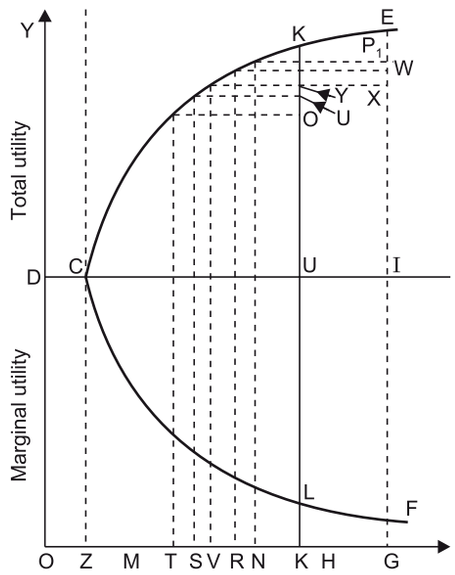

Fig. 5

Under Equal Absolute Sacrifice, taxpayer - A will pay tax equivalent to NG and taxpayer - B will pay tax equivalent to TH means the amount of total tax will equal to MG=NG+TH. If taxpayer- A will pay tax equivalent to NG then the reduction in its total utility will be equal to EP means NG=EP. Inversely, on paying tax TH by taxpayer - B, the reduction in total utility will be equal to KQ means TH=KQ.

Under Equal Proportional Sacrifice, taxpayer- A pays equal to RG and taxpayer- B pays equal to SH and in this way, total payment becomes MG=RG+SH. Where RG=EW and SH=KU. In this way the end of taxpayers will be as follows:

$$\frac{\text{Sacrifice by A}}{\text{Full utility of A}} = \frac{\text{Sacrifice by B}}{\text{Full utility of B}}$$

$$\frac{W}{EI} = \frac{KU}{KJ}$$

Under Equal Marginal Sacrifice, taxpayer -A pays equal to VG and taxpayer-B pays equal to VH and in this way, total sacrifice becomes MG=VG+VH.

Notes

In these conditions, both taxpayers marginal sacrifice will be equal to VN but total sacrifice will be equal to EX+KY which is minimum.

Do You Know? MG=RG+SH, where RG=EW and SH=KU

Under three concepts related to sacrifice of Subjective Approach, the short description of relative tax liability and nature of tax has been given under following table -

Burden on Taxation Under Different Concepts

Concept of sacrifice	Nature of Tax-structure	Burden on Taxation	
		High Income Group	Low Income Group
(a) Equal total sacrifice	Least progressive	Lowest	Highest
(b) Equal Proportional sacrifice	First concept in comparision of most progressive	Highest	Lowest
(c) Equal Marginal sacrifice	Excess speed progressive taxation (Highest rebate for lowest income)	Highest	Lowest

Which Concept is Superior?

The question is which concept is superior in three concepts or views related to Sacrifice Theory?

Adam Smith has said that, "Person should give contribution in proportion to their related ability". In this statement, meaning of word proportion can also be taken from 'Equal Absolute Sacrifice' under some circumstances and it can be taken as ' Equal Proportion Sacrifice' under some other circumstances**.** **J.S.MILL** has supported the theory of Equal Sacrifice but didn't define clearly the concept of 'Equality'. Later when the explanation of these three theories has been given, then there was no agreement in regard of thinkers that which concept would be considered best from these three aspects of Sacrifice Theory. In this way, there wasn't any agreement on this problem that how to decide tax rate schedules under best chosen category of Sacrifice Theory.

It is clear that some classical writers supported Equal Proportional Sacrifice and some supported Equal Total Sacrifice. But, all are agreed with **Pegu** who presented Equal Marginal Sacrifice as 'Last Theory of Taxation'. He supported this theory because least aggregate sacrifice (means equal marginal sacrifice) is also main objective of any modern government and an essential condition to maximize equal welfare of whole community. Therefore, earlier **Edge Worth** and later **Pegu** concluded that **Least aggregate sacrifice is the best theory of tax-distribution,** not because it is sub-judicial, but that so because its birth is for basic utility theory of maximum welfare. Edge Worth has said that, in comparison to Equal Absolute Sacrifice or Equal Proportional Sacrifice, it will be more convenient to implement least sacrifice theory. We only have to need that curve of general marginal utility is going down, not only this, what is the clear rate of bending down of this line? But, by binding on the view of list of unequal utility, this conclusion becomes defective.

Then, fast progressive taxation can cause adverse effect on absolute production of country as a result and on savings. Edge Worth and Prof. Pegu also accepted that fact that fast methods adopted for bringing equality can cause harmful effects on total production. Therefore, they suggested that there must be complete explanation of rule of least aggregate sacrifice from the view of arranging such effects.

1. Limitations of Subjective Approach

Notes

Subjective Approach has been discussed above it, has many limitations also. These are following:

(1) **It is Difficult to Equalize Marginal Sacrifice Practically -** Practically, it will be hard to equalize marginal sacrifice of all taxpayers. Two persons whose income and liabilities are equal then if they pay equal tax even then it is also possible that they couldn't do equal sacrifice. It can be due to difference in their interest and their behaviour.

(2) **Sacrifice and Emotional View -** Sacrifice is an emotional factor, which cannot be measured correctly by government administration. It can be felt only by those persons who is sacrificing. In addition to this, it is difficult to reach such situation in which total sacrifice of all individuals must be equal. Therefore, it is difficult to achieve the good of just administration of tax-burden in community.

(3) **Wrong Base of Income -** That income which is received by wealth and property, compare to income earned from individual service and hard works provides more utility to person. In addition to this, income received from wealth and property, which has been collected from efforts and hard work, provides more utility in comparison to that income which has been received in property received from heir. But, for measuring the capability to pay tax, from the point of view of subjective sacrifice, these facts is not kept in mind. In that condition, it is difficult to guess that how much sacrifice was given to which person.

(4) **It is not Easy to Guess Marginal Utility -** It is not possible that with the increase in income, the rate of reduction of marginal utility will be measured correctly. Its result will be that the decision of progression in rate of taxation will be done randomly. By this, the marginal utility of all will not promote the nature of being equal.

(5) **Wrong Concept of Defective Marginal Utility of Money -** It is clear that when income as ends towards very low level to medium level then the marginal utility of income decreases but when income ascends from medium level to high level then it can not be said that marginal utility decreases with the increase in income.

Lastly, its can be said, as conclusion that Subjective Approach for measuring the capability to pay tax is not only a useful concept, but an ideal also. The area to implement it in practical life is very limited and to achieve its goal is very difficult.

Task Write down the limitations of Subjective Approach.

Self-Assessment

Fill in the blanks:

1. The income received from ..... doesn't receive continuously.
2. The quantitative measurement of ..... received by income is possible.
3. With the increase in income, marginal utility.....
4. The principle of sub-marginal utility constructs the tax structure of maximum ..... .
5. ..... can be presented as equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice.

Notes

9.3 Objective Approach

Many practical difficulties can be faced in implementing sacrifice principles and subjective approach, therefore some writers implemented objective approach for measuring capability to pay tax. **Prof. Salegman** used the word faculty for showing ability in objective approach. In this way, it can be named as faculty theory to pay tax.

Opposite to subjective approach, the principle of production-power keeps in mind the money value of taxable capacity instead of emotions of taxpayers and their sufferings. In this way, similar to Sacrifice Principle, the principle of production power is not based on psychological emotions of taxpayers, but is based on their tax payable capacity which is measured by their income, money and property etc. Therefore, the principle of production power considers many external factors in which income of taxpayer and their property are also included which really affects the taxpaying capacity of a person. For example, this principle not only considers income, but considers this fact also that how that income has been generated (means has been generated by individual labour or hardship or by property) and if it has been generated by property then how that property has gotten, means whether that property had been received in heirship or had been deprieved from individual efforts. The production power of any person depends on economic structure and if the ability to pay tax is measured upon them then the economic structure and the person in that economic structure who receives that benefit must also be considered. In this way, opposite to Subjective Approach of Sacrifice Principles, the Principle of Production power gives importance to social factor.

9.4 Index of Ability in Faculty Theory

According to the Faculty Theory, there are three important factors to measure the ability to pay tax of a person -

(1) The income of taxpayer

(2) The property of taxpayer and

(3) Consumption level or expenditure of taxpayer

(**A) Income -** Income is index of that wealth which is received by any activity by any family under a definite period in which the cost of authorised compactable consumer goods by him is also included. But, as a standard, only net income must be considered. High income individuals must have to pay more tax but the tax must be imposed in lesser quantity in low income individuals or they must have to get exempted. But, income cannot be made the suitable basis of tax ability of income because -

(1) It is possible that tax - ability can be different of two individuals having same income because the responsibility of one may be more from other.

(2) Some persons generate income from hard work; some can generate income from property. In that condition, tax can be imposed with same rate having same income.

(B) Property - Property and the amount of money generated is also considered an important standard of ability to pay tax. Its reason is that the level of standard of living not only affected by income, but also got affected from generated wealth and property. There are following difficulties in making it standard of ability to property -

(1) There can be some individuals in society whose income in very high but they are not capable due to fear of tax. In that condition, if property is considered basis for tax then such people will be free from tax.

(2) The basis of property is also confusing because the income can be received any year from

property and may not be received any year from property. In addition to this, different incomes must be received from equal size property.

(3) If tax is imposed on property then the people will hesitate to collect property and they will be confused.

(4) It is not possible to guess the real value of property.

(5) A general property tax, exerts burden on small property in comparison to big property, therefore, it is of regressive nature.

(C) Consumption Expenditure - Some economists like **Prof. Caldor** believed that true standard of capability to pay tax is neither income nor property. They said that economic welfare of people depends on that income which is spent, means not on income, but depends on expenditure. Generated wealth and property cannot provide satisfaction till that time until they are not used for consumption. Therefore, consumption is an important standard to measure capability to pay tax. This base to measure the ability to taxation of consumption level is not suitable practically, because -

1. High expenditure of a person is not an indicator of this fact that its tax-capability is high. For example, consumption expenditure of a big family comes from small family. But, its meaning is not that the tax-ability of big family is more consumption.
2. If it is considered as the base of tax ability then there will be reduction in its consumption as a result of this work efficiency of people will reduce, there will be bad effect on production.
3. It is right that the utilization of income is for fulfillment of needs (consumption) but income is not only used for consumption only. Saving is an important part of income which is utilized later. If the consumption is considered base for tax-ability then saving and investment will be neglected.

There are many limitations of objective approach also. Therefore, the question of method to measure the ability to pay tax remains unanswered. In reality, the facts is that in classical times, essential property was an important base of taxation. But in current times, income is considered just standard to measure ability to pay tax of individual. The benefit for making income as base is that under this, it is easy to make taxation progressive. But, practically, when the ability to pay tax is decided then we must consider property and consumption expenditure in addition to income. Here, this fact is mentionable that its quantity only is not important in connection to income but the source of income is also important, means we must consider this fact also that income has been earned by individual services or has been received from ownership of property. When the ability to pay tax of a person is decided then some other facts must also be considered such as size of family, regularity of income and that period for which income has been counted. In this way, it is clear that to achieve the objective of just distribution of burden of taxation, it works as supplementary of objective Approach. After the above discussion, it can be said as conclusion that from the view of just distribution of burden of tax, Ability Theory is most suitable theory.

Modern Views—Maximum Welfare Principle

For suitable distribution of taxation, modern economists have preferred welfare principle in place of justice principle. **Prof. Pegu** implemented marginal sacrifice principle keeping welfare in mind. As **Worth** accepted the fact of welfare, he said that welfare will be maximum when marginal utility will be equal. Inversely, **Pegu** has related the minimum group sacrifice principle to maximum welfare. In reality, equality principle and welfare principle of taxation both are defective. Both these views are narrow because they study only the taxation of tax. In reality, while studying the justice in taxes, only tax burden is not taken but those benefits must also be included which are receive from public expenditure. **Dalton, Pegu** and **Musgrave** tried to provide justice by including government services in problem of its distribution and burden of tax because tax and public expenditure both affect welfare.

Notes

The tax lessons welfare and public expenditure increases welfare, **Pegu** and **Delton** implemented two principles related to budget policy -

1. Government have to spend on different heads in such a way so that the marginal utility received from amount from each head must be equal.
2. Public expenditure must be increased till that extent so that the utility produced from this expenditure must not be equal to dissatisfaction produced from taxes imposed by state.

It is suitable for maximize social welfare by budget policy. According to **Musgrave,** "In the allotment of taxes, Minimum Sacrifice Principle matches with decision of public expenditure and both of these are found in general principle of budget".[1.] Musgrave has tried to explain it by fig. 6. Public income has been shown on OX-axis in figure. AB curve shows satisfaction received from society from public expenditure. Inversely, A'B' curve shows marginal social sacrifice produced from taxation. AB curve is reducing down which tells that as the public expenditure increases, so as the amount of benefit and satisfaction of persons decrease. Inversely, A'B' curve shows that with the increase in taxation, the amount of sacrifice of taxpayer increases.

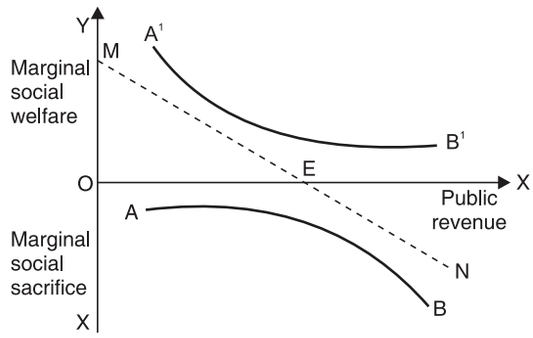

Fig. 6

MN is that net social welfare which is gotten by reducing A'B' from AA^1. E is a point where marginal social sacrifice = marginal social benefit. Maximum social welfare will receive from this point.

9.5 Ability to Pay Theory and Under-developed Countries

Many thinkers believe that Ability to Pay Theory is universal and it can be implemented easily in under developed countries. But, it is not right because Ability to Pay Theory in condition of under-developed countries cannot made according to the structure of taxation, it has following reasons -

(1) **Economic Development** - The main objective of taxation is under-developed countries is to save for economic development. In under-developed countries, Ability to Pay Theory can be implemented when the inequalities present in distribution of income and property have to be reduced. But, the main objective of these countries is economic development. The reduction in inequalities of income is becoming a controversial topic. For fulfilling this subject, Ability to Pay Tax has not proved much helpful. In this regard, the comment of **NUXRE** is appropriate, "The primary objective of public finance in economic development is not to change inter-personal income distribution, but have to increase national income in capital construction".

1 "Minimum sacrifice approach to be the allocation of taxes is matched by a maximum benefit approach to the determination of public expenditure and the two are combined in a general theory of budget planning." **—Musgrave**

(2) **Limited Amount -** The main base of Ability to Pay Theory is income and property whereas their amount is limited in under-developed countries. To implement the tasks of economic development, government have to do financial management that is received by mainly direct taxes. Because of limited amount of income and property, tax is imposed in limited amount only.

(3) **Receipt of Resources -** From the view of Activating Finance and Functional Finance, receipt of resources are considered for development of taxation. If we consider this view then it cannot be basic theory in Ability to Pay Tax in under-developed economy because income of people in under-developed countries is very less more and differences are found in income. It is clear by above discussion that whether the Ability to Pay Theory is just, the situations in under-developed countries cannot be implemented.

Self-Assessment

Multiple Choice Questions:

6. Which view has been adopted to measure ability to pay tax by some writers specially American writers?

   (a) Objective (b) Subjective

   (c) Practical (d) None of these

7. The production power of an individual depends on which structure of society mainly?

   (a) Uneconomical (b) Economical

   (c) Social (d) Cultural

8. As a standard, which income must be considered only?

   (a) Powerful (b) Single

   (c) Weak (d) Dual

9. Which cost of property cannot be calculated?

   (a) Real (b) Unreal

   (c) Public (d) Market

10. According to many thinkers, Ability to Pay Theory is based on which theory?

    (a) Public (b) Universal

    (c) Individual (d) All of these

9.6 Summary

- Liquid burden of taxation must be divided in such a way that each taxpayer have to give equal sacrifice. In this way, it is essential to bring just equality in taxation and individuals living in same conditions must be treated well so that horizontal equity can be achieved and all individual living in unequal conditions must be treated differently in matter of imposing tax, so that vertical equity can also be achieved.
- Such distribution of taxation, which must be according to principle of least aggregate sacrifice, it is possible that it must be equal to marginal sacrifice but not equal to total sacrifice provided by all members.
- Persons should give contribution in proportion to their related ability. In this statement, meaning of word proportion can also be taken from 'Equal Absolute Sacrifice' under some circumstances and it can be taken as 'Equal Proportion Sacrifice' under some other circumstances.

Notes

- Opposite to Subjective Approach, that principle of Production Power keeps in mind the money value of taxable capacity instead of emotions of taxpayers and their sufferings.

9.7 Keywords

- Equity - Fairness
- Contribution - Give jointly with others to common purpose
- Equilibrium - Equality
- Bounties - Generosity

9.8 Review Questions

1. Why property has been called base of payment capability?
2. How the ability to pay tax is measured?
3. What is the difference between Objective Approach and Subjective Approach?
4. Explain equal Absolute Sacrifice.
5. Explain Musgrave's Utility Model Theory.

Answers: Self Assessment

1. Property	2. Utility	3. Decline	4. Progressive
5. Mathematical	6. (a)	7. (b)	8. (c)
9. (a)	10. (b)		

9.9 Further Readings

Books

1. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
2. Indian Public Finance Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking and Public Finance—*Sundaram V., Alpha Pub., 2009.*
4. Money Banking: International Trade and Public Finance—*Nee. Thai. Somshekhar Anmol 2004.*
5. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Unit-10: Impact, Shifting and Incidence of Taxation

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Impact of Tax
- Understand Incidence of Tax
- Know about Shifting of Tax.

Introduction

In general meaning, shifting of tax means to shift tax-burden on others by taxpayer. Shifting of tax is that process in which taxpayer tries to shift burden of his tax-burden on others. In this way, shifting of tax is deeply related to tax-burden, because to avoid tax-burden, shifting is used.

Tax-burden is also called incidence of tax. It is the last result of shifting, it is direct tax-burden.

10.1 Impact of Tax

Impact of tax is on that individual on which government imposes tax and he actually pays tax and the name of that individual is registered with government as taxpayer. For example, if tax is imposed by government on sugar at ₹ 10/- quintal then it is received from producer of sugar. Therefore, impact of tax will be on that producer because government receives tax payment from buyer. In other words, this producer "bears primary burden of payment of tax". According to **Seligman, "The immediate effect of paying tax lies on that person; it is called impact of tax".** When taxpayer could not shift the burden of a special tax on others then the burden of tax lies on impact of tax also. Direct tax are of that nature such as, income tax, property tax etc. affects impact of tax and shifting of tax which are deposited in government to easury.

Notes

10.2 Shifting of Tax

In general meaning, the shifting of tax means to shift the burden of tax to another by taxpayer. **Shifting of tax is that process in which taxpayer tries to put burden of his tax burden on others.** The process of shifting of tax happens when the pressure of tax and burden of tax lie on different individuals, such as sale tax is taken from businessmen firstly then the burden of tax increases on them, but when businessmen tries to put the amount of taxes on consumers by including in value of goods completely or partially then the burden of tax puts on consumers lastly. In this way, on reaching the state from incidence of tax to impact of tax is shifting of tax. In the words of **Prof. Musgrave,** "In classical meaning, the meaning of shifting of tax means that process by which the direct burden of tax is removed to last point from point of pressure by including tax costs". In this way, shifting of tax is directly associated with tax burden because shifting of taxes used to avoid tax burden. When shifting of tax does not happen then the impact of tax and incidence of tax lie on same person.

Types of Shifting of Tax

Shifting of tax is of two types -

(1) Forward Shifting

(2) Backward Shifting

When tax is impose on a product, but he puts it on buyer then it is called **Forward Shifting,** and opposite to it, when the tax is imposed on a producer and the producer transfers this tax to the person supplying raw goods or labours working on production then it is called **backward Shifting.** The types of shifting of tax can be explained by an example. When government imposes consumers tax on sugar and he shifts the burden of consumers tax of sugar on consumers then it will be called **Forward Shifting,** but if the producer of sugar succeeds in shifting tax burden on producers of sugar cane then it is an example of **Backward Shifting,**.

Notes Taxpayer tries to shift tax burden on others, which is called shifting of tax.

Self-Assessment

Fill in the blanks:

1. The burden of tax lies on that person on which government imposes..... .
2. Producer bears initial .....of payment of tax.
3. .....is that process in which taxpayer tries to shift burden of tax on others.
4. Shifting of tax is directly related to ..... .
5. Shifting of tax is not beyond that point, that point is the point of ..... .

10.3 Incidence of a Tax

The burden of tax is also called **Incidence of tax.** in the words of **findail shiraj, " incidence of tax is the last result of shifting of tax, it is direct burden. In this way, in the problem of incidence of tax, it is analysed that who pays tax means on which the burden of tax lies".**

Notes

This definition clears that the burden of tax lies on that person who lastly pays tax means bears the burden of tax lastly. Such as tax is imposed on producer of sugar. If producer succeeds in shifting this tax on consumers by increasing the cost of sugar then the burden of tax bears on consumers because lastly the burden of tax will be on producer of sugar. If the producer does not get success in shifting the burden of tax on consumers then the burden of tax as well as impact of tax will be on producer. Normally, the producer of sugar cannot shift further on burden of tax and have to bear the burden of tax himself.

According to **Prof. Salegman,** "Imposition of burden of tax on last tax payer is called burden of tax".

According to **Phillip E. Taylor**, "The burden of tax lies on that person and cannot be shifted further".

In brief it can be said that incidence of tax includes following three factors -

(i) Incidence of tax is last burden of tax which cannot be shifted any further.

(ii) It is the burden of tax.

(iii) It is direct tax because it is equal to the total amount deposited in government treasure.

10.3.1 Distinction between Impact and Incidence of Taxation

Distinction between impact and incidence of taxation is done on the basis of primary and last burden of taxation. The main points showing distinction in impact and incidence of taxation are as follow -

1. Impact of tax shows primary burden of tax and incidence of tax shows the last burden of tax.
2. Impact of tax lies on that person which pays that amount where as incidence of tax is on that individual which bears that tax burden lastly.
3. The meaning of impact of tax is the payment of amount spent on tax whereas incidence of taxation means direct burden of tax.
4. Incidence of tax is on that person which cannot be shifted on another whereas tax in impact of tax can be shifted on others. In other words, **Impact of tax or burden of tax can be shifted, but incidence cannot be.**
5. To avoid impact of tax is called Tax Evasion which is illegal whereas incidence of tax or to avoid tax burden is totally legal.

10.3.2 Money Burden and Real Burden of Tax

Prof. Delton has differentiated between direct and indirect burden of tax as well as duplicate and original burden of tax. If a producer succeeds increasing costs of goods according to the amount of tax then **The Direct Burden** of tax lies on consumers because they have to pay more value of tax. Sometimes it happens that produce has to pay same taxes to government prior by which producer losses on that amount as interest, it is called **Indirect Burden.** In other words, when taxpayer has to deprieve of more amounts in comparison to amount of tax then it is called indirect burden.

Do You Know? Tax burden is on that person which cannot shift it further.

Notes

Tax Evasion - The income of person is taxable but he pays less payment on taxes by showing false accounts or by showing false sale then it is called tax evasion means taxpayer steals tax in it.

Tax Avoidance - It is a different state from Tax Evasion. When taxpayer saves tax while obeying law then it is called Tax Avoidance. Such as according to modern law in India, if salaried employee saves upto ₹ 80, 000 /- from life insurance, general provident fund etc. then he gets upto 20% of relaxation from income tax (maximum ₹ 16, 000 /-)

Difference between Tax Avoidance and Tax Evasion

There is difference between Tax Evasion and Tax Avoidance. When taxpayer pays the payment of tax but he shifts the burden of tax on others then it is called Tax Avoidance. For example the seller shifts the amount of sale tax on consumers. In Tax Evasion, taxpayer avoids paying tax by presenting false accounts.

There are following differences between Tax avoidance and Tax Evasion -

(i) Tax Avoidance is a natural and scientific process whereas tax evasion is an illegal process which is a punishable offence.

(ii) Government doesn't loss revenue from Tax Avoidance whereas government bears heavy economic loss from Tax Evasion.

(iii) Anyone has to bear the burden of tax in Tax Avoidance whereas payment of taxes is not done in Tax Evasion then there is no question of his burden.

(iv) There is no relation of moral decline from Tax Avoidance whereas Tax Evasion promotes undesirable tasks like dishonesty, corruption etc.

Task What do you mean by Tax Evasion?

Self–Assessment

State whether the following statements are True or False:

6. Burden of tax is called Incidence of tax.
7. Impact of tax shows last burden of tax and incidence of tax shows primary burden of tax.
8. To avoid impact of tax is called Tax Evasion.
9. If a producer succeeds in increasing according to amount of tax to values of goods then the burden of tax lies on producer.
10. When the taxpayer saves tax while following law then it is called Tax Evasion.

10.4 Summary

- Impact of tax is on that individual on which government imposes tax and he actually pays tax and the name of that individual is registered with government as taxpayer.
- The immediate effect of paying tax lies on that person, it is called impact of tax. When taxpayer could not shift the burden of a special tax on others then the burden of tax lies on impact of tax also.

Notes

- In general meaning, the shifting of tax means to shift the burden of tax to another by taxpayer. Shifting of tax is that process in which taxpayer tries to put the burden of his tax on others.
- Incidence of tax is the last result of shifting of tax, it is direct burden. In this way, in the problem of incidence of tax, it is analysed that who pays tax means on which the burden of tax lies.
- Distinction between impact and incidence of taxation is done on the basis of primary and last burden of taxation.
- If a producer succeeds increasing costs of goods according to the amount of tax then the **Direct burden** of tax lies on consumers because he has to pay more value of tax.

10.5 Keywords

- Shifting - Shift on others
- Incidence of Tax - To impose tax

10.6 Review Questions

1. What do you mean by Shifting of Tax?
2. Define Impact of Tax.
3. Explain Incidence of a Tax.
4. What is the difference between Impact of Tax and Incidence of Tax?
5. What do you mean by Monetry and real burden of tax?

Answers: Self Assessment

1. Tax	2. Duplicate	3. Shifting of Tax	4. Burden of Tax
5. Incidence of Tax	6. True	7. False	8. True
9. False	10. True		

10.7 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
3. Indian Public Finance Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V., Alpha Pub., 2009.*

Notes

Unit-11 Theories of Tax Shifting : Concentration and Diffusion Theory

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Theories of Shifting of Taxes or Incidence of Taxes
- Know about the Factors determining Incidence or Shifting of Tax
- Know about Importance of Incidence Problem Study.

Introduction

Naturalist economists of France expounded the Concentration Theory and France's economist **Kennard** and British Scholar **Mansfield** expounded Diffusion Theory. When tax is imposed on a goods or there is an increment in rate of old tax then the taxpayer tries to shift the burden of tax on others. The problem of justice is very important in impact of tax. Therefore, the burden of tax must be distributed equally on different categories of society.

11.1 Theories of Shifting of Taxes or Incidence of Taxes

Three main theories are presented in regard of burden of tax which are as follow -

(1) Concentration Theory - France's naturalist economists implemented this theory. They believed that net product is received from land only therefore the tax must be imposed on land. They thought that whether the tax is imposed on any individual or goods, its last burden will be on land means they concentrate on land lastly. Therefore, government must impose tax only on net income of tax but not by imposing different type of taxes. In this way, the tax process will be easy and collection of tax will be less.

Above mentioned theories have been criticized because economists believed that only land is not producer but other business are also producers therefore taxes must be imposed on other categories of society. The distribution of taxes will be just by it. However, Concentration Theory is defective but it shows this fact that the payment of tax can be done easily which is the base of modern theory of tax burden.

(2) Diffusion Theory - This theory is implemented by France's economist **Canard** and British scholar **Mansfield.** This theory is opposite to concentration Theory and shows that all taxes which must be imposed on any form, they spread in whole society. In other words, Shifting of tax occurs till that time until it spreads in whole society. According to **Canard**, if blood oozes out from a vein of body then the loss in not only that vein but this loss spreads in whole body, in the same way, if government receives tax from a special category then the burden of that tax divides on all other categories from the medium of shifting of tax. In this regard, **Prof. Findley Shiraj** gives the example quoting **Mansfield** that "The tax imposed on any place is like a pebble dropped in a lake which creates such circles in water that one circle gives momentum to another circle and the circumference oscillates from the centre".

The above mentioned theory has been criticized. The belief of this theory is wrong that each tax can be shifted. In reality, direct taxes cannot be shifted. **Secondly**, this theory tells the nature of spreading of tax; it doesn't clear the amount of tax. **Thirdly**, this theory runs parallel to the belief of absolute competition which is unreal and imaginary.

(3) Modern Theory of Incidence - The modern theory of burden of tax is based on analysis of value and cost. This theory assumes that the payment of tax can be given from surplus and it is part of consumption cost of tax goods. **Prof. Dalton** and **Prof. Taylor** believed that the shifting of those taxes is possible which are related to Price Transactions. That's the reason that direct taxes cannot be shifted because they are not related to Price Transactions. As it has been explained in the beginning that the payment of taxes can be done from surplus. If taxpayer doesn't get any surplus then he shifts tax and this shifting will continue till that time until this situation doesn't happen that he starts getting surplus. The costs of goods must be such that by which payment of tax can be given. If the cost of goods doesn't increase after imposing tax then it means that the seller is getting surplus at current cost. Inversely, if payment of tax cannot be given from current cost then the cost of good will be increased.

Notes It depends on the nature of tax, demand of goods and flexibility of requirement, production of goods, cost etc. That how much part of tax can be shifted on other by taxpayer.

11.2 Factors Determining Incidence or Shifting of Tax

If tax is imposed on a goods or there is increment in rate of old taxes then the taxpayer tries to shift the burden of that tax on others. It depends on above factors that upto what extent the burden of tax can be shifted to another Person-

(1) Nature of Tax - It depends on nature of tax that how shifting of tax can be done or not and if it can be done then upto what extent. For example, taxes imposed on net income such as sale tax can be received from consumers. If their adverse effect on sale by including cost of burden of taxes during short term, then the seller doesn't shift the whole burden of tax on consumers.

(2) Amount of Tax - If a tax is imposed in very less quantity by government on a goods then the businessman bears the burden himself and doesn't shift it on consumers. Its reason is that they do not want to annoy their customers. If the amount of tax is more than it is tried to be shifted on consumers by hook or crook.

Notes

(3) Elasticity of Demand - Shifting of tax depends on elasticity of demand. If tax is ought to be imposed on a goods if its demand is elastic then the tax cannot be shifted and businessman bears the burden himself. Its reason is that if the businessman increases the cost of goods then the consumers will reduce the demand of goods and the sale of the seller will reduce and he will get loss. Opposite to it, if the demand of goods is unelastic then seller will shift the burden of tax to consumers easily because consumers will not reduce the amount of goods on increasing the cost of goods. For example, the burden of tax imposed on essential goods can be shifted but the businessman bears the burden of tax on luxuries.

Shifting of tax in different demand elastic directions are shown in figure - 1(A), 1(B), 1(C), 1(D) and 1(E).

(i) When demand curve is completely elastic ($e_d = \infty$)

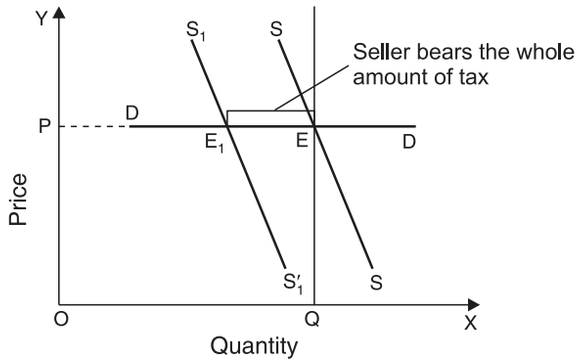

Fig. 1(A)

(ii) When demand curve is completely non-elastic ($e_d = 0$)

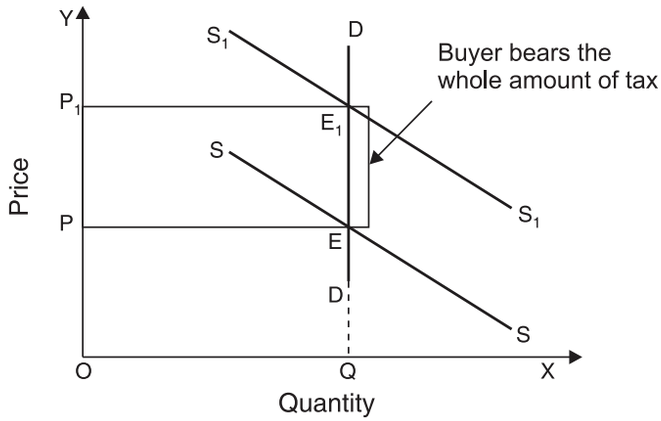

Fig. 1(B)

Notes

(iii) When demand curve is above than a unit (e_d > 1)

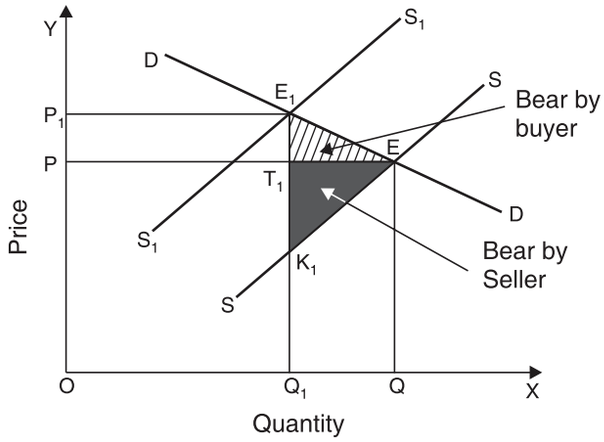

Fig. 1(C)

(iv) When demand curve is less than a unit (e_d < 1)

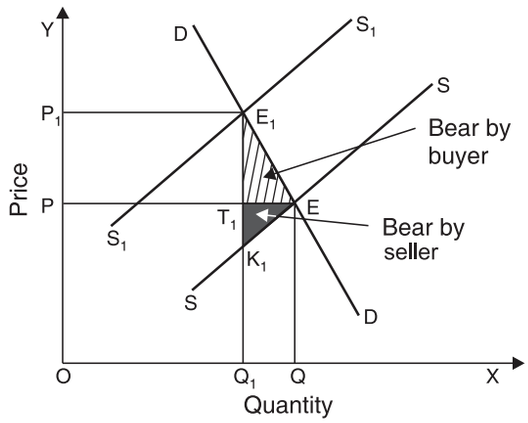

Fig. 1(D)

(v) When demand curve is equal to unit (e_d = 1)

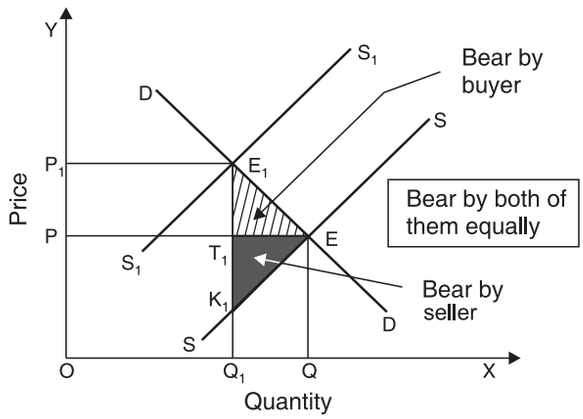

Fig. 1(E)

Notes

Taxation burden position in different curve state of demand

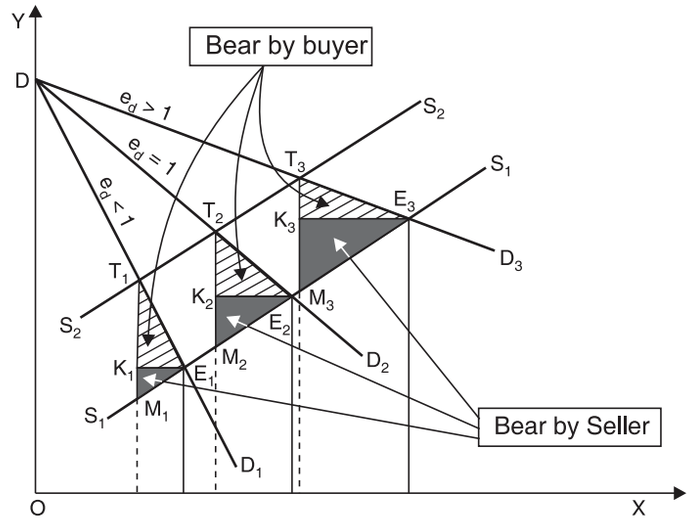

Fig. 2

In above fig. 2, it is clear that as the elasticity of demand increases so as the tax burden increases on seller means as the elasticity of demand will reduce so as the burden of tax will increase on seller and opposite to it, the elasticity of demand increase, the tax-burden will increase on seller.

(4) Elasticity of Supply - Elasticity of supply affects the shifting of tax. If the supply of goods is non-elastic then the burden of tax imposed on it will be on businessman because in that condition, buyer cannot affect the supply by increasing the cost of goods.

Opposite to it, if the supply of goods is elastic then the burden of tax can be shifted on consumers. Its reason is that as a result of tax, with the increase in goods, demand declines, then the businessman reduces the supply of goods because of which the cost doesn't decrease. In this way, the tax is imposed on a goods if the demand of that goods is elastic and supply is non-elastic then tax cannot be shifted. If the demand of goods is non-elastic then the burden of tax can be shifted.

Shifting of tax in different demand elastic directions have been shown in figure 3(A), 3(B), 3(C), 3(D) and 3(E).

(i) When supply curve is completely elastic ($e_s = \infty$)

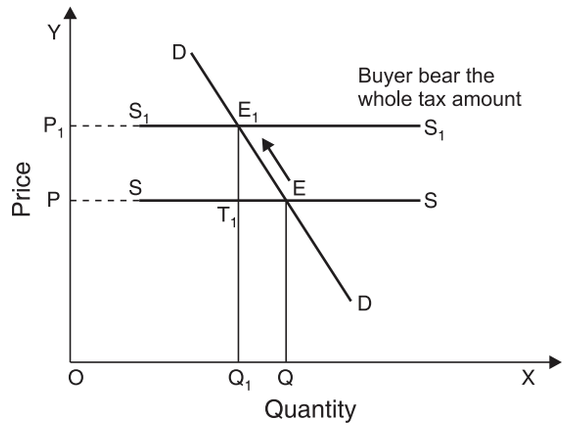

Fig. 3(A)

Notes

(ii) When supply curve is completely non-elastic (e_s = 0)

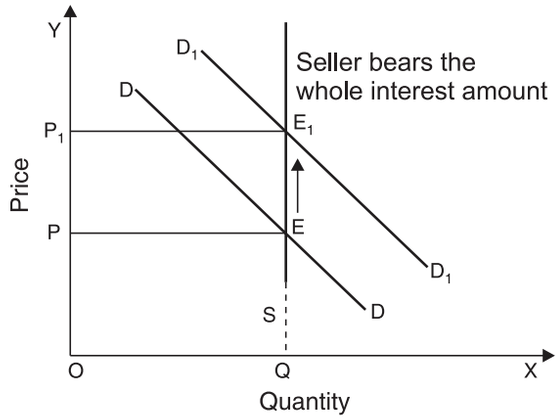

Fig. 3(B)

(iii) When supply curve is more than a unit (e_s > 1)

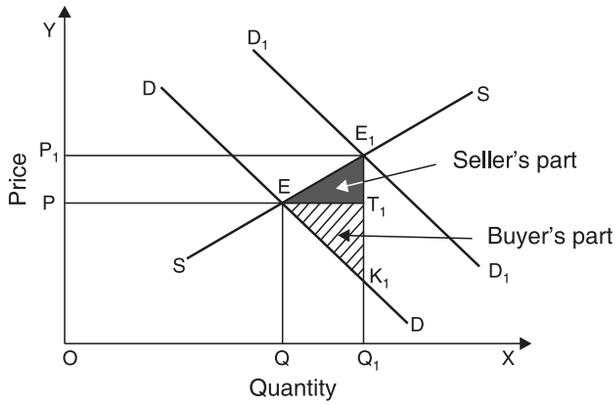

Fig. 3(C)

(iv) When supply curve is less than a unit (e_s < 1)

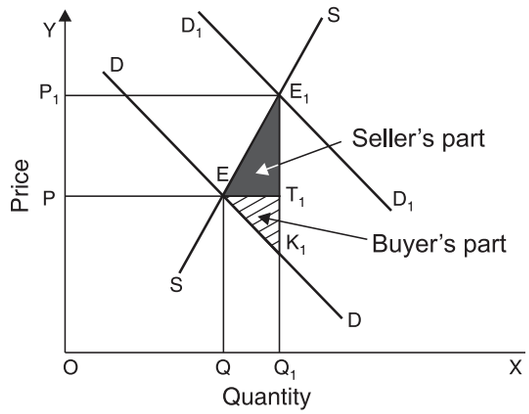

Fig. 3(D)

Notes

(v) When supply curve is equal to unit (e_d = 1)

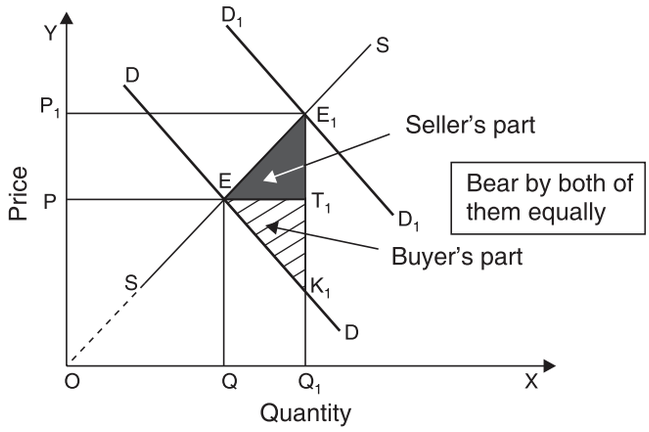

Fig. 3(E)

According to **Prof. Dalton,** "Each consumer tries to shift the burden of tax on seller by reducing their demand whereas producer or seller tries to shift the burden of tax on consumer by reducing the supply of goods. The real distribution of burden of tax is determined by their comparative powers to purchase".

In this way, the burden of tax depends on elasticity of demand and supply of that goods on which tax has been imposed.

(5) Competition in the Market - This fact leaves impact on shifting of tax that what is the part of competition, the amount of tax can be shifted because in that condition the shifting of tax depends on elasticity of goods. In this way, the condition of incomplete competition, the shifting of tax depends on this fact that how are the elasticity of demand and what is the factor of competition. It must be kept in mind that absolute competition and authority are imaginary direction of market. In reality, only incomplete competition exists.

(6) Object of Taxation - Some taxes are imposed to this objective that there shifting must be done such as, direct tax. But, the objective of some taxes on which taxes are imposed, must pay for it and their shifting must not be done such as income tax.

(7) Availability of Substitute - The tax is imposed on that goods if the substitute is available of a goods then the burden of tax cannot be shifted easily. Its reason is that when the producer includes the cost of goods in taxes as a result of that producer uses substitute goods which are cheap. The goods which do not have their substitute goods if tax is imposed on these goods then the seller easily shift the amount of taxes because consumer is forced to buy such goods.

(8) Basis of Taxation - Shifting of taxes can be done on the basis of special taxes mean on the basis of quantity, weight or size. But, it is difficult to shift taxes on the basis of **Advalorem** because when the cost of goods increase, the amount of taxes also increase.

Do You Know? In the condition of absolute competition, the amount of tax can be shifted.

Notes

(9) Laws of Return - On shifting of tax, the rules of origin also affects whose detail is as follow -

(i) **Serialwise Origin Decrease Rule -** If the production of a goods is under origin decreases rule then its meaning is that when production increases, per unit cost increases. Therefore, when the amount of tax is added to income then the cost of goods increases more because of which there is a possibility of reduction in demand of goods. Therefore, the absolute amount of tax cannot be shifted.

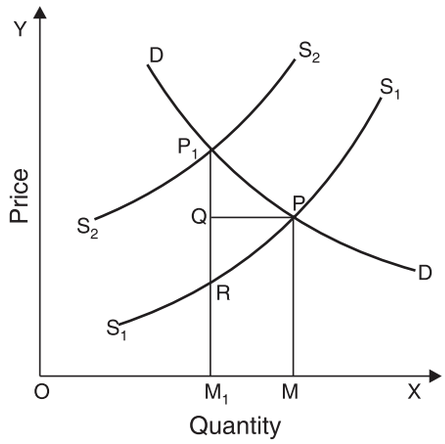

Fig. 4(a)

In fig. 4 (a), S_1S_1 is supply curve before imposing tax whereas S_2S_2 is supply curve after imposing tax. The cost of goods before imposing tax is PM and the cost of goods after imposing tax becomes P_1M_1. Therefore, the increment in cost is equal to P_1Q so the burden of tax on sellers is equal to P_1Q which is lesser than amount P_1R. In other words, the burden of tax on sellers is equal to QR.

(ii) **Serialwise Origin Equity Rule -** If the production of goods is under Origin Equity Rule then there is no effect on cost on increasing or decreasing origin. If amount of tax is added to the cost of goods then its demand doesn't get affected and the whole amount of tax is shifted to consumers by adding it to the cost.

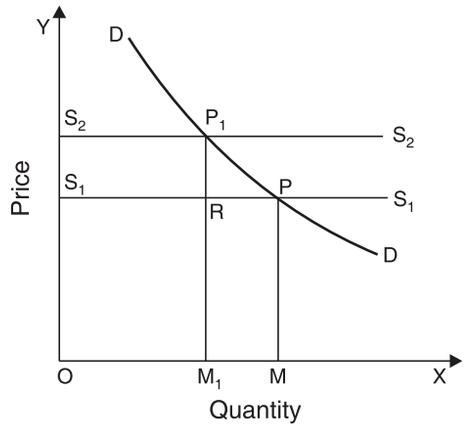

Fig. 4(b)

Notes

In fig. 4 (b), S_1S_1 is supply curve before imposing tax and S_2S_2 is supply tax after imposing. Cost before tax is equal to PM whereas the cost after tax becomes P_1M_1. In this way, the amount of tax is equal to P_1R_1. It is clear from the figure that the whole burden of tax is born by buyers and the seller - bears no part of tax burden.

(iii) **Serialwise Decreasing Cost Rule -** If the production of cost is under Decreasing Cost Rule then as the production increases, per unit cost decreases. If tax is imposed in that condition then the cost of goods may increase more than amount of tax and its burden will be on consumers.

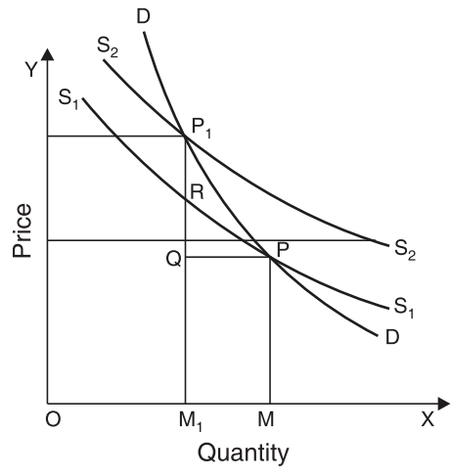

Fig. 4(c)

In fig. 4(c), S_1S_1 is supply curve before imposing tax and S_1S_2 is supply curve after imposing tax. The cost before imposing tax is equal to PM, the amount of tax is equal to P_1R whereas increment in cost is equal to P_1Q. In this way, it is clear from the figure that the cost of tax imposed in Decreasing Cost Rule increases more and buyers have to bear more burden than the amount of tax.

(10) Time Element - If tax is imposed on a seller for a short period temporarily then he bears the burden himself and doesn't shift it on his customers. But, those taxes which are imposed permanently, seller tries to shift them.

(11) Mobility of Capital - If the capital is mobile completely then the producer succeeds in shifting the burden of tax on consumers because he gets profit from it by the capital then the burden of tax cannot be shifted on consumers.

Task Describe the rules of production.

Self-Assessment

Fill in the blanks:

1. Direct taxes cannot be ..... .
2. The modern theory of tax burden and .....is based on analysis of ..... .

3. The costs of goods must be such that by which the amount of tax can be ..... .
4. Shifting of tax depends on .....of goods.
5. Elasticity of supply of goods affect .....of tax burden also.

11.3 Importance of Incidence Problem Study

The problem of justice is very important in taxation therefore the burden of tax in different categories of society can be shifted equally. But, until finance minister doesn't know that the burden of tax lies on which at last, he cannot just distribute the burden of taxes. Taxation is according to the ability to pay tax or not, to know this, problem study of last burden of taxes is very important. Such as if government decides that the tax must be imposed on producers of sugar because they have ability to pay. But, if these producers succeed in shifting the burden of taxes on consumers then the objective of government fails.

According to **Prof. Seligman, "To know the different economic effects of taxes the study of tax burden is essential".** In his words**, "It is only when have ascertained the incidence that we can proceed to discuss the wider effects of a tax".** [1.]

The last burden of tax has its own limitations. Not single units of tables have been developed till now by which we can guess rightly about incidence. But, instead of this, practical and moral both forms of incidence have utility of study, sometimes, it becomes impossible to know incidence due to changes in costs. Then it is not possible to differentiate between incidence and effect of tax. **Prof. Cannan** believed that, "**To know only that incidence lies on a particular person, it is not a proof of this that he is bearing more burden in comparison to others".**

Notes The tax system which will develop without giving attention towards incidence will be away from justice and equality.

11.4 Study of the Incidence of some Important Taxes

(1) Incidence of Tax on Income - Taxes imposes on income includes **income tax, additional benefit tax, municipal tax**, **capital gains** tax etc. Because taxes are imposed on net income, so their burden is on those individuals, on which they are imposed.

If tax is imposed on income received from wages and labour then they cannot be shifted normally. The shifting of this tax can be done on employers but employers will not be ready to give wages and labour that the tax has been imposed on the income of labourers. Its reason is that by imposing income-tax, there is no increment in production of employees.

Till the question of commercial net benefit arises, some economists believe that the cost of goods must be increased and it must be shifted in such a way but this theory doesn't appear appropriate because in reality, incomplete competition is found in market. Businessman cannot increase the cost of goods easily in incomplete competition. In this way, the burden of tax imposed on net benefit lies on businessman. If tax is imposed on income in large quantity then the burden of this tax lies on taxpayer. But, the tax is imposed heavily on production then it costs adverse effect on investment and production.

1 "It is only when have ascertained the incidence that we can proceed to discuss the wider effects of a tax." **—Seligman**

Notes

(2) Incidence of Tax on Property - The study of burden of tax on property for convenience of analysis will be divided on two parts - **firstly**, tax on total property which is used on production and **Secondly,** tax on that property which is used for the direct fulfillment of needs. When tax is imposed on ownership of such property which is used for production, then this tax can be shifted. For example, tax is imposed on building of factory then the producer includes in cost of goods by considering it cost and he gets succeed in shifting it on producers.

When tax is imposed on such property which is used for direct fulfillment by taxpayer, such as house for living, jewellery etc. the shifting of this tax is not possible because cost cannot be used in its shifting.

(3) Incidence of Sales Tax - The tax which is imposed on goods, the seller includes it into the cost of goods and gets success in shifting the amount of tax on consumers it means incidence lies on sellers but the burden of tax lies on consumers, but this statement cannot be generalized because the seller doesn't get success in shifting sale-tax. **Saler gets success in shifting only those goods whose demand is unelastic** and whose shifted goods are available, it is not possible for sale to shift the amount of taxes imposed on them.

That condition, can also be created that the seller by not shifting taxes on consumers (front shifting) shift it backward it means by not increasing the costs of goods, force bulk dealer or producer to sell it on low cost. Sometimes, the burden of sale-tax lies partially on buyer and partially on seller also which is decided by bargaining power of purchasing of consumers and sellers.

(4) Incidence of Taxes on Production - This tax is imposed on production of goods. The study of burden of taxes on production is similar to sale tax. The taxes which are imposed on production, they are included in cost of goods by producers and are shifted on consumers. According to **Philip E. Taylor**, "All taxes imposed on production, are considered production cost by producer or seller but on different production costs on which impact of tax occurs, shifting of taxes is different for them".

According to **Prof. Taylor**, three type of taxes are imposed on production -

(i) Those taxes whose amount are definite and they have no relation with the quantity of production.

(ii) Second type of taxes are those which fluctuate according to the ratio of amount of production. Under this category, we can include Excise Duty. These taxes are similar to variable taxes and they can be included in per unit cost of these goods. But, upto what extent, these taxes can be shifted; this depends on flexibility of supply of goods and elasticity of demand.

(iii) Third type of taxes are those which fluctuate with the change in variable cost but the change in immovable cost.

Prof. Taylor believes in regard of shifting of above mentioned taxes that, **"Any production tax can be shifted or not, it will depend on the power of saving against the shifting. The power of saving reflects in demand and supply of elasticity".**

(5) Incidence of Export and Important Duties - Export and Import duties are direct taxes. Generally, the burden of taxes lies on consumers because importer receives the amount of tax by increasing the cost of exported goods. When government imposes tax with the objective of conservation then the rate of these taxes became high. In that condition, importer could not totally shift tax and partially bears the burden of tax himself.

When government imposes tax **with the objective of receiving revenue** only then the rate of tax is not very high and the burden of such taxes can be shifted on consumers. But, this shifting will be upto which extent, this will depend on available goods, elasticity of demand of consumers etc. in the country.

The burden of **export Duty** lies normally on exporter but according to circumstances the burden of export duties can be distributed between importer, exporter and foreign consumers. If the demand of

exported goods is elastic then the burden of exported tax lies on exporter. Opposite to it, if the demand of exported goods is inelastic and more active then the burden of imported tax will be on consumers of the country doing export. If the importer country has the right on goods and many countries in the world are their customers then the burden of import tax lies fully on exporter country.

(6) Incidence of Professional Tax - Tax is imposed on progressive basis on businessman of different types randomly by government means when the income increases with the business, the amount of business tax is also increased. This tax is like direct tax whose last burden lies on taxpayer. But, this tax can be shifted in some circumstances, such as if tax is imposed on the profession of a doctor then he can shift this tax on the fee received from patients but business tax on a businessman can not be shifted. In this way, the shifting of business tax depends on the nature of business.

Self-Assessment

State whether the following statements are True or False:

6. Taxes imposed on income include income tax, additional benefit tax, municipal tax, capital benefit tax etc.
7. If tax is imposed on income in heavy quantity, then its tax burden doesn't lie on taxpayer.
8. When tax is imposed in bulk on production then it leaves adverse effect on investment and production.
9. Import and Export Duties are direct taxes.
10. Generally, the burden of exported taxes lies on producers.

11.5 Summary

- Shifting of tax occurs till that time until it spreads in whole society. According to **Canard,** if blood oozes out from a vein of body then the loss is not on only that vein but this loss spreads in whole body, in the same way, if government receives tax from a special category then the burden of that tax divides on all other categories from the medium of shifting of tax.
- The modern theory of burden of tax is based on analysis of value and cost. This theory assumes that the payment of tax can be given from surplus and it is part of consumption cost of tax goods.
- It depends on the nature of tax, demand of goods and elasticity of requirement, production of goods, cost etc. that how much part of tax can be shifted by taxpayer on others.
- If tax is imposed on a goods or there is increment in the rate of old taxes then the taxpayer tries to shift the burden of that tax on others.
- Shifting of tax depends on elasticity of demand. If tax is ought to be imposed on a goods if its demand is elastic then the tax cannot be shifted and businessman bears the burden himself.
- Each consumer tries to shift the burden of tax on seller by reducing the supply of goods. The real distribution of burden of tax is determined by their comparative powers to purchase.
- To know various economic effects of taxes, the study of tax burden is essential.
- To know only that incidence lies on a particular person, it is not a proof of this, that he is bearing more burdens in comparison to others.
- Any production tax can be shifted or not, it will depend on the power of saving against the shifting. The power of saving reflects in demand and supply of elasticity.

Notes

11.6 Keywords

- Shifting - Roll down
- Elasticity - Flexibility

11.7 Review Questions

1. Explain serialwise laws of origin of equality.
2. Explain with examples serialwise laws of decrease of destruction.
3. Briefly explain the laws of origin.
4. What do you understand by the elasticity of demand of goods?
5. Briefly explain the theories of incidence.

Answers: Self Assessment

1. Shifting	2. Cost	3. Payment	4. Elasticity
5. Shifting	6. True	7. False	8. True
9. True	10. False		

11.8 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking: International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Unit-12: Diffusion Theory

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know about Diffusion Theory
- Import Knowledge about the Errors of Diffusion Theory.

Introduction

There is a belief about Diffusion Theory that there is such a market system in economy which is competitive in nature and because of it, production resources can go easily and fastly from one employment system to another employment system.

12.1 Diffusion Theory

According to this theory, the last arrangement of taxes shatters in such a way on activities of total economy, goods and income that no definite form can be decided of its allotment. According to this belief, the existence of income residue is not only in agriculture, but also in heads of earned income from different sources. Due to this, as a result of total dependence on economic activities of different categories, taxation changes due to fluctuation in costs. Taxation by this process spreads in such a way that its last structure cannot be decided.

The hidden belief in this theory is that there is a such market system in economy which is competitive in nature and due to this, production resources can go easily and fastly from one employment system to another employment system.

Notes If these conditions are fulfilled then there is no difference from this fact that where is primary impact of taxes. Its effect spreads in whole economy in each direction.

Notes

Limitations

On observing this theory carefully, its many limitations are as follow -

1. If it is supposed that the last structure of taxes spreads in whole economy, then its meaning is not that government does not consider this fact while imposing tax that where it is imposing tax. Its reason is that the vast effect of taxation can take any form in addition to their last structure and the structure of these effects depend on this fact that when, where and how to impose tax, what are their rates and other related merits etc.
2. This theory is based on impractical beliefs. Total competition is not seen in market economy and in present time, unitary factor has become its essential factors. Therefore, it is not necessary that the structure of each special tax shatters. Opposite to it, in many matters, a pattern is found on fixing of taxation.
3. **Prof. Dalton** believed that the conclusion obtained by this theory, to obtain the knowledge of obtaining the last structure of taxes and discourage information of a suitable tax policy. But, the formation of tax policy is such a task which must be done smoothly despite of all type of hurdles.

Self–Assessment

Fill in the blanks:

1. The centralization of taxation is not ..... .
2. Taxation spreads in whole economy in such a way that its last formation cannot be.....
3. The vast effect of taxation takes many forms in addition to its last..... .

12.2 Summary

- According to Diffusion Theory, the last arrangement of taxes shatters in such a way on activities of total economy, goods and income that no definite form can be decided for its allotment.
- There is a belief about Diffusion Theory that there is such a market system in economy which is competitive in nature and because of it, production resources can go easily and fastly from one employment system to another employment system.
- If it is supposed that the last structure of taxes spreads in whole economy then its meaning is not that government does not consider this fact while imposing tax that where it is imposing tax.
- The formation of tax policy is such a task which must be done smoothly despite of all type of hurdles.

12.3 Keywords

- Diffusion - Spread
- Limitation - Shortage

12.4 Review Questions

1. Explain Diffusion Theory.
2. What are the limitations of Diffusion theory?

Answers: Self Assessment

Notes

1. compulsory
2. decided
3. incidence

12.5 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking ; International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Notes

Unit-13: Classification and Choice of Taxes: Direct and Indirect, VAT

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand Direct and Indirect Taxes
- Collect Information Related to the Comparative Study
- Understand Proportional, Progressive and Regressive Taxes
- Know Specific Tax and Ad-Valorem Tax
- Know Single Tax System and Multiple Tax System.

Introduction

Taxes can be divided into four main sections according to their structure, nature and the way of putting them.

(i) Direct and Indirect Tax.

(ii) Proportional, Progressive and Regressive Taxes.

(iii) Single Tax System and Multiple Tax System.

(iv) Specific Tax and Ad valorem Tax.

Its detail explanation is like this —

13.1 Direct and Indirect Taxes

Notes

Many economists defined Direct and Indirect Taxes on the basis of impact of Taxation and Incidence of Taxation. According to the Impact and Incidence the person who is effecting from the starting pressure is called the Impact of Taxation or the Impact of Tax. But sometimes, the person becomes successful to avoid the pressure of tax on others from he is going through, it means the last payment of tax is given by any other person which is called Incidence of Tax.

Normally, the **Direct Taxes** are those Taxes paid in one time and these taxes are payable to those person getting there taxes it means they can't avoid its pressure on others. On the other side in Indirect Taxes the taxes are paid by producer but after that they moved to manufacturers. Through this only one person is getting the pressure of Impact of Taxation and Incidence of Taxation, like Income Tax but in Indirect Taxes the pressure of taxes are on different people like **sale tax**.

According to **Dalton**, "Direct tax is a tax paid by that particular person to whom our law told him to pay, but the Indirect Taxes not paid by that particular person but paid by any other person completely or on installments on behalf of any compromise.

Notes In the view of Dalton shifting of direct tax is not possible but the shifting of indirect tax is possible.

According to **Prof. J.S. Mill,** "Direct Tax is that tax asked to the person who is looking capable of paying but the Indirect Taxes asked to those persons can able to put their burden on others and can fulfill their losses.

Above said definition is according to the desire of government but this cannot be possible in the matter of taxes.

According to **Bastable**, "Direct Taxes are those taxes getting on the permanent or regular occasions and the Indirect Taxes are getting on special incidents those are rarely present". But the difference of Bastable is not scientific about Direct or Indirect Taxes.

According to **Armitage Smith**, "The meaning of Direct Tax is that it is not possible to transfer or shift it but getting from that person only who can afford its pressure. Income Tax is a good example of Direct Tax. Indirect Taxes are taxes on things and services can be shifted to other persons.

This is clear by the above statement that the pressure of Direct Tax is lastly on that person only who pays this in government; it means it is not possible to shift the pressure of Direct tax.

In words of **Phindley Shiraj,** "Direct Taxes are the taxes on the person, property and salary in immediate and paid directly to the government by tax payers like, Income tax, Property tax, Death tax etc. Instead of these other taxes are in the group of Indirect taxes effects their income by the manufacturers on the use of things and their enjoyment, like tax on business, entertainment tax etc.

Prof. D. Marco has given a difference between Direct and Indirect taxes on the basis of salary weight. According to **Prof. Marco** it is must to know anybody's salary count before putting exact tax on any person. Marco said, "If we count a person's salary in a direct way, we say that the tax is Direct tax. But is not possible to count it directly always or many things never count in salary. So, the salary never counts directly then this salary counts when the manufacturer spends it and the tax on that is called Indirect tax.

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13.1.1 Merits of Direct Taxes

These are merits of Direct taxes -

1. **Equity and Justice -** It is possible to follow rules of justice in Direct taxes because there is a type of arrangement that each civilian could pay the tax according to their ability. The structure of Direct Taxes are progressive, it means rich people pay more taxes and poor pays less or left free for taxes to this section. By this Direct tax is according to ability of taxation and this obeys the rules of justice in taxes.
2. **Elastic** - Direct tax is depend on a person's property and salary. When there is production and increase in country then there is also increase in the property and salary of people and because of Taxes there is salary increase also. These taxes are elastic in this manner because government can increase their sources of income by a little bit increase in these taxes.
3. **Certainty** - Direct taxes also satisfy the policy of certainty in taxes because government know that how much money he is getting in these taxes and tax payers also know that how much amount they have to pay in tax. Certainty helps the government to make budget.
4. **Economy -** To collect taxes administration has to spend money but in the comparison of Indirect taxes there is less amount use in the collection of Direct taxes- because government collect more than that at the time of collection. In many matters these taxes easily collect at the time of salary and the collect tax amount completely send to the government-fund.
5. **Productivity** - Government collect a big amount from these Direct Taxes. By the study of different countries its clear that government is collecting a big amount from Direct Taxes.
6. **Civic Consciousness -** Direct Taxes have a merit of people awareness in it. Tax payer knows that he is paying tax to the government, their interest is in that how the government is spending this amount. By this, a person is aware of his civic duties and rights.

13.1.2 Demerits of Direct Taxes

By the above mentioned merits there are some demerits also, these are -

1. **Tax Evasion -** A big demerit of Direct Tax is there are more chances of tax evasion in it. Normally, people show false calculation not to pay tax or they do tax evasion, it means they pay less of their due taxes. Many of the people save them as the governments have no fixed information about their actual income so they don't pay the taxes.
2. **Inconvenient** - Direct taxes are inconvenient by this manner because account payers have to maintain a long account according to government rules. In case of a small mistakes account payers have to face many problems. Account payers have to face mental stress as they have to pay a big amount of tax in one time.
3. **Adverse Effect on Saving and Investment -** If there is high rates of taxes then it effects adverse on saving and investment. Normally, the pressure of direct taxes are on those sections only those can save and adverse.
4. **Limited Scope -** As direct taxes are on property and salary, their scope is limited and the sections of poor and low income people are out of their range. In other words, it depends on direct taxes only it is possible to reach weak section. By this direct tax have a limited scope.
5. **Arbitrary Rates of Taxes -** The rates of direct taxes fixed by the government, they don't have any scientific reason. Below a fixed amount of property and income people have a convenience in taxes and on more earning people there is getting taxes according to Arbitrary rates. By this rich people feel excited.

Notes

6. **Mental Worry -** A person knows very well about paying his direct taxes but in indirect taxes a person has no idea about the pressure of taxes directly. By this manner, direct taxes give pain and mental worry to the people.

13.1.3 Merits of Indirect Taxes

We have already explained that indirect taxes are on things and services and the pressure of these taxes lastly shifted to the Consumers.

Merits of Indirect Taxes are -

1. **Wide Coverage -** Today, there is a view that every person should pay the tax to the state according to their capability. By this manner, the merit of direct tax is that all the people have its pressure because its base is wide and all the rich and poor people use things. So, everybody have to pay tax.
2. **Tax Evasion Impossible -** Tax evasion of indirect tax is not possible. The reason is this tax first collect from the producers and businessman's and then this tax includes in the cost of things and collect from the consumers. But sometimes businessman show false account and do tax evasion.
3. **Convenient -** The merit of this tax is that is convenient for tax payers because these taxes have to pay in installments and not in one big amount, it means according to the use of things. As these taxes are included in the cost of things so tax payers or manufacturers don't feel its pressure.
4. **Leading to Social Welfare -** By these taxes, there is an increase in social welfare because those things which effects social welfare by their use, it is possible to increase the rate of tax and the excitement of the use of that thing. This is the reason why there is high tax on wine, cigarette and the other narcotic drugs.
5. **Elastic -** Indirect taxes are elastic, it means government can increase their fund by increase in the rate of tax. The things that is non elastic it is easy to increase tax rate on it. But it is important to look that by the increase in these things there is more pressure on poor manufacturers.
6. **Popular -** Sometimes people don't feel any pain to pay the taxes as in indirect taxes they don't know about it.

Do You Know? There is high tax on narcotic drugs.

13.1.4 Demerits of Indirect Taxes

There are merits of Indirect taxes but there are demerits also, these are following -

1. **Lack of Justice -** A big demerit of indirect tax is it's not full of justice because these taxes are same on rich and poor people. So it's clear that there is more pressure on poor people.
2. **Uncertain -** Government can easily estimate that how much money will be collected because it depends on the flexibility of consumers demand. Consumers never know how much amount they have to pay for indirect taxes because there is always increase in the rate of it sale person also collect Arbitrary rates on things.
3. **Regressive -** Direct taxes are paid by the rich and poor people equally. As a result poor people get more pressure of these taxes; it means Direct taxes are regressive to nature.

Notes

4. **Lack of Economy** - Government spend a big amount on an administration department to collect these indirect taxes. There is corruption also in these taxes and government never collects actual income.
5. **Adverse Effect on Consumption and Production** - As a result of Indirect taxes there is an increase in things rate and the use of things became less. Because of less there is less demand of things and less production.
6. **Lack of Civic Consciousness** - In direct taxes, manufacturers never know that they are paying taxes and how much amount they are paying. The reason of this is taxes are included in cost. So, there is a lack of civic consciousness in tax payers and they never take interest in this matter that how the government is using this amount of their tax amount.
7. **Tax Evasion -** Although we have seen in the merits of indirect taxes that tax evasion is not possible but this is not true completely. This is right that consumers can never save tax but normally sellers show false accounts and show less sale amount and by this they became successful in indirect tax evasion.
8. **Savings Discouraged** - Indirect tax includes in costs so people have to spend more on their uses. In this way, there are less chances of saving for people as they are spending more on their needs.

Self-Assessment

Fill in the blanks:

1. According to the impact and incidents the person who is effecting from the starting pressure is called ..... .
2. In direct taxes ..... principles can be followed.
3. Direct taxes depend upon a person's ..... and income.
4. ..... taxes collects on things and services.
5. A big demerit of indirect tax is that this is not ..... .

13.2 Direct and Indirect Tax: A Comparisonative Explanation

By giving the comparison between direct and indirect taxes **Prof. D. Marco** has given his view that both the taxes are similar to one another. According to **Prof. D. Marco** it is not possible to have a complete calculation of rich people's actual income. This is clear that the pressure of direct taxes are on those people only who's calculation of income is possible like, workers who are getting income. On the opposite side, there are people getting more income but it is not possible to count their income, like, doctor, lawyer etc. So, these people easily save them from tax. By this, the calculation of these taxes become imbalance. But by indirect taxes, it is possible to remove this imbalance. Those people So counting of income cannot possible and they save their self by paying taxes, they have left their income, that income they spend to buy goods. On this income indirect tax can be possible. By this, the pressure of taxes can be divided equally on different sections. So, indirect taxes are supplementary to direct taxes because it can be put on that income which does not include in direct income.

By a different manner, indirect taxes are similar to one another. There are regular changes in a person's income. But in direct taxes, it is not possible to count and people save them from direct taxes. But the increase of a person's income, there is increase in use also. In indirect taxes, more amount of taxes have to pay.

According to **Prof. D. Marco.** In many ways, direct taxes are similar to indirect taxes first Indirect taxes are not possible on those things used by the manufacturers themselves, like farming. In these

matters direct taxes are needed. **Second**, indirect taxes are not possible on each type of things and services. So, it is not enough to have indirect tax on a person, but direct tax should also be put. **Third**, like direct taxes, it is possible to tax evasion of indirect taxes. So, by this manner not only the right income of a person can be find out by indirect taxes and in a supplementary manner indirect taxes should be taken.

Task Differentiate between direct and indirect taxes.

13.3 Proportional, Progressive and Regressive Taxes

In taxation, justice and pressure of taxes can be divided into four parts.

13.3.1 Proportional Taxation

According to **Dalton**, "In proportional taxation all the tax payers pay their taxes according to the equal proportion of this income.

According to **Philip E. Taylor**, "The table of the rate of proportion taxation have same rate of tax even there is change in the base of tax.

Table of Proportional Taxation

Income (₹)	Tax (%)	Amount of Tax (₹)
40,000	20	8,000
50,000	20	10,000
60,000	20	12,000
70,000	20	14,000

Above table can be shown according to following illustration -

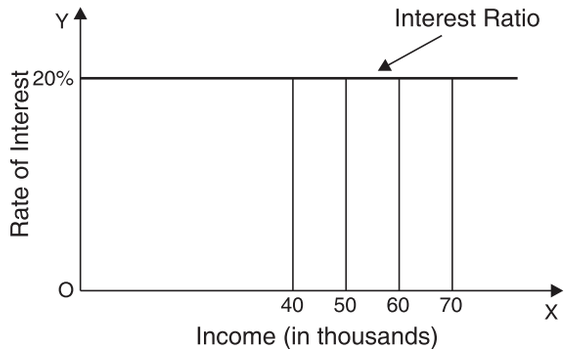

Fig. 1

The Merits of Proportional Taxation—The process of proportional taxation has two merits -

1. **Simplicity** - Its biggest merit is its simplicity. **Prof. J. B. Sey** said, "Proportional taxation is so simple that there is no need to give its definition".

Notes

2. **It is not Possible to Fix it According to Anybody -** In this procedure, the rate of tax for rich and poor is same to put. So, in this process it is not possible to get and fixed the rate of tax in different income getting sections.

Demerits of Proportional Taxation - In this procedure, there are demerits more in place of merits, these are -

1. **Lack of Justice -** This tax procedure is not full of justice. If we use utility destruction rule of currency it is clear that a person of more income got tax satisfaction from extra unit from currency as comparasion to poor. By this, the division of the pressure of tax from proportional tax is imbalance.
2. **Tax is not Getting from Rich Section According to their Capability -** As the rate of tax getting from rich and poor is same, so government got that much income he should be from the rich section. Today, there is lot of increase in the money they are spending so it is not possible to have enough income to government from proportional taxes.
3. **Lack of Elasticity-** There is a lack of elasticity in proportional taxes. If government need more income and the rate of taxes are already high then it can not be possible to get more tax from poor people specially because in this condition there is no possibility to increase the rate of tax.

By this, if we adopt the system of proportion tax by this the division of the weight of taxes will be in justful. Government will be never got enough income and there will be lack of elasticity in the structure of taxes.

13.3.2 Progressive Taxation

Progressive tax system is a system in which not only the income increases as well as the rate of tax. Its principle is, "More income, more rate of tax". According to **Dalton**, "In progressive taxation whatever increase in income of tax payer have, in that particular rate, he pays the tax".

According to **Prof. Taylor**, "The table of progressive rate of tax is that in which there is an increase in the base of tax as well as the increase in the rate of tax.

Table of Progressive Taxation

Income (₹)	Tax (%)	Amount of Tax (₹)
40,000	5	2,000
50,000	10	5,000
60,000	15	9,000
70,000	20	14,000

Above table can be shown according to following illustration -

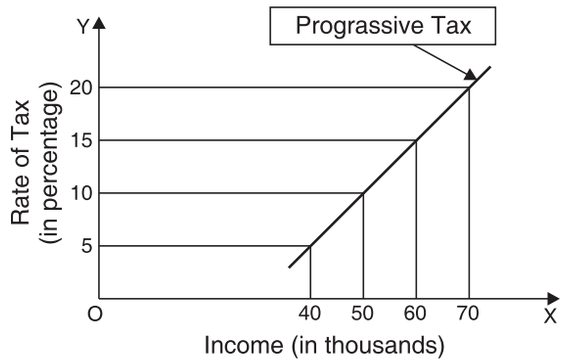

Fig. 2

Notes

Progressive Taxation, Merit or Points in its Favour— These are the points in favour of this system.

1. **Justicefull -** This system is full of justice because in this more rate is taken from earning high income that is according to the utility destruction unit whatever more income a person have, he got that much less satisfaction in extra unit of currency. So, it can be possible to take more tax from rich people. By this, this system is according to the capability to tax.
2. **Total Sacrifice According to the Minimum Principle -** In progressive tax system, poor people have to give less sacrifice which is clear from the utility destruction rule. If there are high rate of taxes for rich people and the poor people are free from taxes or less rate of taxes are to be taken then there will be low pressure of taxes on the whole society. In this matter, **Prof. Pegu,** thought that it is two equal rich people after paying tax will remain equally rich. Even after that they will become more rich but similarity will be there and there will be no more destruction in their satisfaction.
3. **Equality in Division** - By progressive taxes, there can be more similarity in the division of money. By these taxes, it can be possible to low the credit - power of rich people and this income can invest by the medium of public invest equality in division is possible. Its base is that there is less last usage in extra unit of currency for rich people and the poor people got more usage of the unit of currency. By this, it is possible to increase the total satisfaction of society. For this target, many countries are adopting this system of tax.
4. **Possibility of Increasing Government Income -** In present, the work-area of governments are increasing so there, need of money is increasing. By the medium of progressive taxes government can fulfill their income by taking the high rate of tax. We have clear that government never got enough income from proportional system so today progressive tax system is needed.
5. **Elastic -** There is a merit in progressive taxes it is possible for government to increase their income at the time of need but this is not possible in proportional taxes because poor people get more pressure if there is increase in the rate of taxes. In progressive taxes by the increase in the rate of tax for rich people, more income can be taken.
6. **Economy -** Progressive taxes are economic also because there is no more income spends to collect it. The expenditure is same to collect taxes whether the rate to tax is low or high. By this, at the time of collecting taxes spending less amount government can collect more revenue on the basis of progressive taxes.
7. **Financial Balance** - If, at the time of financial crisis there is increase in spending power of people so there is possibility of increase in financial actions and the level of unemployment. So, this should be a target of policy that more people have credit-power. But, if credit power is with a little bit rich people then they will never spend because their usage thinking is limited. But if this amount is taken from the government from rich people on the basis of taxes and this transferred to the poor people by the help of public investment so there will be increase in total usage because by the increase in credit-power demands will be high. As a result, there will be increase in production and employment and there will be financial stability.

Demerits of Progressive Taxation - Even if the present progressive tax system is adopting by all even then starting economist **Mc. Culloch** has given his protest against progressive taxes. **Mc. Culloch** told that by the protestation of proportional taxation and by adopting progressive taxation our condition is just like that person who is standing at sea shore without compass.

These are the points against progressive tax system -

1. **Effect on Production** - If there are high rates of progressive taxes then there is an effect on saving, investment and production. When people feel that a big part of their income will be taken as tax then they take no interest in production. But this problem is not right completely

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because there is no effect of progressive taxes on all sections. This thought is based on the total investment of government is unproductive.

2. **Wrong Base of Taxes -** Some Economists thought is that the base of progressive tax is wrong. This thought is on that base that in comparative manner limitations of a rich people, currency is less than a poor. But some economists thought it is not right because it is not possible to compare the usage of mental factor. **Prof. Robins** thinking is same but this comment is not right because currency is not exception of utility destruction rule and people of same situation feel same satisfaction.
3. **Progressive Tax System Finish there self at the End -** If this situation becomes regular, there will be no progress in the base of taxes. But this criticism can be right when we agree that there is effect on production because of progressive taxes. But we have already cleared that it is not possible always.
4. **Arbitrary Rates of Taxes** - This is also criticise, that the rate of tax fixed on the different incomes is arbitrary. That is injustful in any manner. In this matter, Mc. Culloch said, "There is no border line of injustice in progressive taxes that you can't do." In **Prof. Lutz** words, "Progressive taxation is a big dangerous tax weapon because there is no natural or escilator control on its misuse". It can be said that the rates of taxes can be arbitrary but in this system because of slab system of taxation it is possible to stop it.
5. **Saving and Labour Discouragement -** The critics of progressive taxes say that this tax system is against the person who are hard workers and savers and in favour of lazy and the person who are wasting their money. According to Prof. J.S. Mill, "After a fixed point progressive taxation, injustice way of collecting tax and infact a progressive dacoity". But this is not right completely because hard work and economy are not the main reason of constructing property but there is also an important role of social and financial facilities and the facilities provided by state.

Conclusion - In the last, we can say that today many countries are adopting progressive tax system because of their merits. Even if there are some demerits, like, arbitrary rates of taxes and effect on production, but it can remove by the help of administrative perfection.

13.3.3 Regressive Taxation

At that time, we say that a tax system is regressive when there is increase in the income and property of taxpayer and the rate of tax payer are low. Like, if there is ten percent tax on low income and five percent tax on high income then this is the example of regressive taxation. In **Dalton's** words, "In regressive taxation whatever high income a tax payee have the ratio of giving tax is that much low". By this definition, it is clear that the pressure of taxes are high on lower income people as compare to rich people. So, it is not appropriate on the basis of justice and equality. This system is inelastic and non-productive because government got no income. By this manner in modern times there is no importance of this tax system.

Table of Regressive Taxation

Income (₹)	Tax (%)	Amount of Tax (₹)
40,000	20	8,000
50,000	15	7,500
60,000	10	6,000
70,000	5	3,500

Above table can be shown according to following illustration -

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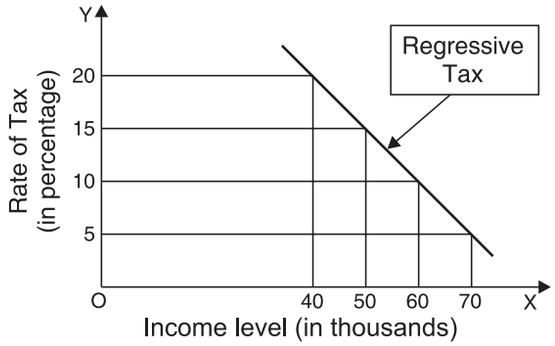

Fig. 3

13.3.4 Degressive Taxation

The degressive tax is progressive to a fixed point. But after this point these taxes becomes proportional. In present time developing economies are using these taxes more.

Table of Degressive Taxation

Income (₹)	Tax (%)	Amount of Tax (₹)
40,000	5	2,000
50,000	10	5,000
60,000	15	9,000
70,000	20	14,000
80,000	20	16,000

Above table can be shown according to following illustration -

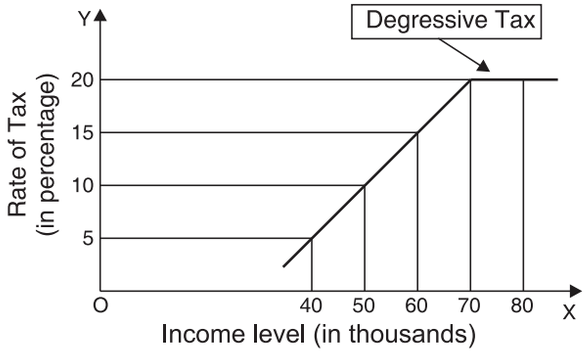

Fig. 4

13.4 Specific Tax and Ad-Valorem Tax

Indirect tax are of two types :

(i) Specific Tax (ii) Ad-valorem Tax

Notes

Specific taxes are to put on figure of thing, shape and weight like if there is a tax according to ₹ 50 each metric term on anything's weight.

Ad-Valorem Taxes are those getting according to the cost of things like if there is a tax of 10% rate on the cost of anything then it will be Ad-Valorem Tax. Debit taxes are normally according to this process. Above said both the taxes are not competitor but are similar to one another. The thing whose counting in not possible, then there is a specific tax on them and those things which cannot count there is Ad-Valorem tax on them.

Merit of Specific Taxes

The merits of specific taxes are -

(i) Collection of these taxes is convenient.

(ii) Tax evasion of these taxes is not possible because figure of things and weight can be checked.

Demerits of Specific Taxes

The biggest demerit of these taxes is that they are not justiceful because their pressure is more on lower class. Lower class uses the things more whose weight is more as compare to rich people.

Merit of Ad-Valorem Tax

Ad-Valorem tax, are complete as compare to specific taxes because these are collected from progressive rates. Normally rich people use costly things and if there is high rate of tax on these things so there is a progress of these taxes.

Demerit of Ad-Valorem Tax

(i) Ad-Valorem taxes are inconvenient to collect, it is important to know the right cost.

(ii) Tax evasion-In this it is possible because tax payees make false bill to save them from taxes.

Do You Know? Indirect Taxes are of two types -

(a) Specific Tax (b) Ad-Valorem Tax

13.5 Single Tax System and Multiple Tax System

In single tax system, there is only one tax from the state which is on the production of agriculture, is on income or any other thing.

13.5.1 Single Tax - Only on Agriculture

Physiocrats - Economists thought is that there should be tax on agriculture production because agriculture is the only production business. Physiocrats agree that except agriculture all the business are non-productive. Their thought is based on that we get net product only in agriculture.

Issac Sherman - His thought is the tax on land can be shifted so the pressure will be on all the people of society.

Demerit of This Tax - If there is a tax on land only then there are two demerits of this -

(i) **Insufficient Income -** If there is tax only on agriculture then the income of government is not sufficient. Today, there are increases in the work of government and there is a need of more money, then single tax system is not enough and government can never get important amount of money.

(ii) **Against of Justice -** The pressure of tax of agriculture is effect farmers only and rich people are save from these taxes. This is wrong that the tax on land can be transferable. As compare to rich people, poor people use more agriculture products. So their pressure of tax is more on lower class. So, these taxes are injusticeful and taxes are not according to the ability of giving.

13.5.2 Single Tax-only on Income

Socialist thinkers always favour single tax only on income. Their criticsm is that the tax pays from the income so this is right to collect one tax and it can be according to the ability of paying tax by making it progressive. **Prof. Dalton** always favour income tax instead of land tax, then they never feel it enough.

The Demerit of this Tax is - These are demerit of putting tax only on income -

(i) It is not possible to get enough income by putting tax only on income.

(ii) It will not be possible to put tax on property from other resources except income.

(iii) There will be tax evasion on big scale.

(iv) There will be tax on the income of lower class and they will be inconvenient to maintain the account.

(v) It will be enough expenditure by all the people from income tax.

According to the above said demerit in present single tax system is not in practical and in place of this all the countries except multiple tax system.

Task What do you mean by single tax system?

13.5.3 Multiple Tax System

This is also called system for many. As the words clear, by this government collect important money by putting different type of taxes. In **Arthar Young,s** words, "If I explain the most better system of taxation then it should be like no more pressure on main point but small - small pressure on last point". But it is important to look that there can be many points of tax but that should not be last because by these taxes will become problematic and even getting them will be a problem.

Today, almost in all the countries multiple tax system is popular. In these taxes, it can be justified by including the merit of progressiveness. Today, government is adopting different types of taxes like - income tax, debit tax, property tax, gift tax, death tax, production tax, import tax etc.

Notes

Merits of Multiple Tax

Merits of Multiple tax are following—

(i) Government can get enough income by getting these taxes.

(ii) It is possible to make taxes justiceful by making them progressive.

(iii) By the medium of multiple taxes, it is possible to get help from all the classes of state.

(iv) Tax evasion can be stopped by adopting right ways.

Demerits of Multiple Tax

(i) Multiple tax system put more pressure on consumers. It affects their savings and the ability of doing work.

(ii) In multiple tax system, there is a pressure on rich people more than poor people.

Notes Multiple Tax System is popular in all the countries.

Self-Assessment

Multiple Choice Questions:

6. Indirect Taxes are of directs -
   (a) supplementary (b) complimentary
   (c) same (d) unequal
7. What is the biggest merit of Proportional Taxation?
   (a) harship (b) easiest
   (c) soft (d) hard
8. Progressive Tax System is that system in which what happens in the rate of tax if there is an increases in income?
   (a) destruction (b) becomes equal
   (c) growth (d) becomes unequal
9. What is the Collection of Specific Taxes?
   (a) easy (b) hard
   (c) useful (d) convenient
10. What the government got by the help of Multiple Tax System?
    (a) income (b) investment
    (c) loss (d) non of these

13.6 Value Added Tax (VAT) and Modified Value Added Tax (MODVAT) in India

Introduction - Value added tax (VAT), is started as an option of debit tax, very first it starts in 1954 in France where value added tax is to be put on different things except imported things. It also starts

in different countries of common market in Europe. This tax puts on the each transaction of sales on every country of Europe before starting. As a result, there is an increase in the cost of thing. So, this decision has been taken that in each case, there will not be a tax on whole cost but only on the extra cost. By this, there will be less growth in the cost of things and there will be a gain to consumers. This is called value added tax. It started in 1973 in America.

13.6.1 Definition of VAT

Vat is a tax system in which tax applies only on extra growth in production method. This cost growth can be used by the consumer and saler.

According to, **L.K. Jha Committee,** "Value added tax is a tax on all the things and services in which imported things and administrative services to be separated. This tax is added on the totals in the growth of tax of business on each level. So it is called "Vat". Growth of tax means that amount got from the less cost of physical resources from the credit of the production of total cost. By this a businessman pays bill on the increased amount and not on the total cost of thing. We can say it is net value. All item can be explained by following way -

Notes Added cost = total cost of thing – cost of loose material and the cost of extra material

As above, the tax that put on grown cost that is called value added tax. We can explain it by giving a simple example - The bread in the market, is prepared with the help of flour of wheat - there are three steps of making it - wheat, Maida (superfine) from wheat and by making it dough and prepare bread after heating it. If we put tax on wheat and then on maida and then on bread then it will be two to three times on one another and the low rates of bread will become very high. When Vat system started there was a difference that the tax on maida is on that portion only in which the rate of maida increased. Imagine if wheat is Rs. 3 per kg and maida is Rs. 3.50 per kg and the tax earning from maida is according to the total rate of it before then after starting VAT the tax will only be on 50 paisa.

It is possible to explain it by giving example of a truck. We need steel to make a truck first, then this steel used to make different parts and then truck made. Above three things made in different factories and if there is tax on each different part then the cost of truck will become so high. So, the tax should be on the extra growth of cost.

On the above explanation **Prof. J.C. Winfrey** gave the definition of VAT, that is, "VAT is never earned from the debit cost of getting from the increased cost in the production of different stages.

13.6.2 VAT and Sales Tax

As VAT is started as an option of debit tax, so it is important to know the difference of these two sales tax collected only one time on the total cost of thing but VAT is collected on the extra increased rate in each step of production. As the total cost of the thing is the total of cost increased by the produces, so it can be said that there is no difference in between these two. But the main difference is where the VAT collects on the extra cost their sales tax is collected only one time on the total sales tax.

Now the question is why VAT is presented as an option in Sales Tax? The reason is following -

(i) There are many complications in Sales Tax.

(ii) Because of sales tax, there are many complications in the credit - debit of things in many status.

(iii) As sales tax collects only on one point, there is a possibility of tax evasion more.

Notes

13.6.3 VAT and Excise Duty

Excise duty, government put this on the production of any firm. If there is production of any thing or unit from different firms means if one firm use the loose material made by another firm then each firm has to pay the excise duty. So, at last there is more pressure of tax on final goods. In its opposite, according to VAT each firm have to pay the tax on extra cost.

In India, main Economists favour excise duty instead of VAT. Its reason is that there are many complication, these are -

(i) Sometimes there is excise duty on some things according to specific and on some things this is according to Ad-valorem. Though this complication comes in system.

(ii) As there is tax on different stages of excise duty, for their administration there is a need of a large scale of workers.

(iii) Because of administrative problems it is not possible to include small industries in excise duty. Government is in loss for this.

Explanation of Value Added Tax by Example

Imagine a firm (A) sold his material of ₹ 10, 000 to wholesaler (B) wholesaler (C) sold it to retailers at the rate of ₹ 10, 500/-, then the counting of Value Added Tax will be like this -

(i)	The rate of sale material by wholesaler -	₹ 10, 000/-
(ii)	The cost taken by the wholesaler -	₹ 10, 500 /-
(iii)	If the rate of tax is 10% then the cost of given tax will be 10% on wholesale tax - 10, 500/-	₹ 10, 050/-
(iv)	The tax paid by firm 'A'	₹ 1000 /-
(v)	The tax paid by firm 'B' (Value Added Tax)	₹ 50 /-

13.7 Various Forms of Value Added Tax

Prof. Carl Shoup has given the explanation of Value Added Tax, that is -

(i) **VAT based on production** - Each firm take material from another firms to do production and earn income by selling their production. We called it Gross receipts. If we subtract the cost of the credit of thing from the total amount of any firm then we can estimate the VAT of that firm. The tax on that increased cost is called VAT based on production.

(ii) **Consumption Based Vat** - If we subtract total investment from national product then whatever left, that is capable to use and the tax on it is called consumption based VAT. This is the most popular tax used as an option of sales tax. This tax puts on the things the use as a last consumption.

(iii) **Income Based Vat -** This tax is used as a option of corporation tax. This tax puts on the income of business corporation and companies. In production, there is a contribution of different resource, like, land, labour interest, salary and gain. If we total the above labourers and we count it as a base and put tax on the increase cost then this is called Income Based VAT.

(iv) **Wage Based Vat** - Whatever left after subtracting the interest and use of machine etc. of different inputs from the cost of productive units of firm that is wage cost that is equal to the labour paid. This is called wage based VAT.

Notes

13.7.1 Merits of VAT

(i) **Neutral to the Different Stages of Production -** VAT is different from sale tax in this manner if sale tax puts the pressure of tax it differs according to the different production stages. As a result, it increase, the pressure of tax. But VAT becomes same in all the conditions. VAT doesn't depend on this from how many hands any particular thing go through at the time of sales.

(ii) **Less Tax Evasion -** In VAT, there is less fear of tax evasion because each firm pays tax on increased cost that is very less in comparison of sales tax. Naturally, production never encourage tax evasion.

(iii) **Encourage Export -** It is possible to separate VAT from estimated production and it is possible to Encourage export business by separating the pressure of tax. If we compare this from another taxes we found VAT helps to increase the export business.

(iv) **Helps to Control the Cost** - As a result of sales tax the cost of goods increase but the pressure of VAT remains same in all the production steps and the cost never increases.

(v) **Practical -** As compare to other tax, VAT is more practical. The reason is most European countries are following this.

(vi) **Increase the Production Capability of a Firm -** VAT always put according to the quantity of production and is not based on the profit. Whether there is gain or loss the firm have to pay the tax so each firm tries to do more production in less investment.

Demerits of VAT

(i) **Problems in Implementation -** There is a need of expert administration to start VAT that is able maintainance of the records of increased cost in different systems in production, but there is a problem to start it in the lack of these type of workers.

(ii) **Impossible to Implement without the Help of Taxpayers -** This tax system starts at that time only when the government have full support of tax payees. For this the counting of production and cost is important for a firm. Firms have to calculate that in production the credit material used by the firm how much money they are paying as a tax.

(iii) **Problems Related to Counting** - The counting of this tax is not easy because there is many complications in it.

(iv) **Problem to Start in Undeveloped Countries -** It is difficult to start this tax system in a backward and lack full economy.

13.8 Modified Value Added Tax - MODVAT

Meaning of **'MODVAT'** is - Modified Value Added Tax means MODVAT is a correctional form of VAT that was popular before.

In India VAT has been put in place of production fee, and in other countries it is put in place of sales tax. It means, it is put as a modified form in India. That is why, it is called MODVAT.

Very first in India **Bhoot Committee lingam** gave their favour to VAT in production fees. In the year 1978, the house of **Mr. L.K. Jha** suggest to put VAT on some things as he was appointed to read the indirect taxes. This is to put on manufactured goods and the name given to it was MANVAT, (Manufacturing Value Added Tax) and after modified it became MODVAT.

According to MODVAT the tax on inspirits and mediatory things finished and put only on productive final goods. By this, doubting of taxation finished.

Notes

Do You Know? MODVAT scheme was started after the budget in 1980 - 81 in India.

Why there is a need to initiate MODVAT in India? According to the that time finance minister, the problem that is to be solved in production fees was the taxation on input and the stored effect of cost on the last product. In long term Fiscal policy this was a suggestion that, this will be the best solution that by leaving some main problem area the present Performa Credit plan should be started on all the things capable of production fees. The name to this was 'MODVAT'.

13.8.1 What is the 'Performa Credit Plan'?

To look after there should not be tax on tax continuously government have made 'Performa Credit Plan'. In this plan each firm who is using goods at the time of production and the tax on it is already given, then the firm shows Performa to the government and there is no tax witch has been taken at the time of taking tax. In this plan, only those businesses get profit where the input and last production includes in the list of production taxes in one section.

In India in 1986-87 , budget when MODVAT started then it declared till then the input and last production includes in the 37 pages of specified and there will be product fees on some last products there will also be credit on the fees of inputs available. By this, there will be less loss in the making of last product.

Modvat is not a plan invented in India. It is already been started in common market of countries of Europe. In starting, India started putting MODVAT on some things like, things made of mirror, plastic, distember and some tools etc. This is right MODVAT effects some things cost but this convenience will be temporary and on some things only. But the main target of MODVAT is to stop tax on tax.

CENVAT

On 1st April, 2000 MODVAT converted into CENVAT. In the year of 2000-2001 , budget the rates of product fees (8, 16 and 24%) changed into a rate of 16% MODVAT capable and the name given to it was (Central Value Added Tax - CENVAT).

Self–Assessment

State whether the following statements are True or False:

11. Value Added Tax (VAT), started as a option of sale tax.
12. Added Cost = Total cost of thing + cost of material and the cost of other material.
13. There are many complications in sale tax.
14. The main economists of India favoured VAT in place of production tax.
15. Firm never have to pay the tax at the time of loss.

13.9 Summary

- In direct taxes, impact of taxation and incidence of taxation is on one person like income tax: and in indirect taxes, this is on different people like sale tax.

Notes

- The meaning of direct tax is that the transfer of this tax is not possible; but put on that person who is able to target its pressure. Income tax is the best example of it.
- Indirect taxes are elastic, this is its merit-means by increasing the rate of tax government can increase their income. Those things whose demand is non-elastic, it is easy to increase the rate of tax on it. But it should also be looked after that by the increase in these things cost there is pressure on the poor manufacturers.
- Direct and Indirect taxes are supplementary to one another.
- In proportion taxation all tax payee's pays according to their equal ratio taxes of their income.
- The list of the rates of proportional taxes in which even after the change in the base of tax the rate of tax remains same.
- Specific taxes are those taxes put according to the figure, shape and weight of a thing like, there is a tax on the weight of thing according to ₹ 50/- per metric ton.
- Ad-valorem taxes are those taxes put according to the cost of things like, if there is a tax according to the rate of 10% then it will be Ad-valorem tax. Sale tax normally put through this policy.
- According to single tax system there is only one tax by the state that can be on agriculture production, on income or any other thing.
- Today in all countries multiple tax system is popular. By adding the merit of progressiveness it can be just. Today, governments are adopting many taxes like income tax, sale tax, property tax, gift tax, death tax, production tax and import tax etc.
- VAT is started as an option of sale tax. Very first it had been started in France in 1954 , where except export things there is VAT on different things according to different rate.
- VAT is completely on tax on all things and services in which administrative services are separated from export goods. This tax on each level includes in the increased cost of business. That is why we call it VAT.
- MODVAT means Modified Value Added Tax. MODVAT is a modified form of VAT (Value Added Tax) popular before it.

13.10 Keywords

- Proportional — Releted to proportion
- Specific — Having some speciality

13.11 Review Questions

1. What do you mean by 'Direct Tax'?
2. Write the definition of 'Indirect Tax'.
3. Describe the merit and demerit of indirect taxes.
4. What do you understand by 'Regressive tax system'?
5. Explain the merit and demerit of 'Multiple tax system'.
6. What do you mean by 'CENVAT'?

Notes

Answers: Self Assessment

1. Taxation	2. Justice	3. Property	4. Indirect
5. Just	6. (a)	7. (b)	8. (c)
9. (d)	10. (a)	11. True	12. False
13. True	14. True	15. False	

13.12 Further Readings

Books

1. Public Finance—*H.L. Bhatia, Vikas Publishing House, Pvt. Ltd.*
2. Indian Public Finance Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking : International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Nandkishore Prasad, ABD Publication, 2011.*

Unit-14: Effects of Taxation on Production and Growth

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know About the Effects of Taxation on Distribution
- Know the Measurement of Tax Progression
- Understand Distribution vs. Production
- Know Taxation and Economic Stability.

Introduction

Today taxation is not only used as a source of collecting tax, but also used to achieve as a main source of some social and financial targets, like regulating use and production, the control on the conditions of inflation and depression encourage financial progress and to finish the inbalance in income. On these financial actions the effect of taxation can be good or bad. So, government should not have on keep the tax in mind but the effects of taxation on finance should also be noticed. In this matter **Dalton** says, "As matter of finance the taxation's best policy is that who show best effects or less financial effects."

14.1 Effects of Taxation on Production

The classical economists favour was that the main target of taxation is to collect income but in modern time the target of taxation is more expand. In present, taxation is not only for collecting income but also to effect the production and to make the equal money distribution in the society.

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In **Mrs. Hike's** words, "Any country's tax system affects a lot to that countries economy". So, we have to study deeply that there have no effect of taxation on production, distribution and employment etc. Prof. Learner says we should not think about financial gain or loss at the time of adopting relation policy of tax but should also think about stability in economy and to stop inflation or depression Prof. Dalton explains the effects of taxation by these following topics -

1. Effects on Production
2. Effects on Distribution
3. Other Effects

Effects on Production

(a) The effect on doing work, save and invest.

(b) The effect on the thought of doing work, save and invest.

(c) Effects on effacing of production or on pattern (means effects on the division of resources in different industries and areas.

Now, we discuss how taxation affects the three forms in the level of production.

Notes Taxation's main aim is to collect income.

14.1.1 Effects on Ability to Work, Saving and Investment

Simply, it can be said that putting of tax is a bad effect on people's ability and ability to save. But this is not right in each situation.

(i) Ability to Work - The meaning of taxation is the transfer of purchasing power from personal hands to government. In other words, it means lack of purchasing power of tax payee and the lack of ability to fulfill the luxuries and important things in life. This effect of taxation feels more on the poor people. When there is effect of taxation on poor people then it affects their use of luxury things and it put their level of life low. So, by this taxation affects the ability and capability of poor people. It's opposite; there is no more affect of taxation on the ability and capability of rich people. The reason is the taxation on rich people effect only their luxurious use, that doesn't effect their ability and capability. This is the reason why almost many economists are against to heavy tax on poor people in the society. So, this is right that the tax should be low on poor people and there should not have the effect on their health and ability, capability of work. This is in favour of production that there should not have tax on low income people and on those things used by the rich people in the society very rarely.

But it is not necessary that all the taxes affects the ability of doing work of people. Taxes on narcotic drug is a good example of this. The use of this is harmful for health of workers and their ability to work. By this taxation, stops the use of these things and it fovourable creative effects the production.

(ii) Effects on the Ability to Save - Saving depends on income and when income is less because of taxation then there is less saving automatically. So, by all the taxes the ability of saving becomes low for those whose income is that much that he could be able to save a little bit or more. There are many taxes that not only effects the saving ability to a fixed point but completely is on those poor people whose income is very low and even saving is not possible for them. So, it is clear that on the basis of some other talks the heavy taxes on rich people are justiceful. But we should remember that by this the ability of saving becomes low.

Invest - Ability of invest depends on that how much savings are available to invest. By the above explanation, this is clear that by taxation savings become less, so if there are less savings then the ability to invest becomes automatically low.

But here, this is mentioned that this explanation is not free from comparison. The reason is here the effect of taxation are mentioned but the gain of government investment are not shown. The ability of desire to work, saving and investment becomes low by taxation, it can be possible that by the government investment this ability become more from this ratio. The target of taxation is that it could help to increase finance of country. So, when we study the effects of taxation then the effect of government investment should also be seen.

Do You Know? Saving depends on income.

14.1.2 Effects on the Desire to Work, Save and Invest

Taxation effects the incentive of the people's desire to work, save and invest and in this condition production effects automatically. So, to discuss the effect of taxation on production we will have to think that what is effect of taxation on the incentive of desire to work, save and invest. Effect of taxation on financial incentive - (1) nature of taxes and (2) depends on the psychological reaction of tax payee.

1. Nature of Taxes

Normally, this is to be said that taxation's last target is to encourage people to do hard work and to do more saving. Yes, this is it that the effects of taxes are different. On the desire to work and on saving so taxes affect a lot or it does not effect completely, but there are other taxes effect disastrously in this direction. For example, tax on wind falls means tax on those gains which take very small time and gives unusual gain, sudden profit heir tax and on the fixed amount of tax on the increased cost of land etc. are the examples of above first section. These gains or income is incidental so the tax on these incomes never effects the desire to work and decide to save. Like this, the tax on monopoly profits leave the effect of stability. The reason is the monopoly productions arrange its production at that point where the last money spend and the last income both are similar and that is the point where he gains the maximum profit. Now, due to taxation he reduces his production then by this, there will be less work for him. In this condition, it will be right for him to pay the taxes on these monopoly profits. Its opposite, if there is reduction in the tax as the rates of a productive thing of monopoly people becomes low by this he will get encouragement to do more production. And he will be able to sell more material by reducing the rate of thing and could gain more. By this, their desire to work and desire to save will increase.

Beside this, it may be possible that there have to be no bad effect on the desire to work and to save from the production tax and sale tax (a tax of criticized thing). But if the government already collect a big part of income as a form of using taxes then it is possible that there are less savings because the tax, is already paid on them. Because of tax, those things whose rates go high, their demand can be less and as a result it can be possible their production also become low. There is favour of import duties so Indian production could get protection against foreign competition. These taxes can increase the desire to work and the desire to save and can encourage to invest more in the production of things those are imported. So, the favour of light export taxes has done so the export can increase and to cover foreign markets. So, low export duties can encourage the production increase of these things which is exported and by this, these taxes can increase the desire to work and desire to save. It is

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clear that this is the nature of tax and its type that fix the effects of his desire to work and desire to save on production.

Like this the nature of income tax, wealth tax, inheritance tax and expenditures tax; comparisonative effect is different. Income tax and wealth tax normally the desire of those people who are hard worker who want, to save more. Mostly highly progressive income tax encourage hard working tax payees and the people do more savings. If the condition is of wealth tax. Yes, this is it that as comparison to wealth tax, the income tax affects less on the tax payee for the desire to work. The reason is that income tax never directly affects its prize or labour. But, on the desire to save wealth tax effects unfavourably as comparison to income tax and this is because after paying income tax whatever income is left there is no tax again on that.

Like this, there is preference to inheritance tax as comparison to income tax. Its reason is that the tax payees pay income tax from his present income, but the wealth tax pays from that income and from that money that he gets in his inheritance in future. It is clear that this income is of unearned nature. Even both the taxes (income tax and inheritance tax) effects the desire to work and desire to save. But on this desire means on production the effects of income tax in place of inheritance tax are more unfovourable.

On the desire to work and desire to save the effect of expenditure tax can be more fovourable than income tax. A progressive expenditure tax discourage the waste expenditures on use and encourage saving and investment. Expenditure tax can be used to change the figure of consumption. But in a developed economy, there is a chance of developing deflationary tendencies. The reason is, by reduction consumption investment, the effective demand will also be low and the rate of gain will be low whose effect on saving and investment and on income can be unfavourable bet is by the increase in government investment till not fulfilled its demand.

On the incentive of doing work, saving and investment as comparison to proportional taxation there are more unfoavourable effects of progressive income tax, wealth tax and property tax. By this, it is clear that taxes are of different nature and the incentive of people means there are different effects on the desire to work, saving and to invest.

2. Psychological Reaction of the Tax-Payers

Prof. Pegu has given the name "**announced effect of taxation**" to the psychological or mental reaction of taxpayers. Its summary is only that the tax-payer also effected psychologically by the pressure of taxation. When tax is announced the tax payer feels that his income automatically reduced. The physical condition of tax payess can effect the desire to do hard work and to save more.

About the tax, there is different mental reaction in each person and this reaction is effected by that how much is the demand elastic for income. In Dalton words, "The reaction of any person towards taxation is decided according to his elastic demand of income". Now, we will see that what is the meaning of elastic demand of income and what is its contribution in desire to work and desire to save.

Income Elasticity of Demand - (i) Elastic Demand - Towards the income, the demand of a person said to be elastic when a person never feel excited to maintain the present level of his income and he never do hard work to get that amount of income. Imagine, a person earning ₹ 12,000/- per year and he pays tax of ₹ 12,00/- on his income. In this condition, his demand said to be elastic when we will found that his desire is not very high to maintain the present level of his income and he never does more work to get extra income, so that he could fulfill the unfavourable effects of taxation and could maintain his income on ₹ 12, 000/- his previous level even after paying tax.

(ii) Non-elastic Demand - The demand of a person said to be inelastic towards his income when his desire of maintaining the income is very fast and even after paying tax, he is fixed to maintain his income on the previous level ₹ 12, 000/- by doing more work.

By stability curve, it is easy to understand the effects of the elastic and inelastic demands of income on the desire of people to do work and to save.

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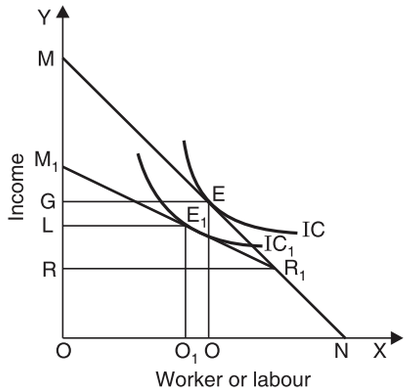
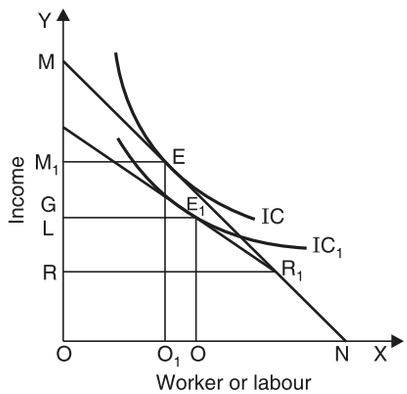


The picture attached on X-Axis the work or rest and on Y-Axis income (labour) is measured. Each worker gets 24 hours in which he can do work or rest. If he does work 24 hours then they can earn OM income or labour. The line MN show labour or income line. The slope of these lines whatever more the rate of labour will be that much high.

Task What is 'Elastic Demand'?

If government does not put tax on his income then in this condition his income line will be MN. In the condition of balance he will be on E point because on this point his border line curve and income line touch one another. In this condition, he will get OG income. In this situation, he will take rest of OQ hour and he will do work on QN hours.

Now, imagine government leaves tax free to OR income and takes tax on the remaining income. By putting in tax the income of labourers, will also be equal to the quantity of tax. After paying income tax, now he will get his new income line M_1R_1. In this situation, he will be balanced on point E_1. Now he will do work equal to N_1Q_1 (NQ + Q_1O) and get the LO income. In other words, as there is income tax he wants to do work for more hours. Before having income tax, he does rest for OQ hours but after having income tax he does rest only from OQ_1 hours. If we agree that there is direct relation between the hours of work and production then there will be more quantity of production after having tax on income. This is based on this thought the demand of income is elastic and non elastic.



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Opposite to it we agree that the demand of income is elastic then in this condition can be shown by the above picture. In this picture before putting tax, the labourer is on E point in a balanced condition. In this condition to get OQ income he has to work for QN hours. Means on this income he has OQ hours rest available. Imagine government put tax on income. In this situation point E_1 balance point will get, because on this point new line M_1R_1 touches the borderline curve C_1. In this condition, for OL income he only had to do work for Q_1N hours. In other words, before having income tax he does rest for OQ_1 hour and he does work for QN hours. After paying tax, now he takes rest for OQ_1 and do work for only Q_1N hours. By this, the labourers after paying tax do more rest as compare before. Now, he dose not have any thought for dropping of his life-level. It is clear by this, the demand of income in elastic condition effects badly on the desire of a person to work.

So, if the demand of a person is elastic towards the income then it can be possible that the incentive of his saving and about his work due to tax will effect and it can be effected the production also. Towards other, if the demand of a person is not elastic to income then there will be no nonfavourable effect on the incentive of doing work and doing saving but he also got courage to increase them.

(iii) Elastic Demand of Income Equal to the Unit - For income, demand of a people can be elastic or non-elastic or can be equal. Demand for income is said to be equal even after paying tax, the desire of a person to do work and to save remain same. This is become possible when a person never get chance for doing extra work. This is the situation in which almost all the government servant does work. Then, there are some people whatever tax they are paying, but they are habitual of doing work and for saving. In these matters, the demand of a person for income remains same and it can be possible that the taxation never put unfavouable effect on the incentive of doing work and doing saving.

But it is not easy to measure the elasticity of demand of a people for income. The reason is the elastic of this demand is different in person to person and in different situations. Normally, it is seen in practice that the demand of a person is in elastic for income it means this desire normally found in people that the fixed level of income could remain stable by any how.

The following factors are responsible for the demand of a person for income to be in elastic -

1. **Minimum Fixed Level -** Some people desire to maintain a minimum level of their living for their family in each situation. These people always be ready for doing work and to do more saving at the time of putting tax.
2. **Future** - Some people wants that in future there should have a minimum fixed income for there dependent or for him from his savings.
3. **To Get Superiority in Society** - Some people have a very fast desire found that they collect money and by this they can get power and superiority in the society. These people are also found desirable to do more saving at the time of putting tax.
4. **Attachment Towards Work -**Those people who love their work those people do hard work and more saving because they could remain their income stable even after paying tax.
5. **To Get More Satisfaction** - Normally, people wants to do more work and more saving because by their income saving and the collection of money, they could get more satisfaction as comparison to other people, it means by their income and money they could get satisfaction is a big quantity as comparison to other people. Prof. Pegu has given his following explanation on this topic, **"The satisfaction which the rich people get from their income, a big part of it, is not from the quantity of his income, but is gotten topic from the relative amount. If all the rich people's income is reduced even then there will be no change in the part of their satisfaction".**[1] People don't want to be rich but they want to be more rich as comparison to other people. Transfer paying tax a person A is more rich than B then there will be no problem in the way of doing hard work and doing more saving for person A after putting tax.

1 Pegu, Economics of Welfare, page 90.

Notes

There are some other situations; in these the nature of taxation effects the condition of tax payers. These are following:

(1) Effect of Taxation in Booms and Depression - At the time of booms or at the time the rates go high, the businessman and manufacturers become positive thinker about the gain in future so high taxation never stop them to do hard work and to invest and to save more. So, at the time of booms, there is no unfavourable effect of taxation on the incentive of people and by this there is no bad effect of taxation on production. Its opposite at the time of depression or when the rates go down the businessman and manufacturers feel bad for the losses they imagine in future. So the taxation discourages their desire to do work, to invest and to save. By this taxation puts unfavourable effects at the times of depression and it figures damage the production.

(2) Effect of Taxation at the Time of War - The time of war is also be the time of the rates go high. This happens at the time of war because on one side government in high quantity and on the other side there is a high demand of things and services. In this condition, businessman and manufacturers think positively to earn gain. By this, they do not have any unfavourable effect on taxation of their desire to work, to save and to invest. Except this, there is a question of citizens of the country, because of their patriotic feelings, they never feel bad or ask any question if they have to pay more part of taxation.

(**3) Effect of Taxation and the Type of Industries -** A type of industry, whose base is solid, and earning a lot of gain, they are able to handle the heavy taxation weight, as compare to the industries newly established and struggling only for their identity. So, infant industries taxation can leave nonfavourable effect. In this situation, it will be right that these newly established industries could not have to pay the tax. So, they could develop fastly and these industries could be able to complete other industries working in the market for a long time.

(4) Effect of Taxation on Corporate Enterprise - Till now, we have explained that on the incentive of personal tax payers, businessman and manufacturers, means their desire to work, to save and to invest have the effect of taxation. But today, a big part of total savings and investments is used by corporate enterprises. Even by taxation corporation never effected as the person effected, even then investment production and the policies related to its development effected by the nature of taxation, for example if there are taxes on the heavy amount of gains, again used in industries then it effects the production unfavourably, because of taxation, the rate of investment will be decreased. In its opposite, if there are heavy taxes on the distributed dividends of share holders and the dividends left free from tax which is going to invest again then it will encourage the increase in production, because the rate of investment will increase if the dividends will be free for investment again.

So, as a conclusion this can be said that taxation does not also leave an unfavourable effect on the incentive of people to do work, to save and to invest, as normally thought. Except this, we can see taxation encourage the desire of people to work, to save and to invest instead of discouragement. But this is already mentioned that in most progressive taxation, most high wealth tax or property tax or steeply graduated income - tax finish completely the incentive of doing work and to save the people of high income earning. In the investment form, when the target of these taxes is to capture the local property and money of the people.

14.1.3 Effects of Taxation on Composition and Production

The quantity of production and national income in the country depends upon the desire and capability of doing work and to save for people. But the composition and production depends upon that how the resources divided in between different industries and different areas. For the diversion of resources in between different industries and areas taxation can be fixed as a weapon of Fiscal policy. By this, taxation not only can effect the base and the increase of production but can also be effected the composition and production. So, there can be a change in the composition and production.

Notes

When there are taxes on the productive things of some industries so their cost increase by there is a increase in cost the demand becomes low and as a result there are less gains. As a result, the resources of these industries transfer to the other industries on whose productive things have no taxes or the rate of taxes are less. This is done to reduce the effect of taxation or to save from the pressure of tax by the diversion in these resources, there can be a change in the composition of production of industries and can change its figure.

By the side of tax payer industries, non tax payer industries or towards less taxpayer industries this side diversion will be on how much end, this thing depends on the demand of these industries productive material and the elasticity to fulfill it. If the demand of tax paying things is in elastic and their supplies are elastic then the incidence of tax will be on buyer more cooperatively, as a result of this there will be no division change of resources. But its opposite, if the demand of this productive thing is elastic, but its supply is inelastic, then the pressure of tax will be on production. In this situation, if the manufacturer looks there is no gain on the production of tax payer industries or less gainful comparatively than the resources can be transferred towards non taxpayer industries.

(1) Beneficial Diversion - Some diversions of resources are beneficial. The harmful things of consumption like taxation on addiction things discourage their production. The result of it is that the amount and labour spend in these industries transfer towards other industries. On narcotic substance and on other harmful things the cost becomes high if there is tax on it and the use become less because of the rates go high. In this condition, the resources used in this transfers to the use of other gainful things. If there is restriction on the use of harmful things, it improves the health and capability to work of the manufacturers. So, as a social view tax on these things feels mandatory. Like this, the tax on the production of luxurious substance diverts it to the need of labour and amount. The diversion change of these resources called gainful mainly in undeveloped countries.

(**2) Harmful Diversion -** Necessarily needed things and normally used thing tax is not said to be desirable as social view. Tax on these things increase their cost and the use of these reduce. The effect can be harmful on the health and capability of doing work of people. Then, as the rates of these things go high, there demand becomes less and their production comes down. But by this it affect gain and it can be possible in this situation that the resources are busy in the production of most necessary needed things or in the normally used things. Transfers to the less needy things production. So, the diversion of resources like this is harmful and said to be desirable as a social view.

(3) Diversion of Resources from Present to Future Use - Some times taxes are put because it could discourage the use and encourage the savings. This happens normally in the time period of planning and development. The use reduces because of taxation and saving goes high. By this, because of taxation resources transfer towards present uses to main uses. Then, the saving increase, there is increase in investment also. As a result, it grows the power of production for society completely. To encourage the savings whatever tax exemptions or concessions provided, their effect is same.

Its opposite, when taxation discourage savings then it increases use. By these resources transfers from the main use to the present use and it can effect the production unfavourable. This happens in that situation when the government income which is collected from taxation is been spent on the day to day administrative and non-productive work. Whether this income is to be saved or to spend in the productive work.

(4) Diversion of Resources from One State to Another - In the arrangement of federal system, when different states put different type of taxes or starts different rates of a particular tax, then the diversion of resources from one state, where the pressure of taxes are high, can be transferred towards the state when the pressure of taxes are not very high. But this problem can be minimised if there are same taxes and equal tax rates in the country.

(**5) Diversion of Resources from One Country to Another -** If the pressure of taxes is very high in any country then enterprisers can think it is more favourable for them to spend the amount in those

countries where the pressure of taxes are not very high. But, the transfer of these resources can be stopped to a particular point, if there is a tax on the complete income of a person, whether this income he earns in the country or in foreign. By this, the transfer of money from one country to another can be stopped, the point is the owner of that amount never goes to foreign country with that amount himself.

(6) Protection and Diversion of Resources - When government decides to protect some industries in the matter to left free from tax in the form of grants and bounties this is because these industries could complete foreign competition or can develop itself, then from other industries towards these industries the transfer of resources can be possible, but in the long run the development in the industrial field will be in very high speed, that much is not possible in other conditions and if the waste resources are diverted towards the establishment of protective industries, then there will be more industrial development completely in very high speed.

Self-Assessment

Fill in the blanks:

1. On the economy of any country, the tax system of that country affects ..... .
2. The meaning of taxation is the transfer of .....from individual hand towards the government.
3. The last target of taxation is to .....the people to do hard work and do more saving.
4. The demand of a person for income can be elastic or inelastic or can be ..... .
5. To resources some .....or diversion changes are gainful.

14.2 Effects of Taxation on Distribution

In the present time for financial welfare maximum production is important but if the distribution of maximum production is not equal and just, that will not be good for any economy. That tax system is said to be good who could reduce the inequality of money and income without leaving any unfavourable effect on production. According to the reputed economists like **Adam Smith, Ricardo**, **Mill** etc., the main target of taxation is to collect money We can count first economist who give stress the name is Wagner, who said taxation should be used as a weapon to reduce the inequality of income. Their thought of "social and financial" about public finance is not been liked by many economists, but this is very solid view according to the theoretical form and modern governments are following this regularly. The favour of **D. Dalton** is that the importance of distribution is not less than the importance of production. As comparison to the financial production of money, the less unequal distribution can not be felt less desirable. In other words, as comparison to the increase in production the equal justified distribution of money is more desirable.

Notes Wagnor is the first economist who favoured that taxation is a weapon to reduce the unequality of income.

But in the different sections of the society the effects of taxation on the distribution of income and money are depending upon two factors-

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(I) Nature of Taxation or the Rates of Tax.

(II) The Parts of Taxes

14.2.1 Nature of Taxation or Tax Rates

Nature of Taxation means how the pressure of taxes distributes in between the different section of the society means whether the nature of taxation is progressive or proportional or regressive. By this, in any tax system the structure of taxation can be progressive, proportional or regressive. A tax is said to be proportional when all the tax payers pay an equal proportion of their income as tax. Any tax is said to be proportional when whatever high income a tax payer have in that much proportion, he has to pay the tax and, any tax is said to be **regressive** when whatever high income a taxpayer have he has to pay the tax in that much less proportion.

If we follow the regressive taxation then it increases the inequality of the distribution of income and money because in these taxes situation the pressure of taxes is more on poor people as comparison to rich people. Toll tax always be regressive because in this the amount of tax is same for rich and poor but the importance of money paying tax is more for poor people as comparison to rich people, so in this condition of tax, the pressure of taxes are more on poor people as comparison to rich people.

According to the proportional taxation, if the income is as it before then inequality also be continued as before. But if income changes into unequal proportion then in this, there are more inequalities in it. For example, imagine the present income of A is ₹ 500/- and B is ₹ 1000/-. Now if there is tax on both at the rate of 10% then after paying tax the net income of A and B will be ₹ 450/- and ₹ 900/-. Now if the income of A and B change into ₹ 600/- and 1400/- , then after paying tax their net income will left ₹ 540/- and ₹ 1260/- . It is clear that in after situation there is an increase in the inequality of distribution of income. In proportional taxation as the income goes high, the pressure of tax have more on poor people as comparison to rich people.

But in **progressive taxation**, the inequality of income and money reduces and that is because in the form of tax there is a big part of proportion of the income and money of rich people as comparison to poor people. So the most progressive tax system reduces the inequality in the distribution of income and money and the condition is that the rate of progressiveness is more fast, and it has the thinking of reducing the inequality of income. It is clear that the progressive taxation is said to be intellectual as a view about more equitable distribution of income and money. As a critic view, the target of the distribution of equitable income is to put tax on big earners and above to a fixed level, all the earning should be on one level, by this never put tax on the low earning. **Dalton** said, "All lengthy heads of poppy should be pointed". But this will not be practical because it can affect the production unfavourably.

So, the tax system should be based on the principle of **ability to pay**. Whatever high income a person has the ability of paying his tax is that much more and its opposite in the opposite situation. Those people who get unearned income, their ability to pay the tax is more than the people who earn income from their personal services. So, in this condition, it can be possible to put high rates of taxes on the people of first section as comparison to second section. As a view of equitable distribution the composition of progressive tax system could be managed as they do not have unfavourable effects on production. In other words, this can be said the rate of taxes should be according to highly progressive rates for the section of high earning and for middle income section it should be according to low rate and the low income getting should left free for paying tax. At the time of putting tax, the base of family and the nature of income should be seen.

But here this thing also be seen that the direct taxes can only be able to reduce the inequality of income and money when they are of progressive nature, otherwise not. For example, the direct tax according

to the proportional rate or the direct tax putting on the tax payer in equal quantity like toll tax becomes regressive nature, mainly then, when the distribution of income and money is unequal in the society. By this, this tax is not said to be right for the society because in these taxes, the pressure of tax is more on poor people as comparison to rich people. This type of tax will increase the inequality rather than to reduce. If, there is a proportional tax on personal expenditure then this is said to be of regressive mentality. The reason is, as the income increases, it reduces the proportion of saving on income. The result is, there is more pressure of tax on poor people as comparison to rich people. As a result, it can be said that direct tax can only be able to distribute the equitable distribution of income and money when they are steeply graduated or progressive.

Do You Know? As the income increases, the saving proportion of income reduces.

14.3 Measurement of Tax Progression

To measure the progressiveness or graduation of taxes, **Dalton** had taken help from Mathematics. According to him, if we show t as a rate of tax then the income is on x, then we can measure the progression or degree of progressiveness of tax by $\frac{dt}{dx}$.

In other words, at the time of change in income any quantity of progressiveness of tax whatever relative change happen, it can be measured by its proportion $\frac{dt}{dx}$.

$\frac{dt}{dx}$ on the change in income, the relative change of the rate of tax.

Now if $\frac{dt}{dx}$ is positive, then taxation will said to be progressive.

If $\frac{dt}{dx}$ is zero, the taxation will be proportional.

If $\frac{dt}{dx}$ is negative, then the taxation will be regressive.

It measures the regressiveness, it puts tax scale to a fixed or specific point, but it doesn't completely highlight about the tax system or the quantity of progressiveness found in the tax scale.

Dalton also shows a formula by that it can be possible to measure the degree of progression present in the tax system. This formula is like this:

$$P = \delta - \delta' + k$$

In that: P = quantity of progression

δ = the circle of inequality of income before paying tax

δ' = the circle of inequality of income after paying tax

k = positive constant

Here, this point is been kept in mind that the growth in inequality is not just because of proportionalness and regressiveness, but even because of slight quantity of progressiveness. So, as a conclusion, this can said that according to the base of above mentioned formula, inequality can only be reduced when P is positive and more than k. Sources also said that present tax system which is made up of both the taxes direct and indirect, it means that tax system, in which progressiveness and regressiveness both the elements are available, the desirable effects regarding distribution can only put when compensation of the effects of the elements of regressiveness by the elements of progressiveness, and by this, as a whole the tax system made progressive.

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14.4 Distribution Vs Production

This point is already been clear that mostly graduated and heavy taxation discourage the production and reduce it. If there is no increase in production then we can understand the meaning of equality of distribution to the equal distribution to poverty, not the equal distribution of money. So, taxation should not be so much heavy and most progressive that discourages the production. Now, if we see the second Part of problem and think according to the distribution of problem then it is very important to reduce the inequality of income and money that most progressive and heavy tax should be put. In actual the point is that correction in production and distribution, there are two targets of taxation, normally these two intersects at the time of practical. So, there should be a balance between these two targets of taxation that the tax system, in complete form, never put any unfavourable effects on production and not on distribution and this thing depends on the intelligence and technology whose use is done at the construction of the structure of country.

In developed economical country, where the productions reach to its optimum level, the target of taxation is to distribute the income and money equitable, and to maintain the present level of production. On the other side, in a developed country, the problem is not so easy, but very tough. In front of that country, there is a problem of improving the production or economy very fastly and the other side the problem is that how to remove the inequalities of income and money. Then, in a developed country, the disparities of income and money are very fast and the production level is low. In this condition, if by the most serialwise and heavy taxation tries to remove that disparities then by this saving discourage and there is a loss in production and without leaving unfavourable effects on savings by the direct and indirect taxes, there is an increase in production by making resources speedy then by this there is an increase and similarities and in disparities. In this problematic condition, where there is a question of removing disparities, about that they have to adopt soft way but in the speedy improvement in economy, hard step should be taken and by making resources speedy and the increase in investment the production increase has to be done and to alive economy. In these attempts, it is also important to be seen that the gain of increase in production could reach the poor section of the society in big quantity as comparison to the rich section. So, it is desirable that in an undeveloped economy the distribution also to be looked after along with the production.

Self–Assessment

Multiple Choice Questions:

6. Single tax is always -

   (a) regressive (b) progressive

   (c) proportional (d) same

7. By what the quantity of progress can be inform?

   (a) $\frac{dx}{dt}$ (b) $\frac{dt}{dx}$

   (c) $\frac{dy}{dx}$ (d) $\frac{dx}{dy}$

8. If $\frac{dt}{dx}$ is positive, then taxation will be of what types?

   (a) regressive (b) proportional

   (c) progressive (d) equiproportional

Notes

9. What effects does the most steeply and heavy taxation left on production?
   (a) increases (b) encourage
   (c) there is a loss (d) discourage
10. In which country the disparities of income and money are very fast?
   (a) developed (b) undeveloped
   (c) rich (d) progressive

14.5 Other Effects of Taxation

Effects of Taxation on Employment

The main target of public finance is economic stability, means stability in the levels of employment and financial actions. What is the contribution of government investment to maintain the financial stability, this is already explained. Now this is to be explained that what the taxation contribute to maintain financial stability. In this matter **Prof. Lerner** saying is right that the target in taxation should affect the form and result of financial actions. Any other is not a target like getting fiscal etc. Taxation reduces the credit power presents in the hands of people and reduce their expenditure by this. By the reduction in use, the effective demand of things and services produced also reduce and when the effective demand reduce then the level of financial actions and employment are also reduce. In its opposite, if there is increase in use, there is also increase in business actions and the quantity of employment. This thing is more right about the developed countries. When use reduces then there is increase in the actions production, business and employment. This thing is more right for **undeveloped** countries.

By this, when taxation reduces the normal level of use and increase the savings then the level of business actions and employment goes down, mainly in the developed countries, by this, when taxation discourage the savings and investments, then the level of business actions and employment goes down, mainly in the **un-developed** countries.

Task Give a brief account on the effect of taxation on employment?

14.6 Taxation and Economic Stability

For the growth of any economy, economic stability is important. To follow the rules of economic life of society, government can take help from taxation. It relates the thought of **Prof. Lerner**, "The only target of taxation should be to regularize the shapes of action related to production distribution and consumption".

14.6.1 Taxation and Inflation

In the time period of inflation and depression taxation can give its contribution differently. At the time of inflation, the target of taxation is to reduce the purchasing power from the hands of people. So, by putting new tax and by increase in the rates of popular taxes, it stops consumption, by this the possible demand level drops, and it helps to bring stability in costs. Not even this, in the days of

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inflation, by heavy taxes popular and the increase in the rates of taxes, the purchasing power of people transfers to the hands of government, if it is completely used as in the production work, it increases the employment and the level of financial actions and in the fulfillment of things and services the desirable increase the costs going high, stops. At the time period of inflation it can be important to give some tips regarding tax and some concession also because in the rates of investment on savings. For example, savings can be left free from taxation or that savings can be left tax free on those who used to pay the installments of insurance. Not only this, the new established industries can be left free on completely from paying tax to encourage production or it can be possible to put taxes on them by light rates for some years.

14.6.2 Taxation and Depression

As above already been told, taxation reduces the purchasing power from the hands of people. By this, taxation transfers the purchasing power from the hands of people to the hands of government because of this consumption discourage and it reduces the effective demand of things and services. By the reduction in effective demand, there is an increase in depression. So, if there is reduction of the quantity of taxes and the rates at the time of depression then there can be favourable effects on financial actions and employment. Except this, the government income collected by the taxes can be spent on the construction of roads like public utility services. So, there could be increase in effective demand. Not only this, those taxes put more pressure on poor section like normally, the production tax on the things used by poor people and sale tax, if in these taxes, if reduced, then there can be desirable effects on the financial actions and employment. The reduction of these type of taxes on one side the spending of people for consumption expenditure will increase and the income of manufacturers and retailers will also be increased and they will be encourage to increase production. As a result, there will be increase in employment and investment. The people normally related to low income spend a big part of their income. Sox, if there is reduction in these tax then there will be solid increase in total expenditure. Its opposite, the taxes affect more on the people of rich section by this consumption never discourage. So there is no need important to reduce them. In actual, in depression time the target of taxation should be to increase the purchasing power of poor people and this target can be achieved when there is less pressure of taxes on these people and purchasing power is to transfer from the rich section to these people. By making deficit budget, the purchasing power of these people can increase. By the increase in purchasing power of these people, there is an increase in effective demand also and as a result of this, the level of employment and business section goes high.

It is clear that in the depression period, by putting new taxes and by increase in the rates of old taxes and by removing taxes in currency reduction or by reducing taxes economic stability can be achieved. Modern economists called it Functional Finance which is the main part of economic policy.

14.7 Regulatory Effects of Taxation

Taxation can be used as a source of regulation of production and consumption. For example, by leaving the production of total things tax free and by putting tax on some other things of production the quantity and nature of production can be regularized. Not only this, but also by putting tax on the production and use, the consumption can be controlled. For example, the target of some taxes can be to reduce the consumption and production of wine like harmful things. By this, the international businesses of the country can be controlled by doing export, import. They says it is already clear that follow the rules of the quantity of consumption and production only taxation is always enough, its not right. To control the production and consumption including taxation there are many other ways to which can be adopted to control it.

Self–Assessment

Notes

State whether the following statements are True or False:

11. The main target of public finance is to maintain economic stability.
12. Taxation increases the purchasing power present in the hands of people.
13. When there is reduction in consumption then the saving and investments increase.
14. Economic stability is not important in the development of any Economy.
15. At the time of depression the target of taxation is to reduce the purchasing power present in the hands of people.

14.8 Summary

- At the time of adopting tax related policy, the target should not be to achieve Economic gain but also to maintain Economic stability and should stop inflation and depression.
- The meaning of taxation is to transfer the purchasing power from individual hand to the government. In other words, its meaning is to reduce the purchasing power of taxpayer and reduce to the ability to achieve the necessary, comfortable and luxurious things in life.
- The ability to invest depends on that how much saving are available for investment.
- Taxation affects the incentive of doing work, saving and investment of the people and in this condition, production affected itself.
- On the desire to do work and to save as comparison to income tax, expenditure tax can leave favourable effects. Progressive expenditure taxes discourage the waste expenditure on consumption and encourage the saving and investment. The use of expenditure tax can be to change the structure.
- The demand of per capita income is said to be elastic towards income if a person is not excited to maintain the present level of this income and he is not ready to do hard work to get that much quantity of income.
- Towards income, the demand of people is said to be inelastic when he has very high desire to stable his present income and even after paying tax he is bound to do more work to maintain the level of his precious income ₹ 12,000/- .
- The quantity of production and national income depends upon the ability and desire of people to do work and to save. But the composition of production and its form is demands that how the division of sources happen in between different industries and different areas. In different industries and different areas to do the diversion of sources, taxation can be fixed as a weapon of fiscal policy.
- The diversion of some sources are gainful. The harmful substances of consumption like the taxation on liquid substance discourage their production.
- Stick needy substance and normal consumption substance, the tax on these is not desirable as a social view; By the tax on these substances, the cost increases and by the increase in cost the consumption of these substance reduce.
- Reputed Economists like **Adam Smith, Ricardo, Mill** etc. said the main target of taxation is to collect revenue. German Economic **Wagner** can be counted as a first Economist who gave stress on this, "The taxation should be used as a weapon to reduce the inequality of income".
- **In the developed Economic Countries**, where the production rised to the optimum level, the target of taxation is that there should be sub judicial distribution of money and income in the

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society and the present level of production should be maintained. On the other side, but in an undeveloped country, the problem is not so easy, it is very complicated.

14.9 Keywords

- Preference - A greater liking for one alternative over another
- Invest - Put money into a financial schemes
- Enterprises - A large productor undertaking

14.10 Review Questions

1. Explain the effects of taxation on the composition of production and structure.
2. Explain the reason that affects the mental condition of taxpayers.
3. What is the difference between elastic and inelastic demand?
4. What do you mean by 'The nature of taxes'?
5. What are the substances which are responsible for the inelastic demand of income per person?

Answers: Self Assessment

1. Important	2. Purchasing power	3. Encourage
4. Equal	5. Internal	6. (a)
7. (b)	8. (c)	9. (d)
10. (b)	11. True	12. False
13. True	14. False	15. True

14.11 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Finance Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking - International Trade and Public Finace—*Nee. Thai Somshekhar, Anmol, 2004.*
4. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

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Unit-15: Public Debt: Meaning of Public and Private Debt and its Limitations

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Understand about the Comparison between Private and Public Debt
- Know the Objectives of Public Debts
- Know the Classification of Public Debt.

Introduction

Public debt is a source of collecting income by state. Public or local debt is the debt the state collects from the citizens of other countries. When government borrow, than it gives birth to public debt. Government can take debt from banks, business or organizations, business houses and the person. Government can take debt from inside the country and from outside the country, or from both the sides. Public debt normally is in the form of bonds (or if debt is for short time, then in the form of fiscal letter). In these bonds government process that he will not only pay back the money on fix time, but also give installments on a regular gaps on complete fix rate or in last in the form of a fix amount he will pay interest also. Debt is the last way of income for government. According to **Dalton**, "Public debt is a way of collecting income from public officers".

According to **Prof. J.K. Mehta**, "Public debt is comparatively modern incident and it would come in practical form with the development of democratic governments". The 'Adam Smith' said that, "Public debts create the conditions of war and extra expenditure".

Causes of Borrowing

Government can borrow because it can possible that local income was not enough for their expenditure due to incidental expenditure government could have to borrow because it is not possible to increase

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the tax income at that point. Government can borrow finance arrangement of capital expenditure because current revenue will not be enough to fulfill the target.

At the time of depression, when private demand is not enough then government borrow, the extra savings of people which is not in use and spends it to increase the effective demand and by this gives birth to the extra income and employment in the society. Its opposite, in the time of Inflation when effective demand is more than the completion of things and services available on current revenue then government put tax more than the need and expenditure so the extra purchasing power is complete or small part form can be changed and the purification could be done. These extra amounts from government taxes are supplementary to each other. Because of this 'fiscal policy' can not start successfully.

1. **Small Share of Taxes in National Income:** After India got independence, there is an increase in national income four times more. In present, there is a part of tax less than 20% in the national income but this percentage in America is 22.42%, in Sweden 26.3%, in Australia 27.9%, in Nederland 29.2% and in England 30.4%. Except this, in these countries, the most part of income from taxes got from direct taxes and in India the most part of the tax income is from indirect taxes. So, in this condition, fiscal policy can not be able to help in the increase in the development of Economy.
2. **Burden of Indirect Taxes:** In Indian tax system, there is a burden of indirect taxes that is not just. In the economy there is an inflation increase in indirect taxes that the complete tax arrangement has become imbalance and injust. Most of the pressure of taxes are from in indirect taxes the lower class people who have to face as comparison to rich section so this increase, economical problems in society. Regarding this, **Prof. K.T. Shah** says right, "Even there is more tax ability in rich section and there is less tax pressure on them. In its opposite, on lower section the tax pressure is equal to the part of lion and the ability to face is equal to the baby sheep".
3. **Imperfect Tax System:** The Indian tax system is not work perfect. In India, there is very high tax evasion because our tax system is full of error. According to the idea of **Prof. Kaldor,** in India there are tax evasion of ₹ 200/- to ₹ 300/- crore, every year. Except this, the complete part of income tax is never collected. In India, the income tax collection is less than 70%.
4. **Misuse of Public Income:** In India, a big part of public income misuses. A big part is spent on undeveloped plans, except this some plans are started on the basis of standard. A big quantity is spent on them even public got no gain from these. There is a big quantity spent on government departments where there is corruption, bribe, and redtapism available and work is completed with very difficulty. By this reason, there is a reduction in production.
5. **Increasing Public Debt:** To fulfill the five year plans in India, there is a big quantity of financial resources needed. To fulfill this public debt is to be taken as a help. And there is a regular increase in the pressure of it. Because of most of them depend on foreign debt, there is non-definite plans of economic development.

Notes There is four times more increase in the national income of India after getting independence.

Suggestions to Improve Fiscal Policy

In India, there is a need of improvement to give the speed to the economic development. For this, there are some suggestions -

Notes

1. **More Income From Taxation:** For economic development of the Public Expenditures fulfillment, it is necessary that the state government must try to collect more in income from taxation. For this, it is necessary to found new areas for taxation. At the time of collecting taxes it is necessary to be flexible. The pressure of indirect taxes, which is on poor people should be reduced. There should be tax on agriculture income by this, there will be increase in government income and in agriculture and non agricultural areas there will be equality in taxes.
2. **To Stop Tax Evasion:** The tax system to be made just and practical and tax administration should be perfect so there will be less tax evasion. There should be a change in the structure of tax so that there is increase in national income and the part of taxes to be increased.
3. **Tax-Pressure on non Paid Section:** non-paid section left free from taxes after getting high income or pays a very small quantity. This section spends most of their income part on unnecessary use. There should be a type of taxes in tax system so that these people could not save from paying tax.
4. **Work Perfection of Public Industries should be increased:** As a bad luck, there is not enough money collected from the local industries in India. Most of the industries are in loss. So, it is important that their work perfection should be increased and this income should be spent on development work.
5. **More expenditure on Social Services and Welfare:** If it is not possible to avoid tax pressure of indirect taxes which is on poor people then expenditure is on social services and welfare so that poor can take that gain. In it's regarding there should be more expenditure on education, health and other services.
6. **Encouragement to Saving and Capitalization:** In India, for economic development, it is very necessary to do Capitalization. By fiscal policy consumption should be discouraged and saving should be encouraged.
7. **Less Dependency on Foreign Debt:** A type of change is needed that we could less depend on foreign debts. This is right that to give high speed to the economic development, foreign debts are used to pay the debts taken at the time of depression or to fulfill the important needs. So, this is clear that a peaceful government debt policy can be used to face the conditions of inflation or depression.

   In last some years, there is a big growth in government work and because of this there is an increase in his income and expenditures. Because of the increase in the expenditure in after reasons of modern war increased and this is also a big reason for the growth in government debt.

15.1 Comparison between Private and Public Debt

There are many similarities and dissimilarities between private or (non government debt) and government debt. Private person and business home use this debt money to get some resources. So, private debt transfers the money from one use to another use. By this, the meaning of public debt is those productive uses who are liked by no government area, sacrifice for those uses, which the government likes. By this government and non government debt, are both normally transferred for money from one use to another. The difference between public and private debt are following -

1. For government, there are internal and external both the sources are available but for persons these type of sources are not available.
2. The use of debts taken by the government is for the complete society but the money got from private debts are used only for gain of debt taken person.

Notes

3. As state has a good position, so as comparison to private debt, the rate of interest is law in government debts. Normally, it happens that some corporation got debt on simple rates like government.
4. Government can force people to give debt but a person can not.
5. Government takes debts normally for production works but a person can take debt for consumption.
6. Personal debts are returned by public income, in which public industries income is also included. But a person pays debts from his personal income. So, by public debt, the nature of pressure is different from the nature of private debt's pressure.
7. In the last government can borrow debt in a form of policy, whether he needs money or not. It can be possible that debt helps to bring stability in economic life. In the days of depression, it reduces the quantity of work power in the hands of people, it helps to bring the rates down. In the days of depression, government is able to do some types of expenditure by debts; it helps to bring the level high for employment and business actions.

Do You Know? Private debts transfers the money from one use to another use.

Self–Assessment

Fill in the blanks:

1. Public debt is a .....to get income for state.
2. After India got independence, there is an increase in national income more than .....
3. In Indian tax system .....abundance of taxes.
4. .....debt transfers the money from one use to another use.
5. The nature of the pressure of public debt is .....from the nature of the pressure of private debt.

15.2 Objectives of Public Debt

1. Income and Revenue: The target of public debt normally is to cover the ditch that developed in any year between proposed expenditure and expected revenue. Whenever because of increased administrative expenditure or flood, feminine, earth quake and communicable diseases like unexpected problem government's income becomes less because they have to spend it to covers these problems then government cover it by taking Indian and Foreign debts. This is the government; whose income is different from all the taxes and revenue sources.

2. In Times of Depression: Depression is the condition when costs reduce, there is a lack of courage in people for spending money on industries and in future there is no possibility of getting gain. This condition can be removed when there is increase in the demand of things and services and that is possible when in the country there is an increase in the expenditure of public construction work or most important public use and infra-structure services. But, the increase in government expenditure is only possible when there is increase in government income and increase in public income is not possible by taxation because it affects unfavourably the incentive to do work and to invest that reduce the effective demand. So, there is only one way to take debt for the government. Governments mainly take debt from banks so that they can get money for investment and could increase the income or

employment and as its result effective demand could also be increased. By this, the reduced cost can be stopped and government is able to bring process and to develop it at the time of economic depression.

3. To Curb Inflation: Inflation is the name of that condition at the time of increased cost. So, government by taking debt can take back a big quantity of work power from the hands of people but modern economists believe that as comparison to government tax, taxation is said to be more important will to remove inflation, because if the debted government money is never used in productive use, it increase the responsibility for government to give it back. But waste tax - income can easily to be debitted in the government fund so the pressure can be removed from production in economy.

4. To Finance Development Plans: In undeveloped economy, there is always a lack. In these countries, as the ability to pay the bill is less. So, government can not take shelter on heavy taxation. But to remove poverty from the country, this is also most needed and important to do arrangements of development plans. In this condition, the only way is to take public debt. So, the governments of undeveloped countries take debts from within the country or from foreign governments or from people to do finance arrangements.

5. The Finance Public Enterprises: Government also takes debts for the arrangement of finance for the commercial enterprises running by itself.

6. Expansion of Education and Health Services: Government can also take debt for the construction and development of education and health services and other services like this. That helps to increase normal social welfare but does not give any direct finance and that is not productive from the angle of currency.

7. To Finance War: Government can take debt for the self defence work. In the present century of increased international pressure and atomic war, there is a need of money in big amount to save the country from foreign attacks and for self defence services and to do the arrangement of modern decoration. But it is very difficult to collect the money for modern wars only by taxation because it affects the production unfavourably. So, to cope up with this type of situation government can take shelter from public debt from inside and outside the country.

8. For the Establishment of Social Society: For the establishment of socialist society, government is doing nationalism of industry and business in present time and running it themselves, but to run modern industries, there is a need of big quantity of money government can only fulfill this by taking debts.

9. To Cover the Expenditure on Administrative Work Till Getting Income: The income which government got from taxes that is available at the end of the year but expenditure is from the starting of the year so at the beginning of the year government spends money by taking debt and pays the debts when it got the income in the last of the year.

10. To Make the Public Verdict Favourable: When the citizens are not able to pay the tax then the government have to take debt. Some times even then the more capability of public, the government never increase taxes because the public verdict sticks to favourable.

Task Give your views on Depression.

Self–Assessment

Multiple Choice Questions:

6. In the time of emergency from which sources, the government take debt?

   (a) only Indian (b) only imported

   (c) Indian or imported (d) all

Notes

7. What type of situation is depression?

   (a) when the rates going down (b) when rates are increasing

   (c) when rates are stable (d) above all

8. In undeveloped economy there is a lack of what?

   (a) labour (b) majority

   (c) money d) courage

15.3 Classification of Public Debt

Economists have divided debt on the bases of use, target, time limit and terms of payment. The different types of public debt are following -

1. Internal and External Debt

Internal debts are those public debts taken from the country inside, but the external debt is a debt taken from foreign governments. Foreign people and international organizations, In **Dalton's** words, "A debt is internal if given by those people or organizations living in that area that is controlled by the local officer of taking debt, a debt is external, if given by those people and organization living outside of that area". By the payment of interest on foreign debt, there is a reduction in net income of debtor country because their income's big part goes to the foreign country, but it doesn't effect at the time of paying interest on internal debts. Whether the interest on internal debts leave on tax payers or taken from them and paid as a form of interest on war debts, it does not effect the national income of the country, that becomes stable like before. This is form of method by which money is taken from the taxpayer one pocket is been debt in another pocket. So, the payment of this interest never affect the production capability of country completely, but it can be possible the affect indirect, so if foreign debt is used on production purposes and is used even for the purpose of war works, it can not be wrong. In first situation, its payment can be from there, where its investment is done and they will be able to save the owner of the country for that we can not say any sacrifice big.

2. Productive and Unproductive Debt

This classification depends upon on the use of public debt. Debts can be used for the production works and unproductive debt. Productive debts are those debts which are used in those plans which provide income, like railway, plans of electricity and the plans of irrigation. The income got from these plans can be used to the payment of yearly interest and for the payment of Principle. So, productive or reproductive debts are those debts where are same costs or the assets of more cost kept. By this, productive debt never put pressure on government and taxpayer.

On the other side, unproductive debts are those debts used in that plans, no income is provided, for example, war. So, unproductive debts are those debts, no assets is in the back. The main reason of unproductive debt is not only on war but at some point the losses of interest is also the reason.

3. Redeemable and Irredeemable Debt

Redeemable and Irredeemable debts are those debts the government promises that he will pay back the debt on a fixed date. These debts are also called **terminable debt** and those debts which are without any promise they are called **irredeemable** or **perpetual** debt. When debts are not returned then the governments have to do same arrangement to paid back the debt. If government decides that these debts will be paid back from the tax income, which is the best way in almost all the situations for this

work they have to put new taxes. So in the condition of redeemable debts government have to pay both interest and principle amount on a fixed future coming date. But in the condition of irredeemable debt government only have to pay the interest regularly. Redeemable or term debts can be re-categorized as short term, medium term and long term debts. Short term debts get mature between a period of 3 to 9 months such as Treasury Bills. The rate of interestis normally low on such debts. Long term debts usually mature or due after a period of ten years and their rate of interest is high. Medium term debts mature between short term and long term period means it matures after 5 years approximately and their rate of interest is of medium quality, means neither more and nor less.

4. Funded and Non-funded Debt

Government debt can also be divided in the form of funded and non funded debt. Funded debts are long term debts. Payment of these debts can be done within one year or it can be possible, not to give any promise regarding this in other words funded debts are those debts, in which the payments are given with in, one year. Treasury bonds are unfunded debts, because these debts are given for three or six months and their time period is not more than one year. Even then, this is clear that in the condition of funded debts, government is responsible to pay the regular payment of interest to the debt payer; yes their basic money payment is totally left on the government. So, in these debts condition the bond holder have no other right except this, to get interest on that amount they have given as a debt to the government.

5. Voluntary and Compulsory Loans

Government debts are normally of voluntary nature and to person and organizations controlled by the government bonds are voluntary. Today compulsory loans are not much popular but in the condition of war, government are can put pressure on people to give loans. Government can also help in the condition of depression, so that work power from the hands of people could be reduced and stop the increasing rates. In almost all the matters, the loans are **over subscribed** given by the government because the credit of government is very good as comparison to private companies or person and this is the reason that the rate of interest is low on government securities as comparison to other loan securities. Government securities are said to be the best loan security. But on government securities when there is less rate of interest then it is difficult for government to take loan from the public voluntary and in this condition he has to use its effect.

6. With Rate of Interest and without Rate of Interest

On loans with rate of interest, government gives interest on a fixed rate to the loan taker after a fixed time period, but on without rate of interest, loans government don't have to pay any interest.

7. Purchasable and Non–Purchasable Debt

In purchasable debts, it includes government securities; whose sale and purchase is not possible independently. Its opposite, those securities are included in non-purchasable debts, whose sale and purchase is not possible in the open market and can only given back to the government on a fixed rate.

8. Total Debt and Net Debt

On a fixed time whatever debts governments have, the total of all is called total debt. If government collects any fund to pay back the debts then the amount of that fund subtracted from the total debt and whatever left is called net debt.

9. Short Term and Long Term Debt

When government takes debt for a short period, then this is called short term debt. These debts are paid back in the time period with in a year that is to be taken to complete the tenure of debts. When governments take debt for a very long period then this is called long term debit. The time of giving it back is not fixed. At that time the debt is paid back, the debt giver got regular interest.

Notes

Self–Assessment

State whether the following statements are True or False:

9. Internal debts are those public debt; taken from inside the country.
10. Interest paid on foreign debt increase the net income of the debtor country.
11. When the debt is perdue then the governments have to do arrangements to pay back.
12. Unfunded debts are those debts which are paid back within one year.
13. On a fixed time whatever debt governments have, their total is called total debt.

15.4 Summary

- There is an increase of four times more in the national income after India got independence and in nation income there is less increase in the percentage of income got from tax. At present, there is a part of tax is less than 20% when this percentage is 22.42% in America, 26.3% in Sweden, 27.9% in Australia, 29.2% in Neederland and 30.4% in England.
- This is important for the fulfillment of increasing local expenditure on economic development that state government should try to collect more income from taxation. For this, the new area of taxation is to be found.
- In last some years, there is an increase in the works of government and by this there is also increase in their income and treasure related expenditures. Because of modern war and for their own safety expenditure, there is an increase in government expenditure and this increased expenditure is responsible for the increase in government debts.
- Private debt transfers the use of money from one use to another like this, the meaning of public debt is that the productive use of those non government area like to sacrifice for those uses liked by the government.
- The target of public debt is to cover the ditch that has been developed between proposed expenditure and expected revenue.
- The depression is the name of increasing rates. So, government can take back much quantity of credit power from their hands and by this.
- Internal debt are those public debts taken from inside the country.And the outside debt from foreign government and towards international organisations responsible for the countries payback money. In **Dalton's** words. A debt is internal if it is in that area that is cotrolled by the local officer who collects debt. The debt is outer, if given by those persons or organization who lives out of that area.
- Debt can be used for productive works and for non-productive work also. Productive debts are those debt which are used in those plans of electricity, plan who gives income , like, railway, plans of electricity, plan of irrigation. The income from these plans use in paying yearly interest and paying basic amount lastly.
- Reedemable and Irredeemable debt are those debts in which government promise to pay it back on a fixed date. These debts are called term debt.

15.5 Keywords

- Expected - Think that something is likely to happen.
- Debtor - A person who owes money.

15.6 Review Questions

Notes

1. Write a short note on:
   (a) less share of taxes in national income.
   (b) Indirect taxes.
2. What are the suggestions for improvement in 'Fiscal policy'?
3. What is the difference between public debt and private debt?
4. What are the objective of 'Public debt'?
5. Explain the classification of 'Public debt'.

Answers : Self Assessment

1. sources	2. Four times more	3. Indirect	4.Personal
5. Different	6. (c)	7. (a)	8. (c)
9. True	10. False	11. True	12. False
13. True			

15.7 Further Readings

Books

Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt.Ltd.*

Indian Public Finanace Administration—*Manjusha Sharma, O.P Bohra, Ravi Books.*

Money Banking : International Trade and Public Finance—*Nee. Thai, Someshwar, Anmol, 2004.*

Public Finance—*Nandkishore Prasad, ABD Publication,2011.*

Notes

Unit-16: Effect of Public Debt : Public Debt and Economic Growth

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Understand different effects of public debt.
- Collect the information about the burden of public debt.
- Know the management of public debt.
- Know things regarding gain or loss from public debt.
- Understand public debt and economic development.
- Know about inflation.

Introduction

Notes

Public debt of any country affects its economy in two types – It puts 'revenue effect and 'expenditure effect also.

1. **Revenue Effect:** When money is taken from public by the medium of local debt then the people have to do changes in their buget .Whether, it can be possible that Public debt doesn't affect consumption- expenditure directly as the taxation does, because people use the saving of present and future to buy government securities. But in some matter, it can be possible that the people try to increase their saving by reducing their waste expenditure to buy securities. It is clear that public debt affect the consumption expenditure, this can be said **first effect of public debt.**
2. **Expenditure Effect:** To spend the money on people collected by the public debts, the gain are to be given. This is the second effect of public debt. These gain are not different from those given by the expenditure of tax income – The thing is the collected money from debt is used in similar way as the tax income are to be used . But the fact is that to left some matters, the money collected from debt is always used differently as the tax revenue are to be used. But this difference is not always fast. For example, tax ravenue can be used to give salary to the teachers then the amount of debt can be used to construct buildings of school. But the expenditure of taxation and debt proceeds whatever affects come, they are mostly similar. But in some matters, we can see difference clearly. The consumption of amount taken from debt is used to arrange finance of capital nature, like the establishment for the production of atomic power; but the proceeds of taxes are used to do financial management of current or revenue expenditure. It is clear that the first type of effect is different from second type of effect.

16.1 Other Effects of Public Debt

Now, we will discuss that what are the effect of public debt on consumption, production, distribution and non-governmental are following –

1. Effect on consumption
2. Effect on production
3. Effect on distribution
4. Effect on non-government area
5. Effect on production
6. Effect on employment
7. Effect on investment

1. Effect on Consumption: When people buy government securities then it is not important always that they do credit of them from past savings. Sometimes people buy these securities from their present income whose usage they do on different things in other situation. As they have offer to buy government bonds of less amount, so they buy bonds by leaving consumption of some things. For the financial arrangements of five year plans in India, the saving plan is of the same nature. So because of the money investment in national plan certificates the people; present expenditure becomes low to such a level. But, when people buy government securities from the money of their savings then they have different affect. It doesn't affect the present expenditure and it remains the same as before. In this condition, the private non-government investment becomes in-affective but if this amount is credited from the amount saving in banks then it reduces the available money the banks have. In this situation, the banks have less money to give debt to private business so it affects the private investment.

Notes

2. Effect on Production: If people buy government securities by selling industrial organization's share and debentures then it puts adverse effect the non-government investment, the net effect on investment depends upon that how the government use the' money of public debt, If the government use the money of public debt on governmental industries then it does not put adverse effect on available investment for production. But, if the government invest it in unproductive work then some investment will definately affected.

If people buy government securities from their spare money then there will not be any effect of it on non-governmental investment. But, if the purchase of securities is done by withdrawing their money from bank then there will an adverse effect of it on non-governmental investment, because the bank's capacity to lend decreases due to reduction in deposited amount.

The bank's ability to lend is usually elastic. The power of giving credits by banks depends upon its resources and the policy of country's central banks. When the centre promotes creation credit then the extension of credits in country is clearly more. The bank can extend reputation on the basis of ad-hoc or newly created securities. In this way, governmental credit does not lesson investment in non-governmental area, on the condition that there must be sufficient money in the market and on the condition that the government must use creditted amount on productive works. In addition to this, it may be possible that the government may use receiving of loans in payment of purchased goods from contractors and may use it to give wages to its employees. New purchasing power will reach in the hands of people by this and it will increase deposited amounts in banks and it will be use to give loan in non-governmental area. Therefore, if government takes credit from banks then it is not necessary that it may affect investment of non-governmental area.

If government uses credited money in unproductive works, then the payment of those credits can only be done by additional taxation in future and the consumption can be affected from this additional taxation in future. But, it is not the fact all proportional credit consumption get affected. The credits which are used in welfare plans increase the work-effeciency of production of those employees and labourers. When production increases then the income of society also increases and in this state, there is not any effect of additional taxation by consumption. If credits are used directly in production works then the income of people increases. As a result there isn't any adverse effect on consumption, but it increases further. Not only this, the interest can also be paid with the basic money from this increased income.

3. Effect on Distribution: The buyers of government securities are mainly from rich section. But to pay the interest on those debts whatever tax the government puts, it also affects the lower class. So, public debt increases imbalances in income. In this condition, it is clear that the public debt can't put desirable effects on distribution. If the bond holder and tax payer both are same then there is no redistribution of income and in this condition there will be no increase in the imbalances of income. But normally it doesn't prove right. So, if the bond holder and the taxpayer will be related to different sections, there will be a little bit redistribution of income and as it is already been said, there will be increase in the imbalances of income.

If public debt is used for economic welfare of low income groups then the inequalities of income reduce and there is more equal distribution of income between different groups of society. But, if inflation occurs due to financial condition of debt, then the good effects of distribution of income due to price-rise become fruitless. In this way, if the receivings of debts are spent on welfare plans, then it casts favourable effect on distribution.

4. Effect on Private Sector: Now, we will discuss that what are the effects of public debt on the private sector of economy or non-government area. By each type of government expenditure, there is an increase in the quantity of purchasing of power of people and more money comes in circulation. So, there is increase in the demand of things, when this expenditure fulfills the taxation, then the current consumption reduces, But when it is fulfilled by the borrowing then normally people uses extra saving to pay debts. As a result, there is no loss in current consumption. If government uses the debitted

money to buy the things produced in private areas, then the demand of there things will definately be increased at that point where the government spend this debted money for this work, by this extra taxation. How ever, it is possible that some part of borrowed money may be spent in giving wages to employees. In this condition, officials can purchase produced goods in non-government area. So, the effect of debited money may be such that the demand of produced goods of industries of private or non-governmental area may increase and there isn't any adverse effect on supply. In this way, the effect of public debt on non-governmental area can be said favourable.

5. Effect on Cost of Production: Here, this will be right to discuss the affects of public debts on the cost of production. Cost of production depends upon the cost of raw material and the other factors of production. It can be possible government may use the money taken as a debt to provide raw material on combined rates to the manufactures and to provide the services of transport and training. Government can also use this money for industrial research and can use to provide materials to private industries.

These are the examples in which by the expenditure of the money taken as a debt there is a reduction in the cost of production. So, the effects of the debted money are also favourable in this direction.

But this is a topic to be discussed that when the debted money is used then there is a demand of labour and capital. If there are lack of labours then in this condition rates of labour become high. Because of the rate increase, the cost of production also increase and if affects the private industries unfavourably. But if by the increase in rates, there in no unfavourable affect on the demand of production of things then there is no bad affect on private industries. In other words, because of the use of the debted money, the proportional increase in demand, because of lack of labour is more than the proportional increase in the cost of production then there is no nonfavourable affect on industry. But the lack of labour is always stable, this is not right.

Notes This can be possible that waste labour is more in quantity and if the government use these labours then it doesn't unfavourably affect the private industry in the I.R. of the cost of production.

6. Effect on Employment: In the time of depression, the cost, consumption and production falls down. In this condition, government collects money from the securities on the basis of centralization and spends on those works that increase the employment and laxcity of business become end.

7. Effect on Investment: Normally, these is unfavourable effect of public debts on investment. If government get debt from the banks purchasing this extra power will came in the public and there is no reduction in the amount of investment. But if the money for debts are taken from the private savings or business then by this the investment will reduce. If the rate of interest is stable and there is no special attraction then there is minimum possibility of reduction in private investment.

16.2 Burden of Public Debt

The meaning of the burden of public debt is that sacrifice which public have to bear because of the effects of increase in taxation. The increase in taxation is to be done when the public debts are given back and when the payments of yearly interest has to be given.

The public debts burden can be direct or indirect. The measurement of direct money burden is to be done by the quantity of amount for debt return and by this, the quantity of increase in taxation. Direct real burden is equal to the loss of that economic welfare that is because of the increased direct money

Notes

burden of taxation. But the meaning of indirect burden of the debt is the quantity of unfavourable affect of increased taxation on the level of production.

At the time of estimating the burden of public debt, it should also be seen that the debt is productive or non productive, that is internal or external and what is the condition of price level in the economy.

Do You Know? If the level of costs drops, then the value of money increase and in the opposite situation, it is totally opposite. If the level of cost drops then the real burden of intrest increases and in opposite condition, this is totally opposite.

Estimation of the Burden of Public Debt

There are many ways to estimate the comparative burden of public debts. But in this matter, the result is that if we think about all the matters, are not to following one method, all the methods includedly should be apply. The most useful methods are:

(1) To know the proportion of national debt on national money and income and (2) To know the percentage of the expenditure of debt services on total normal expenditure. (3) To estimate the relative burden of public debt mixture of both of these methods is useful.

Burden of Internal Debt

Wherever till there is a matter of internal debt, it can be possible that on society, completely, does not have any direct money burden, because the repayments of intrest and debt and the taxation to fulfil that is the only transfer of the purchasing power from the people of one section to the people of another section. If the bond holder and tax payer both are same then it can be possible that there have to be no net burden on the society. But if the bond holder and tax payer both are from the different income group, then in that situation, there will be definite changes of the distribution of income in between different groups. But at the time of estimating the burden of public debt, the objective of debt should also to keep in view. If there is a use of debt for productive purposes, then their repayments can be done by the gains of investment, put for the financial management of war, the debt taken is said to be dead weight debt and their repayments done by the increases in taxation. It is clear that, there is no burden on the above said first example. In the condition of examples also, this is said that whatever burden the tax payers have due to taxation, ended by the gains they got from the intrest of bonds. But here, one should be remember that if rich people pay less as a term of taxation in an I.R. of proportionately, in which proportion, they have public securities available then it affects the society directly in actual. Thus Dalton conclusion is that there is always direct real burden of internal debt because all the securities are to be taken by rich people and the progressive sequential taxation normally is not very progressive that it could counter balance the income from the rich people's government securities. It is clear that there is net increase in the burden of society and we will also agree with it. Society also feels the burden of government debt in another way and for the repayment of this government debt they put taxes on the people who are courageous, patriotic, active and young, but the people who get gain of this taxation are rich, old and the people who are fond of luxury those who get the intrest of their debts given to the government.

At last, the increased taxation that is to be put for the reimbursement of debts and their interst can affect the ability of doing work and to save money, so, this is very important the matter management of payment of debt should be of that method, it have no nonfavourable effects on the production and distribution.

As conclusion, it can be said that the internal debt as a whole put burden on the society definitely and this is a faith that internal debt put no burden on society, theoretically wrong and practically unelastic.

Burden of External Debt

The nature of external or foreign debt is different from the nature of internal or Indian debt but at a glance the burden of external debt is same as the burden of internal debt, the government have to pay the internal and external debts by the extra taxation. In Dalton's words. "In a form of normal rule, the possibility is that the internal debt will put extra and indirect burden on society, and the external debt is definately do this."

However, point of view from other I.R., the burden of foreign debt is more than the internal debt. The reason is that in the case of internal debt, the payment of principal money and interest is done in the country, its result is that the reimbursement of debt and interest and in this, there is only transfer of money from one section to the another section of the society and some time taxpayers and interest gainer, both are same. But in the condition of foreign debt, the return of debt and the payment of interest goes to those people who live in foreign. So by the payment of the foreign debt, the net income of the debted country reduces because a portion of income of that country transfers to foreign countries. But there are no affect like this on the payments of internal debts. Thus, it is clear that foreign debts put more burden than the Indian debt. Then, direct money burden of foreign debts is said to be the payment of that money that is to be done to return the principal money. But the direct real burden is that net loss that have to be on debted return bear in the field of economic welfare in the form of use of things and services. So, the direct actual burden of foreign debt examption to the people will be different from that proportion in which different sections of the society will give their contribution to the payment of government debt, because the money paid to the foreign debtors, that is collected by the taxation, so if the relative burden of taxation is more on rich people then it is completely on society, the quantity of direct relative burden will be less as compare to that condition and the relative burden will be on the poor people.

This can be explained in a different way also foreign debtors collects money in the replacement of debts, they use to them to buy things and services but in other conditions, this money remains with the citizens of debtor country, so the citizens of debtor country is left behind from that much quantity of things and services, in which quantity, the residents of creditor country buy in place of debt. So, if a debtor country is left behind from whatever quantity of things and services that quantity is the indicator of actual direct burden on society. If this is left behind alone, quantity mainly comes in the part of rich people. Then completely the direct actual burden on society is less than the condition when this is left behind alone quantity have left on poor people mainly.

The direct real burden of foreign debt depends on that target or work in which this debt is spent. If foreign debt is used to fulfil the war expenditure then this is called dead weight debt because this expenditure is of unproductive nature or it does not help in the increase of production society. If foreign debt is taken for short period then the posterity left is saved from the burden of that because the only present generation pays it, but foreign debt is taken for long term then it affects the posterity. If foreign debts are spent on the productive works, means if it is used in the agriculture and industry and the other areas development economy for machinery, raw material, technical knowledge and to buy other capital material then the debtor country is able to reduce the actual burden of foreign debt to some point. In this condition, posterity not only get the burden of foreign debt in her, but also get the gain in the economic development and extra income with very fast speed. So that they easily pay the previous foreign debt without experiencing the actual burden. Alexander Hamilton, who was the treasure secretary in ministry in Washington, favoured for the need of foreign fund for development. They have said that whatever the critics against foreign fund that non-critic and the result of illogical

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and unwisely jealously. **Foreign fund is very important for the encouragement of industry**. Yes, this is right that there about are some dangers in of society foreign fund like foreign funds gives birth to exploitation and kill the spirit of comptetion, but Hemilton's faith was that it can be possible to be saved from these dangers.

The indirect burden of foreign debt depends upon the costs. When the cost drops then it increases and that the time of cost increase it decreases. For example, if cost drops, then the United States of America will have to import services and things in more quantity to repay 100 dollars.

Foreign debt indirect burden is only developed at that time when there is affect on the production ability of society and this is only possible when foreign debts are used in the non-productive works. In this condition, foreign debt becomes dead weight debt for the society.

As a result, it can be said that the foreign debt used in productive works are not burden. So they don't have to discourage at that time till then they are capable to increase the economic progress of economy and for the development of society completely.

16.3 Loans Versus Taxes

Sometimes government to face such problems to fulfil any expenditure they use the way to put tax or to get debt. By heavy taxation and the debt taken without any thought, this is a fear that the financial structure may not be destroyed and it does not become a reason of bad luck for the society completely. So, we will discuss on that for regarding the revenue collection what normal rule should be followed.

Public debt or tax which one is good source, this question is very difficult but even then these following facts are important:

1. **Local Expenditure:** The meaning of local expenditure is the expenditure of police, Public administration, education and medical. The local expenditures should complete with the taxes because it does not construct any property. So, if local expenditures are completed with the debts then the public debt will increase continuously and for its reimbursement heavy taxes will have to be put.
2. **Emergency Expenditure:** From emergency conditions like famine flood, war, people have to face limitless suffering. In this condition, if the support of taxation is to be taken then there will be the condition of internal insurgence in the country. So in this condition, to do financial management it is said to be right to depend upon debts.
3. **Expenditure in the Time Period of War:** War expenditure is of the huge shape and government have to depend on tax and debt to maintain the financial managements because it is not possible to collect a big amount of money from one resource.
4. **Currency Expenditure:** There is a construction of stable property by currency expenditure like rail, road, sources of irrigation etc. Currency expenditure is on big scale and its gain is normally to the coming generation. So, currency expenditures should be complete from debts so only the coming generation feels the burden. But today thought is that the currency expenditure which is also called development expenditure, should be completed by taxes.
5. **Economic Development:** Many plans have to be started in the country for economical development. A big amount of money is spent on these plans and this amount not only can be collected from the taxes. So, it is compulsory for the government to take debt.
6. **Public Welfare Services:** In undeveloped countries, Government have to finish many welfare services like transport, postal and telegraph etc. To fulfill these services a huge amount of money is required. Whose fullfilment can not be Possible by taxes only. So, they have to take debts.

16.4 Difference between Taxes and Loans

Notes

1. Taxation is a burden on current income but if the loan is the reduction in coming efficiency of expending shows the reduction in power of debt expenditure.
2. Taxes are paid by the yearly income and their relation is with the deduction of present facilities but debts are paid by savings and it reduces the funds available for production in the non-government areas.
3. Tax is a compulsory contribution but debt is normally additional. The burden of tax is instantly affective but the burden of debt is effective on future.
4. It can be possible that the burden of heavy taxes are not be consistent, but the burden of debts becomes consistent in long term.
5. Tax controls habit of doing rashly expenditures but it loan gives hope to increase the income in future and this hope makes the person extravagant in present.

But it doesn't mean that the financial arrangement of debts should be neglected completely. Actually the fact is that the taxation and debt both should be made combine in the legal from. There is sufficient elasticity found in a good tax-policy. So, this is right that the increase in government income should be according to the medium of taxation. But, when the increase in taxation comes to an end, then for the financial management, the shelter of debts should be taken.

Task What is the difference between Tax and Debt?

The rules of the financial managements of non-simple expenditure on the non-economic works are following:

1. Wherever possible and practical, fulfillment of local expenditure should be in yearly gains. If there is a increase in expenditure the increase in taxation should be done at the same time.
2. If there is non-recurring in big amount then its financial managements should be debt. By this, there will be no possibility of change in the prevalent tax system.
3. But, when there is a possibility that uncommon expenditure will continue till many years then there must be some changes in the structures of taxes for its fulfillment.
4. This theory doesn't work where; (i) there is no consistent distribution of big taxes, (ii) the production of different taxes have to be increased much, or (iii) where heavy taxations are inappropriate from political point of view. In any circumstances a person should take support of debit with taxation.

16.4.1 Role of Taxes and Loans in Financing Development Plans

Many underdeveloped countries have to face the problem of money for their development plans, the problem is that whether finance for development plans must be done from taxes or loans.

Generally, poverty is found in under-developed countries, per capita income is very less, the distribution of money is unequal, the standard of living of people is very low and the ability to pay tax of people is very low, in that condition, the area of additional taxation for financial development plans in such countries are also limited. Heavy taxation limits consumption and discourages motivation of production, therefore, in such countries, it damages the objective of development. In addition to this, it is possible that some projects must be so expensive that the fulfillment of expenditure cannot be done by taxation. In that condition, loan must be taken from internal and external sources for financing

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of development projects., the ability to take internal loan of under-developed countries is very low, therefore, it is very important for them to take loan from external people.

Finance of development projects by loans can be considered suitable on this basis that projects are productive and the consumption of their benefits are availed by next generations also. Therefore, if their burden is kept on next generation then there is no harm. The payment of such taxes can be done on such time when these projects begin to production. In that condition, long-term loans must be given preference because short-term loan becomes mere postponement next of taxation for some time.

The belief about financing of development projects by loan can be right theoretically, but practically, it is considered dull to depend upon loans totally. Budget surpluses can also be used for financing in such investments. This source is managed for five yearly plan of India. Not only this, other countries have also used budget surpluses for this task. Economists believe that if financing of economic re-construction is not done by budget surpluses then economy of different countries have to bear harm. In addition to this, the conditions related to inflation can be banned in appropriate quantity also when budget surpluses have to be used, because during development, due to heavy investments, such surpluses are normally created.

In this way, it is clear that financing of development programs must be done by both taxes and loans. There is no doubt that loans have important place in development finance but financing of a part of development programs must definitely be done by budget surpluses. By it, there will be no more real burden on current consumption in society that will be caused by same amount of government loan.

Self–Assessment

Fill in the blanks:

1. When the money is borrowed by the people through the medium of public debt then people have to change their ..... .
2. The buyer of government securities are normally the people of ..... class.
3. The nature of external debt is different from nature of ..... debt.
4. Tax is a compulsory contribution but debt is normally ..... .
5. Heavy ..... is usually found in under-developed countries.

16.5 Public Debt Management

The objective of Public Debt Management means that there must not be any adverse affect on economic condition of the country on debting and methods of their return by government. Opposite to it, help must be provided in maintaining economic stability from these methods. In other words, taking debt and the method of its return by government must be such that there must be less affect on economy, by inflation and deflationary effect and government get money for its requirement. Therefore, all those rules and regulations must be included in public debt management which is adopted by government for achieving these objectives by debting and the process of their returning. For example, if government reduces its public debt then it can cause inflationary or deflationary effects. If government gets the return of public debt by deficit financing or by last savings then its affects are inflationary. If taxes are increased to return debts of banks then its effects are deflationary. In these conditions, public debt management contributes in such a way that such methods must be adopted which do not encourage the condition of inflation or deflation. Therefore, during the days of inflation, government increase

the amount of their debt and increasing the rate of interest and does opposite to it during the period of deflation. Not only this, the usage of budget surpluses collected as taxes can be used for debt return during the days of deflation and additional taxes can be imposed during the days of inflation. These methods bring economic stability instead of creating economic unstability.

16.5.1 Definition and Significance

Public Debt Management is related to some such decisions in regard of debt that what must be the structure of public debt issued, what must be the conditions for selling new bonds, how to return matured debts, what must be the ratio of issues different types of public debts, what must be the structure of maturation of debts and ownerships of debts etc. In brief, it is related to characteristics related to the structures of public debts. Some people believe that public debt must not be reduced and the payment of interest must be either paid by tax-receipts or by issuing new currencies. In addition to this, return of debt on maturing debt must be done by new issues and issuing debt letters. But, some people believe that when public debt gets mature, it must be reduced.

It is very important to manage public debt appropriately because there are important economic effects of changes on the size of public debt on conduction of economy. These changes give life to monetary and fiscal policies of government and can be unorganize them.

Notes Public debt policy, monetary policy and fiscal policy are related to each other very closely and all these things include determine economic policy collectively. Therefore, they must be active while maintaining co-ordination with each other.

16.6 Principles of Public Debt Management

Many theories are prevalent in regard of public debt management, some main theories are as follow:

1. The Interest Cost of Servicing Public Debts must be Minimized

According to this theory, government must be in such condition that it can take public debt and can return it. But, all this work must be on minimum interest – cost. This must be an important objective of public debt management because government has to either impose additional taxes for the payment of interest or has to increase current rate of taxes. If the cost on debts is minimum additional taxes in lesser quantity otherwise it happens reverse and if taxes are imposed in less quantity then their adverse affects are also caused on less different economic motivations means desire to work more and save more.

The interest-cost of public debts is kept minimum in that condition whereas central bank of the country can be motivated for this fact that they have to reduce the rate of interest through their monetary operations means bank tax policy etc. When the rates of interest are low in the market then the government becomes capable to issue their bond at low rates of interest and in this way they get debt at low interest-cost.

But, the burden related to inflation in the policy of interest-rate is possible and it occurs especially when the economy is already working in the directions of whole employment.

Therefore, low interest debt policy, which creates burden related to inflation and economic unstability, cannot be considered desirable.

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2. Satisfaction of the Needs of Investors

Some people believe that the management of government debts must be in such a way that they can fulfill the desires and needs of investors related to the kind of public-debt letters and the conditions to issue them.

If the needs of investors can not be fulfilled, then difficulties occur in managing public debt. For example, if the government wants to keep its short-term debt into long-term debt then it has to present special conditions on long-term securities such as high rate of interstate etc. also do this that government may provide such security on security holders that they can change their security letters into cash without any harm and can purchase new debt-letter issued by government. In this condition, the general cash form of public debts remains the same as new tameable form.

But, when the needs of investors are not satisfied through the management of public debt, then it is possible that due to the sale of securities or debt-letters, the mismanagement will happen in security markets and the bond holder will begin to sell their debt-letters and begin to receive cash. But, if the interest of investors are kept on priority then the cost of public debt for the government will increase. Therefore, some people believe that when public debt matures then it must be reduced. But, if debts are paid by issuing new currency then it will generate inflation and if its payment is paid by imposing additional tax, then it will generate deflation. Therefore, both conditions can be evaded by maintaining suitable balance in the methods of payment of public debts.

3. Funding of Short-term Debt into Long-term Debt

One view can also be given that the management of public debts must be in such a way that it must be more helpful in determining short term debts in the form of long term debts. (Specially in the form of very long-term debts, such as British Council means untimely bond which never matures). But, their funding operations must be done in such a way that it does not cause any harm to economic stability. But, the benefits which can be counted for this policy, which can be considered not much, because private short-term debt is present in the country and it make unsolves all monetary management.

Due to this policy, the rate of long-term interest increases with the increase in demand of long-term funds, therefore, the budget-expenditure of the future increases because of it. Addition to it, the rate of short-term interest decreases due to the reduction in demand of short-term funds. But, due to this unsuitable increase in the rates of long-term interest, the amount of private investment and interest decreases, as a result of it recession and unemployment is produced. Therefore, it is necessary that funding operations must be done in such a way that there must not be such unappropriate increment in the rate of long-term interest which causes adverse affect on amount and rate of non-governmental investment. But, if the need is felt in this regard that non-government investment must be reduced then government has to determine short-term debt into long-term debt.

If the rates of short-term debt are low then it can encourage this fact that short term capital must flow in such countries where the rates of short term interest are high. But, it is not in country favour. Therefore, the funding of short-term debts into long term debts must be in such a way that it can fulfill the needs of investors.

4. Public Debt Policy must be Co-ordinated with Fiscal and Monetary Policy

Co-ordination of Public debt with monetary and fiscal laws, is necessary for maintains of economic stability and economical development. For example, if government forces central bank for this fact that it must impose low rate of interest policy so that the cost of payment of interest of public debt can be reduced, then it can create the position for inflation and as a result of that, economic unstability can occur. Therefore, by maintaining suitable co-ordination between public debt and monetary fund policies, such economic unstability can be avoided.

The conduction of public debt policy with fiscal and monetary fund must be in such a way that these three policies must contribute for economic stability and economic progress. Therefore, the return

of public debts, conversion of current debts and those conditions on which new debt-letters must be solved-all have to contribute for economic progress and stability.

5. Maturity Distribution and Kinds of Debt Holders

If a big ratio of total debt is in the form of short term debts and a big portion of total debt is kept by banks then a big amount of debt remains in cash form. In that condition, the burden related to inflation can occur whereas to impose the policy against inflation is desirable. In this way, high liquidity of debts make difficult to control inflation. If such debts are purchases even then they will not be much affective against inflation opposing methods. The usage of high liquidity debt kept by persons can be used as a form of anti-deflationary. By increasing the costs of such debentures and encourage people to transform debt into cash. In this way, it is clear by the study of these theories that it may not be possible to achieve all objectives of arrangement of public debt.

Do You Know? Thus by following the policy of low interest, the positions related to inflation can develop whereas the policy of short-term debt in long-term debt creates laziness and unemployment.

Therefore, the management of public debt must be in such a way that it gives maximum economic benefit and minimum economic loss.

16.7 Redemption of Public Debt

Redemption of debt means – return payment of debt. Excluding permanent investment in self-dependant industries, all public debts must be returned as possible. Regarding control and the regular transfer of debt provision of their payment must be done when they are issued. Government searches opportunities to postpone the payment of their debts. But, it must be done that being confident about the regular payment of debts; each possible caution must be treated.

16.7.1 Advantages of Debt Redemption

1. It avoids bankruptcy of government.
2. It discourages extra useless expenditures of government.
3. It encourages faith of debters in government.
4. To issue debt by the government becomes easy in future.
5. It reduces the cost of debt-management.
6. If debt is paid early then it saves future payment from the burden of tax.
7. When the payment of public debts is done then these sources are transferred towards private investment. In that condition, an environment creates for private investment.
8. Reimbursement may work as the deflationary measure.

16.8 Methods of Repayment

Now, we will study the different methods of reimbursement. These methods are as follows:

1. Debt Repudiation

Debt Repudiation means to deny the payment of debt by government. In 1917 it had done by Soviet govt. Whereas he denied to pay Czarian debts. In this way, in some states of United States of America, before domestic war of 1861-1865, same thing had done who denied to pay debts from English citizens.

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When government denies to pay debt then the faith of people and banks in government shatters. Because of it, government has to face difficulty in issuing new debentures to government in near future. This step of government is considered very unconsistent and discriminative because this affects only that group who buys debentures debt consistent and it leaves other groups unaffective. But, with repudiation, if government denies all agreements related to return of owners of property then it is not the fact about discrimination debentures. It all agreements related to refunding are denied then many serious problems will generate for that country. Foreign governments take the help of steps like economic security and army operation for receiving their debts. In addition to this, it is not a wise thing that debt repudiation policy has to be followed by government because it is considered an immoral and dishonest step.

2. Refunding

If government issues new bonds for the payment of its current debts then it is called refunding, Refunding is a name of that process by which new bonds are changed in place of maturing bonds. Sometimes, payment is done before maturing date of bonds. It happens so whenever the rate of interest is low or government wants to change the maturity date of remaining debts. But, the meaning of refunding is considered so that the needs related to maturity of debt can be fulfilled. Generally short-term debts which are spent for the fulfillment of current expenditure which are paid from the money received by sale of long term debts in public latter so that the place of short-term debts can be taken from long-term debts.

3. Conversion of Debts

Conversion of Debts means change of old debts into new debts. According to this theory, the payment of debt is not done in reality, but only the form of debt is changed. The, process of conversion of debts means to change high interest rate debt into low interest rate debt. It is possible that when government has taken debt, at that time the rate of interest is very high. **But, now, when the rate of interest is lowered then government changes old debts into new debts so that the burden of taxes on government must be minimum. Then, low interest rate on public debt means low unequal distribution of income.**

But, the task of change of debts can be successfully completed only when the credit of government is good and it has more stock than normal. There is a need of able management of public debt. Dalton said in this regard that conversion of debts do not reduce burden of debt, because by the reduction in rate of interest, the ability to pay tax of bond holders decreases which becomes the reason in reduction of government revenue and by the reduction in government revenue, the government's capacity to pay debt decreases.

There is no difference between the words refunding and conversion and unfortunately, they are used in place of each other. Refunding means postponement of payment of debt, but conversion means in addition to postponement of maturity date of debt rearrangement of other facts related to rates of interest and debt. Refunding and conversion can be combined under one operation. In that condition, it can be called refunding and can also be called conversion of debt.

Task What are the advantages of debt redemption?

16.8.1 Actual Repayment

Three methods have been mentioned above; they have no relation with actual repayment of debts. Following methods are adopted for actual payment of public debt. Here, this question arises that the actual payment of debts must be done slowly and slowly or quickly. But, this fact depends on income

and capital of the countries taking loan and specially when more debt is taken from foreign countries. The amount of money which is in abundance in any country and then amount of debt is minimum, the speed of reimbursement of debts will be fast.

1. **Sinking Fund:** The method which is normally adopted for regular repayment of debt is the construction of sinking fund, means the construction of such fund in which a definite part of government income is submitted every year and the payment of debt is done from this fund. This fund is used for the purchase of debts and for the last payment when their duration completes. Earlier, the flow of money in sinking fund was available till that time until the duration of debts completes. But, these days, when the money is available in these funds then it is immediately used for the settlement of debts.

Dalton believed in this regard that the construction of sinking fund must be done from current fiscal revenue, not by loans etc. If the construction of sinking fund is done by taking new loans, it cannot be called real sinking fund actually.

Practically, money is not consumed year by year in sinking fund. Instead of this, a definite money is withdrawn each year from current income and a part of debt is paid that year from it. For example, government of India adopts an annual provision of 5 crore rupees in its revenue-budget for repayment of debts. If the construction of sinking fund is done suitably then it becomes a good source of regular settlement of debts, But, this is slow regular process of repayment of debt and there is a fear that government doesn't use these funds tor other tasks at the time of financial crisis.

2. **Surplus Revenues:** The policy of surplus budget is also adopted for settlement of public debts slowly and slowly each year, instead of this that firstly , one fund is constructed and then their repayment is paid on completion of duration. But , these days , government expenditures are increasing rapidly. Therefore , surplus budgets are rarely therefore, surplus are rarely made. In addition to this if government makes surplus budget in the duration of depression then it will be considered an unintelligent step of government. Therefore, the policy of surplus budget cannot be implemented in the duration of depression in this situation reimbursement of debt can not be done.
3. **Terminal Annuities:** Government can issue such terminal annuities, a part of which matures every year according to a serial number and their payment is paid every year. The determination of serial number is either done in the starting or by lottery. Debt is reduced each year in this system the burden of interest reduces each year in same quantity, In this way , it is a system of returning installments of debts. The burden of debts reduces every year according to this system and they are settled completely before completing the duration of debts.
4. **Capital Levy:** Capital levy is an indicator of very heavy taxes on property and wealth. It is imposed only once on properties of capital of more from a definite value. Capital levy has been instructed to be imposed just after war so that wartime proportional debts can be paid. They are imposed serialwise on single property.

In Favour of Capital Levy - Capital levy can be considered just on the basis of following aspects:

1. War–time debts is non-productive and it is also a dead weight for the society. Therefore, it is considered good that the debts must be paid one time by imposing capital continuously year by year for the payment.
2. Capital levy can be considered just on this basis that those people who have earned heavy profits in war-time , they have to give their contribution in arranging debts to people without experiencing any type of difficult.
3. Poors have to bear more difficulty in comparison to rich during war-time therefore rich people have to give their contribution for the payment of public debt according to the principle of equality and justice.

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4. The affect of capital levy is against inflation because it takes additional purchase power from the hands of rich people.
5. If the condition of depression occurs after the war then the burden of public debt increased letter debenture holders get profit in abundance. In that condition it becomes necessary to impose capital levy for complete settlement of debt.
6. In war–time, to reduce the unequal distribution of income and money in society capital levy proves helpful. Therefore, it makes the distribution of income and money subject.
7. By capital levy, people experience mental relief in this regard for returning public– debts that in future, for the payment of debts more taxes will not be impressed on them.
8. If public debt taken during war–time is not paid at once by imposing capital levy, then additional taxes have to be levied year for it, which will create adverse affect to reduce its affect to save and to invest.

Dalton suggested in this regard that capital levy must be imposed for the payment of public debts. This tax is important for the point of view of social justice, it makes possible to return debts at once and there is no burden of tax on future transaction. This method is considered very affective due to deflationary speciality.

Against of Capital Levy – But, following expects can be presented against capital levy –

1. It is difficult to find that what is actual and judicial cost of property earned during war – time. In that condition, it is difficult to invest money or property in it which has been earned during war – time.
2. It create hurdle in inflow of capital in foreign countries which casts adverse affect on trade and commerce.
3. It seems that capital levy is punishment of misery because this tax is imposed on only on those which has saved and invested money and have spent uselessly in war – time, they are exempted of tax.
4. This tax can affected the beliefs of people in financial administration and it can encourage tax- evasion.
5. It casts an adverse affect on the desire to work, to save and to invest.

But, it is true that capital levy is a speedy and just method of payment of debt. But due to, its adverse affects, some people give importance it other method of payment of debts. For example, **Mrs. Higgs** said that, "capital levy imposed in this way is like a big operation in the body which either destroys the body or settle it, its nature and affects are very different from the affects of regular dosage given in the form of general taxes."

Repayment of External Debt

Sinking of foreign debts can be only when foreign currency is earned for their repayment and foreign currency can be earned only when export surpluses are created in comparison to import. If foreign debts are invested in such trade which increase the completion of substances of export then foreign debts can be repaid easily. But, if foreign debt are used for unproductive works then export surpluses can only be created when there must be reduction in domestic consumption. In this condition, people fear the burden of foreign debt.

Self-Assessment

State whether the following statements are True or False:

6. Interest cost of public debt must be minimum.
7. If the needs of investors are not satisfied, then no difficulty can be faced in managing public debt.

Notes

8. It is very important to maintain economic stability and to speed up economic growth that there must be coordination with fiscal and monetary policies of public debt policy.
9. Debt repudiation means to accept the payment of debt by government.
10. If government issues new bonds for the repayment of their current debts than it is called Refunding.

16.9 Advantages and Disadvantages of the Public Debt

Advantage of Public Debt

Advantage of public debts are as follow:

1. **Increase in Origin in Money:** Public debts encourage industries in country, production increases, national income increases by which the life standard of citizens of the country increases.
2. **Suitable Repayment Balance:** Business and repayment balance become in favour of taking debt and the problem of foreign investment solves.
3. **Economic Development:** Undeveloped countries become capable to do their economic development by public debts.
4. **Control on Natural Calamities:** Government takes the help of public debts to control natural calamities.
5. **Successful War Conduction:** Wars have become very expensive today. Therefore, taking debt is essential for conduction of war.
6. **Harmony:** Equal and suitable distribution debts take place by which harmony and cooperation increase.
7. **Secure Investment:** Public debts are secure sources of investment and every individual considers it profitable to invest money in it.
8. **Public Works:** With the help of public debts public works and plans like building of roads, water-electricity, canals, bridges etc. can be implemented by government.
9. **Non-economic Benefits:** Friendly relations develop between countries taking and giving debts from public debts.

Disadvantages of Public Debt

1. **Misuse of Resources of Country:** Such conditions must be laid while taking public debts that the industries on which debt is used, that must have partial control on country debtor. Misuse of sources of country takes place in favour and a big part of money goes to foreign countries as interest.
2. **Fear of Government's Bankrupcy:** If government receives debt easily then there is a fear that whether government may receive such a large amount of debt whose repayment may become impossible.
3. **Nature of Extravagancy:** When public debt begins to receive easily then there is a fear of its extravagancy.
4. **Political Burden:** Debt-giver country intervenes in the policies of debtor country for the defense of capital of their citizens and debtor country loses its political freedom.

Notes

5. **Emergency:** There is a fear of emergency like political controversy and war from public debts.
6. **Burden on Public:** When debts are taken for non-productive works then the burden of tax is increased on public for its repayment.
7. **Economic Backwardness:** Foreign debt makes the economy of the country weak and country begins to depend on other for their economic development.

16.10 Public Debt and Economic Development

There are many aspects of relation between public debt and economic development—

1. **Development of Financial System:** The need of currency and prestige increase with economic development which has two reasons. Firstly increase in economic activities and increase in ratio of monetary activities. Secondly, for fulfilling the increased need, it is essential to increase debtors. Its reason is that all agreements of financial business in economy are in amounts of currency. Currency works for the base for all financial structure, and generally government has to take debt for increasing availability of currency (Specially from Central Bank).

Here, this aspect is mentionable that if government uses carelessness in taking debt than the financial structure of its economy can be destroyed in place of being benefitted.

2. **Saving and Capital Formation:** There is a need of saving and investment for maintaining its production capability in each economy. The needs of an under developed country become more intense, because it lacks capital, But, such economy has to face more difficulties in comparision with general in saving and capital formation. Due to reduction in per capita income and due to increase in number of poor people, its saving capacity is very loss. Therefore to fulfill this reduction, some affective steps are considered from government. If government fails to suitably invest and capital investement from their revenue receipts then it can spent on those aspects by taking debt which increase in production capability of saving, investment and economy directly or indirectly.

The results of policy to invest capital from taking debt by government can be doubtfully in some conditions. For example, when government invests in the tasks of capital formation by taking debt from the market, then investment resources are transferred from private sector to public sector. Due to this, the rate of investment in private sector can be decreased and the affects on investment in country become indefinite. In this way when government takes debt from Central Bank, then costs increase because of it available purchasing power of financial resources decreases. By this activities of government, private sectors are forced to increase their actual saving and this actual saving comes in the hand of government.

Public debt can be helpful in economic development also by reallotment of investment resources of economy. It is hoped that government will take their investment decisions in such a way by not giving importance to commercial benefit by which there will be suitable growth in long term production – capability. For example, the government will invests for the development of infrastructural facilities, because production capability of economy will increase from investment also by not being beneficial from commercial view. Opposite to it, it can be assumed from private sector that its investment activities will be affected from possibility of commercial benefit, by which there will fear of missing some basic facilities of economy.

This aspect in mentionable in regard of above mentioned discussion that if government imposes the amount receipt by Public debt over consumption expenditure or other non-productive sources then it will be useless to hope for promotion received from economic developed.

Notes As long as financial consumption of public welfare plans from public debt are concerned, to adopt this policy is an objectionable subject. Some people believed that financial consumption for government must be done by saving in their unnecessary expenditure or by increment indifferent tax and tax revenue.

16.11 Inflation

1. Inflation or increment in costs and public debt are closely related. But government taking debt tries to show that there is no fear in increase in costs due to this activity. The explanation of this dam is given by the following type:

When government takes debt for investment expenditure then its statement is that there will be no increment net in whole demand from it, only the expenditure goes into the hands of public sector in place of private sector.

Government claims it at that time also when it is spending it for its consumption by not investing it on investment spends of resources by public debt. Government's view is that there is no increment in demand, and there is no burden on costs due to this.

2. Both aspects of above mentioned view are confusing. The fact is that due to deficit budget of government, the demand increases, and change take place in allotment of resources because of which supply flows are affected. It is clear that the nature of increment is efficient by these two factors.

The explanation of this statement is as follow:

(a) Government investment comes to provide unstructured facilities and industries of capital–goods and not for production of consumption goods. For giving guarantee in long-term increment in economic development, doing so is very suitable and beneficial. But this policy is controversial from the view of increment in costs. Investments expenditure of such type instantly increases monetary income and demand of people, But for fulfilling this demand, it takes a long time to increase goods and services, It is clear that due to the balance between demand and supply burden on costs increase.

(b) When government debt is taken from Central bank, then the amount of currency increases with net increase in debt. This condition implements to fulfill the shortage in deficit budget by net shortage in cash in hand. Due to increase in amount of currency, as a result of increment in creative ability of banks, demand and cost increment are promoted.

3. When government takes debt from commercial banks, then as a result of increment in their credit capability, there is an increase in amount of bank currency.

4. Due to different administrative and other restrictions, time expends to create government expenditure production facilities and their suitable usage.

The average cost of government production increases from it, as a result of it, government has to increase the costs of government goods (services).

16.12 Role in Regulating the Economy

An efficient policy works as a weapon for the government to regulating Public debt economy. Through this medium, for achieving directed goals financial structure (institutions with , bazaar etc.) can also

Notes

be affected suitably. Public debt is an important factor to fullfill by net credit. It has big ratio in net availability of liquidity. According to one meaning, liquidity, second name of readily usable purchasing power. Therefore amount of public debt and by changes in its factors, changes can be made in amount of liquidity and its flow. If an organised study is done on Public debt then we come to the conclusion that short-term debts are more liquid in comparison to long-term debts therefore government decides on the basis of above information that what must be the detailed structure of debt policy, and what changes must be made in its time–bound structure, etc.

For example, for the objectives of bringing reduction in availability of liquidity in phase of inflation in economy, there must be a policy of increment in amount of long term debt and reduction in ratio of sort term debt. In this way, it can be hoped that with that increase in debt by government, by reducing expenditure, burden on costs can be reduced. Opposite to it, when we have to face depression in economy then with the increase in total amount of public debt, the ratio of long debt must also be increased. In implementation of debt policy, open market operations of central bank in also have an important role. In the same way, the rates of interest and bank reputation also got affected by public debt. The information of this affect can be availed by above survey and theoretical analyses and appropriate modification in debt policy on this basis can be done.

It is clear from above discussion that there must be basis coordination between debt policy and fiscal policy of government and monetary policy of central bank because there is a strong possibility of creating the state of conflict in the objectives of three policies and their related activities. For example, the state of such conflict is that where central bank wants to reduce the regulation of usable amount and central bank currency, but government wants to take debt from central bank for completing its budgetary loss. In this way, it is possible that government may be in favour of short term public debts for reducing its budget cost, but if central bank wants to increase ratio of long term duse to reduce liquidity in market and wants to increase rate of interest.

Self-Assessment

Multiple Choice Questions:

11. What are the changes in need of currency and credit with economic development?

    (a) Increase (b) decrease

    (c) remain equal (d) none of the above

12. What is needed to maintain production capability of each economy?

    (a) Income and expenditure (b) saving and investment

    (c) Investment and expenditure (d) none of the above

13. Which pair has deep relations?

    (a) Saving and investment (b) Income and profit

    (c) Inflation and public debt (d) all of the above

16.13 Summary

- Public debt of a country **affects its economy in two ways**—leaves revenue effect and expenditure effects also.
- The buyers of public assests are mostly the people of rich class. But government imposes tax on debts on giving interest, its burden casts on poor classes.

Notes

- If government uses debt money for non-productive works, then the payment of those debts can be done by additional taxes only in future and the usage can affected in future by this additional taxation.
- Many under – developed countries have to face the problem of money for their development plans. The problem is that arrangement of finance for development plans must be done by taxation or by debts.
- The means of objective of arrangement of public debt is that there must not be any adverse effect on economic condition of country of policies of their returns and by taking debt from government.
- Some people belived that the arrangement of government debts must be in such a way that the type of public debentures and the conditions to issue them etc. must be satisfied to the needs and desires of investors.
- The industries of the country encourage due to public debts, production increases, national income increase because of this the life–standard of citizens of the country raises.
- The need of currency and credit increase with economic development, which has two reasons. Firstly, increase in economic activities and increase in ratio of monetary activities. Secondly it is essential to increases government debtors for fulfilling these increasing needs.
- Every economy needs saving and investment to maintain their production capacity.
- Inflation or increase in cost and public debt are deeply associated with each other.
- Public debt acts as a capable policy weapon in the hands of government for regulating economy. Financial structure (institutes, markets etc.) can be affected for achieving desired goal through its medium.

16.14 Keywords

- Revenue – Income
- Expenditure – To spend

16.15 Review Questions

1. What is the role of public debt in regulating economy?
2. Throw light on public debt and economic development.
3. Write merits and demerits of public debt.
4. Write the policies of refunding.
5. Define the theory of management of public debt.

Answers: Self Assessment

1. Budget	2. Rich	3. Internal	4. Desirable
5. poverty	6. True	7. False	8. True
9. False	10. True	11. (a)	12. (b)
13. (c)			

Notes

16.16 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
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Unit–17: Public Expenditure

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the reason of growth in public expenditure.
- Know the public expenditure and economic life.
- Know the principle of public expenditure.

Introduction

Public expenditure is that expenditure, which is spent for the fulfilment of community needs of citizens or to improve their economic and social welfare. These days the amount of government expenditure is increasing in almost all countries. Its reason is that the works of government and other local bodies are continuously increasing on different areas and fields. The principle of government expenditure was not considered impotent in 19th century because the area of works of government was very limited, but in 20th century the works of state have expanded in the area of social matters like education and public health and commercial and industrial matters like—railway irrigation, electricity and other plans, therefore government expenditure has increased due to this. Due to nature and amount of government expenditure and for this reason that it affects economic life of country in many types, its importance has been increased. For example, government expenditure affects general level of economic activities and level of production and distribution.

Classical Views

Classical economists had given less importance on public expenditure. Due to limited area of work of then state, they didn't understand the need of the principle of public expenditure, classical economists used to give emphasis, on personal economic freedom. They didn't like that state could unnecessary

interference in state economy. That's the reason by which classical economists wanted to keep the area of state limited. According to **J.B. Say- "The best of all plans of finance is to spend less."**[1.] Adam smith believed that the works of state must be limited to justice, security and some public services' management. As quoted by an American critic, "the ancient English writer did not need a theory of expenditure because the theory of government which they held implied a fixed limit to government works."[2.]

According to **Sir Parnail –** "Every particle of expenditure beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack it waste and an unjust and oppressive imposition of the public,".[3.]

This type of, classical economists wanted to keep the functions of state limited, because they considered the government works unproductive and unbeneficial to society.

Modern Views

These days, the above mentioned view of classical economists cannot be considered appropriate, because the states of present time are welfare states which is different from Police state of classical time.

Welfare state has to do more welfare works of public in which government has to spend in bulk quantity for fulfilling many objectives for social welfare and economic development. That's the reason that the tasks of present states have been increased.

These days, public expenditure is done normally for following tasks—

(a) For security,

(b) For the safety of backward groups of society,

(c) For the development of society,

(d) For establishment of public industries,

(e) To reduce the effect of business – circles,

(f) To reduce the ill–effect of natural calamities,

(g) For public services,

(h) For administrative services.

17.1 Reasons for the Growth of Public Expenditure

(1) Increase in the Activities of the State—Government provides services on low cost value or free to consumers, their area has been increased.

Education, health of public and arrangement of entertainment for public are their examples.

The arrangement of house and health services are those new areas in which governments have entered. Government arranges these services keeping the principle in view that if the benefactors can avail these cases by their money more by the Government in comparison by themself then it will be in favour of them.

1. "The very best of all plans of finance is to spend little." —J.B. Say.
2. "The older English workers did not need a theory of expenditure because the theory of government which they held implied a fixed limit to government functions." —Quoted by Hugh Dalton, op. cit., p. 139.
3. "Every particle of expenditure beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack it waste and an unjust and oppressive imposition of the public." —Quoted by Adams, Science of Finance p. 50.

The expenditure on works of public construction like rails and roads by government have been increased, so that the difficulties of people can be reduced and useless labour and resources can be used. The expenditure of this type can be considered desirable from the view to overcome the state of depression of country. In this regard, it can be considered that **Wagner's law** is a suitable option in regard of increase in activities of state in current time. **Wagner said that a permanent nature is found of expensive and intensive increase in tasks of state. States are taking new tasks in their hands continuously and are completing new tasks with more accuracy at greater level.** Therefore, for completing these increasing tasks, government expenditure is used.

(2)Industrial Development – there is no change in industrial structure in list countries of the world due to industrial revolution but their political and social structure have changed. There were many changes in the methods of production due to long list of inventions after industrial revolution in these change the social and political reasons gave their contribution. With the increase in industrial production, the income and life–standard of people raised, a big part of population got aid and they got capability to fulfill their new needs. With all these changes, problems developed, as a result of which labourers relations regulations of trade and commerce, conservation of consumers, distribution of money and income and the tasks and expenditures, of government related to economic insecurity increased.

(3) Increase in Social Security – At present time states has been transformed in welfare states and they provide social security in any form to their labourers in whole country. It is the responsibility of governments is that they watch that whether industrialists are giving actual wages to labourers or not and whether they have been provided social security appropriately or not. In this way present government spend in bulk on social security of their citizens like old–age pension for industrial laboures, dependent benefits, free education, aid in sickness, accidental benefit, health facility etc. In addition to this; many governments have started unemployment benefit plans and help in house construction. These days government expenses is bulk on health and medical facilities for their citizens. Different type of facilities are being provided to employees under state Act in 1948 in India also.

(4) Nationalization of Industries and Trade—Nationalization of industries and trades is an effort by government by which government manages for services provided on goods on commercial basis for public. Government can take such responsibilities on it for many reasons such as in order to solve major problem of regulating monopolise or half-monopolise, provide goods or services on subsidised rate to the consumers or determine the limitations of non-governmental economic activities. There is a possibility of improvement in the conditions of labour and distribution of income. But, for the payment of fulfilment of loss of nationalized industries and for the establishment of those industries and for their **conduction,** government has to spend in bulk. **In addition to this**, government can take custody of private trade and commerce so that it can solve the problems and can earn more profit for treasury.

(5) Development of Agriculture—Development of agriculture of a country specially developing country like India is the centre of development of her economy. It is essential to provide facilities for the development of both sectors – agriculture and non-agriculture because both depends on each other. For example, with the increase in agricultural income, the consumption of industrial goods also increases as a result of which industrialisation got encouragement. In this way, there is mutual dependency between agriculture and industries. This dependency can be shown as follow – The raw material of agricultural sector is used as inputs in industries. In this ways out put of industries is used as input of agricultural sector. In this way, it inessential to strengthen agricultural structure to provide speed to social and economic development in country like India. Therefore developing countries are spending in bulk for their agricultural development. Government spends on facilities like to provide debt to farmers on low interest rate, to provide facilities of contribution, sale of agricultural goods at fixed prices to exporters. In addition to this, government spends in bulk on contraction of agricultural research and agricultural resources.

(6) Rising Trend of Prices – The nature of raising trend of prices which is found in each country of the world, government expenditure increases due to this. Governments are forced for this aspect that they must pay more money for those goods and services which are liked by them and the wages and dearness allowance of government servants must be increased. This state extends government expenditure more, it is not essential for this extension whether increase in government activities. In this way, the increment in government expenditure appears more in comparison to actual.

(7) Problem of Defence – There are no two opinions that the problem of security of country has become a main reason of increment of government expenditure. One country wants to make armies powerful for their security and anothers are forced to draw such step for self-defence only. Heavy amount of money has to be spent on maintenance of army and production of artilaries, due to day by day change in methods of fighting , there is a need of new weapons for army also. The burden of expens increases again due to this. Security expenditure not only includes expenditure of armies and army goods but also includes of debt for pension of armies and war. There has been much progress in science and art of war that the weapons of today became old and useless tomorrow because of which war system became very expensive. Many contries are spending in bulk on security. For example, Pakistan spends at their approximately 15% of its national income and India spends approximately 5%. In India this expenditure was only 164.13 crore in 1950-51 which was calculated 9728 crore rupees in the budget of 1986-87.

(8) Urbanization – There is no doubt that increasing urbanization of population is an important reason of increment in government expenditure also. The rule of increasing costs in cities applies completely. With the increase in size of city, per person cost of expenditure spent on services like water supply transport service and its control police security health and hygiene etc. In addition to this due to construction and maintenance of hospitals, roads streets, lights, playground and community hall etc. and duets distribution of life saving, essential goods and due to control also there is additional burden of expenditure on governments.

(9) Change in Attitude Towards Government – Some increment in government expenditure is due to this reason because there are many changes in general view towards government in last years. Before one century people got scared even from the name of government and considered it as a symbol of autocratic and licentiour powers. But today's, the general view in this regard is that good thing for common person and more comfortable life for all people couldn't be available until we must not depend in more on government. **There are many reasons of this change in regard of government.** Some important reasons are given below:

(a) Technical change – The sentiment of dependency has been increased due to technical changes and due to this, many people remain incapable to work between such powers which are out of their control completely.

(b) When there were small units of business and production—Economic system seemed to work efficiently as a self-working machinery, the same economic system seems trapped in the marsh of single system control and appears to impose exploitation. As a result of this, there has been demand from government that they must appose commercial depression and make balance in half trades. Some people insist that government has to take the responsibility of maintaining economic stability on itself, but it is possible only when government expenditure has to be increased.

(c) Human welfare—Due to the development of sentiments of humanity on present times, the extensive poverty in any country is considered very bad and aggrigative steps are suggested to eradicate it. In that condition, the cooperation of government becomes essential and they have to take shelter in heavy expenditure for the works of public welfare and public construction.

(d) Economic and political complexions – it is also felt that these days, complexities of political and economic problems have been increased. It is also a reason out of other reasons that

promotes the increment of expenditure in bulk for education and other many such welfare activities such as medical house, police and home administration etc.

(10) Economic Development – Government expenditure is increasing rapidly in under – developed countries. Many countries out of these countries implement the programmes of rapid economic development. The management of basic financial services like transportation, communication and electricity are managed under these programmes. It is essential for the state that it must manage for best economic and social services so the industries can develop rapidly. In addition to this, it has been become a policy of many modern governments that private persons have to be helped in that efforts of production. They can do so by giving bounties, loans and grant–in–aid to farmers and industrialists. Not only this, by providing different type of aids, help is given to them by government such as help of technical guidance and raw material etc.

(11) Economic Planning – all countries have started their economic development in planned way by getting affected by the success of economic planning of Russia. This type of efforts are done in economic planning that available resources must be consumed in such a way that standard of living of people can be developed with multidimensional economic development and national income must be increased. Government has to make big plans for economic planning, for completing them, capital is required in bulk. After taking loan from country and foreign countries, if expenditure is not fulfilled then have to manage deficit financial system.

For example, six five–year plans have been completed in India till date and there has been much expenditure on them. The arrangement of more expenditure was planned in seventh plan in comparison to last plans.

The amount for seventh plan (1985-1990) was based on the costs of 1984-85. The actual total expenditure in sixth plan was 11,000 crore rupees. 1,80,000 crore rupees were arranged for public sector in seventh plan. Eight plan is for 1992-1997.

(12) Increase in Population – An another important reason for increase in public expenditure is population increment rate also. Government has to spend in much quantity for comfort and facilities of increased population. There has been rapid increment in population in last years. According to World Health Organization, the population of the world has been increased to 415 crore from 155 crore in last 45 years.

The population of India has become 68.38 crore according to census of 1981. There has been approximately 2.5 per cent yearly increase in the population of India. There has been increment in expenditure of administration of state not only but also the expenditure of state also increases with the increase in their comfort and facilities. Government has to spend in bulk on education, health, entertainment, dwelling etc. for increasing population.

Notes According to census 2011, the population of India is one billion 21 crore.

(13) Other Reasons – (i) Increase in costs – After second world war, costs have been increased in every country. As a result of increment in price level, government has to spend more in comparison to earlier. Government has to buy many goods and services and secondly, government assumes for that expenditure for production, government has to spend more in comparison to earlier on that production due to increment in costs.

(ii) Increase in national income and standard of living—As a result of economic development in last year's, national income increased as a result of which standard of living of people increased. Government has to spend more with the increase in this standard of living.

(iii) The Burden of Democracy – There are democratic government in many countries of the world. Government has to conduct by polls and midterm polls for this and government has to spend more for completing them. In addition to government has to spend more on ministers and other selected representatives. Governments have to maintain diplomatic relations also with other countries. Governments have to open embassies in other countries on which government has to spend more.

(iv) International Cooperation – Each country has to economically cooperate with other countries in present age. Each government gives loan, contribution and other economic aid to any country. In addition to this, international financial organizations such as – International Monetary Fund, International Reconstruction and Development Bank, International Development Federation, Asian Bank etc. have to give membership fee to government from time to time. In this way, government are spending more for maintaining international cooperation.

17.1.1 Wagner's Views on Public Expenditure

Germen economist Wagner believed that increment in public expenditure is essential due to economic development. The ratio of increment changes as the form of expenditure increases per capita production. In this way, due to increment in national income, total consumption increases.

According to **Dalton**, the rules of Wagner are applied in three conditions—(i) the work efficiency of public organizations due to economic growth becomes more than private institutions because (a) The produced goods by public institution are of good quality, (b) There is the no dearth of goods in the market and (c) the capital is easily available in public sector.

(ii) By the public expenditure those services are incurred which are useful for the whole society like school, hospitals, parks etc. (iii) those service which non-government agencies unable to do, completed by the state itself. In this way public expenditure is increasing day by day.

Before Wagner, Angel said that with the increasing of income, elasticity of income on eatables becomes less than unity which means with the increment of income, expenditure on food decreases. As the income increases people choose comfortable and luxurious items to spend instead of food materials. According to **Wagner**, for government services income elasticity is more than unity.

17.1.2 Difference between Private and Public Expenditure

The problem areas of private and public expenditures are normally same. Both try to establish a balance between income and expenditure. On both the same economy rules applies in general . In both the situations. The same financial policy is applied but some fundamental differences between both, which are as follows:

1. **Adjustment between Income and Expenditure –** State first decides the quantity of expenditure and only after that tries to achieve its income, on the other hand private expenditure normally depends on the individual income and generally every person spends according to his income. In the words of Dalton, "A person decides his expenditure according to his income whereas a Public sector decides its income according to its expenditure."
2. **Difference of Elasticity –** There is no elasticity in public expenditure an increase in the public expenditure can be easily done, but it is difficult to lessen. On the other hand elasticity on be easily find out in private expenditure as deficit and increment are the two factors of this expenditure.
3. **Difference of Scope –** The area of public expenditure is wide because the working area of public sector is quite vast whereas the area of private expenditure is limited as the working area of every individual is also limited.

4. **Willingness of Expenditure –** Public expenditure is not optional. It is essential to spend government income on social welfare but private expenditure is based on one's wish. There in no such priority on this private expenditure.
5. **Direct Benefit –** There is no direct benefit in public expenditure like, famine, war etc. while government spends on these no such direst benefit takes place. Where as an individual gets direct benefit from every expenditure.
6. **Object –** The objective of public expenditure is social welfare and private expenditure is social welfare.
7. **Control –** Parliament controls the public expenditure and an individual controls by the particular person.
8. **Economy –** During public expenditure economy is not the important priority but in Private expenditure it means a lot.
9. **Effects –** Public expenditure effects on the whole society or nation but in private expenditure effectors lies on a particular person.

Self–Assessment

Fill in the blanks:

1. With the ..... of industrial production, income and living standard of the people raised.
2. In India in ..... according to the state rule different facilities are providing for employees.
3. In the word's every country nature of price increment is there, because of this public expenditure appears ..... .
4. The increase in public expenditure is one of the main reason of ..... increment.
5. The objective of public expenditure is social ..... .

17.2 Public Expenditure and Economic Life

Public expenditure effects economic life in many ways. To bring improvement at the level of production and distribution and maintain economic stability the help of government expenditure can be taken. It can taken uplift in the level of production by alloting loan and equipment for agriculture and industries. On the public expenditure technology information, transport, communication and electricity etc. can also be managed so that production can get encouragement to increase. The production of essential lifeworthy materials and capital goods can be started by the governmental expenditure and completed with private industries. In the time of inflation by decreasing the expense. In this way, through public expenditure the whole structure of distribution can change. This can be done by increasing government employees, salary and by arranging social security and medical facility and on the other hand by nationalization of industries and by possessing of land this can be done public expenditure helps in maintaining economic stability. In the time of deflation it can be done by increasing expenses and in the time of inflation by decreasing the expense and in this way financial ups and downs can be stopped in financial life of a country. Here one thing has to mention that public expenditure can be a weapon of government economy policy through which production and distribution can improved and economy should remain stable. But one cannot agree with this that with the help of this economic policy only we can get the proper results. There are some other means also like monetary, financial control and taxations etc. If want to achieve of economy policy then these policies should be made progressive in this direction. Because of this economy policy will become more useful and effective.

17.3 Principles of Public Expenditure

The principle of public expenditure has been already discussed when public finance's principles was studied and in principles of maximum social benefit were described. In that first principle indicates that limit where net public expenditure should have been increased and second principle indicates towards the distribution of resources so that net social profit can be maximised. Their brief description is given again:

1. Public expenditure should be done in every direction at the limit when in any area, a small amount of increment for the welfare of the society, or in public expenditure loss, in the area of increment can be adjusted. This rule presents an ideal limit in both public income as well as expenditure. **Prof. Pigou** also describes almost the same "in every directions public expenditure should be increased at that point on which satisfaction occurs even after the spending of last shilling, that satisfaction should be equal to those public services which are destroyed by that last shilling." In this way this principle allows public expenditure to continue at that point of time till every last penny is spent on social welfares and it should be equal to left over limit.
2. "Public expenditure should be done in every direction at the point when in any area, a small amount of increment for the welfare of the society or in public expenditure loss in the area of increment can be adjusted." It means the expenditure between battle ships and poor relief should be distributed like this that with every last shilling one gets the same satisfactory return. This means that government should distribute all at its resources in a way that it should be equal to the limit of every aspect. In this way it is clear that if government distributes its resources and keep in view this principle then it can get maximum satisfaction. This can also be termed as 'maximum satisfaction rules. Thus , it is clear that if this principle is keep in view the government at the time of distribution of his resource in between different expenditure then the government can get maximum satisfaction. It is already mentioned that the measurement of marginal social welfare is very tuff but not impossible.

According to **Prof. G. Pigou –** If we assume society a living thing and government its brain then expenditure should be stretched in all directions to that point where satisfaction from the last shilling is equal to the loss of satisfaction from the same.

In this way for the state it really become difficult to maintain a balance between the marginal social welfare of minimum money equal to that marginal social welfare which is receiving by the tax payer from his last one penny. We can look deeply with an example – for example, public expenditure and taxation are done by different government departments. So it makes more difficult to make a comparison of marginal profit obtained by minimum money and it obtained by receiving last penny by taxation. Above all public expenditure is effected with other factors also like non-economical reason political pressure, strikes processions etc. It is concluded that public expenditure which is mentioned above are only ideals and true only in the theoretical form. If the question of business then it is difficult to implement them.

17.3.1 Guidelines for Public Expenditure

Prof. Alfred G. Bulcher mentions some of the public expenditure's Guidelines which should be applied in day to day life by the Public authorities. According to him, "Till now the principle of expenditure did not rises as that of taxation. But still there are some basic principles which can work as the guidelines for both government and it is not founds people, till that period of time. Some of the guidelines are as follows:

1. **Increase in social welfare:** Through public expenditure social welfare should increased but it may possible that sometimes government expenditure happens for welfare of a particular

section of society. So it should be ensured that while working for the betterment of a particular section of society, whole society should not be neglected.

2. **Profit is more than cost –** Government officers and elected representatives should ensure that the expenditure should be less than the profit and the expenditure is less than the welfare of the society. and this goal cannot be achieved until or unless expenditure done by the private companies people.
3. **Preference to social welfare activities –** Firstly those services should be attended by which increase in social welfare takes place maximum. These service through which social welfare is less expected to expenditure should be taken later.
4. **Results of profit –** Conclusions from the expenditure can only be done after the calculation of adverse effects of taxes and receiving income any other source.
5. **Administrative expenditure –** The expenditure which is incurred for Public administration it should assume that this amount is also a part of social welfare expense. If abundant administrative expense becomes abundant then it seems that there are some deficiencies in the methods of management or selection of secrecies.
6. **Availability of resources –** Government services can handled only when there are enough resources available. Through loan only temporary receipts can be managed because this type of loan can be refunded by other sources of income in which taxes are important.
7. **Expectations of income –** Some services are transferable nature, for example, Public work. By spending on these, it should be seen that what are the possibilities of income in and future whether they are completing through common business situations? To complete these services proper time should be selected which is better according to the society so that the effects of these services can turn towards increases of economic stability.
8. **Limitations of expenditure –** There are some limitations on expenditure not in the initial stage but at the final stage. These limitations are: while looking at the population—income of society or money area, other resources and specially distribution of money and income.
9. **Service coordination –** There should be coordination between different government services so that maximum benefit should be given to the society and no duplication produce.
10. **Administrative ability –** Administration should be able and honest. Only legelly expenses should incurred. All the records should be kept of all the expenses and through reports etc. Another record should be maintained of government finances so that comparison can be done between cost and gain by government for governmental officials as well as public.

17.3.2 Canons of Public Expenditure

According to **Prof. Shiraz** there are four principles of public expenditure which are as follows:

(1) Cannon of Benefit – The main motive of this principle is to achieve maximum social welfare, which means the strategy of public expense should be done in such a way that it will be profitable (as a whole) for the society and no for a particular sector of the society., "if other things remain the same then public expenditure can bring many social achievements like increase in production protection from external attack and internal violence. With these achievements protection can be done of society and if possible lessen income discrimination". In short it can be said that public expenditure should be done in the social welfare area. In other words, maximum satisfactory gain should be received from the public expenditure and this can be possible only while the government spend this type of expenditure distributes resources equally so that the marginal satisfactory result obtained by uses will equal. This can be possible only when maximum satisfaction rule applies this in turn means distribution should be done according to above polices so that:

(a) Increases total production of the whole country.

(b) In order to protect society from internal and external dangers it could be maintained adequate armies and police.

(c) Difference of income between citizen could be lessen.

(d) Not only for one section, but it can maximize the welfare of whole society.

In other words, maximum profit of maximum people, is the only target of the principle. This is one of the useful principle of public expenditure and no students of economics can go against this principle in the form of ideal which is adopted by the government apart from this principle if only come to the Question of Practical then it has be notable that through state it is difficult to achieve aim. This is on one hand it is not possible for the government to make every gain of every resource equal and on the other hand to calculate profit of the whole society – In the end it is concluded that the objective of every public expenditure should be the improvement in production and distribution.

(2) Canon of Economy – Means of principle of canon of economy is that the state should maintain economic view about economy. There two things are important. At firstly government should spend minimum amount on every aspect. Secondly it should make increment in production power of society this is the positive aspect of economy. First thought is related to present while the second one is related to the future. Its only objective of this principle is to get rid of production of extravagance and corruption. The social welfare can be maximized only when there do not exist extravagance and corruption in expenditure. This principle is such practical rule which can followed by the government. One of the important aspect of this principle is that whenever government planned its expenses then it should also be adopted.

(3) Cannon of Sanction – The principle of sanction means that without the sanction of officials or government no public expenses can occur. This means that not even a small amount can be used without sanction of related officials. Every government department should have freedom to spend till a secured limit but beyond the limit expenses occurs only when the related officials gives a nod. So the objective of this principle is to keep a ton on extravagance because people experiences that unauthorized expenditures encourage extravagance. In this principle one of the thing should be ensured that the sanctioned money should be used in right direction. In the end of the financial area government accounts are guided and inspected. Prof. Siraz's principle represents the proper work system for determining public expences.

In the current phase this principle of sanction developed e.g., in democratic countries government itself required to take approval of parliament or legislation before spending. Every government department or ministry required take approval from finance ministry. Within one department also it is essential to take permission from the Head of the department approval like this process continues of taking approval. Because of the permission taking sometimes it becomes late in completing work and it gives birth to red tapism. But it has to be tolerated so that in the expense administration honesty and economy stays and it can be stop extravagance.

Do You Know? No amount can be spend until it get the approval of the related authority.

(4) Canon of Surplus – According to surplus principle in public expenditure one should avoid loss. In Prof. Shiraz words, "In the matter of income received and expense governments should behave like common citizens.

Like a 'private person who does not exceed his expense by his income government should also make a habit of balance budget. Yearly expense should be balanced without any new loan. "this principle

seems solid and safe. This principle tells that like a private person government should also expand in its periphery but this does not means that government can never take loans. If actually if the required he should borrow the loan. But its income have to be more so that it can pay interest and also made a sinking fund for the return of loan.

But modern economist not always like the balance budget. How to make budget is totally depends on county's economic condition. Surplus budget seems more likeable in inflation as it lessen the purchasing power of the people which intern make the effective demand low and in this way it maintains a balance between current demand and current production in its opposite, in deflation deficit budget seems good because it increases the purchasing power of the people and also effective demand and in this way balance current demand and production.

Like this way balanced budget becomes proper when in economic there is a stability in employment and prices. Except this in a developing country deficit budget is seems as a weapon to increase the rate of capitalisation to see whether losses are more or less otherwise inflationary any tendencies will be create in economy.

So it is to be concluded that principle of surplus or budget does not hold that position or importance which it holded in olden times.

17.3.3 Other Canons of Public Expenditure

Some economists also explained some of other principles besides the principle explained above which are as follows:

1. **Canon of Elasticity –** According to this principle state's expenditure policy should be like this that it can change according to the situation it can be possible to increases or decreases in public expenditure. Actually the objective of this principle is to maintain elasticity in the public expenditure so that in the case of emergency like war or overall development finance arrangement cannot become unsuccessful. In other words the arrangement of public expenditure should be like that, if in emergency mutual transfers of resources take place then the country's economic life should not get effected for example, in war time there should not be any difficulty if expense done on war instead of house construction.
2. **Canon of Equitable Distribution –** This principle states that public expenditure should be done in such a way so that the difference of the distribution of income is low. In other words public expenditure gives satisfaction of equitable distribution of income between different sectors of society. This aim can only be achieved when the more gain reaches to the poor people by public expenditure. This gain can be given in the form of medical help, education, house construction and old age pension. This principle is more beneficial in those countries where a huge disparities is found in income distribution. This is the reason that this principle is implemented in developing countries like India implementing economic activities and tregory policies of states. For example, in such countries periority in employment is give to the backward section of society and also scholarships and other education related facilities are also gives. Like this some agencies works only for small farmers for their upliftment. For example, Small farmers, development agency.
3. **Canon of Productivity –** According to this principle expenditure and policy of state should encourages country's production. It is clear that according to this principle maximum public expences should be done for production and development work. Underdeveloped countries can gain a lot from this principle because in these countries, "For the increment in social and government services and for consume facilities of community public expenditure has to be elaborated, " so the objectives of public expenditure are to provide maximum employment production and income.

Task Explain canon of elasticity.

17.3.4 India's Public Expenditure: On the Basis of Principles

If we look Public expenditures of India at the principles we find that it is according to some but again improvement is required thereafter the independence lot of expense have done on public expenditure like setting up of heaves industries, increase in formation of financial and social capitalization, increasing of planning of social welfare etc. and this is the reason in last two decades India's economy become stable. The regional development Policy which was adopted underplaning was according to the 'principle of benefit, because in this beneficiaries were the backward class especially rural population. But due to administrative laxity the principles of economy and sanction are not to be obeyed. Deficit budget has been traditional weakness of our government and the situation becomes so critical that not only central government but also state government do most of its work on deficit budget. The reality is that the capacity of the people of paying taxes is almost finished, and public expenditure is increasing day by day. To solve this problem government regulate new currency but it led to inflation. For the last decade the problem became more serious. But on the other hand it is remarkable that the expenditure policy of production and distribution was quite success full. In this way it is clear that India's expenditure policy has scope to improve.

Self-Assessment

State whether the following statements are True or False:

6. Public expenditure can effect economic life in many ways.
7. By the public expenditure, distribution structure cannot be changed.
8. Through public expenditure, social welfare should be increased.
9. All the services are of transferable nature.
10. India's expenditure policy has scope to improve.

17.4 Summary

- According to Wagner a permanent instinct of extensive and intensive increase are found in state's work. The state is taking new works slowly and gradually and completing its previous one efficiently.
- With Industrial Revolution not only the structure of industries changed but in fact its, political and social forms has also changed.
- In any developing country like India can develop with the development of agriculture. For economical development it is needed to provide facilities for development of both agricultural and non-agricultural areas.
- One of the reason of increase in public expenditure is increasing of population. Government would have expanded a huge amount to fulfill their needs of increased population.
- Normally the problem of public and private expenditures is same. Both of them tries to balance between Income and expenditure and the economy policy applies on both of them.

- Public expenditure can affect economy of any county life in many ways. To improve the level of production and distribution level and for economic stability, support can be taken from public expenditure.
- Public expences should do in every area till the limit when its benefit goes to the society and the opposite of this i.e., a small increase in public sources and loss takes place because of it. This can balance the situations. This principle represents an ideal limit for both public and private income.
- If we assume society a living thing and government its brain then expenditure should be stretched to that point where satisfaction from the minimum money is equal to the loss of satisfaction from the last penny.
- Till now expenditure principles are not developed as that of taxation. But again also there are some basic principles which are still working as the guidelines for public and the government and there is need to innovate new proper levels.
- The record should properly keep of an expenditures and in easy and proper way of financial activities of government should be done through reports for that Public as well as government official can compare the costs of government services gains.
- If other things remain proper then public expenditure can bring social achievements like increase in production, as external attack and internal violence and possibles as lessen the inequity of income protections.
- The meaning of economy is to protection of the benefits of tax payers – not only by effecting expenditures but also to increase public income.
- To increase the facilities of social and government services and increase in community consume it is essential to increase or expand public expenditure.

17.5 Keywords

- Monopoly – Right of only a person or group.
- Return – Result.
- Agency – Working under some institution.

17.6 Review Questions

1. Public expenditure provides for which works?
2. What are the reasons of increasing in public expenditure?
3. What is the difference between private and public expenditures?
4. Explain principles of public expenditure.
5. Write notes on the following:

   (a) Administrative expenditure (b) Service coordination.

Answers: Self Assessment

(1) Increase	(2) 1948	(3) increasing	(4) population
(5) Welfare	(6) True	(7) False	(8) True
(9) False	(10) True.		

17.7 Further Readings

Books

1. Lok Vitta—*New Royal Book Company*
2. Bhartiya Lok Vitta Prashasan—*Manjusha Sharma, O.P Bohra, Ravi Books.*
3. Money Banking – International Trade and Public Finance – *Nee-Thai. Somshekhar, Anmol,2004.*
4. Public Finance—*Nandkishore Prasad, ABD Publication, 2011.*

Unit-18: Effects of Public Expenditure

Notes

CONTENTS

Objectives

After studying this unit students will be able to:

- Understand the Importance of Public Expenditure.
- Know the Role of Progressive, Proportional and Regressive Expenditure.
- Understand the Forms of Progressive Expenditure.
- Know Completely about Production vs. Distribution.
- Gain Knowledge about Depression and Public Expenditure.

Introduction

Today, the government expenditure is known as not only for financial arrangement but also as an important sources to fulfill the social targets. If we want to achieve the target of socialism then it can only be possible when we not only concentrate on the collection of government expenditure but also adopt a solid and accurate policy of government expenditure.

Traditional Economists — Thought was that the state should interfere little bit the economic activities as the government is only an agent of public whose work is to maintain the political organisation therefore Adam Smith favoured the minimum actions of state and favours the state actions limited to the justice, police and army. Adam smith's thought was that the public expenditure is normally a waste. Public expenditure is the only money transferred by the public to the government and if this money spends by the public comparative government then it can provide more usefulness or satisfaction quality. So Adam Smith's thought the government should keep limit for their economical activities.

Its opposite, modern economists interpreted a new thought of government expenditure. Today the rule of Wagner, to increase the government expenditure in each manner is said to be right. In present time, the increase in government expenditure is not found in particular country only, but it is found in almost all the countries of world, whatever their social and economic and political structure are good or not. In a developing country, it is not possible to fix any clear limit of government expenditure. Today this type of each government expenditure is said to be desirable which is not wasteful, but effect solidly on the production and distribution, and by this completely increase the social and economic welfare of the country.

18.1 Significance of Public Expenditure

Where there is a question of the importance of government expenditure this is clear by this point that government manages the services for public, whose management in not possible for private people or it does then, it is not done in that much quantity and by doing that much expenditure that is possible for the government. The significance of government expenditure is also clear by this point that government manages the complete the actions related with defence administration and development of the whole country and to fulfill this government have to buy things and services from the private people and firms that increase the income of private people. For arranges these services if government use the resources which are not to be used in other condition, then it increases the nation income and employment. Some expenditure of Government is a nature of transferable for this type of expenditure transfers the purchasing power of one section to another section of the society, if the transfer of this income or purchasing power is towards poor people or towards those people who are in favour of using more, whether the other thing are like before, then it increases the national income and in the condition of non-transfer, the result is its opposite. So it is important to study that what are the effects of government expenditure on the production and the distribution of income on the level of employment in the country.

18.1.1 Direct and Indirect Effects

Government expenditure can affect the production of county by two types—one is directly and another is indirectly, the industry of public sector contributes directly in the production or national income. In India, the expenditure on Railway and irrigation is productive directly.

Expences on public administration, postal and telegraph and roads is completely productive indirectly. In democratical countries, mostly government expenses is helpful in production indirectly. Now, we will discuss about the effects of government expenditure on production.

18.1.2 Effects of Public Expenditure on Production

While analyzing the effects of government expenditure, Dalton said this is right "Taxation should be like that reduces the production minimum and government expences should be like that it increases more production, in the condition that point is the other things remain same. Dalton had also said the proper study of effects of government expenditure on production only can be done when the evaluation of its effect will be done on following elements.

1. The effect on the ability of doing work, to save and to investment.
2. The effect on the willing to do work, to save, and to invest.
3. And the effect of the diversion of economic resources in between deferent utility and areas. On all the elements, the effect of government expenditure can be favourable or unfavourable also.

Now, we will study the effects of government expenditure on these elements.

1. Effects on Ability to Work, Save and Invest

Government expenditure increases the ability of people to work, save and invest in many ways. The expenditure on education, medical facility, facility of economical housing and the resources of communication increase the ability of people to do work. Except this, some type of expenditures of them like free education, unemployment allowance and free medical facilities increases the purchasing power of lower income group people that increase their ability and capability to do work and to save. Not only this, government expenditure on increase of salary and wages of people and providing food and other important materials at minimum price, government expenditure increase the standard of their life and by which capacity of purchasing power of people increases their ability of doing work and save, like this. In the same way, government expenditure on establishment of law and order builds confidence in the hearts of people; therefore it encourage them to invest in productive activities. As the production increases, so as the income of people increase, and when people have enough income in hand then in increases their ability to work, to save and to invest.

The problem of ill effects of local expenditure can be remove by two types—(i) The income of poor section must not be increased all of sudden but it must be increased slowly and (ii) Government aid must be given in the from of goods and services instead of cash from so that there will be no possibility of their misuse.

Opposite to it, if a big part of government expenditure is used on the social works and on drugs and on it is used to the production of other such substances which are harmful for health of people and their work capability and only at the cheapest price, than there may be adverse effect on capability of people to work, to save and to invest. In this way, if expenses on helpful resources of production like roads, rails and other means of transportation and communication, construction of engineering and medical colleges are not done but government expenditure is used for construction of film studios, cinema halls, hotels and pubs then this diversion of government expenditure cast unfavorable effect on ability of doing work, save and invest.

Notes The Governmental expenses should be used in such a way that it proves minimum benefit to whole community.

2. Effects on Willingness to Work, Save and Invest

According to the modern Economists expenditures are of two types — future regarding expenditure and present regarding expenditure.

(i) **Future Expenditure –**Till then relation of work with investment depends till limit of the nature of governmental expenditure and policy. For example, old age fund, provided fund benefits and the facilities of governmental expences of medical and unemployment provides protection and investment. Therefore it reduces willing to do work and save of the people. It is clear why a person will do work hard and why will save more when he knows that in the condition of inefficient to do.

(ii) **Present Expenditure –** Like this a person never likes to do work and to save at that time, if he understands that he will never get any income in future from his present saving and investments. In other words, if he thinks his future is insecure then their desire to save and to invest will reduce but if by the increase in work and saving, government is providing funds which also increase

then there will be definite increase in the desire to work and to invest, otherwise opposite of this will be happen. The desire to do work and to invest can also be increase, when people have full faith that their present saving and investments are safe and they will get goods goings from these. This is also be said that social security measures reduces the desire of people to do work, save and invest. But in practically, they do not have any unfavourable effect. There is an example of England and United States of America in front of us. There by the government social and working security facilities have provided, which instead of saving being discouraged, there is a help to increase the savings. These measures are said to be desirable from the social point of view is that the social and facilities should be provided at that point till that it could not discourage the saving and investments. So, government expenditure should be like that the government could provide the facilities of social security in big quantity but it does not have any direct or unfavourable effect on the expenditure of saving and investment. There should have to be a type of offers by the government expenditure in which the savings and investment done in it should be rewarded completely and there have no increase in the dissimilarity.

3. Effects on Diversion of Economic Resources

By the public expenditure, there is an effect on the proper use of economic resources. This effect can be shown by as follows –

(a) **Direct and Indirect transfer –** Government expenditure diverges the economic resources from private use to the governmental use and this diverges by many ways like the expenditure on self-defence, police and civil administration, diverts the resources from private sector to public sector. Sometimes this expenditure is said to be economic waste. As the Dalton said that "Each self-defence programme comprises economic resources in which if these resources remain then they could have direct contribution more than economic welfare."[1] But this is also not right to think that the transfer of these resources from non–government use to government use reduces the use of things by the people and as a result there is a reduction in economic welfare of people. For example, the government expenditure of self-defence is not non-productive because in any country that will be most important in the view of internal peace and outer protection and without this the economic welfare of that country could not be increased. So, the expenditure on the arrangement of self-defence police and justice is important because by this a proper atmosphere can be grate in which the best use of local and developing resources of the country becomes possible to used but it should also be seen that the huge expenditure on these services if other things remain common, can affect unfavourably the production so is right, this type of government expenditure should not be more and should not be very less. The governmental expenditure on construction of some basic facilities like roads, rails and irrigation schemes is significantly helpful to Economic development of a country. So this is very important for a developing country that for the arrangement of these basic services. The resources should be diverges from non-government area to the government area. This type of, the government expenditure by the increase in the shape of the markets of different things and services encourage the private inverstors to invert the money in different economic works. The reality is this, in any country, the availably of these basic economic services and the quantity shows that how much possibilities are there in the country for economic development.

By the government as a form of economic aid the bounties and subsidies are to be transferred to the new and local industries and like this government expenditure provides help to the people to open new industries and for the increase in the production of working industries of the people. This, the government expenditure on education, training, public health, schemes of social security and old age pension increases the capacity of human capital and in perfection and social welfare and gives its contributes for the economic development

1. Dalton Public Finance, Page 153.

of the country. As compare to developed countries it happens mostly in the developing countries so as to these social services if the economic resource uses in the government sector in place of non-government uses then it should not be considered non productive, mainly in the under – developed and developing countries. So, it can be said concluding that for the completing basic economic and social services, the government expenditure is more important because it provides external economies to the industries and increase the social welfare of human capital thus, it encourages the non–government money to the industries fastly and is helpful for the economic development of whole community.

Except this, Dalton explained some other type of expenditures at increased the production power and are desirable in the social eyeful. These expenditures are following – (i) debt redemption, where the mostly given back reinvest, normally by expense on public construction works. 2. Productional project like irrigation, foresting land reclamation, the development of electricity and transport etc. These plans provide profit in long run but do not at present so the private investors never encourage to invest money to it. 3. The government expenditure on education, training, research, invention and information given or getting 4. Public – health 5. Government expenditure on the social security plans for doing help. These expenditures at some limit increases the work efficiency, so these are helpful in increase of production – Dalton's also said that government expenditure on these items is desirable in the social point of view because this money increase more in production power as compare to left in private hands.

There are some people who say that there should be reduction in public expenditures, while others say that the area and amount of these expenditures should increase. Whatever it is, the right thing is that there should have to be balance between the effects of changes according to it in the public expenditure.

Do You Know? The government expenditure on the construction of road, rails and irrigation systems is favourable for the economic development of country.

In other words, the expenditure on each item should be stretched on that point where the marginal social benefit got by each item will be equal to the marginal social benefit that is developed from the lack of production or due to the transfer of resources towards government sector and social or economic welfare in private section but most of the modern fiscal scholars thought is the increased government expenditure in these directions is very much right by the angle of present and future profits. As Dalton said that: the more and more government expenditure in these many directions is desirable as the distribution of community resources could be like this in different uses that results are best and that can be maintained balance between present and future without any distribution. So, it can be said as a conclusion that the diversion of resources contributing in the increase of production and as a result, the economic and social welfare of country and this type of increased government expenditure is very important in the view of economic progress and social welfare.

(b) **Economic stability and Diversion of resources –** In order to maintain economic stability means complete employment and for maintaining the stability of cost diversion of economic resources is said to be important. In any fixed time, this can be done. It should be such that the quantity of investment does not match with the quantity of savings, it means investment is not equal to the savings. The lack of coincidence is a reason of inflation deflation and unemployment in the unstability of cost–level. To bring this coincidence means to maintain balance between saving and investment normally government interference is needed.

When the quantity of a saving is more than investment then slow down develops in this condition, which gives birth of recession after all. In this condition this is important that the government expenditure should be more than government revenue and adopt the budget policy of depression. In this condition the financial arrangement of extra expenditure should be done by the debt taken by the bank and the diversion of their expenditure should by the expenditure on the works of public construction. There is an increase in the amount of liquid income in the hands of people and it increases the aggregate effective demand. To fulfil this increased demand, the amount of investment in non-government sectors also increases. As a result, the condition of complete employment develops. In other words, by the help of government expenditure, investment becomes equal to the savings. In its opposite, when investments are more than savings then the condition of inflation develops. In this condition this is important that the government expenditure, must remain low from the level of government income, it means to adopt the policy of government surplus budget. If there is lack of risk capital found, the government should be given this money of surplus budget to the public bodies as a debt to give the private industries. This can also be possible that by giving this debt, government becomes share – holder in these industries. But here, this thing is to be noticed that this point of view is more correct for the developed countries as compare to the developing countries. Thus it can be concludly as a result this can be said that there should be a variety in government expenditure by which economic stability that means complete employment and cost – stability maintained.

(c) **Transfer of Resources in between different areas —** Some times by the government expenditure, there is a transfer of economic resources in between different areas. In this production power increase and normally the in-equality in regional reduces. Government can expand special expenditure for backward areas so that the balance of economic development of complete country could maintain. For the fast industrial development of backward area government can give special debt, subsidies and other facilities to these In different areas, in between rescues, this type of diversification starts in the unitary states in the medium of grants-in-aid. Normally grants-in-aid is given to state by the central government and by the state to the local government so the economic resources are from the developed areas to less developed areas. It increases the production–power of backward areas and the regional inequality removes.

Dalton has said rightly that the contribution of government expenditure in diversion of economical resources between private sector and public sector as well as between different areas is said to be important when the area of economic activities of public authorities is small. In other words, in capitalize economy, there is more importance of this contribution. As this range increases, the importance of government expenditure decreases and it happens in the socialistic economy. For example, in Soviet Union, where there is complete control of state on the resources of production, public finance completely mix up in the complete government economy. Here state controls the complete economy system. In this economy, there is no question arises of diversion of resources from the private sector to the public sector. There whole economy system is directed by central planning Authority to achieve some specially selected targets.

In the mixed economy like in India, where both the government and the non-government sectors give important contribution. In view of economic development of the whole the effect of government expenditure on divided of resources and on ability and willing to do work save and invest has great importance. It is clear that by the public expenditure economic resources can be transferred from one place to another and from the one sector to another.

The production can be increased by transfer the economic resources to some special business. This transfer can be done by giving grant for establishment of private industries. By the production of private industries the different resources of production will also be pull towards private industry the production will continuously increase. The use of the resources is capable to complete the needs of present and future for human beings.

The transfer of economic resources by the government expenditure can be on different places and the increase in production can be done. For example, if central government provides grant to local government then by proper use of the grant there will be sufficient increase in production and the different resources of production will also be attracted towards that.

In some places, where there is no industrialization, the facilities of conveyance, electricity, water, home and banking is if provided by the government the industrialists will establish industries on these places, and as result, the resources of production will also be attracted towards it.

Conclusion: Dalton's thought in regarding of effect of public expenditure on production is that, "The types of public expenditure in the view of production are said to be good for the society that if left the required capital in the private hands then they increase more in production power as compare to that of government sector."[1]

Dalton also believed that only taxation alone can keep control on production. In his words – there can be no any doubt that by the arrangement of local expenditure wisely that encourage production that, should be more than the rescue in production by the taxation and the important other methods to complete the arrangement, if these are selected wisely"[2]

Effects of Public Expenditure on Distribution

Local expenditure not only affects the production, but this is the most powerful weapon of the hands of government for a equal and rightful distribution of money.

For doing equal and rightful distribution of money, Government not only use its taxation policy, but to achieve the target government expenditure also gives its important contribution. In reality, the things is to remove the inequality of income in the contribution of taxation and government expenditure is complementary and supplementary. When the government determines its expenditure policy then it decides to which section it has to give the most benefit. If government spends their almost money on the welfare of rich people only, then there will be more increase in the inequality of income in the country. Its opposite, if the overall money spent on the welfare of poor people, then in the society there will be more equal and rightful distribution possible.

Self-Assessment

Fill in the blanks:

1. Government expenditure can be affected the production of the country by two types, one by directly and second..... .
2. There is an effect on the right use of ..... resources because of public expenditure.
3. When the amount of saving is more than investment then it develops slow down in economy that gives birth to ..... lastly.
4. To diversion for economic resources in any particular business ..... can be increased.

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1. "From the point of view of production those forms of public expenditure are socially desirable which will increase productive power more than it would be increased if the funds required were left in privets hands" —Dalton.
2. "There can be little doubt that stimulate, to production afforded by a wise system of public expenditure should far outweigh the check. If any two production results from the taxation and other devices required to finance this system , provided that these too are well chosen." —Dalton.

5. To remove the disabilities of income, the contribution of taxation and government expenditure are complementary and ..... .

18.2 Role of Progressive, Proportional and Regressive Expenditures

On regarding the production and employment the question of the effects of government expenditure Dalton conclusion is that "Where there is only taxation been taken then the product will be block by this and where there is only government expenditure has been taken, there will be definite increases in production." Dalton faith was that there will be always increase in the production by government expenditure, the thing is, it will be done by as wisely if there is any block in the production by taxation then it become remove by the government expenditure.

Meaning of Progressive, Proportional and Regressive Expenditure

Expenditure – If government expenditure provide more benefit to the high income group people and less benefit to the poor people of the society, then the expenditure will said to be regressive public expenditure and if the government expenditure is to be done in ways that it provides benefit to the different sections of the society in the same proportion of their income then this expenditure is said to be proportional expenditure. In the proportional expenditure, the gains also increase with the increase in income but the increase in gains are in the ratio of income. In regressive expenditure, the gains increase more than the rate of increase in the income. But in progressive expenditure, in which speed the income increases, the benefits of public expenditure reduces more than that speed.

(1) Regressive expenditure – Whatever less income a group have and if that section is getting that much less ratio benefit from the public expenditure then this local expenditure is said to be regressive.

Example – If Indian government spends money on the primary education for the children of high class instead of the primary education of the children of poor's then this will be regressive expenditure.

(2) Proportional expenditure – If different sections got benefit in the ratio of their income by the public expenditure then this expenditure is said to be proportional expenditure. For example – with the increase in income of the workers they got benefits from the public expenditure in the same ratio.

(3) Progressive expenditure – Whatever less income section have more ratio of benefit from the public expenditure then this will be called progressive expenditure like – free education for poor people, expenditure on medical, old age pension etc.

The progressive expenditure is said to be the best to reduce inequality. Whatever more the public expenditure will, the inequality of income will increase that much and whatever progressive will be the expenditure, the inequality of income will reduce that much more speed. This is also essential to achieve the target for more social welfare that there should be that policy of grants adopted, the types of progressive expenditure can be following froms–

So in the distribution, the objective of local expenditure should be like that it reduces the inequality of income so that the economic and social welfare could increase maximum.[1] In Dalton's words," That policy of government expenditure is the best in which regidness is found that can reduce the income". By this, it is clear that the progressive policy of expenditure reduces the discrepancies in income. Not only this, the rate of progression in expenditure is whatever fast, he has the tendency of regidness is more to reduce the inequalities of income, it means to cover the ditch between rich and poor people. In this condition, government expenditure provides more benefit to the people of low income group as compare to the high income group so, if any government wants to reduce these inequalities then the shelter of progressive expenditure should be taken.

Task Explain the proportional expenditure.

1. Ibid.

18.3 Forms of Progressive Expenditure

There are many forms of Progressive Expenditure; some of them are given below—

1. Cash Grants: Cash grant is that a payment of money that is given by the government to the recipient in cash. Old age pension and disease the benefits at the time of accident, disease and unemployment are the important examples of cash grants. All these grants as redistribution in the favour of low income section, so these are of progressive nature. Recipient get these payments or benefits in that situation when they really need it. No doubt this type of government expenditure definitely reduces the inequalities of income and increases the social and economic welfare of people. The fulfilment of these targets are in that situation is more but these grants are given according to the shape of the family of the person and in the different time periods in his life according to his need. In almost all the countries of world, the processes of social security like — old age pension, sickness benefits, benefits for unemployment, industrial injury benefits, maternity benefits, widow pension, children's allowance and for free health service arrangement whatever law makes, there target remains same. "If according to the ability of getting benefits the government expenditure and taxation according to the ability of paying"[1] implement theory, and then the maximum social welfare target could be achieved.

2. Free or Cheap Goods and Services: Those things and services are given on cheap costs or free by the government, by this, poor section get more benefit as compare to the rich section of the society. Because of these benefits income of poor section increases, so the inequalities of income reduces by this. Free primary education, waiver of fee for high education for economic weaker section and free arrangements of milk or food for the children of lower section school going children, the government expenditure on it is of progressive nature and this increases more the actual income of poor people and in social and economic welfare in it. Like this, the government expenditure on the arrangement of cheap grains is also progressive; the thing that the people of poor section use a big ratio of their expenditure on its marketing as compare to rich section people.[2] The arrangement of free health services for all the people of society is the other example of progressive expenditure that reduce the inequalities of income, "right as reduction area of health service."[3] But this is said that, "This is only a road to reach the target of unequal society."[4] Like this Dalton favour the thought of those modern Economists those believe more in progressive expenditure as compare to the thoughts of Prof. Towney.

Now, this matter is being absolutely clear that the progressive government expenditure plays an important role to reduce the inequality of income and to increase the income of poor people. But it also have some limitations. These are (i) the trials of people can be hurt by doing work and saving by government expenditure (ii) second, this can also be possible, for fast progressive public expenditure the fast progressive taxation discourages the desires of taxpayers to do hard work and to save more. In Dalton's words only, "Due to any grant a person does less work and saving, as compare to that he does in other situation, then it reduces the effect of grant increase in his income, and in its opposite direction there will be increase in the effects of grant."[5]

Thus, this is very essential that by the progressive expenditure and progressive taxation people start to think that they do not have need to do work, saving and invest, and this is the duty of government to fulfil all needs of there life. So, this normally except that the plan of government expenditure should be like as, it does not effect unfavourable on the desire do work, save and to invest.

1. Ibid., Page 167.
2. Ibid., Page 165.
3. Prof. Towney's—Quoted by Dalton, page 166.
4. Dalton, Public Finance, page 166.
5 Ibid.

18.4 Production Versus Distribution

Some people thought that by the government expenditure the effect of redistribution can be clash with the target of increasing production. So, this is to be said that due to progressive public expenditure the fast progressive tax is to be put, the savings and investments can be discouraged by this and this is because the people start thinking the increased income they will get from savings and investment, that's most part government will take as taxes. Like this, the highly progressive taxation can ends the courage of people to do hard work, to save and to invest and can be prove unproductive for economic progress and when by the government expenditure, to increase the facilities of poor sections of society and for the equal and rightful distribution of money, because of more tax putting the production will reduce then in that condition by the government expenditure this type of redistribution, distribution of poorness will take place not the money or income. In undeveloped countries, it happens mainly at that time when the income of rich people is to be taken in the form of taxes and it does not put in the production works and is to be used in the welfare works to remove the inequalities of the distribution of money and income.

In spite of, it does not mean that all type of taxations are indesirable for production and economic development. But its opposite, it should be done that a logical policy of taxation should be adopted which is based on the principle of ability to pay. By this taxation, production never discourage. Like this, in the different section of the society, the distribution of government expenditure should be done according to the principle of ability to receive and according to the shape of family and the needs of a person. On one side of this there will be no unfavourable effect on production and on the other side, of this will give its right contribution in the proper distribution of money and income. So, as a conclusion it can be said that these two targets always clash one another, this it not right, but its opposite the fact is, if the government maintains balance in between these two targets then these two become necessary or complementary to one another.

18.4.1 Public Expenditure and Economic Stability

For the analysis of economics stability or unstability, an appropriate system is needed to measure it. Economic unstabilites is figuristic or quantitative concept that is regarding the quantity and speed of the irritation of any ideal. The importance of two type of economic stability is more: one is unstability of output (or unstability of income or employment) and second is unstability of prices. These are the main unstabilities on which the analysis of effects of government expenditure does.

Meaning of Economic Unstability — The meaning of economic unstability is on the stable price levels departure from the complete employment, complete employment, and the important situation of stable price levels, according to Kinz, "It happens when savings equal to the investments (menas S = I). When savings more than investment then it brings recession in economy and by this the condition of depression produces. Its opposite, when investments are more than savings then it produce the condition of inflation. These conditions of booms and depressions has made the main symptom of capital economies over a decade. Rising prices and after the condition of inflation, the condition of down costs, business losses and unemployment means deflation comes.

Notes The time period of these cycle of booms to depression and from depression to booms, is equal and not even the quantity and speed is equal.

These cyclic up-down do random to the complete economy and produces heavy problems for almost all the people. The rising prices stands a mountain of problems in front of the fixed income section

people. On the other hand the falling of prices causes heavy losses as well as calamities and wider unemployment spreads.

Self-Assessment

Multiple Choice Questions:

6. Where, there is only taxation is taken then what will be the effect on production due to it?
   (a) Production will block (b) Production will continue without any hurdle
   (c) Production will not done (d) Production will stop completely.
7. In which expenditure, the benefit also increase with the increase in income?
   (a) Equal proportional (b) Proportional
   (c) Progressive (d) Depressive.
8. Whatever less income a section have, if the ratio of benefit from public expenditure is that much more then will it called?
   (a) Proportional expenditure (b) Depressive expenditure
   (c) Progressive expenditure (d) Above all.

18.5 Unemployment is the Result of Economic Unstability

Unemployment is said to be a main sign of economic disorganisation. This produces only when there is maladjustment or disorder produces in between different resources of production. This is a most unpleasant situation for economy; the reason is that it creates many the people who are its target, problems for them and their moral degradation does. So, this is the responsibility of government that he creates the situation of complete employment and maintains that as possible as release the economy from the curse of unemployment, Kinz's general theory of employment explains the causes of employment and tells that how can we get the condition of complete employment. Here, there is no need for us to go deep in the theory of employment, but only this has to be seen that to determine the quantity of employment and what contribution can government expenditure give to bring the condition of complete employment.

18.5.1 How does Economic Unstability Occur?

Here a brief introduction of Kinz's employment theory is important to know because one could understand that how can a normal level of economic activities can establish, in other words this could be known that how economic unstability produced or how unemployment takes birth?

Kinz employment theory is directly based on this logic that whatever an expenditure of one person, is the income of another person. Any expenditure does whether on purchasing of things of usable products or on the purchasing of those which are used in the production of product facilities, like, to collect labours for the effect of public expenditure of factory, the production of metal, cement or power and construction of canal and sewers.

The income which earns the people by producing the goods of usable and investable, he can spend that income on usable or can save some of the part that means he did not spend that part. If he spends all his income then it increases that much income of any other person; or if each person spends his complete income then it is believed that the cycle of income and expenditure is stable, it means there is no up and down in it. This is called complete employment or the condition of stable costs or the condition of economic stability.

But if a part of income is got by a person does not spend and the lack of expenditure is not fulfilled by investment expenditure, then this reduced expenditure of one person will reduce the income of other persons. Due to less income, those people will also spend less as its result, the income of other people will also reduce. So, the circumference of these circles of incomes and expenditures will also reduce and because of it, unemployment produce.

According to Kinz, "Savings always have a nature to equals the investment."

$$Y = \text{Total income} = C + I$$

Here C is the symbol of income has been got from usable things, I is the symbol of income got from the things of investment. Income whether can be spend on use or can be saved. So,

$$Y = C + S$$

Here, letter C shows the income used in consumption. And letter S shows the symbol of saved income. So,

$$Y = C + I \text{ and } Y = C + S$$

$$\therefore \quad C + I = C + S$$

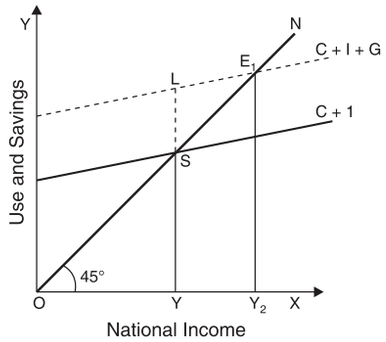
$$\therefore \quad I = S$$

Thus, it is clear that investments are always equal to savings. We call it the condition of economic stability or complete employment. In this condition, total income (Y) is whether spent on purchase of consumer goods (C) or on purchase of such goods and services (I), Which are put in more production of money. But, as the income increase, the people's propensity to consume decreases. In other words, a big part of additional income is saved instead of spending it. Therefore the people's propensity to save increases. This saved income creates unstability in economy. Therefore, for maintaining economic stability, in other words, for maintaining income and employment on popular level, it is very essential that due to reduce consumption, the reduction in demand of produced goods is affected. In this condition, the objective of government expenditure must be that the balance must be kept between savings and investment or between income and expenditure.

Do You Know? According to Keyens, savings always have a nature to equal the investment.

18.6 Depression and Public Expenditure

As it has already been told, depression is that condition of economy in which saving are more than investments. Its results that its total aggregate effective demand reduces so prices comes down. By falling prices businessman and manufactures incur loss and they reduce their faith to invest in future. Its result is that they reduces the production and employment also reduce. In this way worker, labours and major number of staffs are to be retrenched. Its result is the consumption of unemployed labours and staff reduces. And because of this again aggregate effective demand reduces and then deduction to be done on production and employment. As its result, more reduction comes in aggregate consumption and demand and this sequences again continues further. In this condition, government should give work to the people on public work projects. The people on work get wages from the government and it increased their demand in different things. This increased demand is helpful to increase in amount of production. Then the quantity of employment also increases and people get job by this aggregate effective demand of various materials increases the quantity of production and the availability of employment also increase. The sequence of this increment continues further, like this due to reduced consumption the effects of reduced demand of produced things can be finished by investing same increment in expenditure on public construction works and in this way, government expenditure can help to maintain economic stability.



The effect of public expenditure on the income level and the employment quantity can be easily clear by the above figure. In the figure, Y-axis the quantity of consumption and investment is measured and on X-axis, the level of income is taken. One is the income line that intersects the line of consumption and investment C+I on the point E, which is the initial balance level that means when there is no any type of expence by the government, expenditure in that condition on OY income level is employment. Assume government increases the income equal to EL and its natural that there will be new line of consumption and investment will be C+I+G. In this condition new balance will be E. In this condition , the nation income OY will increase up to OY, and as a result, the level of employment on the ratio of income increment will also increase. In this say it is clear that in the means of public expenditure depression period can be put to be end by the increase in income and employment.

18.6.1 Compensatory Expenditure

In the time period of depression to fulfil the lack of the non-government expenditure and to maintain the economic stability or national economy on the most favourable level, the government expenditure on it that is said to be Compensatory Expenditure. The system of compensatory expenditure is that there are heavy amount of expenditure in the time of depression and as the economy comes out of the cycle of depression then there is automatic slow reduction in this expenditure.

So it is very essential for the government to come in front and to remove the effects of depression or to finish the effect of increasing propensity to be found in private people, government should expand. In the time period of depression, the meaning of compensatory expenditure by the government is to adopt the deficit financial arrangement. There are three suggestions for the compensatory expenditure to arrange the money, taxation, borrowing and creation of new money. More taxation's first suggestion is not possible in that time when there is more unemployment and the level of income is low. But if the government got money by putting tax on those people who do not save then it can be possible it does not have any unfavourable effects. To complete the expenditure of loss, if government gets money by borrowing and if this borrowing reduces in the available money for the consumption and investment of non-government consumption then it does not have any beneficial effects. If government borrows money from the banks on less interest then effects of compensatory expenditure are like the same as currency flow. These borrowings do not reduce the amount of money that is required for the private investors. So, borrow from personal saving in condition of that it does not affect the consumption, and the borrow from the bank due to construction of new currency, both are helpful in the financial arrangement of compensatory expenditure.

Task What do you mean by Compensatory Expenditure?

Limitations—economists also told us about these dangers that is involved in the use of government expenditure for production increase and to providing employment is following.

(i) At first it can be possible that government does not have proper plans of public construction and in place of more employment, it provide the useless starts, unproduction and that does not increase the welfare of society ,but its opposite that is harmful for the health and work capacity of society.

(ii) It can happen that the government could not prove capable to operate of commercial establishment.

(iii) It is the arrangement of money for government expenditure done by the deficit financial arrangement then by that condition of inflation can be produced while the government does not have knowledge that when came out from the cycle of economic depression then how could reduce the rate of investment. Sometimes the public construction programmers are of this type of nature (like multi-purpose water electricity schemes) those have to complete definitely if started and could not left in between. It left in between, the amount spent on these becomes unproductive expenditure. Because of compensatory government expenditure as the expenditure on amount of debts and their interest taken by the government increase and the government pressure below the unusual load. So, most of the economics do not like that to rise the level of employment and to increase the production government expenditure to be used. And experience told that at the time of depression to increase production and to avail more employment government expenditure affects very favourably, in condition of the use of it is done very carefully and very wisely.

18.6.2 Public Expenditure in Inflation

Government expenditure can be helpful to control the inflation or rising costs. 'Inflation' is the name of that situation when savings become more than investments. In this condition, government should make surplus budget, it means spend less than income and by this whatever money he collects from surplus budget, that should be used in those areas of the economy when there is lack of money experienced, so that the total production capacity of economy could increase. In the country, by increasing the quantity of things and facilities, the rising prices can be stopped, so, government expenditure should be on those plans, that increase the productive capacity rapidly, if going to do in the field of agriculture then it can be done on the small scale irrigation plans, and on the production of good quality seeds and good quality of fertilizers. In the field of industries are going to spend then it can be done on the establishment of new industries and for the services providing for the extention of actual industries. But, the side of solution of this problem can be proved right for the unerdeveloped on developing countries doing where different resources of production, means many agriculture farms and factories etc. could not reach the optimum level of their production capacity. But where the different resources of production, means agriculture farms and factories etc. already doing work on the optimum level of their production capacity there on the economy by the government expenditure, there is a possibility of inflation regarding pressure. The reason of that is by doing this the extra purchase powers from the hands of people will increase but there will be no much increase in production because the production capacity of these type of countries already been reached to the optimum level. In this condition, government should do less expenditure from their income and to maintain stable it taxes, surplus budget could make and could stop the pressure regarding inflation.

18.7 Role of Public Expenditure in Economic Development and Growth

'Economic development' the use of this word does with other many words like this in the mixed form like economic growth, economic welfare, economic progress, secular change etc. But Schumpeter and

Mrs. Ursula Hicks like economic does a difference in between the economic development and economic progress like commonly using words. The use of 'economic development' word does in the number of problems of underdeveloped countries and the word economic growth is regarding the problems of advanced countries. Mrs. Hicks says that the problems of underdeveloped countries are related to the more advancement of the obsolate resource but the problem of developed countries is related to the advancement of more advance resources. The problem of underdeveloped countries is to do the economic development fastly means to increase fast in the income and production of the society. But the problem of advance and developed countries are related to maintain the economic stability and to do continuous increase and sequence increase in the income and production of the society so this is clear wherever there is a question of increase in the income and production of society, the problems of developed countries are different from underdeveloped countries. As the brief explanation of the contribution of government expenditure in the economic development and economic progress will be done here.

In the developed and underdeveloping countries that big problem has to be face is, the problem of increase in the employment and income. The programme of government expenditure is helpful for many people to provide employment directly. By this, the demand of those people for things and facilities increase and the chances of employment also increase. The reason is production automatically increases if the demand increases so that many more people get employment. But this thing only proves right when if the resources of production in the agriculture and industers not doing that much capacity of production, they can do. If they are doing higher or optimum level of production then there are less possibility of increase in production and employment. By this, the programmes of government expenditure should make like this it increases the production and increases the demand of products also. In other words, "Economic development with economic stability, this principle should follow. So the target of government expenditure should not be increased in the demand, but should to give non-government encouragement and ideas and to do justice. Government can also do governmental expenditure to enter directly in the production activities and industries so that to achieve the larger to balance between demand and fulfilment.

If government expenditure expend with generosity on some economic and social important heads like— education and public health, transportation communication or electricity etc. and then non-government area can be encouraged to do invest fastly investment and increase production in short, the government expenditure need to come in front to do arrangement of external economies and to do help in internal economies. By this, there will be increase both in production and demand. In other words the production and consumption will increase, people will get better income and better level of life.

Government should ready to expend to undertake those enterprises that do not attract non-government area or in that provable capital hesitates because there are less possibilities of benefits or there is need of heavy investment and the result obtained after a long period thus for the fast economic development need those basic industries needs iron and steel atomic power multipurpose water electricity plans, heavy electricity and engineering etc. These are counted in this section. But in the mixed economy, the target of government expenditure is not achieved by just doing help of non-government area but he does work in the form of complementary any for non-complementary area.

Self-Assessment

State whether the following statements are True or False:

9. Unemployment is said to be the main symbol of economic disorganization.
10. Investment is always equal to the expenditure.
11. The meaning of compensatory expenditure by the government is to adopt the deficit financial arrangement.

12. Government expenditure cannot be helpful to control inflation.
13. The principle of economic progress should also be adopted with the economic stability.

18.8 Summary

- During analyze of the effects of government expenditure, Dalton says rightful that "Taxation should be such as that minimum reduce the production and government expenditure should be such as that increase more in production, in the condition that. The other things remain same.
- The government expenditure on defence is non-productive because it is very important and essential for any country's internal peace and from the view of its outer security and without this the economics welfare of that country cannot increase.
- Same basic facilities like roads, rails and irrigation plans construction, the government expenditure on it is very helpful in the economic development of the country.
- The bounties and subsidies are to be given by the government to the new and actuate industries, in the form of economic help, and by this is done government expenditure is helpful for the people of doing the establishment of new industries by their resources and to increase the actual industries production.
- The more government expenditure of this type of many directions are desirable so that because in between sectors, a type of distribution of society resources could do that give best results and that could maintain between present and future without any partiality.
- Economic stability means complete employment, and to maintain the stability of rates, the diversion of economic resources are considered to be important.
- Some time by the government expenditure, there is diversion of economic resources in between different areas. It increases the production-power and it reduces the regional inequality.
- A type of mixed economy like that in India, where both the areas government and non-government are giving important contribution on the transfer of resources, on the ability and will to save and invest there is a heavy importance of the effects of government expenditure on the economic development of the whole country.
- Where there is only taxation been taken, then it is block the production and where there is only government expenditure is taken, there will be definite growth in production.
- The system of that government expenditure is the best in which a rigid tendency of reducing the inequalities of income is found. In this way, it is clear, that the progressive system of expenditure reduces the inequalities of income. Not only this whatever fast is the rate of progression in expenditure, in that to reduce the inequalities of income, means the tendency to cover the ditch in between rich and poor is more rigid.
- If due to any contribution, any person does less work and saving than he does in the other situation, then by this the effect of contribution will reduce to increase his income, and its effects of contribution will increase opposite direction.
- In the time of depression, to fulfil the lacking non-government expenditure and to maintain the national economy on the favourable level that government expenditure does that is called compensatory.
- Inflation is the name of the situation which investments are more than savings. In this condition, government should make surplus budget, means do less expence then his income and by this whatever money he got by the surplus budget that should be used in those areas of economy where there is lack of money expected so that the ability of total production capacity of economy could increase.

18.9 Keywords

- Invest - To use money into financial schemes, shares, or property with the expectation of making.
- Waste - Use more of something than is necessary or useful
- Deflation - Lacking of currency and prices.

18.10 Review Questions

1. What do you mean by direct or indirect effects?
2. How many types of expenditure? Explain it.
3. Explain the contributions of progressive, proportional and regressive expenditures.
4. Prove that unemployment is a result of economic unstability.
5. How is the economic unstability produces?

Answers: Self Assessment

1. Indirectly	2. Economic	3. Depression	4. Production
5. Supplementary	6. (a)	7. (b)	8. (c)
9. True	10. False	11. True	12. False
13. True			

18.11 Further Readings

Books

1. Lok Vitta—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
2. Bhartiya Lok Vitta Prashasan—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking and Public Finance—*Sundaram V, Alfa Publication, 2009.*
4. Public Finance—*Suprit Singh and Anil K Gupta, Domination, 2012.*

Notes

Unit-19: Public Budget

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know the definition of budget.
- Know the important elements of budget.
- Get the knowledge of the process of preparation of budget.
- Know the principles related to the budget.

Introduction

In any country, economy budget is very important. The reason is that it shows the appearance of economic activities of the government shows here . Budget is an assumption, an estimation and a suggestion itself. It is a type of device in which all the activities of financial administration are combined.

At present century, there are complete changes became in the form of budget and in the function of government, on these changes, there is an effect of political arrangement, economic principle, managerial view, account theory and public administration. Modern budget is not only responsible for legislative, but also the element of plans and arrangement are included.

19.1 Definition of Budget

There is an important place of budget in the economy of country because a budget shows the appearance of government economic activities. In simple words, budget is the yearly financial description and the estimate for the expenditure and revenue of coming years.

Notes

In present budget could not kept secret but it presents in the parliament and shows in all the newspapers. It is considered that in present meaning, the use of budget started in early of the 1773. Here, we will discuss about some main definations of budget—

According to Findlay Shirras, "In short, budget is the description of last years incomings of and expenditure and the estimation of incomings and expenditure of coming years. If there is deficit in budget then there are suggestions to fulfil it in the budget also includes and if there is surplus then there is an explanation to divide it."

In Prof. Taylor's words," Budget is the most important financial plan of the government. Budget, presents combine the sured income and proposed expenditure's estimate for budget year."

Pro. Dalton's thought is that." The normal thought of balanced budget is that there is a gain in the income in a time period or it is not less in comparison of expenditure."

According to W.F.Willoughby," Budget is together a report, an estimation and a proposal. It is also a type of device with it all the activities of financial administration are related their comparison is to be done and also it works in coordination."

On the basis of above definations it can be said that" Budget is the estimation of public expenditure and public income that normally made in the end of the financial year and for the coming year. In this there is an explanation of governments clear policies to achieve definite objectives."

Notes It is believed that the application of budget started in 1775.

19.2 Essential Elements of Budget

After knowing the definition of budget, discussion of essential elements of the budget is as follows—

1. **Time Period of Budget—**Normally the time period of a budget is one year. This is another thing that after seeing of expenditure, the supplementary budget should be present in the same year.
2. **The Base of Budget Cash Amount –** Budget is not prepared on the basis of ledger but is prepared according to the cash, means that the government will get net income in cash and expenditure will also be done in cash.
3. **Combined form—**The meaning of it is that budget presents in combined form for all the activities of government so that the complete economic condition of a country could get.
4. **Similarity of Accounts –** Not only there should be similarity in account of central government every year but the account of state should also be similar, so that the comparison of different states could be done.
5. **The Explanation of Gross Amount –** Budget cannot be prepared on the basis of net amount but is prepared on the basis of gross amount. The income of expenditure cannot show less but the explanation of income and expenditure does separately.
6. **The divesion of head of income and expenditure—**Generally in budget, the head of income and expenditure is divided into two parts—Capital account and revenue account, it cleared a head.
7. **Lapse rule—**The assumptions of budget is that if sectioned amount is not spent in that particular year then that amount is to be return. It cant be put in the form of surplus for next year.

Notes

8. **Scientific basis is and Capable Financial Arrangement—**The basis of budget should be scientific means that their construction should be according to the fixed rules and there should be able financial arrangement of estimations. So there can be much similarity between estimation and reality.
9. **The Mark of Economic Progress—**The construction of budget should be according to this view point from that the proper appearance of economic progress of the country could be known.

Self–Assessment

Fill in the blanks:

1. The applications of budget starts in ..... .
2. ..... is the most important financial planing of the government.
3. Normally, the time period of budget is ..... years.
4. Budget is prepared on the basis of ..... amount.
5. The base of budget should be ..... .

19.3 Budgetary Process

The process of the budgetary process goes through the following four steps—

(a) **Preparation of the Budget –** It can be said formulation also. The preparation of the budget continues for many months, but this process can be finished in some weeks in developing countries. In this step, by the legislative, revenue and next expenditure can be advance inferenced.

(b) **Authorization –** In second step, the budget presented by legislative, have to take approval from the speaker.

(c) **Implementation –** After having permission from the speaker, revenue is collected by the administration and on the affirmative head sanctioned amount spends.

(d) In the last step, the matter is checked that after having approval implementation of budget is done properly or not. This controlling work is alone by the medium of accounts and audit. Legislative committees do the same work.

19.3.1 Objectives of Budget

On the basis of budget, attempts have been made to achieve many targets. Following are the main objectives:

(a) Prepare budget structure for policy. For this, to achieve the targets, the work that will have to be done, takes the decision regarding this. This decision is to be taken that from different competitional optional proposals which one is to be choose so that, main national targets can be obtained. It is to be decided that can many targets be achieved combinely.

(b) Budget is a medium to implement a policy. Here standard of work capacity and thriftiness has been implemented, means they try to get policy making regarding decisions on minimum estimate.

(c) Budget is a medium of implementation. All decisions regarding budget take a form of act. The reason to pressurise the law control is to stop the misuse of rights and to save public fund from misuses.

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(d) Budget documents can be sources of providing information about the coming possibilities, activities of past, present decisions and future possibilities budget process provide offers for legislatives and executives that they can tell us the appropriateness of there decisions and functions.

It is clear from above explaination, that there are many targets of budget and sometimes there can be conflict in between them. As all the targets are important. so, it is important to solve this conflict by compromising.

Task Describe the different steps of preparation of budgetary process.

19.3.2 Changing Character of Budgeting

In present century, there are complete changes happened in the form of budget and the function of government. But, this development not became in the planned way , but it became itself. On this changes, there are effects of many elements, like, political arrangement, financial theory, managerial view, account theory and the characteristic is of public administration. Except, these normal elements, it effected by some particular incidents Following are the main incidents –

(a) Two world wars and by result of this increase in public expenditure.

(b) 1930's great financial crisis and as its result changes in the view of state and fiscal policy;

(c) After second world war increase in the public expenditure intensely;

(d) The need of economic stability and getting of complete employment and

(e) Economic development and inhancement and their role of state in that.

In the classical study of government budget there was focus on two main elements, like, (a) complete explanation, of government budget and account managements and (b) activity of legislative and audit. In this section Stourms Franch arrangement, Durell's British Parliamentary arrangement and Willoughby's American's arrangement can be kept. In 1920 and 1930's century in government budget the study of following subjects has done –

(a) The analysis of Administrative process's.

(b) Relation between the budget and financial agencies and the departments of expenditures.

(c) The matters of autonomous and executives and in between legislative as well as hand over the right in between different branches of executives.

As a result of Kent's revolution, the deep study of national income started. Its result is that the preparation of budget started under the whole financial structure. The main and special incident in between two world wars was, to adopt the central plan in second half of the 1920 century. After second world war development countries adopt development plans after getting independence. Because of this, new matters came in front of budget. The result of all became that the improvement has done in budgetory process in industrial and developing countries. In this sequence budgeting, plan arrangement, programming and budgeting arrangement (PPBS) and zero base budgeting developed.

In the reciprocal budget weightage was given on following matters:

1. **Unity –** All the receipts of government are in a combined form under a normal fund, kept for the financing of public expenditure.

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2. **Regularity –** Preparation of budget every year.
3. **Accuracy –** For a compact financial management, it is necessary for the estimation of budget right and faithful. Budget estimations should not be shown less willingly and even not more. There is a saying normally regarding Indian budget that revenue estimation to be show less and public expenditure shows very high. It is improper. So, it is essential that as possible the taxes and budget estimation regarding expenditure should be near to reality.
4. **Clarity –** Budget should be prepared like this that the representative of public and society could understand it and could discuss on it.
5. **Publicity –** As budget is a public document so the society should have knowledge of its contents.
6. **Operational Adequacy –** As budget is a device of administration under government, so it should be operational.
7. **Accountability –** Approval of revenue and expenditure estimate by the legislative.

Do You Know? There was an important incident in between two word-wars that to adopt central planning of decade of 1920.

Modern budget is responsible for legislative wherever, with this the elements of plan and management is also included in it. Except these, budget became the main device of national policy fixer. These budget face the following three objectives –

(a) **Accountability:** On this face of budget there influence of are public administration, political science and account's. The influence of public administration puts on ministries, account and auditing agencies. With the help of political science discussion is done about the relation of legislative and government, political process of the determination of allotment of resources etc. In account Audit, managerial account etc. are included.

(b) **Efficiency Control:** On this point of budget, there is an effect of economics, account, public administration and political science. In allotment, the areas like work efficiency production and distribution come in the circle of economics. The measurement of costing, use of accounts are related to the public administration. The topics include in the area of political science are—circle of government, the limitation of public expenditure and privatisation.

(c) **Economic Control:** It comes only in the circle of economics. Here, fiscal policy, economic structure of yearly budget, tax and most pressure with expenditure and the strategy regarding distribution are discussed. Although analysis of budgetary is a part of political science still it is important for the economists in the form of economic policy device.

19.4 Budgetary Theory

Under this heading, the study of this subject has done that budget should be balanced or imbalanced. Regarding this, two points of view have discussed –

19.4.1 Classical Viewpoint-Balanced Budget

According to the classical writers, the abstract of budget is the balance between revenue and expenditure. This belief is based on the analogy of personal nature. Like people should not spend more than his income, as same as the government should kept the expenditure within the border of

Notes

his income. In the words of Adam Smith,"[1] The intelligence in the nature of every limited family that can perhaps be a foolishness in the matter of a big state." The critical condition like war can be an exception of this theory. The thought of eighteen and nineteen century affects this belief only. Bestaval have explained this thought in following words –

"In normal conditions, there should be a balance between these two sides of financial activities. Expenditure should not be more as compare to income given up the state should only got that much tax he needed for the payment of expenditure."

To keep safe from the loss in budget Bestabul suggests that government should target little surplus in budget. It has been told that if give up target of balanced budget then the result will be over expenditure that stops the country's development and lastly it will step forward to financial devastation. In France, the economist J.B. Says who has popularised Adam Smith in France was deadly against, about public imbalance budget. He has said that because of wasteful public expenditure, there is a loss in budget. Lutz considered the balance budget to be a symbol of financial stability. Including this, he said that this type of budget contributes is long term inspiration to personal efforts., whether the imbalance budget is inefficient of doing so.

Classical economist's balance budget theory is based on the belief of complete employment. These economists thought was that complete employment is a normal condition. In the condition of complete employment, the finance for the budget deficit is derieved from the public debt. The meaning of public debt is the resource to be put on the public form, from the personal employment. The belief of complete classical economy is that there is maximum productive utility of resources in private sector comparatively Public sector. The second critics was that the financial arrangement with full of deficit as compare to debt is less severe. So, the deficit of budget give birth to the irresponsibility. The meaning is that in imbalance budget, there will be unnecessary expanding of public expenditure. The third thing is that the belief of classical economist is different from the modern economists regarding public expenditure. Due to public debt for public expenditure it becomes hard to arrange more finance. The reason is that not only the payment of interest has to be paid on debt, but also the principal money is to be given back, and for all this, there is need to impose extra tax. It dose not adopt in the theory of balance budget that to remove the unemployment is the target of budget policy. So, the belief regarding budget does not have to face any particular problem, but Crencian Revolution clears it even in balance the unwillingly unemployment in economy can be presented on big scale. This is also said that to achieve complete employment the currency policy is also not very useful. So, the help of budget policy will have to be taken and then there is no importance remain in the theory of balanced budget. In balanced budget, public expenditure is not more than revenue. Dalton[2] said that there are three questions remain arise (i) what should be included in public expenditure? (ii) What should be added in revenue? (iii) In which time period the budget should be in balance?

Regarding public expenditure, Dalton says that to this all the payments of public debt should be kept away. Like that a type of expenditure on public works, that is financing by the debts, should not be included also. Their saying is that dividing of a budget into current budget and capital budget is not very difficult. Dalton's meaning to say this is only current budget which should be balanced. There are many problems regarding revenue. Tax revenue have to be included, but all the capital receipts should be kept different. The reduction in public capital assests is equal to the increase in dead weight public debt. So, they give the following definition of balance budget—

"We may define a budget as being balanced if during the counting period there the net dead weight public debt is no increase in "public debt."[1]

1 "What is prudence in the conduct of every private family can scarcely by folly in that of a great kingdom." —*Adam Smith, Wealth of Nations.*

2 H. Dalton, Principles of Public Finance, 1947, p. 301.

Notes

In many developing countries and in some developed countries, government budget is divided into two parts:

Current or revenue budget and Capital or investment budget means are receipt side and expenditure side. Here below both the getting of budget and different aspects are included in expenditure favour as shown:

Revenue Budget

Revenue	Expenditure
1. Tax revenue 2. Non – tax revenue (a) The profits of public industries (b) Administrative fees (c) Fine and confiscation (d) Sale of government property (e) Others	1. Current purchase of things and services. 2. Payment of interest 3. Subsidy to public industries and transfer payment 4. Capital use expenditure 5. Others

Revenue – expenditure = net current loss = net saving or loss

Revenue Budget

Receipts	Expenditure
1. Loss from current revenue 2. Currency use allowance 3. Net borrowing 4. Contribution got from foreign countries	1. Physical investment 2. Purchasing of presently available assets 3. Net loans

Notes Getting – expenditure = change in balanced cash

Capital consumption allowance is an estimation of cost—cost depreciation of physical capital that are the result of obsolescence and depreciation. This is an expenditure for revenue budget, whether income for capital budget. In many countries, this head is not shown in the budget. The meanings of a balance budget can be following –

1. In revenue budget, revenue is to be equal to expenditure. So, there will be no surplus and not deficit in this budget. If there revenue is more than the expenditure then it will be surplus budget. Its opposite, in the situation when expenditure is more than revenue then this is called deficit budget. In the condition of balance budget, there is no need of funded debt. Funded debt is that which is given back within one year.
2. The second belief regarding balance budget is that the financing of current expenditure occurs the current revenue (tax revenue + non–tax revenue) with and capital budget both remain in balance.
3. The third belief of balance budget is where overall balance is discussed. In this type of balance in analysis revenue and capital budgets both are looked after combined and there is no separate balance discussed in revenue and capital budget. This type of balance is shown

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in the chart below. According to this belief of balance budget, there can be surplus or deficit in revenue budget. This type of surplus or deficit will transfer in the capital budget.

Overall Budget Balance

Receipts	Expenditure
A. Revenue (tax and non-tax)	D. Real and earning of financial wealth (Except cash)
B. Net borrowing	E. Increase in cash (+) or reduction (-)
C. Current expenditure	

Balance: A+B = C+D+E

Now, take the question of time. The classical belief is that there should be balance in budget every year. Dalton's saying is that "There is no specific merit in yearly balance, though this is the most usual period".[1] Vainer's saying is that "It is a mouldy fallacy that regardless of circumstances, the government must balance its budget in each year why not in each month or week or hour?"[2] Considering economical conditions, the belief gave birth to the cyclical balance in budget. According to this complete time period of business cycle should be looked after and the budget should be in balance totally in complete time period. In the progress period of business cycle surplus in budget and deficit in depression period.

19.4.2 Modern Belief – Inbalance Budget

The brightness of balance budget reduces at that time when there is unwillingly unemployment remains on big scale. So, Kenz, Hallson, Bevriz and Dalton etc. say that the target of budget policy should be complete employment. This thought is different from the belief of classical Economists because they never discuss about the use of budget policy to achieve complete employment.

To know difference between the classical and modern thoughts, to understand the difference in between two believes regarding public saving. The complete income achieved from the level of complete employment in the classical arrangement is again spent on the consumption and investment. Saving automatic converts into investment. So arranged saving is always equal to the arranged investment. In this type of all government revenue – tax and debts reduce the personal expenditure. This reduction comes through cut in consumption or investment. So, through public expenditure, there can be no increase in the strong demand.

In the central arrangement the belief of saving is different. In this, neigther establishment of complete employment by the private sector itself and also saving never became equal to the arranged investment itself. So, the deficit in budget is essential to finish the unemployment. To do increase in overall income, the budget to be looked as a positive device, so all the areas of economy should be encouraged to do more investment.

The deficit in budget is a form of imbalance budget. The second form is surplus in budget. The economists Kenz, Hansel, Bevriz and Dalton believed that the target of budget policy should be complete employment. To fulfil this target, the deficit in budget can be adopted.

19.4.3 The Role of Budget in Developing Countries

The role of budget in developing countries is very different in comparison to industrialist countries. In the developing countries, through the budget, by maintaining the right level of overall demand reduces

1 "There is no special virtue in a year, though this is the most usual priod."

– *Dalton, op. cit., p. 303.*

2 "It is a mouldy fallacy that regardless of circumtances, the government must balance its budget in each year why not in each month or week or hour?"

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the ups and downs of business cycle which can be minimum. In developing countries the nature of unemployment never be cyclic, but it is chronic which is the result of creative hurdle of economy. So its solution is not increase in overall demand, but is the increase in the level of capitalization and investment. So, in these countries budget is the important part of development plans. The second thing that is to be look after is that in the developing countries the role of fiscal policy is more strong as compare to monetary policy. There is no use of currency in a big part of economy. So, it reduces the work ability of monetary policy. On the other side, there is an important role provides to the public sector in the economic development. The problems of inflation and surplus to the developing countries are also very serious. By the thought of all these matters, this can be said that the budget policy will be more successful comparetively to monetary policy.

To look after the importance of budget policy it is to be discussed that how is this policy going on in developing countries. Some developing countries make a type of rule, according to them, the balance of national budget is essential. These types of policies are based on financial logics. The need is that budget should be matched with the inflation, public debt and targets of private sectiors developing rate. To achieve these targets it is not important for budget to be balanced. Experience told that to obey polices are very tough to follow. One problem is related to this how to define 'Balance budget? The accounts of public industries should be included in budget or not? Then in which period, it should be balanced – Every year or during business cycle or in other time period?

If budget does not remain balance, then by this, there are more chances of deficit and reality is also the same. Now the question is that which measurement the deficit budget should be called logical budget. The answer of this can be that there should be match of budget deficit with the external faith, increase in private investment and control of inflation like typical economic targets. For this, there is a need to divide the financial management in its components. Important division is related to that all the investment totals in the economy should be equal to the total of the saving of citizens and foreigners. This is shown in the following –

1. Public investment + Private investment = Public saving + Private saving + foreign saving;
2. Saving deficit = Public investment – Public saving;
3. Private surplus = Private saving – Private investment;
4. Current account deficit = Foreign saving;
5. Saving loss = Private surplus + current deficit in budget.

The meaning of the savings of foreigners is the income got from foreigners homely economy and their expenditure's difference done on this economy. This difference is equal to the current deficit of surplus. To get the private saving from the over all national income, the taxes and private consumption have to substract. Public saving is the difference of public current revenue and public current expenditure. So the difference of current saving is said to be budget deficit. The logical budget deficit will depend on those elements, that are the level of private saving, the desirable level of private investment and the desirable level of current account deficit Export, the real demand of currency and the rate of over all financial saving is whatever more the loss of budget can be that much more also. Normally in the condition of high rate of economic development the deficit of budget can be more because in this condition export and the demand of currency will be increase more fastly. The economy developing in slow speed, the prudent level of budget loss will be low because in this condition the level of financial saving will be low and import will be block.

Task What is the role of budget in developing countries?

Self-Assessment

Notes

Multiple Choice Questions:

6. What is meant by preparation of budget?
   (a) In list (b) Classification
   (c) Unification (d) Above all
7. When was the great financial depression happened?
   (a) 1948 (b) 1930
   (c) 1936 (d) 1830
8. The economist who made Adam Smith popular was?
   (a) Marshal (b) Kenz
   (c) J.B. Sey (d) None from above.

19.5 Budgetary Classification

In the national economy, it is essential on seeing the importance of budget that the public expenditure related to budget and data of revenue has to be kept in a such arranged way that shows its whole economical importance has cleared. To achieve this target, the classification of budget is essential.

19.5.1 The Types of the Classification of Budget

The classification of budget is to be done to complete many targets. Therefore its classification has occurred in many type which follows–

(a) Functional classification

(b) Organisational classification

(c) Object classification

(d) Economic classification

(e) Programme and Performance classification.

(a) Functional Classification

At the time of presenting the budget in front of legislative to get approval, it is essential for the finance minister to see that the allotment amount should be like this, the fulfilment of government desire became easy. This is the expenditure side of the budget, in the revenue side this has to be care after that the distribution of the burden of taxes should be according to the theory of social justice. These targets of this budget can be completed at that time when the classification of public expenditure is done according to the allotted facilities. This is called functional classification. An example of this type of classification has presented in following –

1. Common Public Services (Self Defence, Justice, Police and Common Administration.);
2. Community Services (Road and Bridge, Cleanliness etc.);
3. Social Services (Education, Health, Social Security and Others);
4. Economic Services (Agriculture, Mining, Construction, Electricity, Transportation, Communication etc.)

Notes

Just like classification of public expenditure, there is that of revenue, like, (a) tax revenue (income tax, Corporation tax, sale tax etc.) and (b) non–tax revenue.

Functional classification is a classification of common dealing on the basis of their objectives. The aim of this classification is to look after that government income spent for the best benefit. By this classification, a type of important information collects about those targets that tries to get by the medium of public expenditure. For this, government programme and actions devides according to the basic services provided by them.

(b) Organisational Classification

Under this, the organisational units of government (like concerned ministry) are divided according to the budget. These units are called the 'doers' of government. It prepares plans of budget programme and also actuates them. In India demand tor grants is placed to the parliament according to ministry. These type of classification of public expenditure is very easy, but the revenue side presents difficulties.

(c) Object Classification

The classification of public expenditure can be according to the spending agencies that is called organisational or agency classification. Topic can also be included with this type Barkhed says that the object classification is the contribution of that time when the legislative and citizens had less faith on administrators. According to this classification, account system includes in the budgeting sting can be kept on defalcation. An example of this classification regarding public expenditure, is given below –

1. Personnel compensation
   - (a) Whole time permanent place
   - (b) Other place
   - (c) Other personnel compensation personnel
2. Personnel benefit
   - (a) Travelling and transportation of persons.
   - (b) Communication, Transportation of goods uses and tax
   - (c) Printing and reproduction
3. Other Services
   - (a) Supply and ingredients
   - (b) Required things
   - (c) Contribution, subsidity and donation
   - (d) Insurance etc.
4. Miscellaneous Heads
   - (a) Total expenditure

As said, above with this classification agency or organisational classification is used. Towards the, Financial responsibility towards legislative is the main target of this classification.

Do You Know? The classification of public expenditure can be done according to the expending agencies which is called organisational or agency classification.

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(d) Financial Classification

This is the classification accordingly which public expenditure and revenue are divided according to the economic sections. The main target of this classification is the analysis of short-term effect of government dealing on the economy activity. All the economic data can be obtained by the economic and actional classification of government's dealing. These data are very important for the determination of economic policy. Economic classification is also important in the matter of national income account. It is also important in the construction of development plans. This classification has presented with an example –

1. Local expenditure
   (a) Expenses on things and facilities
   (b) Labour and salary
   (c) Other purchase
   (d) The payment of interest
   (e) Subsidy and other current transfer
2. Capital expenditure
   (a) Getting of new and present stable capital assets
   (b) The purchase of stock
   (c) Land and the Purchase of non – transferable property
   (d) Capital transfer
3. Net debt
4. Memorandum Head
   (a) Domestic Expenditure
   (b) Expenses in foreign expenditures
   (c) Domestic loan
   (d) Loan in foreign

(4) **Programme and Performance category – Budget Innovations**

One of the important thing which took place in 1950 was the adoption of planning by all the countries. Regarding this, traditional budget arrangement does not remain useful. In this budget, innovations is needed. The conclusion of this innovation is programme and performance classification.

19.5.2 Shortcoming of Traditional Budgeting

To understand budget innovations, there is need to know the demerits of traditional Budget which are as follows:

(a) Dominance of Control and Responsibilities

In traditional budget, stress is given on control and responsibilities. Therefore, no special attention is given on allotment of limited resources in the public sector on programmes and projects achieving national economic objectives in this budget. There are following results on given emphasis on control and responsibility-

1. The structure of budget is prepared in such a way that analysis of effect of budget on economy due to lack of knowledge in relation to the subject of expenditure such as wages, travelling, furniture is not possible by this.
2. The consumption of government resources on special tasks like wages, stationary is given more importance in comparison to questions like programme, development, objectives etc.

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Important matters like programme coordination are also neglected. The previous level of public expenditure is considered given and the requisition of only extra expenditure is investigated. This can be called incrementalism. This is that kind of factor which seems harmful for proper allotment of resources.

3. Evaluation of expense is also to be neglected.
4. Traditional budget is most stable generally in which changes find obstacles.
5. Performance of Programme investigated in the currency form. That is why it is difficult to determine the consequences and profit of expenditure. For example, the information can be had 10 crores rupees but with this expense how many teachers are appointed or how many boys get education and number of rooms made in the school, this information cannot be reaveled.
6. No attempt is made to figure out the current expenses related decisions of coming year's effects.
7. Traditional Budgeting also affects staffing pattern. Budget officials and accountants are given control oriential training. These employees are not appropriate for reference of the allotement of planning and resources.

(b) Budget Fragmentation

Budget, especially in developing countries does not included in all expenditures of public sectors and not even all of Public Activities. Albert Watson called this 'Budget Fragmentation Kasiden and Wildwaski said it 'Disappearing budget.' Budget Fragmentation is the result of many results. It is the reason to separate special objectives and agencies of Revenue tax. By doing this allotment of Budget resources becomes much less and also opportunities to selection between optional choices become less.

Autonomous bodies and corporations are some of the other factors. By establishment of these agencies, revenue has to be kept separated and transfer in a package. This slow down the comprehensiveness of the Budget. Remember that comprehensiveness is one of the speciality of the budget.

(c) Divided Budget

Programmes are divided into two or more Budgets and they can be investigated separately. Current expenditure cannot be balanced out and comming Recurring expenditure is avoided.

(d) Lack of Performance Measurement

In Traditional Budget only performance is measured in financial form. It is hardly measured in physical form. That is why through the medium of expenditure, real received information cannot be find out. For instance, suppose 10 crores expenditure was done on 'Health'. How many beds were arranged in hospitals for patients? How many doctors were appointed? This kind of information is not available in the Traditional Budget. In other words, Traditional Budget remains silent on the topic of physical aims.

(e) Absence of Programme Analysis

In traditional budget, budget estimations has not shown in the form of physical programme. In developing countries, Planning is adopted in any form for the economic development. So, there is need to change expanded and multi-dimensional and multi-yearly planning to special programme and project on annual basis. For this work, one supportive tool is Budget. Through Traditional Budget, completion of this work cannot be done in a proper way.

Notes

With the demerits of the above Traditional Budget one conclusion is that there is a need of innovations. Before the improvement in the economic planning it is needed for that Budget planning which change planning related decision into realistic. In the words of Kaiden and Wildwaski," Planning cannot to be an attention – seeker, until Annual Budget becomes meaningful."[1.] According to John Bayer, innovations in traditional Budget can be made on three bases—

1. Behaviourly, budget is the fundamental manifestation of the development programme and policy related decisions of the Government.
2. Success of the economic planning depends on that type of Budget system which change the planning related decision in reality.
3. Budget tool provides such probable opportunities which remove the hurdles to limit the effectiveness of long-term comprehensive planning.

Above results cannot obtained through Traditional Budget. So, Budget procedure needs a new view point which is named as Programme and Performance Budget System (PPBS).

Self–Assessment

State whether the following statements are True or False:

9. Functional classification is the classification of common dealing on the basis of the their objectives.
10. Distribution of the tax burden should not be done according to the principle of social justice.
11. Public expenditure classification can be done according to the expensing agencies which is said to be organisational or agency classification.
12. In Traditional Budget no stress is there on control or responsibilities.
13. Traditional Budget is a stable document.

19.6 Summary

- In the country's economy Budget has an important place because in Budget, Government economic activities reflected. In simple words, Budget is an account of Previous year's financial distribution and of comming year's Revenue and expense.
- Budget is a most important financial planning of government. The budget presents together the data of expected income and proposed expense. The budget is the estimation of public expenditure and income which is normally made in the end of the financial year for the next year. In this Government clear policies are mentioned to get definite objectives.
- After the approval of legislature, administration collects Revenue and senctioned amount, is spend on approved areas.
- Budget is the medium of the legal control. All the Budget related decision changes into regulations form. There is need of stress on legal control in order to present misuse of rights of people and public find.
- According to the classical writers, the essence of the Budget is the balance between Revenue and Expenditure. This notion is based on personal behaviour analogy.

1 "Planning is not worth much attention until the annual budget is made more meaningful"

– Noomi – Aiden and Haron Wildavshy, quoted in K.S. Sastry, Performance Budgeting for Planned Development, Radiant Publishers, 1979, P 27.

Notes

- On one side, there is wisdom in the behaviour of every limited family on the other side, perhaps it can not be foolishness in the big state.
- In revenue budget, revenue and expenditure is equal. So in this budget neither excess (surplus) takes place nor deficit. If revenue is more than expenditure then it is called Surplus Budget. In opposite of this, if expenditure is more than Revenue then it is known as deficit budget.
- In classical system, total income on the level of complete employment again expenses on consuming and investment saving converts automatically into investment. So planned saving is always equal to the planned investment. In this system, all the government Revenue taxes and debt decrease Private expenses are less.
- The role of budget in an industrial country is different in comparision to developing country. In developed countries through Budget, Business circular ups and downs can be minimised by balancing demand. In developing countries, there is no circulation in unemployment nature, in fact it is chronic which is the result of the structural barrier. That is why its solution is not the increase in Total demand, but increase in assets and investment level. So in these countries Budget development is an important part planning.
- In some developing countries such rules are made according to which National Budget should be balanced. These types of rules are based on weak economic factors. There is need of that Budget should be match up with the develop rate of inflation, Public debt and private area.
- One of the important contribution of the decade of 1950 was the adoption of planning by most of the countries. In this context traditional Budget is no longer remain useful. Innovations needed in this budget and the result of this innovation is Programme and performance classification.

19.7 Keywords

- Performance – To complete
- Operation – To perform
- Recurring – Repeated

19.8 Review Questions

1. Define Budget.
2. Explain main factors of the Budget.
3. What are the objectives of the Budget?
4. Lay emphasis on the points of the Traditional Budget.
5. Explain main principles of the Budget.
6. Present Budget classification.

Answers : Self Assessment

(1) 1773	(2) Budget	(3) One	(4) Gross
(5) Scientific	(6) (a)	(7) (b)	(8) (c)
(9) True	(10) False	(11) True	(12) False
(13) True			

19.9 Further Readings

Notes

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Notes

Unit-20: The Federal Finance

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know Problems of Federal Finance.
- Find Information on Principles of Federal Finance.
- Find Information of Problem of Imbalance in Financial Resources.
- Understand Recent Trends in Federal Finance.

Introduction

India is a federal state. Financial relation between centre and state depends on the principle of federal finance. In the federal administration system with the central administration and central government, different states government in states are also there. So, if more than one government exist in a country then it is called 'Federal Administration System.' Shri R.L. Waat has defined federal system in this way "Federal system is a kind of political union under which two or more than two states together form a government, but these state members keep their internal protection maintained. " According to Encyclopedia "Federal is a kind of government which main principle is to make central government together with two or more than two states for some permanent objectives. "Sir Robert Garran defined in this way" union is a type of government in which sovereignty of political power distributed between central and local government in a way, in which every state is independent to do work in its area "In this way it is clear that in federal administration system, there is one central government and different state government Which are free to do work in their own geographical limits. Central government does not unnecessary interfere in their work but in some cases it is related to the central government. To avoid clashes of rights and duties of different government, Constitution clearly defined every government right and duties.

Notes

20.1 Problems of Federal Finance

The main problem of federal finance is the distribution of finance resources between centre and states because they can't do their finance and future development programmers without financial management, in this way, this is the main problem for them. These factors can be cleared by the following basis:

1. **Division of work according to the financial resources—** According to federal system, centre and state has been given independent work in constitution. So, it is necessary that every government will require financial resources in abundance for fulfilling their work, they will be provided resources in abundance, the tasks of national favour like security, international and foreign trade, postage and communication, railways etc. are given in constitution, whereas state government have been given tasks of local or regional favour such as education, health, social services, internal law system etc. have been given. Economic resources must be available according to all these tasks and in which centre, state and local government should be independent to obtain their income and to spend. But, here this is important to mention that independent and coordinated level can not be maintained intensively between centre and states in any federal system.
2. **Imbalance between works and resources—** There is one more problem in federal finance that interference is created due to changes in social and technical between services and resources. It has been seen in federal system that the sources of income in central government increases gradually, but, neither sources increase according to tasks of states, but their freedom is also at stake. There has been enough increase in tasks of states from the concept of welfare state in present, but they did not get money in abundance. In that condition such a system is required which can redistribute and coordinate resources in changing contribution and by providing more part to states in central tax revenue, establishing concurrent powers.
3. **States relative poverty—** Some state relative poverty produces source of the financial problem. Due to differences in economic development and natural resources, all the states are not at equal level so their financial problems are also different. Because of this difference their social and administrative problems also differ from each other. It is essential to remove all these differences which can be solved by giving grants to the states by centre. Poor states should be given more grants as compare to other states. In our country, finance commission recommends tax revenue and grant for general purpose per person income basis.

20.2 Principles of Federal Finance

Prof B.P. Adarkar, mentioned three principles of federal finance in his book "Problems of Federal Finance". These and other principles which are obeyed to achieve the above objectives are analyzed below:

1. Principles of Independence and Responsibility

Related to this prof. B.P. Adarakar says first that federal and state both the government should be given all arrangements to do financial management through which they can not experience any obstacle to fulfil their social and economic objectives. This means that central and state government should possess their private and independent finance resources, which should be sufficient to complete their works. In other words it can be said that central and state government should be independent of the financial matter in this fields.

Except this, every government should take responsibility of imposing tax, collection of debt and increasing sources of income so that they can smoothly run the development works of his area.

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Regarding this it also has said that, the administration which has that work which pleases expenditure by changing it into income that government should also collect income which is a complex work.

Notes Independence of imposing tax and that of expenditure should remain side by side.

In this regard, some scholars also belief that if the government collects the income which comes under the category of expenditure on every level, then the public expenditure's quantity and size of every state will be different. In a state where rich population is there and where taxes are collected in enough quantity in the form of state's income their social obligations can be fulfilled easily as compared to the poor states. So in underdeveloped countries it is difficult to follow the principle of independence of finance. Because it is not possible to avoid some of the objectives like equal tax rate in all the states, to maintain internal and external stability and to balance social and economic progress in all the states. In other words, these scholars want to say that to impose taxes and to collect income independently and autonomy should be responsible for central government and state government should possess independence and autonomy of expenditure.

Above thought that is in underdeveloped countries, all the income sources should be in the hands of central government can be right on the basis of balance development principle, but behavioural view point also cannot be avoided. If the principle of intensely dependence of state government on central government is excepted then the level of the state government will become like any other expending agencies and they will not understand their responsibility of progress of this state.

So, we come to a conclusion that every unit of the union should remain independent in the field of economic. State government should get right to have enough money for their work, so that they can impose taxes and can take loans in this they should be total independence. But in behaviour full independence is not possible. There are two reasons for it, firstly central government possess important resources of income, which is generally flexible, secondly there are some other sources those which can't be divided that is why central government keeps them to itself only. So every unit of government depends on the union. For example, in India income tax, corporation tax and production tax are the sources of central government which is flexible. These kinds of sources are not available with state government. So for the finance support, state government depends on the central government badly.

2 Principle of Adequacy and Elasticity

In regard of federal finance system Prof. B.P. Adarkar gives more importance to the principle of Adequacy and elasticity. According to this principle state and central government should have finance resources in adequate manner. So that government of every level can easily fulfill its responsibility. In other words, this means that every government should possess sufficient resources of income which can help them to fulfill their work and duties which are assigned to them. According to the Australia's high court former judge Sir John Lothem, "If one federal system wants to exist as a full independent government then state should have adequate resources to fulfill their responsibilities."

Besides Adequacy it is essential of elasticity in financial resources. This means that with increasing financial; requirements there should increase the resources of income. Otherwise in federal finance system in crisis of economic and protective a problem arises. Mostly, it happens that state's work is like that which expenditure increases but income is not elastic in other word income does not increase according to the expenditure. So, Dr. R.N. Bharagva is right that Division of economic resources should

be done in an elasticity form because no matter that planning is better but it will be not suitable for every time.

3. Principle of Administrative Economy

Prof. B.P. Aderkar have force third principle which is a principle of administrative economy according to them it is necessary for federal state and for their financial matter's success that in the arrangement of financial resources the cost should be minimum and there should be no tax evasion or diplomacy in it. While dividing the resources it should be seen that which resources can be prepared better by the central or state government, Corruption and forceful entry should be popped and every resources must be used for the increase in income. Except this, taxes should be applied in the manner so that it will not affect industries and business infect it increases employment and tax evasion lowers down. Prof. Seligman said while talking about the principle of administrative economy, "No matter the planning is more useful, but if its administration is not correct then it will surely become unsuccessful."

4. Principle of Uniformity

In the federal system, uniformity means to give equal part of tax to every government that work which is essential for every state, to tolerate its burden, all the states government give equal part of tax to the central government on the basis of equality or apply equal tax rate on the citizens of the states through central government which imposing taxes every citizen should be treated in an equal manner which doing public expenditure, central government should also behave equali with all the citizen. But this equality is not possible in fiscal policy as the sources of every level and their expenditure is not same. Resource and needs of every state is different. Yes, it may possible that while giving taxes every citizen of one state should not be given special facilities or discount as compared to another state.

5. Principle of Equity

The principle of equity is an important principle in taxation, which Adam Smith stated. To implement this principle in federal finance system is an important things, because according to this principle the distribution of resources in federal and states create the state of inequality which can spoil the whole structure. There can be difference in level of economic development of different states of a fedral, but if taxation is done according to this principle then the burden of taxes in different states will be different. Because, marginal sacrifice will be different in different states. The marginal sacrifice of taxpayers of rich states will be less in comparison to those states which are relatively poor, Therefore, the need arises that taxes of central and state government must be coordinated in such a way that marginal sacrifice must be equal or approximately equal due to both type of taxes on every taxpayer, whether they live in any state. In means that taxes of center and state governments must be included in such a way, by which the burden of taxes must be equal or approximately equal on every citizen.

Do You Know? No matter the planning is more useful, but if its administration is not correct then it will surely become unsuccessful.

6. Principle of Integration and Coordination

A federal finance arrangement should be like that every unit coordinated with one another and no an unit separate from whole arrangement. It is necessary for an efficient system. Regarding this one more thing is there that principle of integration and coordination is not limited only for taxes.

Notes

Coordination of Budget, Assets, expenditure and other related activities must be there between union and state.

7. Principle of Accountability

Federal finance system and democracy are like sisters in a federal government. Every government is responsible for applying taxes and giving accounts to his MLAs, this means about imposing by the government taxes or expenditure and MLAs have the right to take accounts. But, government have to take care of other government that what impact they have on them.

8. Principle of Fiscal Access

Central and state government should not be any restriction from increasing their sources of income as they have to fulfill their increasing needs. This means that with the increasing of government responsibility, their sources should also be increased.

9. Principle of Transfer of Resources

This principle means that the state which is rich, their income should be given to the poor states so that every person of every state can lead a minimum life standard. Its objective is that person of a country should lead a life standard which is below of it. This means that no person can get lower life standard below the national standard. Dr. B.R. Mishra had written in his book 'Indian federal finance that the division of resources between central and state should be based on the principle of 'National minimum, this can be possible by the income transfer of rich states to the poor ones. The main objective of this transfer is to lower down the inequality because economic inequality is not beneficial to the national welfare. Activities of the Revenue can lessen down the inequality.

10. Re-allocation of Resources

Every state should division their resources in a type so that centre and state can get enough money and can complete their objectives efficiently. But this kind of division is not simple. There is no solid point on the basis which can say that the division is favorable. A line between state and central government resources is not easy to draw.

When the decision takes place between centre and state then there are some resources on which central government have the rights and some resources are given to the state and some are given to both of them. These kinds of resources lie in concurrent list.

In concurrent areas disputes occur which solved according to the constitution. Generally, right is given to the central government that it limits the tax, its procedure and arrangement and which the state that in government have to follow. In this way, it is clear that in relation to the concurrent list central government forms a structure and under this, state government makes rules and applies taxes.

One thing have to clear that with the time situation also changes and because of this no definite division can take place. So the solution of the division of resources cannot be limited to one changing situation can be re-divided. In the end, it can only that the division of the resources should be done in such a way from which maximum use of resources and can also increase the economic development rate and can lower down the income inequality.

Self-Assessment

Fill in the blanks:

1. India is a ..... country.
2. If more than one government exists in a country then it is called ..... .

Notes

3. Main problem of federal finance is the distribution of ..... resources.
4. In federal system, every unit should have freedom in the matter of ..... .
5. In taxation, principle of equality is one of the important principle which stated by..... .

20.3 Problem of Imbalance in Financial Resources

It is seen that sometimes imbalance creates between central and state government and their financial resources. Income of sources of different government can be favourable, less or more.

20.3.1 Course of Imbalance

Imbalance between income of sources and needs is because of important and elastic resources given to the central government for the country's betterment. For example, customs, income tax excise duty and corporation tax are given to the central government all these taxes are elastic which means income is increasing day by day because of them. On the other hand, state government handles economic and social development on the basis of independence and so behaviorally it is seen that income of resources of central government increases rapidly than of state government this means central government have income of resources and state government possess responsibilities which resulted in imbalance of federal finance system.

One more aspect related to this is that every government have more work and responsibilities as compared to the past. But when it increases then they states participating in the local government income of resources, which resulted in the imbalance of local govts income of resources.

Imbalance between work and income resource is because of third reason i.e., economic inequality. When the policy of economic and social development is adopted in the country, then more pressure lies on the poor state's resources, which resulted in the interference in establishment of the welfare state, this clearly indicated that resources are less where they needed the most. In these areas imbalance occurs between work and income of resources.

Task What is the main difference of imbalance in income of resources and needs?

20.3.2 How to Remove Imbalance?

Imbalance between central and state's finance can be removed by two methods – firstly transfer of work of state government to central government or to transfer some sources of income of central government to state government. But opposition of this thought is done on the basis of uniformity and administrative efficiency. Except this, imbalance between central and state government can be removed by transfer of some capital from centre to state in federal system, this is very popular.

Commonwealth grant commission of Australia said that we have accepted growing and increasing capital transfer from commonwealth to sates because common wealth can easily increase the income

20.3.3 Forms of Inter–government Financial Transfers

To remove the imbalance of finance between state and central following plans adopted so that every unit of central government can become self-dependent in work and resources. To balance central and

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state's finance resources is also essential because every unit of centre does not get same income from same resources. One of the main reason is that all the units are not same on economic condition, some have strong economic condition while some have weak. This results in inequality of income the same source of different states as their social and economic situations are not same. But it is necessary for a country to balance finance and for this following methods are adopted –

1. **Distribution of tax proceeds:** Under this system central government impose some taxes and collect the income receives from it and collected income is divided in central units. This procedure is known as assignment procedure or distributive pool method while applying this method three problems comes:

   (i) Which income of taxes divided?

   (ii) Taxes of which part of income or how much percentage of income is divided to state government

   (iii) Part of every state or on which basis decided?

   Taxes and Income from Taxes should be divided: As for as the question concerns that which income of taxes is divided to states. it is written in the constitution that of central government that which income that is received from taxes should be divided in states.

2. **Income Taxes of which part of or how much percentage of income is divided to state government and which part central government keep for itself:** This may be mentioned in the constitution. In Indian and African government there is an arrangement in constitution that to establish finance commission, which decide the part of states. Regarding this, Canada has an agreement between central and state government for 5 years. In this matter, Indian system is more elastic their finance commission decides income from taxes to be given to the states according to their needs.

   One thing has to be mentioned that if in the constitution percentage of the state is given than elacity almost ends as amendments in the constitution are not easy.

   Prof. B.P. Adarkar tries to solve this problem of division of income obtained tax between centre and states by the following methods:

   (i) Central government should keep a limited percentage of income with itself and divide rest of the money in states.

   (ii) Central government should divide the entire amount in definite proportion of income tax to all the units of the government.

   (iii) For central government a definite amount should be saved and divide rest of the amount among other governments.

   (iv) Central government only impose and collect taxes and income received from them should be distributed to the state government.

3. **Third problem of distribution of tax proceeds is that part of every state decides on which basis:** In reality, this is a complex problem. In India and African countries, part of state government is decided on some factors like size of the population economic and social backwardness by finance commission. But today importance is given to the last factor, so every part of the state is fixed on the basis of population, economy and social backwardness states obligations and responsibilities.

20.3.4 Advantages and Defects

There are some advantages and defects of this system which are:

Advantages

(a) The top importance of central government is maintained in it and autonomous of state government not ended.

Notes

(b) This system is simple.

(c) This system is successful in dividing income on the basis of efficiency and equality.

(d) State government does that work with encouragement which is important for the central government and central government gives importance only to that matter through which all the states can remain on the same level.

(e) With the increase in income of central government, state's income also increases.

Defects

(a) If the unit which is collecting income did not have right to use it, then the unit will not take interest in collecting.

(b) If the collector's part is fixed already then also the unit will not take interest in collecting the income.

(c) Federal units itself want more and more money instead of giving care to other weakest units. This condition creates disatisfaction among other units.

(d) Some units demand more part census based while some wants more contribution on the basis of their economy and social backwardness. While demanding on the income whatever will be the basis, every unit have disatisfaction in every situation.

(e) Changing on the base of distribution of tax proceeds can lead to the changes in base of income of units also this also creates disatisfaction.

1. Supplementary Levies or Taxes

Second method to remove the imbalance between income and resources, is supplementary levies or taxes. In this, mostly one government, (mainly central government) imposes principal tax, other government applies extra taxes. In this way state government, can increase their sources of income and can maintain balance between needs and resource. It can also be possible that central government impose some special tax and state government impose supplementary levy or tax to increase its income or different states impose some tax and central government intern impose supplementary levies or taxes to increase its income.

In this procedure any method can be adopted. But mostly central government applies taxes and state government intern applies supplementary levies or taxes to increase its income.

Except this, taxes which state government imposes are sometimes different in rates. That is why when central imposes taxes on state government then neither taxation contains uniformity nor it considered justified.

State government can impose which rate of interest it wants on central government's taxes. It already fixed and normally the burden of supplementary levies or taxes is not more than the main taxes. Supplementary levies or taxes are collected by the central government and its income is given to different state.

Criticism: This procedure is criticized by many scholars (*) they said that imposing taxes twice can lead burden on people.

(1) Which results in unfavourably production influence on, distribution and saving, (2) Except this competition startes in state and central because everyone gives importance to their profits. (3) A possibility of burden lies on the tax payers which becomes impossible for him to pay which also affects adversely his lifestyle.

2. Federal Grant–in-aid

This is one of the important method of balancing finance in different states. In this system centre government gives economic help to states. These aids can be with or without conditions, or permanent

Notes

or temporary and changeable. The main objectives of these aids are to provide income of resources according to the state's needs and to bring uniformity in the situation of various states. Except this, central government also gives special grants to backward areas and sections for education. Not only this but federal also gives state government grant – in-aid in the form of economy support for some to implement some activities.

In this way central government gives many kinds of economic support to state governments.

Notes To remove imbalance between income and resources, second method is supplementary levis or taxes.

Economic Help Given on Which Principle

According to prof. A.H. Hansen and H.S. Perloff, following principle should be adopted while giving economic help to states.

1. While giving economic support, central government should take care of state's income and its population.
2. Central should also take care of state's income resources. Those states which have less resources and more needs, they should be given more help.
3. Federal grant-in-aid should be enough so that facility can be maintained on same level in the whole country.
4. Economic weaker states should be given special grants. So that they can come on minimum level.
5. These types of grants should not be wasted.
6. For grants, state should not depend on central government. They themselves can try to increase their resources economy.
7. Central government should adopt an easy policy to give grants to state so that state can come to same level of economic and social equity which does not create unsatisafaction among them.

These types of grants can lower down the gap of finance between central and state government. These types of grant can be given for education, medical aid etc. in this way grant can be under the jurisdiction of central government or finance commission.

In India and America, central government provides grant for special objectives. These types of grants are given only for special programmers and central government gives only a fixed ratio, rest of the money, state arranges itself.

Do You Know? State should not be depended on central govt. for grant in fact it can also try to increases its income.

3. Grants to Central Government from States

Like central gives grants to states, likewise states also give grants to the central government for its expenditure. On what basis and how much grants should state give to centre is a complete problem under this state gives a fixed percentage of its income to the central government.

Notes

But in financial adjustment between central and states, this method is not considered useful as it has many demerit. The biggest demerit of this is that central government have to depend on state government for its expenses, which is fairly improper because central government have to do important work like defence of country. If it has to depend on state to fulfill its responsibilities then it can never work efficiently and confidently. State's area is also very limited. They can not fully support or give grants to centre.

20.4 Recent Trends in Federal Finance

The responsibility of federal government is to encourage economic development for this, it should be provided enough power. According to Prof. F.G Garnell, "In present situation, central government should be given enough power so that it can fulfill social and economic responsibilities."[1] Social services like unemployment protection, sick protection, pensions to elders, pensions to widows and orphans etc. should be given equally to all the states on same principle. It is essential for central government to establish a system and for its implementation also help state government. In this way it is clear that control should be provided more power. These trends affect federal finance and some of these trends are helpful in developing financial policies.

1. Central government provides resources for development and for its implementation state government work in that direction. In this way, government works as a cheif financial authority to fulfill financial needs and for economic development state government works as government executives.
2. In recent years, transfer of financial resources from central government to the state government has been rapidly increased. At present, state government is depending more and more on central government for finance because development projects cannot be possible without the help of central.
3. Central government spends more than state government. So, it is the responsibility of the central government to limit the public expenditure of state government.
4. Central government provides enough finance to poor states for various political, economic and social reasons.

If in any federal finance, these trends are there, then it effects social, political and economical changes. If financial policy does not change according to the situation, then federal finance may not live longer.

Self-Assessment

Multiple Choice Questions:

6. Cooperation tax is:
   (a) elastic (b) inelastic
   (c) narrow (d) All of above
7. Who commented "We have accepted transfer of increased and increasing amount from Commonwealth to the states."
   (a) India's commonwealth commission
   (b) Australia's commonwealth commission
   (c) Britain's commonwealth commission
   (d) All of the above

1 F.G. Carnell —Federalism in India. Page 29.

Notes

8. It is the responsibility of the central government to encourage whom?
   (a) Social development (b) Political development.
   (c) Cultural development (d) Economic

20.5 Principles of Federal Finance and Indian Federal System

Till now, we have discussed finance principles like independence and responsibility plenty and elasticity, frugality in management uniformity, equity, adjustment, account increase in exchequer etc. Here we will analyze these financial principles in order of distribution of financial resources between state and center described in Indian constitution. These taxes whose basis is interstate they have to be colected only by the central government and these taxes where basis is local is collected by the state government.

Clear Cut Division of Taxing Powers

In the central Index (Index I) central's power and work is described. In this list levies and the taxes are imposed by the central government are included. State Index (Index II) includes taxes imposed by the state government and levies. Concurrent list is the Index III.

In the index I, central government have all the rights of included resources. These resources which are included in the index II comes under the state govt. and on III resources only all rights is there on state government. In this way responsibility of central and state are clearly divided in constitution.

20.5.1 A Part of the Central Tax Revenue is Assigned to the States

In central government's, index there are 12 items on which taxes are imposed. Although all these taxes are included in the central Index but this does not mean that the revenue received from these are used by the central government. Taxes which are included in the central are divided in four parts:

1. Those taxes which are imposed and are received by the central government only. Custom duty Law tax and capital tax (except agriculture land) etc. are included. The income received by these items is not distributed among the states.
2. There are some taxes which are imposed and received by the central government but state government also have a share in them. In this income of every aspect except agricultural tax excluded like tobacco and other destructive things (except alcohol and drugs).
3. Those taxes which are impose by the central government and are also received by the central government only but revenue received from these are distributed in the states. Some of the examples of these taxes are successor tax, on train's fare, terminal tax on water – air ways, sales tax on international business (except newspaper) etc.
4. Some taxes are imposed by the central government and are received by the state government and are also consumed by the state only like stamp duty, medical and toiletries excise duty etc.

From the above it is clear that central government gives a part of its revenue to the state government. The share of state governments increased or deceased accordingly there requirements. Except this distribution of taxes is related also with ability and frugality to collect revenue.

Task Taxes included in the central index have divided in how many parts?

Notes

20.5.2 Setting of Finance Commission

Despite of the division between central and state government, there are still some imbalance between the resources and the worksome. To remove these imbalances constitution allows Central government to give revenue as a part of grant to State. In Indian constitution's Article 280-A, a finance commission, in every 5 years is set up to maintain the balance of finance relations between central and state. President has the right to appoint this finance commission before 5 years also. Finance commission submitted its report to the president and after the discussion central govt takes decision on it. The main objective to establish finance commission gives its report to the president and after the discussion central govt takes decision on it. The main objective to establish finance commission is to fixed the share of the state government so that balance can be maintained between central and state and in their sources of income which lead to the balance development of all the states.

From the above it is clear that finance commission plays an important role in maintaining balance. In India, in the constitution (in 1950's constitution), three factors are described to maintain balance between state and the central government.

1. **Income Tax and Federal's Excise Duty Division:** There are some taxes in the constitution, Article – 270 in which settlement of division between state and the central described. In this all income, taxes are included (except Agriculture tax). There is a point in the Indian government Act 1935 in list 140 (I) which says that some of the part of the production tax can be distributed in the state government. This division takes place after the advice of finance commission. In this way, after every 5 years, finance commission investigates the state's needs and fixed their share of income.
2. **Grants to states from federal:** To establish balance between federal and state second important method is to give grants to the states. These are given to these who needs the money. So different amount is fixed for different states. On the advice of finance commission, central gives these Grants to states. Finance commission also limits the amount of grant on the basis of his principles.
3. **To increase income after imposing surcharge:** Third settlement to establish economic balance is of imposing surcharge by the central govt to increase income so that the received income can be distributed in states. In this way, it is clear that federal government can impose surcharge on some fixed taxes described in state government index and on that income central govt have the full right of spending. These types of surcharge are imposed on Income tax in India.
4. **Right to take debt:** Except this, in the Indian constitution a right is given to the central government that it can take loan from its own country or from foreign country. Under the guidelines of the state government, legislative assembly and can take loan within the country from central government if needed.

   In the area of finance, constitution had adopted an expensive trend. This type of procedure can not be found in any other federal constitution. In our constitution, all the principles of federal finance are followed. So, that imbalance can be removed. State government needs federal revenue. This dependence of states on central establishes co-ordination. The other way round central govt also need to establish adjustments.

Self-Assessment

State whether the following statements are True or False:

9. Division of taxes between central and state govt is adopted the principle of independence and responsibility.

Notes

10. In the central index, there is no description of central's power and work.
11. 12 items are in the index of central government on which central government imposes tax.
12. In Indian constitution is Article 280 – A, a finance commission in every 6 years is set up.
13. In Indian constitution is Article 280 – A, a finance commission is appointed in every 5 years.

20.6 Summary

- The main problem of federal finance is the distribution of financial resources between central and state because they can't do their financial and future development programmes without the arrangement of finance. In this way, this is the main problem for them.
- Every government should take responsibility of imposing tax, collection of debt and increasing of income from other sources so that they can smoothly run their development work.
- In federal, government every govt. should remain free in the field of economy, state govt. should have right to have money for their work, so that they can apply taxes and can take loans. These should be independent.
- Division of economic resources should be done in an elasticity form because no matter that planning is better but it will be not suitable every time.
- Imbalance between income of sources and needs is because of important elastic resources given to the central government for the country's betterment.
- To remove the imbalance between Income and resources, second method is supplementary levies or taxes. In this, mostly one government (mainly central government) imposes principal tax, and other government applies extra taxes.
- In present situation central government should be given enough power, so that it can fulfill social and economic responsibilities of a modern center government.
- In central government's index there are 12 items on which taxes are imposed. Although, all these taxes are included in the central index, but this does not mean that the all revenue received from their usage only by the central government.
- In the area of finance, constitution had adopted an expensive method. This type of procedure cannot be found in any other federal constitution.

20.7 Keywords

- Concurrent: Unanimous behaviour
- Surcharge: Extra tax

20.8 Review Questions

1. To establish balance between state and federal what are the main factors?
2. In how many parts, taxes of central index can be divided?
3. What is the meaning of supplementary levies or taxes?
4. What are the procedure of transferring financial resources between governments?
5. What are the reasons of imbalance in financial resources?

Answers : Self Assessment

Notes

(1) Federal	(2) Federal administration	(3) Financial Economy
(4) Economical	(5) Adam Smith	(6) (a)
(7) (b)	(8) (d)	(9) True
(10) False	(11) True	(12) False
(13) True		

20.9 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Notes

Unit-21: Development of Federal Finance in India

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Development of Federal Finance in India.
- The distribution of government income.
- Distribution of Income - tax and export – tax of jute.

Introduction

India is a federal state. Relations of finance between states central depend on federal financial principles. Federation is that form of government in which sovereignty or political power is divided between central and local governments, so that they can remain independent at their work. In the words of **Prof. R.N. Bhargava,**" Meaning of federal finance is the relation between federal and state and finance. In federal system constitutional division of duties, rights and resources has been done. Both these governments are independent in their respective work and duties areas.

The division between central and state governments and unit is different in other countries. Generally, those work which are important for the whole country comes in the area of central government and these which are important in local areas are the responsibility of state government. In this way, defence foreign matters communication sources and currency etc. are the topic of central and education, Public health, legal matter comes under unit of state government. But, it is essential that after the division central and state policies should not be clashed and should be in coordination.

21.1 Development of Federal Finance in India

In India, presently federal administration and federal finance exists. But the present situation of federal finance is the result of decentralisation. To convenient study this, India's federal finance in India is divided into following periods –

Notes

1. First Period—Centralisation (1833 – 1871)

"Till 1857, central government had the control of country's revenue and expenditure. Indian government had strict control on the finance of province, its summary can be given in the following words."

Local government runs the whole administration behaviourally, but actually it becomes powerless and they had no control on finance of their province and also they have no financial obligation.

This system was very vicious. While distributing money in provinces, Indian government did not follow a definite and logical principles. Its consequences were "Distribution of government income created chaos in which only clever and cunning provinces got the advantages" In this way province government were depended on the doles provided by the central government, these doles too were not given on any fixed principle. Related to this 'Ashok Chandra' is right "Distribution of money is not irrational but it created many administrative difficulties." For this reason in 1871, new settlement applied in decentralisation.

2. Second Period—Financial Devolution (1871 – 1919)

In the direction of Devolution of financial right first step was taken by Lord Mayo. While for some services like prison, police, medical care, registration, education, roads civil constructions etc. province government are responsible. Under this system every department had to get grants from central so that the province government could fulfill their duties. Also they were given some right of taxation. Some branches of government income were still in the central right like Railways, Post office and tributes. Except this custom, excise duty, salt and opium were also the part of centre. Income from revenue, excise duty, land, stamp and registration were divided in the fixed ratio between Central and State government. There is no doubt that this system improved central procedure which had many defects for example, there were many dissimilarities in the finance of province. This means that the settlement of 1971 was based on Actual expenditure. So, some provinces got more financial support while some got very less.

Notes To remove these difficulties in 1877, in the period of Lord Lynton except central grants, excise tax, land revenue and stamp etc. are some heads were given to the provinces.

Devolution of financial rights has taken a next step in the period of Lord Ripon in 1882 by Lord Cromer. According to this planning, fixed ratio was removed. Government income tax was divided in three parts "Imperial or central heads", "Provincial heads", "Divided heads", (a) In Imperial or central heads, income of trade Department, profit from salt and opium and terminal taxes were included (b) In provincial heads, income from civil Department and provincial construction work were included (c) In divided heads excise duty, assessed taxes, stamp, forest and registration heads were included. Income received from the heads were divided equally between state and the central government.

After every 5 years, review was done on the situation and in 1887, 1892 and 1897 new settlement were introduction, but it had unstability and lack of continuity. So to remove these hurdles in 1904, settlement was made temporary and in 1912, it became permanent.

3. Third Period—Montagu Chemsford Reform (1919 – 1935)

As it is mentioned above that in 1971 that up to period of 1919, under the planning of devolution of financial right, financial autonomy was given to the provinces but they cannot be defined as solid and

Notes

enough. So according to improvement report of Montagu Chelmsford report, by the ending "divided heads", autonomy of provinces increased. In 1919 government of India Act was based on this report. According to this division of sources of income was completely done between centre and provinces. In divided heads, centre was given Income tax and General stamp and provinces got land court stamp, land, excise duty, revenue and irrigation.

Meston Award— To study Montagu Chelmsford's report, a financial committee was set up under the chairmanship of Lord Meston. This is also known as Meston settlement or Meston Award.

In Montagu Chelmsford report, division of resources were suggested and in Meston Award some amendments were presented. This committee investigated the matter of giving right of procurations from income tax to industrial provinces especially Bombay. But at the end, they came to a conclusion that Income tax's is remain with central head. Committee also recommended that instead of dividing stamps between central and provinces it should be given completely to the provinces head. In this way poor provinces can get the financial help and divided heads will also come to an end.

Meston settlement was critised in many states like Madras, Bombay and Bengal. But it was accept after some amendments and it was included in government of India Act. 1919.

4. Fourth Period—Federal Finance under the Government of India Act, 1935 –Provincial Autonomy

In government of India Act 1935, improved the fiscal situation of provinces to apply federal finance principle. In this Act autonomy has set up provincial. Sources of income of central and province are separated completely. Main sources are as follows:

(a) **Taxes levied and collected by provinces –** (1) Land revenue, (2) Irrigation, (3)(a) Alcohol for the use of human consumption, (b) Opium classified as Indian Bhang and addicting drugs (c) Alchohol based medicines and cosmetics or in para 'B' included excise duty on commodities. (4) Tax on agriculture income (5) Land, Bunglaow and windows tax. (6) Tax on autonomy an agricultural land (7) Miniral duty (8) Capitation Tax (9) Trade, Business and employment service tax, (10) Tax on boats and animals, (11) Tax on sales and advertisement, (12) Consumption in Local area, use and tax on goods meant for sale, (13) Tax on luxurious items including entertainment tax, betting tax, gambling tax (14) Stamp and Registration, (15) Tax on goods and on passengers of internal water ways, (16) Road Tax, Terminal tax etc.

(b) **Tax levied and collection by the federation but Assigned to Provinces -** (1) Tax on autonomy of property, except Agriculture land (2) Exchange letters, cheque, Bond papers, rate of stamp duty, on Insurance policies etc. and (3) Terminal taxes on goods and passengers going through Trains. (4) Tax on Train fare and other fares.

(c) **Taxes divided between the federation and the provinces and the federated states—** (1) tax on other income except agriculture, (2) Salt tax, (3) Excise duty on Tobacco and on other things made and produced in India. (But except (a) from the other category, no. 3), (4) Export tax but under the Regulations and Articles.

(d) **Taxes levied and retained by the federation –** (1) Corporation tax, (2) Making of currency and coins, (3) federal train, (4) Post and Telegraph, Telephone, broadcasting and some means of communication like this including other resources, (5) Export and import tax, (6) Armed received.

(e) **Other –** Except this, above from the 'd' category sources which are described, income from them Central government can kept it partially or wholly.

Indian Government Act 1935 was a wonderful thing as the legal draft point of view. Almost for 5 years, British's best legal draftmen were preparing the articles of the Regulation. Only after that

it became possible that through 1935 Regulation, province provided autonomy simultaneously a powerful union established.

Recommendations of Sir Otto Niemeyer – It was settled in the Regulation act 1935 that before applying Provincial autonomy one more financial investigation should be done. So for this work Sir Otto Niemeyer was appointed and he had been asked to give recommendations on net income tax, division of Jute export tax, grants given to states from central and any other matter of finance between central and provincial government.

Niemeyer recommended that 50% of the net proceeds of income tax should be given to the states. He also recommended that every provinces's share should be given on the collection of income tax and also on population.

Do You Know? About Jute export Niemeyer recommended that export tax on Jute of 62½% should be distributed among Jute producing Province – Bengal, Bihar, Assam and Orissa.

Sub Venations : Sir Otto Niemeyer also suggested that some states which were on deficit loss like Sind, Orissa, Assam and U.P. should be given Annual grants to balance their Budget. Some special matters related to the other states were also recommended for grants.

Cancellation of Provincial Debts : Sir Otto Niemeyer also suggested that the debts of provinces which were taken from the central government should be cancelled. According to him, it would not affect central's economic situation.

War and Partition – In 1939, Second World War broke down. Because of the expenditure of central government in it. The amendment was done in 1940 Act. According to which central get the right to take 4½ crores from the provincial share. This provision continued till 1945–46. After some time, amendment was needed at that time when in 1947, because of country separation Sind and North western province went to Pakistan and Province Punjab and Bengal became smaller in size and in population. So this case went to Sri. C.D. Deshmukh for discussion and it is excepted that his recommendation will be considered final. But Sri Deshmukh suggested new principles for the distribution of income as in the near future, finance commission was needed. So he kept his work limited and advised that income tax should be distributed on the basis of population so that weaker states can also be highlighted. Sri Desmukh also recommended that following states should be given fixed amount as a grant, instead of giving their share in jute export.

State	₹ – in lakhs
W. Bengal	106
Assam	40
Bihar	35
Orissa	5

Deshmukh's decision continued from 1 April 1950 – 31 March,1952. Deshmukh's decision was criticised by many states. Bombay complained once again that they will get a small share in Income tax as they create a large amount of Total income. Like this West Bengal also complained that in Niemeyer decision, if justice was done to them, which is still there. Bihar and Assam complained that no body paid attention on the fact that they were financially backward. But despite all this, Sri Deshmukhs's recommendations were accepted.

Notes

Task What were the recommendations of Sir Otto Niemeyer?

5. Provisions Under the Constitution

Under the constitution Legislative powers between central and state were divided in three lists – Union list, State list and concurrent list (Article 246). These matters on which parliament was fully empowered to make laws were under the seventh article of union list.

In second list or state list these cases were included, on which right is given to legislative to make laws. In the third list or Concurrent list these topic which are included, their right were given to parliament and legislative assembly of the related state. One more thing is there that Residuary powers of making constitution was given to the parliament. In this way the power to make law on those matters which one neither described in union list not state list have given to the parliament. In this way, the power to make law on those matters which are neither describe in union list nor state list that gives to the parliament.

Distribution of Functions

In Indian constitution, there are long list of union powers, state powers and concurrent powers. If ever, clashes occurs among these, then the union power remains the highest. There are some responsibilities which are totally depend on union government, some on state government or some are there which comes under both union and state. Although if any work is left then it comes under union. There are almost 97 work included in the list of union government, they comprise of defence nuclear – power, defence foreign matter, initiative nationality, rail, national road way and foreign airways, post and telegraph, currency and foreign investment, foreign debt, international trade, important industries, shipping and National agencies etc.

There are almost 66 heads in state government, which comprises of public management, police, judicial administration, public health, education, agriculture, forest, fisheries and other industries etc.

In concurrent list, 47 topics are included, in this both union and state government can make laws. These topics are Trade and industry monopoly, labour dispute, social and personal security, grants, marriage, divorce and other social, economic social laws etc.

Distribution of Revenue: Under the constitution, division of government income is almost done in a way like it was in Government Act 1935,. The question of distribution of government income and grants former Indian estates entry in union and the distribution of government income, grants etc. became more important and difficult. Under the constitution, distribution of government income is done in the following ways.

(a) State sources of Revenue

1. Land revenue, its fixing and collection (Head 45)
2. Tax on Agriculture income (Head 36)
3. Tax on autonomy of Agricultural land (Head 47)
4. Estate duty related to Agricultural Land (Head 48)
5. Tax on land and Bunglows (Head 49)
6. Tax on mineral Rights under prohibition imposed by law in regard of mineral development by parliament.

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7. Taxes on things made and produced in state following or countervailing duties apply.
   (i) Alcohol for the use of human consumption
   (ii) Opium, Indian Bhang and other in addicted drugs, but in this medicines are not included (Head 51)
8. Tax on entry of goods used for consumption and sale in local area (Head 52)
9. Tax on consumption and selling of electricity (Head 53)
10. Tax on buying and selling of goods except newspapers (Head 54)
11. Tax on goods and passengers goes through roads and internal water ways (Head 56)
12. In the concurrent list, according to 33rd entry taxes apply on vehicles if they are capable of running on roads (Head 57)
13. Taxes on animals and boats (Head 58)
14. Terminal tax or tolls (Head 59)
15. Tax on business, occupation and employment (Head 60)
16. Capitation tax (Head 61)
17. Tax on luxuries including entertainment, betting tax (Head 62)
18. Settlement given in first list regarding stamp tax and rates are excluded, Taxes apply on other stamp rates (Head 63)
19. Tax on the topics given in the List II, but excluding the fees of court (Head 36).

(b) Central Sources of Revenue

1. Tax on Income except Agriculture Income (Head 82)
2. Tax on custom duties including export duty (Head 83)
3. Excise duties on Tobacco and other goods produced and are made in India but except the following:
   (i) Alcohol used for human consumption
   (ii) Tax on opium and other addicted drugs and other intoxicant and cosmetics which has alcohol (Head 84)
4. Corporation tax (Head 85)
5. Tax on assets and of companies except land and people related to the Agriculture.
6. Estate duty on all the properties except Agriculture land (Head 87)
7. Tax on other properties and on their ownership except Agriculture land (Head 88)
8. Tax on train fare and Terminal tax on goods and passengers going through the train, water or Airways (Head 89)
9. Except stamp tax, taxes on stock exchange and on future markets deals (Head 90)
10. Stamp tax rate on bills of exchange, cheques, bond papers, bills of loading, insurance policies, Devolution of shares, credit card, Debentures and receipts (Head 91)
11. Tax on selling and buying of newspaper and on advertisements published in it (Head 92)
12. Tax on interstate Business and trade, except newspaper, selling and buying of other goods (Head 92 A).

In this way, there are 11 sources which are shown in the union list, although out of these some are completely related to the union. There are other sources of income of union, these are as following's

1. Railways (Head 22)

Notes

2. Airways (Head 29)
3. Postal and telegraph, telephone, broadcasting and other sources of communication (Head 31)
4. Property of union and its income (Head 32)
5. Fees or tax on any topic of union list except the fees of court (Head 96)
6. Public debt of union (Head 35)
7. Currency or its coinage and legal and foreign currency (Head 36)
8. Foreign loan (Head 37)
9. Reserve Bank of India (Head 38)
10. Lotteries introduced by Indian government or state government (Head 40)

(c) Taxes levied and collected by the union but Assigned – Following taxes and fees will be assigned levied and is recovered by the central government but in the any financial year net proceeds of the fees will be divided among the states act to the principles according to law made by union.

1. Duties on autonomy of other properties and law made by union except agricultural land
2. Estate duty on other properties except agriculture land.
3. Terminal tax on goods and passengers going through rail, sea and airways.
4. Tax on fares and train fares.
5. Tax on share markets and future market's deals except stamp duty.
6. Tax on selling and buying of newspaper and advertisements published in it.

(d) Duties levied by the union but collected and appreciated by the States – In the constitution, there are some tax in union index like stamp duty and medical and cosmetics related things have production duty which will be imposed by Indian government but they will be collected by the states and states will keep them with themselves except following situations –

(i) These taxes which are mentioned in the first schedule of category 'C' in the constitution, if imposed in the state then it will be collected by the India government.

(ii) In other cases, only these states collect the taxes where they are applied.

(e) Taxes which shall be levied and collected by the union but the proceeds shall be distributed between the union and states.

1. Tax on other income except agriculture income.
2. Central excise duty, but except those excise duties which are imposed on Medical and cosmetics items recovered by Government of India.

Self-Assessment

Fill in the blanks:

1. In India at present there is federal administration and ..... finance exists.
2. Till ..... central government had the control of country's revenue and expenditure.
3. In the direction of devolution of right first step was taken by contemporary Governor ..... 1871.
4. In ..... through Indian government regulation to apply principle of union federal. Improvement was done in the revenue of provinces.
5. In ..... second world war broke down.
6. There are almost ..... topics in concurrent index.

Notes

21.2 Loans

Central and provincial government both can take the loan from within the country. As compared to the state union government, takes more loan. Because union government have control on the banks and their economic situation is also good, So it becomes successful in taking loans on easy conditions. State can take loan independently without the approval of central government but one of the condition that they have to pay any loan of past. In the last few years, states had taken loans in a large amount from central Limited capacity is one of the serious hurdle which stops state government to take loan. As far as the question concern of taking loans from outside the country, since there needs of good relation with that country step by step so here also central have special facilities. Central government is the main source of loan to state government and state government take loan for development programmes like Agriculture and Industries development and matters related to them.

21.2.1 Grants–in–Aid

Distribution on taxes made state government more dependent on union government. So, to remove the scarcity of resources and to fulfil their obligations related to the welfare activities constitution arranged that central government should give state grants-in-aid. The grant cab be divided into two parts. Plan-grant and non-plant grant. Except that grant which is ad-hoc basis in contingent situation non-plan grants are finalized by the finance commission and plant grants are finalized by the planning commission. In this situation, increasing of expense in planning means that plan grants should also be increased. Grant devolutes resources to state from central government so that huge gap of state's income and expenses can be narrowed down. Grants have also removed the inequality of resources interstate. More grants are given to the underdeveloped and backward states. So, grants are helpful in maintaining balance in development.

21.2.2 Distribution of Income Tax and Jute Export Duty

Distribution of Income Tax: In 1935, Indian government act had decided the distribution of income tax between central and state. Sir Otto Niemeyer had decided 50% share of income tax to the provinces. In the constitution, it is mentioned that how much percentage of net proceeds will be given to the states in a financial year, this will be decided by the Parliament. For this objective, a finance commission will be set up by the president and on its recommendation, President will be decided on the percentage of net proceeds. So, states don't possess any constitutional right to fixed the percentage of income tax. This percentage changes according to the recommendation of finance commission.

Distribution of Jute Export Duty: It was decided in Indian government Act 1935, that every year net proceeds received from Jute export duty, its half share should be given to Jute producing states and it should be given in the ratio of total producing jute. Sir Otto Niemeyer recommended that the estimated percentage to be given to the states should be fixed 62 ½%. It is said in the constitution that the income received from jute and jute goods should not be distributed between union and states. Infact, instead of jute export duty, consolidated fund of India will be given to the Jute producing states like Assam, Bihar, Orissa and West Bengal and it will be decided by the finance commission or president himself before the appointment of the commission. So, today Grants which are given instead of export duty is decided by the finance commission.

21.2.3 In India Union Federal Finance Settlement According to the principles

If we study the finance relations between state and the central, we find that in these principles of fedral finance are included. This can be shown in the following ways.

Notes

1. Principal of uniformity is reflected as the same responsibilities and resources are given to all the states.
2. Central govt. gives more grants to the backward states, which is the example of Devolution principle.
3. As far as the Question of independence is concerned, central provides independent resources to the states but it is limited.
4. Establishing finance commission Indian government tries to follow Administrative susceptiveness principle as finance commission, time to time recommends to provide resources to the states.
5. Establishment of finance commission involved the principle of Adequacy and elasticity.

Conclusion

Distribution of responsibilities and resources between state and central is done by the constitution. The base of its discussion is same as it was in Indian Government Act 1935. Through this development expenditure which is increasing its main burden lies on the states, whereas main resources like excise duty and elastic sources are given. Thus the states became dependent on center for completing their responsibilities to the union. Some people also says about this management that "The importance of state is like an orphan boy who is begging of money and grants from the government". Not only this but because of this system has made development plans of states uncertain. Sir A. Ramaswamy Mudalyar had proved that the draft of the constitution which explains balance of financial power is not adaptation to the states. He said that on one side more responsibility of nation lies on the state but on the other side their responsibilities does not match with their financial sources.

Vishwanath Das also states that the needs of states are unlimited especially in point of view of welfare services and their development programmes. If their resources have to be utilised which is essential for man's prosperity then resources should be given to the state government so that they can't be depend on central.

According to the constitution, there is importance of distribution which is done for the coordination between state and central, so that balance can be maintained. Constitution gives many powers to the union but still it has been used is very less power as compared to the other countries and union devolutes adequate resources to the states. Not only this, but only our democracy is not the only one who wants to make central powerful infact, this wish becomes worldwide, then also autonomy of states which is given by the constitution makers is not enough, this can't be said.

Self-Assessment

State whether the following statements are True or False:

7. Central and state both can take loans within the country.
8. Finance Commission have decided non-plan grants.
9. Sir Otto Niemeyer fixed 50% share of income tax to the states.

21.3 Summary

- In India presently federal administration as well as federal finance exists. But the present situation of federal finance is the result of decentralisation.

Notes

- Till 1857, central government had the control of countries all revenue and expenditure. Indian government had the strict control on the finance of provinces, its summary can be given in the following words:
- Distribution of government income created chaos in which only clever and cunning provinces got the advantages. There was least care on other logic of distribution.
- To study Montagu Chelmsford's draft a financial committee was set up under the chairmanship of Lord Meston this is also known as Meston Settlement or Meston Award.
- In government of India Act 1935, improved the fiscal situation of provinces by applying federal finance principle.
- Indian Government Act 1935 was a unique in point of view of draft. Almost for 5 years British's best legal draftmen were preparing the articles of the regulation.
- There are almost 97 works included in the list of union government. The important of them are nuclear-power, security foreign matter, nationality ,rail, shipping, national roadway, airways, post and telegraph, currency and foreign investment, foreign debt, foreign and international trade, important business and national institutions etc.
- In concurrent list 47 topics are included in this. Both, union and state government can make laws. These topics are—trades, and industry right, labour dispute, social and personal security grants, marriage, divorce and other social, economic laws etc.

21.4 Keywords

- Coordinates – act together
- Tolls – tax related.

21.5 Review Questions

1. Explain union financial development in India.
2. Write the names of those taxes which are impose and collected by the states.
3. What is the difference between concurrent and state list?
4. Write the sources of income of the states.
5. Comment on the following:
   (a) Distribution of Income-tax
   (b) Distribution of Jute export duty.

Answers : Self Assessment.

(1) Union	(2) 1871	(3) Lord Memo	(4) 1935
(5) 1939	(6) 47	(7) True	(8) False
(9) True			

Notes

21.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
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7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Unit-22: Indian Finance Commission

Notes

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know the financial relation between centre and states in India.
- Know the implementation of the recommendations.
- Know the first, second, third, fourth and fifth finance commission.
- Understand the Distribution of Taxes.

Introduction

Constitution tried to give independence of financial resource in central and state. There were some questions like division of receivings of income tax between state and central, division of excise duty of provision is given in the constitution in Article 280 that a financial commission should be established. Division of income-taxes takes place only after the recommendation of finance commission when the president gives order that union has the right that it can criticize the recommendations of the finance commission in the matter of excise duties.

First finance commission was done under the chairmanship of Shri. K.C. Niyogi in 1952. When it was appointed at that time 50% of income tax was given to states. This was done according to Nieymmer and after the partition on Deshmukh-decision.

Notes

In June 1956, second finance commission was setup under the leadership of Shri. K. Santhanam, who presented his final report in November 1956.

Under the leadership of Sri A.K. Chandra third finance commission was setup in December 1960. Fourth finance commission was established in 1964 under the leadership of Sri P.V. Rajmannar and the fifth was setup in March 1968, its chairman was Shri. Mahavir Tyagi.

22.1 Financial Relation between Centre and States in India

Division of financial resources between central and states is most important but it is the most difficult federal problem. Constitution tried to give liberty to both central and state in the financial resources. But this division is not satisfactory so Indian constitution established a provision of setting up an independent agency who can check the relation of central and state and this agency is finance commission.

Division of income tax receiving between central and state, division of excise duties and grants given to the states from central, there are some questions for which a provision is given in the constitution in Article 280 to setup a finance commission. In this article, it is said that within the two years of applying in constitution after that finance commission should be established for 5-year term and if necessary, president can appoint it before the term also. In this, there will be a chairman and 4 members will be there.

Parliament will decide it after making a law that what will be the qualifications of the members and Parliament only.

22.1.1 Function of the Commission

The following works of commission is to recommend to the president:

(a) Division of those taxes which are received by the net recievings distributing between central and state and assessment of every state's share.

(b) Assessment of these principles on the basis of which grants would be given to states from consolidated fund of India.

(c) Compromising of states and changes in their conditions are mentioned in the Article 306 or 278 in the first list of schedule 'B'.

(d) Any other matter which is in favour of financial arrangement is given to commission by the President.

In this way, finance commission recommends its report on the following matters to the President:

1. Percentage of taxes and their receivings, which will be divided between union and state.
2. Share of states in percentage.
3. Regarding internal terminal duties and the conditions given in the part 'B' for amendments and its continuity.
4. Assessment of these principles on the basis of which grants would be given to states from consolidated fund.
5. Grants for schedule tribes and tribal areas.
6. Special grant for particular state.

   Commission will decide its work of pattern itself and will receive its power from the Parliament.

President will present commissions recommendations with comments before every house of parliament.

Important Works : Following are the inevitable works of finance commission— (1) Division of those taxes which are received by the net receivings between central and state assessment of every state's share. (2) Assessment of those principles on the basis of which grant, would be given to states from consolidated fund. Income tax is one of the tax which can be divided whereas division of excise duties are optional.

Notes

Compromising of states and changes in their conditions are mentioned in the Article 306 or 278 in the first schedule of part 'B'.

22.2 Implementation of the Recommendations

Distribution of Income tax is done on the recommendations of the commission but only after the order of the President. This becomes like a tradition that Indian government accepts the recommendations of the commission that how much percentage will be given to the states and distributed in how many states. Share of the states cannot be come apart of consolidated funds in act they are directly put in the consolidated funds.

According to the Article 272 of constitution recommendations of the commission are only recommendations and union government have right to criticize recommendations of the commission regarding excise duties. If it wants to give any part of excise duties to the states then it can made laws accordingly. But union excepted only those recommendations regarding excise duties which were presented in the Parliament.

Constitutional Position – Constitutional position in this regard as like this—

1. Finance commission only recommends those principles through which grants are assessed.
2. If special grants are needed by the states then Parliament can make laws.
3. Parliament should make such laws that only after recommendation of finance commission report the President can order of giving special grants to the states.

Actually this myth was created because finance commission tried some worthless things for the making of principles. For example, finance commission recommends some amount of money and the President orders to distribute the grant in equal amount of money. Union government never gives a thought that it should ask Parliament to make law under the Article 275(I) but any section of Parliament asks it to do so.

Do You Know?

In the matter of fact share of income tax, receivings of excise duties, distribution of grants commission's recommendations are final and accepted by the union government.

22.3 First Finance Commission

First Finance Commission was set up in 1952 under the chairmanship of Sri K.C. Niyogi. Commission believed that it is essential to increase the income of states. That is why it accepted the states's demand to give more grants but while doing this it followed three things—

Notes

1. Resources of the central govt. should be devaluated in such a way no burden lies on defence and economic stability and it can tolerate the burden.
2. Principles related to the distribution of grants should be applied similarly on all states.
3. Objective of distribution planning should be in a way so that dissimilarity between the states can be lower down.

Task When the first finance commission was setup and under whose chairmanship?

22.4 Distribution of Taxes

First work which was assigned to the commission was that the decision of distributing receivings proceeds. As we have already mentioned that these taxes are income tax and excise duties.

When the first commission was set apart that time, its 50% share went to the states. This was according to Nieymmer's decision and after partition it was according to Deshmukh decision. It was said that the percentage distribution was based on collection and rest of the distribution on population. Before Niyogi commission and other commissions, Bombay and Bengal started saying that this distribution should be done on the basis of collection whereas other states said that income tax is a central tax and its collection is done on which place, this does not reflect the actual source of income-tax so it should be done on the basis of population.

After all this discussion, Niyogi commission suggested that the states share should be increased from 50% to 55% and 20% of the share should be based on relative deposit done by states and 80% on the basis of census in 1951. Commission said that it is not necessary to calculate the state's percentage of every year in fact, it recommended percentage of the last 3 years on the basis of collection and this percentage applies for the 5 years from 1952-1953 to 1956-1957.

According to the Article 270 from the net receiving of income tax, a part share of union territories and related employment tax is deducted. This is the job of Auditor-general to calculate debt and announce receiving proceeds. Niyogi commission recommended 2¼ part of receiving proceed part for states (part C) and 55% for the states as it was given earlier only 50%.

Distribution of Excise Duties: In 1935, Government of India regulation Article 140(I) provision of distribution of excise duties was given but it was not implemented and that is why union part was not identified and also Second World War broke down. To implement this arrangement, responsibility was given to first finance commission.

Related to the excise duties, constitution has some myths because Article 272 leaves this work to the Parliament whereas in Article 280, finance commission was ordered to think about the division. Regarding this commission came to a conclusion that this was in their capacity and it should present its recommendation about the division to the President, although these types of recommendations are implemented by the Parliament only. Commission related to this was keeping a new base so it does not want to waste central budget so it has decided to limit its excise duties.

Commission suggested that 40% of the excise duties from Tobacco (Cigarette, Cigar etc), match boxes and vegetable oil should be divided among the states. There were no accurate data available for the consumption of these products so commission decided to distribute it on the basis of population and this system change into the form of definite percentage which was valid for 5 years.

Grants-in-aid – The third general topic of finance commission was to limit the principle of grants-in-aid under Article 275 (I). First finance commission suggested some guiding principles like needs of

states related to the budget, tax efforts, level of social services, responsibilities of states and particular responsibilities of National importance.

Grants in favour of Jute export tax – Commission suggested to give grants to Jute producing states instead of their share. The grant was based on the tax applied on the jute products which they received in the middle of 1943 and 1950. Commission recommended to give following Annual grant instead of jute export tax.

W. Bengal	₹ 150 Lakhs	Bihar	₹ 75 Lakhs
Assam	₹ 75 Lakhs	Orissa	₹ 15 Lakhs

Other matters assigned to the commission – Other than these three matters, commission is assigned other matters also First finance commission was asked to give its recommendation about the conditions of compromise that through Indian government part 'B' whether they will be continued or amended as Indian estate's revenue system was needed through 'part B' that all the former states will come under the British provinces. In 1948, under the leadership of Sri V.T. Krishnamachari, the committee was setup according to which central agreed to give these state grants which were gone in the loss because of the estate's uniformity. These grants were called revenue–loss grants.

These states are the deserving ones of the advantages received due to draft of the state financial commission. Now, they were getting revenue-deficit grants in more amount. According to the first finance commission only Mysore, Sourashtra, Travantacore and Cochin were the states who deserved there grants because other states came on the 'A' level.

Notes

For the Finance commission, third General subject under Article 275 (I) was to limit the principle of grants-in-aid.

Self-Assessment

Fill in the blanks:

1. Every recommendation of the commission president will present its summary and comments to the every house of ..... .
2. Division of income tax only be done after commission's recommendations review with the ..... order.
3. According to the constitution Article ..... finance commission recommendations are only recommendations.
4. When first finance commission was set up then ..... share of income tax was given to the states.
5. Instead of Jute export tax, commission recommended ..... instead of it.

22.5 Second Finance Commission

Second finance commission was setup in June 1956 under the chairmanship of Sri. K. Santhanam, who presented its interim report in Nov. 1956. In the interim report, some minimum changes were recommended which became essential after the re-establishment of states and after the financial unification of Jammu and Kashmir and India. In September 1957, commission presented its final report.

Notes

Distribution of Taxes – Commission had to rethink about tax-collection and population. According to the commission, income increased of sales tax, vehicle tax, electricity tax and entertainment tax led to the stability of Bengal and Mumbai and other industrial states cooperativity economical condition of agricultural states. So, it came to a conclusion that instead of collection, population would be the base. To simplify the change, commission recommended that the division should be 10% on collection base and 90 % on population. It also hoped to end the collection pattern completely.

Commission also suggested that the share of the Income tax of the state should be increased from 55% to 60%. It was implemented for the period of 5 years i.e., from 1957-1958 to 1961-1962.

When the report was presented by the second finance commission till then 'A' and 'B' categories of the states ended and they were re-organised. So commission suggested to be given 1% of the income tax proceeds to the union territories and rest of the 60% should be given to the states.

In 1959, through finance Act income tax getting by the companies came under the category of corporation tax. In this situation, it putted under the category of corporation tax. In this situation, it is not a part of divisible pool. So, the size of divisible pool decreased. So, to compensate this one, more special grant recommended.

Distribution of Excise Duties – Second finance commission studied on the state's demand that excise duty should also be distributed. But it came to an conclusion that this change is not essential. So, commission expanded the area of excise duty from three excise duties, tobacco, matchbox and vegetable oil to other taxes, the expanded ones were excise duty on sugar, tea, coffee, paper and essential oils of vegetables. But, commission decreased the tax of net proceeds from 40% to 25% so that, balance could be maintained between states and union. Some data were also prepared related to this consumption but the commission feel that to divide the consumption, the data is not reliable. So, the commission recommended that in union excise duty, state's share should be 90% on population based and rest 10% can be used for any defect. Second financial commission did not felt to fixed percentage for union territories because in 272 there is no mention about it as it is described in the Article 270.

Grants-in-aid – Second finance commission carried on the first financial commission's principle related to the grants which says "In a union system, where central and state support each other for the development; grants should be supported in this objective." According to it, there is deference between states' general income and expenditure, as far as possible it should be completed through the division of taxes. So, they should be given without any condition. No specific programme should be depend only on to the grants.

Commission also said that Article 275(I) says that grants can be given for special objectives. But there was no requirement of this type because all objectives related earlier with wide planning.

Commission assessed different grants for 11 states for 5 years, from 1957-1958 to 1961-1962. The total grant amount was fixed 187.75 crores. Bombay, Madras and Uttar Pradesh were not recommended as it assumed that the share of income tax which these states are receiving was enough for complete their current and planning expenditure.

Grant-in–aid, instead of Jute export-tax – The commission did not recommend any change in the grant giving to the jute producing states. Yes, because of reorganizing of the states, *i.e.*, some of the areas of Bihar devaluated to the West Bengal related to this for every state amount of grants will be changed are following:

Assam	₹ 75.00 Lakh	Orissa	₹ 15.00 Lakh
Bihar	₹ 72.31 Lakh	W. Bengal	₹ 152.69 Lakh

Other work assigned to the commission – Except these three subjects, commission assigned the following for reference.

1. It is recommended that in a financial year, except agricultural land other assets, estate duty and its recievings, under the Article 269, were divided on which principle.

Notes

2. If necessary amending of rate of interest on that debts of states which are allowed between Aug. 15. 1947, and March 31. 1956, can be done.
3. How to divide industries made clothes, sugar, tobacco and sales tax imposed by the state government, instead of it extra excise duty was imposing.
4. To recommend of the principles which guiding the distribution of tax on train fare and its net receivings from 1957.

Distribution of Taxes applied on Train Fare: According to the Article 269, tax on train fare ended in 1961, but Indian government continued the compensation of 12.5 crores. Commission recommended to decide the share based on net proceeds of passenger fare. But the actual data of passengers fare was not available. So, the commission fixed ¼ share of net proceeds.

Distribution of estate duty: Related to the estate duty the commission recommended to keep 1% share for union territories and rest of the part should be divided between immovable and movable assets. Commission suggested to divide the estate duty on immovable in the equal ratio, on which taxes were imposed on that year. In this way, the amount given to the states was to be divided accordingly to the ratio of net cost of immovable assets of the states and receiving of movable assets accordingly the populations.

Union Loan for States – In this matter commission suggested for unification of loans between 15 August, 1947 and 31 March 1956 which were given to the states (except interest free loan and rehabilitation) and balance of 31 March 1957 should be done uninfected in the following ways:

1. All the loans whose interest rate is 3% or more than 3% and it should be paid back before 1 April 1977, these types of loans should be unified into that loan interest rate is 3% and should be paid till 31 March, 1978 (long term loans).
2. All the loans whose interest rate is 3% or more annually and pay back date is 31 March, 1977 or before should be unified into that loan whose rate of interest is 3% annually and is paid back till 31 March, 1972 (medium term loans).
3. All those loans where rate of interest is less than 3% and pay back date is 9 April, 1977 should be unified into that loan where rate of interest is 2½% and return on 31 March, 1977 (long-term pay).
4. All the loans where rate of interest is less than 3 % and pay back date is 31 March, 1977 or before should be unified in the 2½% rate of interest which should be paid on 31 March, 1972 (medium term).

In this way, loans were divided in two categories long-term and medium-term loans. Long-term loan would have been paid till 31 March, 1978 and medium-term land till 31 March, 1972. Rate of interest of some long-term loan is 3% and some have 2½%. In this way, some medium term loans fixed to 3% while some had 2½%.

In this way, loans given to the states from union were divided into 4 types, except interest free loans and rehabilitation. Commission also recommended to adopt some of the qualities in the future loans but unfortunately government did not except it, though all the states supported it. So, the result was the small and big the loans of the states continued where dates of maturations were different.

Distribution of additional excise duties: With the advice of state government, Indian government decided to apply additional excise duty instead of sales tax on mills made clothes, sugar and tobacco and their proceeds should be distributed among states. The very first thing which the commission to consider on 'Present Income'. As every state had to give this much of amount in the distribution

Notes

planning commission accepted these taxes as present income in 1956-1967. If some part of net proceeds remained then the commission decided its percentage for distribution.

Do You Know? Second finance commission was setup in June 1956, under the chairmanship of Sri K. Santham.

22.6 Third Finance Commission

In 1960, under the chairmanship of Sri. A.K. Chandra third finance commission was setup. Commission gave its report on December 1962.

Distribution of Taxes: The commission suggested to increase the percentage of union territories from 1% to 2½%. It also said that the net proceeds of income tax should be 66 $^{2}/_{3}$% for states. It also recommended the distribution should be 20% on collection and 80% on population.

Here one thing has is noticeable that first financial commission also recommended the same basis but second financial commission deducted collection basis from 20% to 10%. Third commission was in favour to make the base of population as division. But, because of 2 reasons collection will be giving importance comparatively before firstly income tax given by the companies was separated from divisible pool. Secondly, industrial states, who gave collection more money of income tax to more the divisible pool. More expenses was done on administrative and social services. For this reason to commission recommended that the distribution of income tax should be done on 20% on basis of collection and 80% on population.

Distribution of Excise Duties: First finance commission recommended 40% of the excise duties, net proceeds of tobacco, match boxes and sugar to the states but second finance commission deducted it from 40% to 25% but increased the number of goods from three to eight. More over, it also recommended to distribute divisible pool to 90% on the basis of population and 10% for variations in share etc.

The third financial commission increased the goods of excise duties from three to eight. It included all the goods on which tax was imposed in the year 1960-1961, But these goods were excluded where receiving from taxes was less than 50 lakhs annually. Commission also deducted the share of divisible pool to states from 20%. But it is also told what is the correct base of 20% distribution. It fixed some percentage and made the population base of the percentage, but besides this some, other things were also kept in mind like the state's relative economical weakness, differences on development level and percentage of scheduled castes, scheduled tribes and backward classes etc, in the population while recommending the net proceeds of excise duties, the commission said that "In states better life can be provided by the devolution of the union excise duty and it can possible only when the state's share is settled in the union excise duty". So with commission opposed a lot of difficulty the demand of the states that states expenditure are increasing so they should be given share in total proceeds of excise duties.

Additional Excise Duty: Commission decides 1% of net proceeds for union territories and increased the share of Jammu and Kashmir to 1½%. In relation to other states, commission guaranteed to increase a small amount of Annual amount, this increment has done from 32.50 crore to 32.54 cores. After the guaranteed money, balance amount would had been divided in states, this was about to be done on the collection base for sales tax and rest on population.

Estate Duty – Related to the estate duty, the commission did not suggested those proposals which the second commission suggested. Then also it changed the percentage of every state on the basis of population.

Grants in place of tax on train passenger fare – The commission recommended grant instead of share of tax on rail passenger fare to give compensation in the form of grant of 1.25 cores which should be

Notes

distributed in states so that states can again come to that level which they were on April, 1961, when the tax ended.

Grants-in-aid – Commission only discussed the matter about the recommended Grants that how can they complete the revenue gap. So the commission's recommendation for grants were not only for revenue gap but also to complete 75% of revenue part.

Other work assigned to the commission – Third commission was net assigned any new work in fact it asked to give recommendation about the changes of estate duty, additional excise duty and tax on train fare. It was mention earlier that the commission did not recommended any change on this topic.

22.7 Fourth Finance Commission

Under the chairmanship of Sri V.P. Rajmannar in May 1964, Fourth finance commission was appointed, who presented its report to Indian government on Aug 1965. Its main recommendation are as follows:

Distribution of taxes: Fourth finance commission suggested 75% of net proceeds for states. Commission consider, that between states the divisible pool should be distributed on the basis of principles which should be certainty stable. So commission supported its predecessors distribution which was 80% on population and 20% on collection as the third Finance commission was suggested. This means that the fourth commission increased the net proceeds from $66\frac{2}{3}$ % to 75% but maintained the base of division like it was before. The share of union territories were fixed on 2.5%.

Distribution of taxes of union territories – Levied after studying the needs of states, fourth commission expanded the areas of all these commodities on which the tax was imposed in many year. In this state share was fixed 20%. Commission said that in the past there was an increase in the goods which had excise duties imposed. So its actual recommendation was on 35 thing which was around 30% on which excise duty imposed by the third financial commission.

Division between states, commission recommended 80% of divisible pool for the state on the population basis and 20% on the basis of economic and social backwardness.

Additional excise duty instead of sales tax: Commission recommended that in year 1966 -67 to 1970 – 71 instead of sales tax net proceeds of excise tax should be 1% for union territories, 1½% for Jammu and Kashmir and $\frac{1}{20}$ part for Nagaland. Balance amount of net proceeds 32.54 crores should be kept aside as a granted money so that instead of sales tax it would be distributed. Rest of the amount distributed in the year 1961 – 62 to 1963 – 64 on the ratio of sales tax.

Estate Duty: Those principles which were decided of distribution of estate duty by the second commission, third commission also supported that. The fourth commission did not recommended any change in that. But suggested to increased the share of union territories from 1% to 2%.

Grants in aid – The third commission also consider that their recommended grants how much fulfill the needs of planning. The grant-in-aid which it recommended, does not complete the revenue gap. But only 75% of revenue gap was arranged. But the fourth commission did not included plan grants and special purpose grants in its recommendation. According to the commission it is not possible for any finance commission to investigate all the policies in such a short time or given its decision for them. But then also of any state is unable to balance its revenue budget and need money then finance commission should give help to it.

Grants in place of tax on train passenger fare – In the matter of train passenger fare tax fourth commission suggested the same principle as it predecessor commission did. Commission fixed the share of states in percentage and not in actual amount. Regarding this it used every states gauge under which Length of railways route's data came and in 1964 average Annual income of transport.

Notes

Commission also mentioned the state's opinion that the fixed grants made them less of a powerful and elastic source of revenue and also that grants should be increased that much, in which the increase took place in the passenger train fare after the ending of train tax.

Other cases assigned to the commission – Commission was asked to give report on that goods and products where taxes divided between central and states and what will be the effect of sales tax and combined incidence. Commission was also asked to give recommend actions about changes.

This commission came to the conclusion that combined incidence's data was not available. So it is not possible to investigate about combined incidence. So it did not recommended that planning through which excisable commodities on which excise duties imposed should be bound in some limitations of sales tax rates in this case no suggestion of formula exists through which changes can be done in the share of states.

22.8 Fifth Finance Commission

Fifth finance commission was setup in March 1968. Sri. Mahavir Tyagi was its Chairman. Commission presented its interim report in October 1968 and final report in July 1969. Some of its recommendation are as follows.

Distribution of Income Tax: Fifth commission did not changed the share of states in net proceeds and maintained it on 75% as fourth commission. But because of it, in the 5 years actual devolution of money could become more. As in the collection year divisible pool of advance tax collection should also be included. Share of net proceeds to union territories was 2.5%. According to the recommendation of fourth commission population base was 80% and collection base 20%. But fifth commission recommended 90% on population 10% on collection.

Distribution of Union Excise Duty: Fourth commission recommended 20% of net proceeds of union excise duties of states share. Fifth commission did the same but recommended ended these excise duties to be included which were out of the division pool. Fourth commission recommended 80% distribution on population and 20% on social and economic backwardness. Fifth commission continued to do so but from 20% of the amount the states. Which included population of schedule castes, on one lakh population on, number of workers, irrigated area per peasant, 100 sq. km length of roads and train, school going children and hospital number of beds on one thousand population.

Task When was Fifth Finance Commission established and in whose chairmanship?

Estate Duty: In fifth commission division of estate duty fixing no principle was proposed. Division of principle was to given one share to states from immovable property. Rest of the division was done on population base. Second commission recommended this and third, fourth and fifth did the same. But it also gave the suggestion to increase union territory share from 2% to 3% and rest of the states division should keep in divisible pool.

Instead of Train Passenger Fare Grants: Commission did not change it and maintain the same which the second commission recommended and third fourth also supported this. But the commission fixed the state's percentage on new data.

Grants–in-aid: Fifth followed the same principle of its predecessor and it recommended to give ₹ 637.85 crores to state for 5 years. Balance grants which has to be paid remain ₹ 102.47 crore in 1973-74 from 152–73 cores in 1969–79.

Self-Assessment

Multiple Choice Questions:

6. When was the second financial commission appointed?

   (a) June 1956 (b) Dec. 1960

   (c) May 1964 (d) Oct. 1968

Notes

7. The third financial commission established under whose chairmanship.
   (a) Sri. K. Santhanam (b) Sri. A.K. Chandra
   (c) Sri P.V. Rajmannar (d) Sri Mahavir Tyagi.
8. Under which chairmanship of Rajmannar, which financial commission was set up?
   (a) First (b) Second
   (c) Third (d) Fourth
9. When was the fifth financial commission was set up?
   (a) March, 1968 (b) June, 1956
   (c) Dec, 1960 (d) May, 1964
10. Who was the chairman of fifth financial commission?
   (a) Sri K. Santhanam (b) Sri A. k. Chandra.
   (c) Sri Mahavir Tyagi (d) Sri P.V Rajmannar.

22.9 Summary

- First financial commission was set up in 1952 under the chairmanship of Sri. K.C. Niyogi. The consideration of commission was that increasing in income of states is essential.
- First work assigned to all the commissions was to fixed the division of net proceeds between state and central. As it was mention earlier the two taxes are income tax and excise duty.
- According to the Article 270 the share of union territories and union employment from net proceeds of income tax has deducted. This is the responsibility is of Auditor general to estimate the tax and declare net proceeds. Niyogi commission has fixed 2¼ part net proceeds to the state of part C and suggested to give 55% in place of 50% shares to the states as were given earlier.
- In June 1956 second financial commission setup under the Chairmanship of Sri K. Santhanam who presented it's the interim report in 1956. In this those suggestions were sujested which become essential after the rcorganisation of the states and unification of economic of Jammu and Kashmir with India. In sept. 1957 commission presented its final report in sept. 1957.
- Third commission was set up in Dec. 1960 under the chairmanship of Sri A.K. Chandra. It represented its report to India on Dec. 1960 .
- Fourth commission was set up in may, 1964 under the chairmanship of Sri P.V. Rajmannar and represented its report in Aug. 1965.
- In 1968, fifth commission was set up under the chairmanship of Sri Mahavir Tyagi. It represted its interim report in Oct. 1968 and in July 1969 it presented its final report. Topics assigned to it was almost same as before.

22.10 Keywords

- Consumption – act of consuming
- Collection – accumulation.

22.11 Review Questions

1. Write the recommendations of fifth financial commission.
2. Describe third financial commission.

Notes

3. When was the second commission was setup and under whose chairmanship? What were the provisions of distribution of taxes?
4. What were the provisions that were kept in mind when appointing first financial commission.
5. What are the work of the commission?
6. Mention the distribution central excise duties in fourth commission.

Answers: Self Assessment

(1) Parliament	(2) President	(3) 272	(4) 50%
(5) More grants	(6) (a)	(7) (b)	(8) (d)
(9) (a)	(10) (c)		

22.12 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

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Notes

Unit-23: Implementation of Twelfth and Thirteenth Finance Commission

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know the implementation of Twelfth Finance Commission.
- Know the implementation of Thirteenth Finance Commission.

Introduction

In twelfth finance commission restructural planning, central taxes and their participation and importance of local agencies are included. In thirteenth finance commission state and central government's finance sources, service and commodity tax, structure of changes in finance etc. are included. Except this local agencies, disaster management, elementary education and environment are also included.

23.1 Implementation of Twelfth Finance Commission

Planning Related to the Public Finance

1. Till 2009-2010, state's and central government's combined Tax- GDP ratio till 17.6% Primary expenditure of GDP till 23% and money expenditure of GDP increase upto 7%.
2. Foreign loan on exchange rate – GDP ratio to come down by 75% till the end of 2009-2010.
3. Giving loans in future will stop. GDP related ratio for state and central government should be 28%.
4. Related to state and centre GDP of exchequer should be fix to 3%.
5. Upto 2009-2010, interest of revenue should be almost 28%. In case of states interest of revenue received to come down 15% in 2009-2010.

Notes

6. In case of central and state government GDP revenue loss to come down zero in the year 2008-2009.
7. State and worker policy should be applied in always so that total wages, interest paid and pension should not exceed 35%.
8. Every state has to made regulations of revenue so that following can be arranged:
   (a) Revenue loss to finish till the year 2008-2009.
   (b) Exchequer to come down upto 3% or to the level of GSDP so that interest paid in revenue received can be easily defined in ratio.
   (c) To explain downfall of revenue and exchequer.
   (d) To publish annual description of state economy and related exchequer possibilities.
   (e) A special description along with the budget in which agencies of government private and grant received on employee's number and salary will be there.

Notes It was provison in the case of central and state government GDP revenue loss to come down zero in the year 2008-2009.

Central Tax Revenue Partnership

9. In the case of central tax partnership, state's share will be 30.5% in revenue received. In this except for sales tax, product tax is regarded as the common fridge of central tax. If tax on rent will be abolished and if state is allowed to levelled sales tax (or VAT) with any limitation in this partnership then the share will come down to 29.5%.
10. If, after the 88th amendment of constitution any regulation is passed in service tax then it has to be ensured that any revenue received by the state, in case of service tax, is the part of partnership then received part will be low.
11. Total revenue received for the state can be 38% under indicated amount.
12. From 2005-2006 to 2009-2010 following states should be given receiving amounts of partnership in every five years:

State	Part (Except Service tax all the partnership tax) (%)	A part of service tax (%)
1	2	3
Andhra Pradesh	7.356	7.453
Arunachal Pradesh	0.288	0.292
Assam	3.235	3.277
Bihar	11.028	11.173
Chattisgarh	2.654	2.689
Goa	0.259	0.262
Gujrat	3.569	3.616
Haryana	1.075	1.089

Notes

Himachal Pradesh	0.522	0.529
Jammu and Kashmir	1.297	0
Jharkhand	3.361	3.405
Karnataka	4.459	4.518
Kerala	2.665	2.700
Madhya Pradesh	6.711	6.799
Maharastra	4.997	5.063
Manipur	0.362	0.367
Meghalaya	0.371	0.376
Mizoram	0.239	0.242
Nagaland	0.263	0.266
Odisha	5.161	5.229
Punjab	1.299	1.316
Rajasthan	5.609	5.683
Sikkim	0.227	0.230
Tamil Nadu	5.305	5.374
Tripura	0.428	0.433
Uttar Pradesh	19.264	19.517
Uttaranchal	0.939	0.952
West Bengal	7.057	7.150
All the states	**100.000**	**100.000**

Local Bodies

13. In the year 2005-2010 all the states should given grants of ₹ 20000 crore for Panchayati Raj and ₹ 5000 crore for urban areas.
14. Water supply for panchayati raj and cleanliness arrangements and also construction of related properties. O and M grants should be encouraged. Moreover Panchayati Raj should levy taxes on 50% part.
15. Importance should be given to Panchayati Raj's water supply cleanliness and on O and M expenses. Because of this Panchayat can easily carried out their plans.
16. In urban bodies 50% of grant should be used for public expenses. Other than this attention should be given to Municipality, transport etc. The outsourcing of these activities should be completed by the grants only.
17. Except for water supply and cleanliness in rural areas and toilets schemes in urban areas, accounts of all the expenses with the help of latest technology should be given priority. In urban areas some latest technology like GIS for property Maps and Computerisation in finance department should be used for a strong local government and because of this 73rd and 74th amendments can be fulfilled.
18. State evaluates every local body through principles and only after that fund will be decided.
19. Under the 5th and 6th list of constitution areas which are not covered, grants are requested for them. These areas can use the grants in all the outer and inner areas.

Notes

20. There is no condition other than the continutation or usage of the grants through central government.

Self-Assessment

Fill in the blanks:

1. Upto 2009-2010, state and central government's combined Tax GDP ratio recommended to increase ..... %.
2. Till 2009-2010 interest paid on Revenue received should be ..... %.
3. In partnership central tax the part of states will be ..... %.
4. Total revenue received for the state can be 38% under the ..... amount.
5. Under the 5th and 6th list of constitution areas which are not covered grants are ..... for them.

23.2 Implementation of Thirteenth Finance Commission

Finance Sources of Center and State

1. Finance ministry ensures that financial description, surcharges etc. should be present so that in any year the amount given to the state and of that year should not get any disbalance by finance commission.
2. State need to solve the problem of loss which occurs due to electricity.
3. Also try to decrease central sponsored planning and to introduce formula based organisation.
4. To keep a tab or policy of increasing exchequer loss of 2008-2009 and 2009-2010.

Commodity and Service Tax (GST)

5. Centre and state should make "Big Partnership" for the working of GTS model which comprises following six points:
   - *(i)* Design of GST model is suggested in Para 5.25 to 5.35.
   - *(ii)* For its working procedure is underlined in Para 5.36 to 5.41.
   - *(iii)* Sudden changes in the partnership between centre and state is mentioned in Para 5.49 to 5.51.
   - *(iv)* In case of not following the instructions it is described in Para 5.52.
   - *(v)* Implementation list is given in 5.57 to 5.59.
   - *(vi)* Compensation procedure is given in Para 5.60.
6. It is essential for a GST model to have all the point in partnership. To encourage the partnership and for its working the commission requested to give ₹ 50,000 crores grant. This grant will be used as the partnership between 2010-11and 2014-15 for the working of GST and to fulfill revenue loss. According to this the grant will be distributed among the states on 1 Jan, 2015.

Notes

7. The empowered committee of finance minister should changed to commission. From sectary, revenue department, Indian Gout, E.C Secretaryand public expenditure, experience received or 3 member committee is made by a prestigious person and because of their recommendation the loss is divided into tri monthly installment.
8. If, any situation in partnership, disagreement is there then GST model is different from suggested model then the commission recommends that the amount of 50,000 crores will not be distributed.
9. State should try to lessen the time of transport carrying commodities and which are for neighbouring states and entering through police stations and adopts state transport in the form of electronic options.

Finance Sources of Central Government

10. It is necessary to make investment received more flexible in which important structural area and money spent on environment should be included.
11. There is need to keep records of public expenditure so that it ensures that complex resources are kept as a product or should be available as a public planning or other should be sell out.

Do You Know? The grant will be used as the partnership between 2011-11 and 2014-15 for the working of GST and to fulfill Revenue loss.

12. Special category states organisation – support to different need to fulfill and to turn to another direction, this should be stoped.
13. In case of Public sector unit:
    - *(i)* All the states tries to ensure that their public area and its PSU are in the written form.
    - *(ii)* Rest of the state's PSU should be wrapped up by the auditor which shows its flexibility.
    - *(iii)* All the states need to form a frame to stop PSU till March, 2011. Investment and privatisation of PSU should be introduced.
    - *(iv)* Corporate Ministry's responsibility is to monitor PSU of state and centre.
    - *(v)* To keep a tab on Investment/ Privatisation a committee should be formed, also a re-structural Permanent Committee under the guidance of secretary can also be formed so that recommendations can be applied. One independent, Technical section should also be formed which advises on finance.
14. In the field of electricity:
    - *(i)* To stop the loss in Metering, feeder separation, thigh voltage distribution and to stop distribution of transfer metering and electricity theft. Actions should be taken in Distribution franchising and electricity service company (ESCO)
    - *(ii)* Unexpressed needs should be given primary importance. Improvement should be made through state load distribution and finally it should be made autonomous.
    - *(iii)* In the delay of some proposals, planning should be made clear.

Notes

(iv) Instead of establishing sources of coal in distant places of thermal electricity plants, we must think about establishing joint state project coal rich in states or near them.

(v) Case I Auction procedure should be kept a side to save it from high revenue.

(vi) Investment agencies should be made strong by capacity construction consumer education, Multi year tariff. Highly principles and procedures of corporate should be applied in electricity area.

15. Progress should be made in new pension scheme.
16. Before giving loan to states, first ensure their use and try to improve them.
17. In case of Accounts improvement—

    (i) Indian government should ensure the same budget code in all the states. Finance of the states need to mention in a written format.

    (ii) Accounts of fund or description of debt or credit should be available in state's finance in written.

    (iii) There is a need of fund in public area. These kinds of funds or through civil saving amount expense should be brought under Accountant General.

    (iv) Following description of state with the financial accounts need to be available—

    (a) All the subsidiary related numbers.

    (b) In every level under taking of employees is involved. In this description employee related information and salary should also be included where the expense is the part of grant–in–aid.

    (c) Detail of expense.

Revenue Tax Central and its Participation

18. Central tax of net revenue received in state participation 2010-11 to 2014-15 will be 32% in every financial year. Except production (essential commodities) according to Tax Regulatory act, 1957, all the commodities from 1 march, 2006 received grant from tax. The central government long sales tax on sugar and tobacoo products. In the light of there activities the state net received part is 32% which is unchanged whether these states apply VAT or not.
19. According to the 88th amendment of constitution one regulation has to ensure that according to legislative committee state should not get less revenue, if its need is more.
20. Central government should apply regulations so that their participation can lad to the decrease of revenue.
21. State should be kept in the upper limit of 39.5% of revenue.
22. Upto 2010-11 to 2014-15, in every financial year the participation of Central taxes of net received the part of state is according to the table 23.1.

Amended Outline of Fiscal Consolidation

23. There is a need to lessen or finish the revenue loss of central government so that till 2014-15 so that its situation can rise again.
24. In the combined loan of state and centre GDP target 68% should be achieved in 2014-15. It is also essential to bring down GDP upto 45% in centre of loan stock and for state it has to be 25% in 2014-15. Both of them need to lessen.

Notes

Table 23.1: Partnership of states

State	Except service tax share of all Participable taxes(%)	Share of Service tax (%)
Andhra Pradesh	6.937	7.047
Arunachal Pradesh	0.328	0.332
Assam	3.628	3.685
Bihar	10.917	11.089
Chhattisgarh	2.470	2.509
Goa	0.266	0.270
Gujarat	3.041	3.089
Haryana	0.048	1.064
Himachal Pradesh	0.781	0.793
Jammuand Kashmir	1.551	0
Jharkhand	2.802	2.846
Karnataka	4.328	4.397
Kerala	2.341	2.378
Madhya Pradesh	7.120	7.232
Maharashtra	5.199	5.281
Manipur	0.451	0.458
Meghalaya	0.408	0.415
Mizoram	0.269	0.273
Nagaland	0.314	0.318
Orissa	4.779	4.855
Punjab	1.389	1.411
Rajasthan	5.853	5.945
Sikkim	0.239	0.243
Tamil Nadu	4.969	5.047
Tripura	0.511	0.519
Uttar Pradesh	19.677	19.987
Uttarakand	1.120	1.138
West Bengal	7.264	7.379
All States	100.00	100.00

25. Mid term exchequer planning (MTFP) should be amended and in place of reference description bouned should be prepared. An unification between MTFP and multi-years frame work available by annual budget is expected.

26. Following appearance of Annual central Budget and MT and FP should be included –

    (i) Description of Grants and planning related to the states.

Notes

(ii) Expenses of tax and their description should be kept sequencewise with right procedures.

(iii) Information of conformity cost of main taxes.

(iv) Idea of revenue results of capital expense in MTFP.

(v) In MTFP changes of exchequer's result should be included.

(vi) With MTFP a list of Private Participation liabilities should also be included.

(vii) Prices of MTFP should be ensured in which received and expense is give and within the limit how much they can be different.

27. In public article investment received allotment should be stopped and all the investment received should be kept as a fund.
28. Indian government should made a list of all the industries in which returns are low on Assets and which should be low as compared to the specialist committee.
29. In FRBM is Regulation these points should be encouraged in which FRBM is giving discount.
30. In school economical case instead of giving more loan or discount to states they should be given loan through central state distribution and allotment formula.
31. Because of salary commission's recommendation left over or reminder money should be avoided. Salary should be given on Date.
32. Arrangement of independent review system should be made and its evaluation should be done by exchequer council to improve procedure.
33. After looking at 2008-09 and 2009-10 exceptional situation exchequer policy was affected. Hope that after the improvement it will come on its place.

    (i) These states whose Revenue deficit is zero in 2007-08 or received revenue reminder they should finish the less till 2011-12. Other states have the time of doing this till the year 2014-15.

    (ii) General category state who get zero revenue loss in 2007-08, they have to get Gross State Domestic Production (GSDP) of exchequer loss at least 3%. All the other states need to do this till 2013-14.

    (iii) In 2007-08, GSDP less than 3% exchequer less based states can do the loss upto 3% and after that can maintain them. Manipur, Nagaland, Sikkim and Uttarakand do the loss less than 3% of GSDP.

    (iv) States like Jammu and Kashmir and Mizoram should limit their exchequer loss of GSDP upto 3%.
34. The states need to a debt FRBM Regulations for amendments. For united state special grant should be forwarded for any state.
35. Under FRBM Regulations independent monitoring committee should be arranged through states.
36. By finance minister steps should be taken on the limit of loan to improve exchequer and they have to work in this direction for the improvement.
37. According to National Small Saving Fund (NSSF) in 2006-07, interest on loan for states should be received to 9% with some conditions till the end of 2009-10.
38. National Small Saving Fund should be transformed into a market related planning and it is expected from the state government to improve it on their own level.
39. By the end of 2009-10 through Indian Government maintain Accounts to states from finance department with some conditions.

Notes

40. In the view of exchequer weak states who are unable to take loan from market, they can take the loan from central government. This type of arrangement is essential.
41. In loan and Relief facility, these states who are untouch by the profit they can be given facility like less interest rate under FRBM Regulatory and it should also be expanded.
42. States can get the advantage of NSSF interest relief only when, if they arrange amendments of FRBM.

Local Bodies

43. In the constitution amendment should be done in Para 280(3) (b) and (C) so that it changes words from "on state finance commission's recommendation" to "After taking care on state finance commission."
44. In the amendment of constitution in Para 243(1) word should be included like "every 5 year" and after it "or before" should be included.
45. Grants should be sufficient for local bodies and they should be divided in these states which are given in the Index 10.15 (a) and 10.15 (c).
46. It states follow conditions then only they can be approved for Grants. There Grants are distributed according to the instructions and more information on this is given in 10.15 (b) and 10.15(d).
47. Grants should be distributed by the states according to population ratio.
48. State government should make its Accounts department according strong by increasing the number of employees.
49. State government should encourage revenue storage by some or all local taxes on zero, percentage, cutting off self revenue or by some of the grants policy.
50. To make Account procedure more strong, different accounts of Panchayat State agencies and urban local bodies should be made in which their budget and real expense should be there. We recommended to apply this from 31 March, 2012.
51. India and state government should pass an order so that their department can pay to the local bodies.
52. State government received increasing royalties they have to give a part of it to the those local bodies who collect these tax.
53. State government should ensure that the recommendations of state finance commission work out as soon as possible and the report (ATR) should immediately present in front of the legislation.
54. A thought process should be done on SFC index 10.5 which is the dose of the report.
55. SFC like corporate body should be established in states which is not covered in the part IX of the constitution.
56. A discussion should be made for the working of the best procedures related to the local bodies.
57. The grant which is given to the urban local corporate bodies should be used within the area related to the fire services.
58. Local bodies should be linked with the urban planning work with these bodies one has to get revenue also.
59. Under the army area (except sensivitive areas), civilian progress planning should be presented before district planning.
60. State government made their guidelines for organising the corporation or calamity.

Notes

Disaster or Calamity Relief

61. National calamity Casualty fund should be involved in National Calamity Work fund and State calamity Relief Fund (SCRF) further included in State Disaster Relief fund. The grant of SDRF in case of central and state should be 75:25 ratio and state which comes under special mention their ratio will be 90:10.
62. On 31 March, 2010, under CRF and NCCF and according to the situation balance money should be distributed between SDRF and NDRF.
63. There is a need for NDRF to make budget, according to the expense of last year fund. It is also essential to identify optional sources of finance which can only be done after the starting of GST.
64. Total size of SDR is measured in 33.381 crore in which except 525 crores balance should be used in Grants in the form of ratio.
65. To maintain the stock of commodities of National Calamity Work Power 250 crore in terms of support should be given.
66. To look over the main points of Disaster Management (DM) in District Disaster Relief Fund (DDRF) and they should be left on states for their creation.
67. Through FC grants funds planning should be made and re-constructed activities should be left out so that progress planning fund of central and state can be completed.
68. Through FC grants should be made uncharged and working fast of NDRF sustained list of disaster should also be maintained.
69. DM Regulatory or state disaster Management on central level and state Disaster Management on state level should be completed according to state: All the matter of finance will be decided by finance minister according to the procedure.
70. To continue central help for SCRF accounts should be followed.

Task In thirteenth finance commission's recommendation what were the recommendations related to the calamity Relief?

Grants for State

NPRD and Grant Encouragement

71. For 8 states and arbitrary period 51,800 crore is recommended for planning grants.
72. 1500 crore is recommended for 3 special level states for Grants to whom listed in planning revenue loss is related with NPRD.

Primary Education

73. For arbitrary period 24,068 crore is recommended for Primary education.
74. Education grant for primary education to be given to states excluding general expenditure. Under Primary education expense or main used 2202, sub main head-01, year-2010-15 will be at least rate of 8%.

Notes

Environment

75. For arbitration period for forest Regulation 5000 crore is recommended.
76. For the first 2 years grants are unconditional but preparations of planning should be given priority. For the last 3years release of grants should be related with the development of numbers of alloted plannings.
77. For the last 3 years 25% of grant is fixed for conservation of forestries. This grant excluded and wild life related revenue and given in the Article 12.3. For the last 3 years 75% of grant will be used for development.
78. For the encouragement of Renewable energy of Grind, 5,000 crore is implemented which is based on 1 April, 2010-31 March, 2014 states achievements in renovational power generations. In this regard a review is required or the state executed data or renovation of power generation.
79. 4 years, 2011-12 to 2014-15 arbitration period amount 5000 crore rupees approved as water area managements.
80. Release of the grant of water area will be under establishment of water supply authority and state collection of generally fix rated water authorities.
81. Water grants for maintenance will be an added amount which will be looked after the state and according to the para 12.8 where conditions are given for and monitoring.

Improvement in Results

82. State should encourage the nominees of those people who take part in welfare programmers in UID. In this state government has to give 2987 crore grant as reflected in the para 12.9.
83. State should also encourage to bring down death morality rate in babies. For this 5000 crores grant is recommended.
84. For the improvement in judiciary grant of 5000 crore is given. In which morning/evening courts publicity, Problem's solution of cases, increasing support of lok adalat and training etc. are included.
85. In state to encourage new public service and to arrange CIPM 20 crore grant is recommended. One crore for every district to increase more capability.
86. To maintain the quality of statistics, we recommend 1 crore for every district which is not identity by Indian statistics planning and 616 crore for states.
87. For employee and pensioner database ₹ 10 crores for general class state and 5 crore for special class state should be available. We requested Indian government that it should work parallel in the field of employee and pensioner database.

Maintaince of Roads and Bridge

88. In the four years arbitrary period (2011-12 to 2014-15) 19,930 crore is recommended for the maintaince of roads and bridges.
89. Grant for roads and bridges excluded the other expenses of states its condition is given in the Para 12.17.

State's special Needs

90. For the special needs of state 27,945 crore is recommended.
91. According to the Para 5.52 and 9.82 following conditions should be included while giving the grants.

Notes

(i) State's special grant should not be used in land possession. If the land is needed for the proposal then it has to be arranged by the state government.

(ii) There are instructions only in table 23.2. State can inform Central government to about its condition. This grant can be given in 2 installments every year.

(iii) Maintaince of Account and usage certificate should be available according to general finance Regulation 2005.

Monitoring

92. Under the chairmanship of secretary high level monitoring commission will evaluate and improve the uses of grants. It is established after the recommendation of 12th finance commission.

93. For arbitrary period State's total money of grant is in table 23.2.

Table 23.2 – Grants for states

			Crores ₹
I	Local body		87519
II	Calamity Relief (capability construction included)		26373
III	Allotment planning – Revenue loss		51800
IV	Encouragement		1500
V	Primary education		24068
VI	Environment		15000
	(a) Forest Conservation	5000	
	(b) Renewable energy	5000	
	(c) Water area management	5000	
VII	Improvement in Results		14446
	(a) Decrease in death rate of child	5000	
	(b) Improvement in justice	5000	
	(c) Encouragement of introducing UID	2989	
	(d) District and New funds	616	
	(e) On state and District level improvement in statitics	616	
	(f) Employee and pension database	225	
VIII	Maintaince of Road and Bridge	19930	
IX	Special state	27945	
X	Working of GST model total	50000	
	Total	318581	

Self-Assessment

Notes

State whether the following statements are True or False:

6. Indian government should ensure equality for all the states.
7. It is not essential to lessen down or completely abolishe the revenue loss of centre.
8. It is essential to guideline the regulations of F.R.BM which should be discounted by FRBM.
9. State government should not make local Accounts fund strong by increasing number of employees and capability.
10. In arbitrary period ₹ 5000 crore is recommended for forest grant.

23.3 Summary

- Till 2009-10, state and central government combined Tax- GDP ratio till 17.6%, Primary expenditure of GDP Till 23% and money expenditure of GDP increase upto 7%.
- In the case of central tax partnership state's share will be 30.5% in revenue received. In this espect for sales tax, additional excise tax instead of sales tax is regarded as the common pool of central tax.
- Water supply for panchayati Raj and cleanliness arrangements and also construction of related properties. ODM Grants should be encouraged. More over Panchayati Raj should levy taxes on 50% part.
- Empowered committee of finance minister should changed to commission. From secretary, revenue department, India government EC secretary and public expenditure experience received or 3 members committee is made by a prestigious person and become of their recommendation the loss is divided into tri-monthly installment.
- Central tax of net revenue received in state participation 2010-11 to 2014-15 will be 32% in every financial year. Except production according to tax regularly act 1957, all the commodities from 1 March, 2006 received grant from tax.
- According to the 88th amendment of constitution one regulation has to ensure that according to legislative committee state should not get less revenue, if its need is more.
- These states where revenue loss is zero in 2007-08 or received revenue reminder, they should finish the less till 2011-2012.
- State government received Royalty after looking salary and they have to give a part of it to the local bodies.

23.4 Keywords

- Commission – a group of officials
- Implement – to recommend or to apply

23.5 Review Questions

1. Explain twelfth finance commission's implementations.
2. Write briefly thirteenth finance commission's implementations.
3. With the help of the table explain states grants.

Notes

Answers: Self Assessment

(1) 17.6	(2) 28	(3) 30.5	(4) Central
(5) Implementations	(6) True	(7) False	(8) True
(9) False	(10) True.		

23.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Unit-24: Indian Public Debt

Notes

CONTENTS

Objectives

After studying this unit students will be able to:

- Know the historical Development of Public Debt.
- Know the Information related to Public Debt since Independence
- Understand the External Public Debt Structure.

Introduction

Constitution gives the right to the union government that on the basis of the consolidated fund. It can take Debt after following Parliaments limits. Like this any state, Legislature within the limit can take Debt. But no state can take it without the approval of Indian government.

24.1 Historical Development of Public Debt in India

Public Debt before Independence

Like any other government India also took loan and still taking. In the starting days of the British rule India's borrowings were mainly because of wars. But then also a big part of India's public debt was productive which was used for expenses like railway and irrigation planning. In 1939 the total Debt of India was 1,206 crore in which 925 crore was Interest yielding Assets and secured in securities and rest of the money was unsecured and unproductive. Out of 1,206 crore of the total debt Around 736 crore was internal or domestic and around 470 crore was in England as India's obligations.

During Second World War India got chance to repay its loan of sterling assets. However, for this many developing work sacrificed which was a big thing. In the time of war, India exported a large number of military and non-military commodities to England and in return of these we only got sterling assets to keep in the Reserve Bank of India. So, because of favorable balances India stored sterling balance in a large quantity till 1945-46 the Quantity of sterling balances became 2,300 crore. Through Indian government one of the part of sterling assets used as sterling Debt.

Notes

Rupees and Sterling (in crores)

Year	Rupee Debt	Sterling Debt
1914	179.77	265.81
1947	2,142.00	36.61
1948	2,134.97	30.21

In this way during the war period India's sterling debt decreased but rupee debt increased. During the war money in the form of rupee and its total debt increased from 736 crore to 1,937 crore, which means increase of 1,200 crore. The reason of government debt was expense on war in which expense on Defence and instead of sterling counterpart rupee counterpart was also included government borrow a large part of the debt on a very low interest rate, i.e. for 3%.

Self-Assessment

Fill in the blanks:

1. In the starting days of the British rule, India's borrowings were mainly because of .....
2. In ..... the total Debt of Indian expenditure was 1,206 crore.
3. Out of 1,206 crore of the total Debt around ..... crore was internal or domestic.
4. During second ..... India got chance to repay its loan of sterling Assets.
5. During the war period India's ..... debt decreased but rupee debt increased.

24.2 Public Debt since Independence

In March 1947, total debt of India was 2,381.39 crore. In 1946 because of partition there was a problem of distributing assets and liabilities of unpartition India. In 12 Dec, 1947 a financial agreement was signed with Pakistan, according to which it was decided that all the financial Debt and responsibilities which were at present 15, Aug 1947, were taken by the Indian government This means that all the people of unpartitioned Indian who had purchased securities their interest and principal will be paid by the Government and it doesn't matter that the person is residing in India or gone to Pakistan. But Pakistan government will pay 300 crores of the total government debt in 50 Annually installments which begins from 1952. But unfortunately Pakistan never paid its credit and still didn't started paying installments and by looking the Political relation between the two countries it can't be hoped that Pakistan will fulfill its promise.

Notes In March 1947, total debt of India was 2,381.39 crores.

India's public debt can be divided into three parts.

(1) External debt (2) Internal debt (3) Other responsibilities or obligations

Notes

24.2.1 Internal Debt

In internal debt, loan is taken from open market. It is mainly divided into following:

1. **Permanent loans:** These are called funded debt or dated loans. These loans are of 12 months or more from the starting date. Under these loans instead of short term liabilities, long term loans are given and mostly they are of interest based.
2. **Temporary or floating loans:** In this following loans are included:
   - *(i)* *Treasury Bills:* These bills are considered the main source of loss of budget related to the Indian government. Maturity of these bills are 13 weeks and paid on at par.
   - *(ii)* *Treasury Deposit Receipts:* The main aim of these is to fulfill the needs of finance in short term and to include the liquidly of banks. Their maturity period is of 6,9 or 12 months and they are only for commercial banks and their interest rate is low.
   - *(iii)* *Ways and Means Loan:* This is the temporary short term loan from Reserve Bank of India to fulfill the need of finance.
   - *(iv)* *Special Floating Debts:* These securities are to fulfill the responsibilities of world bank, International development commission and other world finance agencies.
3. **Other obligations:** In this bonds, prize bonds, small savings, state provident funds are included.

Growth of Internal Public Debt

The internal Public debt of India in 1950-51 was 2,022.36 crore which was increased in 1990-91 to 1,54,003.77 crores. It was increased almost 76%. India's internal public debt is reflected in the table. In 2001-2002 India's internal public debt was (R.E) 9,13,061.13 crore and in 2002-2003(RE) 10,94,812.93 crore estimated and for the year 2003-2004 the total internal debt was 12,19,570.32 crore. India's present Public Debt is in the following table.

Do You Know? Permanent loan is also known as funded debt.

Total Internal Public debt (in crores)	
Year (In the end of March)	**Total Internal debt**
1950-51	2,022,30
1980-81	29,008.49
1990-91	1,54,003.77
1995-96	3,07,868.60
1997-98	3,88,997.78
1998-99	4,58,842.40
1999-2000	7,14,254.23
2000-2001	8,03,697.63
2001-2002	9,13,061.13
2002-2003 (R.E)	10,94,812.93
2003-2004 (B.E)	12,19,570.32

Notes

Net Increase in Market debt every year:- In 1980-81, Total market debt was 2,949.00 crore in which 270.00 crore were paid. In this way in 1980-81, internal debt increased upto 2,679.00 crores like this in 1990-91 total internal debt obligation was 8,988.00 crores out of which 987.00 cores paid back. In this way this year increment in public debt was 8,001 crores. Internal debt and its increment in different years is shown in the table.

Internal debt in every year of net increase (in crores)			
Year	**Market debt (Gross debt)**	**Debt paid**	**Net increase**
(1)	(2)	(3)	(4)
1971-72	631.47	833.74	257.73
1977-78	1,309.99	124.55	1,185.44
1980-81	2,949.00	270.00	2,679.00
1990-91	8,988.00	987.00	8,001.00
1997-98	43,390.00	10,891.00	32,499.00
1998-99	79,714.00	14,803.00	64,911.00
1999-2000	86,608.00	16,331.00	70,277.00
2000-2001	1,00,206.00	27,275.00	72,931.00
2001-2002	1,14,213.00	26,489.00	87,724.00
2002-2003(R.E)	1,27,373.00	27,420.00	99,953.00
2003-2004(B.E)	1,39,887.00	32,693.00	1,07,194.00

Public debt of Indian Government (in crores)					
Types of debt	**1950-51**	**2001-02**	**2002-03**	**2003-04 (amended)**	**2004-05 Budget estimation**
1. Internal debt.					
1. Market debt	1,444.95	5,16,517.48	6,19,105.46	7,04,902.01	8,25,403.19
2. 91 days Treasury bills	358.02	5,046.65	9,672.88	6,983.88	25,983.88
3. On special securities and on it saving of 91 days treasury bills	-	1,01,817.95	61.817.95	-	-
4. Selling securities changes		20,000.00	55,000.00	-	
5. Special securities issued to RBI	-	3,221.74	3,595.95	1,16,817.95	1,11,817.95
6. 14 days Treasury bills	-	3,000.00	5.628.04	3,595.95	1,725.23
7. 182 days Treasury bills	-	3,000.00	3,000.00	5.628.04	5,628.04
8. Financial Advances	-	5,176.00	-	3,000.00	3,000.00
9. 364, days Treasury bills	-	16,584.16	23,122.45	-	-
10. Golden bond, 1988	-	-	-	22,996.45	38,860.45
11. Compensation and other bond	-			-	-
12. Securities issued to international finance agencies	6.73	14,380.86	27,624.22	45,547.12	53,406.84
13. Securities as a substitute of small savings	212.60	22,551.41	23,616.81	22,246.20	22,149.44
	-	2,02,270.61	1,88,505.03	2,02,302.75	2,03,652.75
Total internal debt	**2,022.30**	**9,13,061.12**	**10,20,688.79**	**11,34,020.35**	**12,91,627.77**

Notes

24.2.2 External Public Debt

A developed country needs external help in its initial stages of development. The help can be purchasing of resources and raw materials from foreign countries. India too wanted external capital for its economic development. In this way to complete, paid balance and industrial gap, India took loan from foreign countries. In 1950-51, India's external debt was only 32.03 crores which increased in 1990-91 and become 31,524.77 crores. In this way the debt increase was 100%. According to the 2000-2001 budget the total external debt was estimated 65,945.23 which again increased in 2002-2003 (RE) to 57,649.58 crores and in 2003-2004(BE) it is estimated 60,931.12 crores.

External Public Debt (in Crores)	
Year	**Total External Public Debt (in flow)**
1950-51	32.03
1980-81	10,782.39
1990-91	31,524.97
1995-96	51,248.74
1998-99	57,254.33
1999-2000	58,437.19
2000-2001	65,945.23
2001-2002	71,545,79
2002-2002 (RE)	57,649.58
2003-2004 (BE)	60,931.12

Net increase in External Public Debt :– In 1980-81 the total external debt of India was 1,728.00 crores out of which Government paid back 447.00 crores. In that way this year net external Public Debt was 1,281.00 crores. In 1990-91 the external Public Debt was 5,339.00 crores out of which 2,158.00 crores paid back. In this way that year net increase in external public Debt was 3,582 crores. Total external Public Debt was estimated 17,328 crores in 2000-2001, in which 9,823.00 crores was paid. So the increase in external public debt is 1,180.00 crores.

Task How much India's total external debt was in 1980-81?

Increment of net external debt in every year. (in crores)			
Year	**Total External Public Debt**	**Debt Re-Paid**	**Net increment in Public Debt**
(1)	(2)	(3)	(4)
1980-81	1,728.00	447.00	1,281.00
1985-86	2,145.00	630.00	1,515.00
1990-91	5,339.00	2,158.00	3,181.00
1998-99	10,015.00	8,095.00	1,920.00
1999-2000	9,893.00	8,713.00	1,180.00
2000-2001	17,328.00	9,823.00	7,505.00
2001-2002	14,790.00	9,189.00	5,601.00
2002-2003	11,713.00	25,209.00	-13,496.0
2003-2004	13,203.00	9,621.00	3,582.00

Notes

Composition of External Debt

In India external Debt is found in many forms. These debt's can be – with conditions, paid in Rupees or foreign currency etc. Generally Agricultural commodities are paid back in the form of money. Technology help is also received in many forms by many countries. To balance the paid amount short term debt received by international Monetary fund. India has also borrowed money from international agencies like International Monetary fund, International Agricultural development fund, Asian development bank, etc. Except this, Government also received debt Grants, commodity Grants and special debts from the countries like United States of America, Canada, Denmark, France and Japan. As far as the debt is borrowed from different countries, except International agencies India received most of the debt from U.S.A. Debt which is borrowed from the International agencies has less political interference as compared to the other external countries but the interest rate of International Reconstruction development bank is very high and on the other hand International Development commission provides debt in small amount but on less interest rate as it gets less help from the developed countries. Asian Development bank is a new group which will get time to collect funds.

24.2.3 Other Outstanding Liabilities

Government too has some liabilities, which have to be paid, and for this Government needs debt. Other liabilities can be divided into three parts.

(i) Small Saving Schemes.

(ii) Public Provident fund contribution, state provident fund, non – government provident fund contribution and

(iii) Reserve fund and money saved in different departments.

1. **Small Saving Schemes:** Indian government post office savings, Bank saving fixed deposits, National saving certificate and 7-years National saving certificate are these things which can collect small saving. In 1950-51 only 336.87 crores were the small saving which increased in 1990-91 to 50,100.18 crores. In 2002-03 (R.E) it was 1,49,166.07 crore estimated and in 2003-04(BE) 2,85,545.63 crores.

Public debt of Indian Government (crores in rupees)								
Year	Internal debt	Foreign debt	Other debts	Total debt	Debt on Pak. (Before division)	Net responsibilities on central Govt.	Aburdance of debts and capitalising place of Indias	Capital and Debt
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1950-51	2.022.30	32.03	811.06	2,865.40	-300.00	2,565.40	-	-2,565.40
1960-61	3,978.00	760.26	1,805.28	6,544.24	-300.00	6,244.24	-	-6,244.24
1977-78	19,025.29	8,984.74	12,193.92	40,203.95	-300.00	39,903.95	9,06,410**	38,907.54
1980-81	29,008.49	11,316.35	18,393.38	58,723.22	-300.00	58,423.22	575.59**	57,847.63
1990-91	1,54,003.00	31,524.97	1,29,029.12	3,14,557.86	-300.00	3,14,257.86	77,517.56	2,36,740.30
1995-96	3,07,868.96	51,248.47	2,47,115.01	6,06,2332.32	-300.00	6,05,932.32	-	-
1999-2000	7,14254.23	58,437.19	2,48,337.19	10,21,029.38	-300.00	10,20,729.38	-	10,20,729.38
2000-2001	8,03,697.63	65,945.23	2,98,898.16	11,68,541.02	-300.00	11,68,241.02	-	11,68,241.02
2001-2002	9,13.061.13	71,545.79	3,81,801.51	13,66,408.00	-300.00	13,66,108.43	-	13,66,108.43
2002-2003 (R.E)	10,37,163.43	57,649.50	4,67,062.58	15,61,875.51	-300.00	15,61,575.51	-	15,61,575.51
2003-2004(R.E)	11,58,639.20	60,931.12	5,60,493.55	17,80,063.87	-300.00	17,79,763.87	-	17,79,763.87

* Debt from International Monetary Fund.

** Extended capital Expenditure is included in liabilities

Notes

2. **Provident Fund Contribution:** Provident Fund of India is related to three Heads (a) State Provident Fund Contribution (b) Public Provident Fund and (c) Non-government Provident Fund for special saving.

   Provident Fund Contribution of India in 1950-1951 was 95.05 crores only which increased in 1990-1991 to 11,670.34 crores. In 2000-2001 it was estimated around 41,723.74. In 2002-03 (Re) it was 54,394.43 crores and in 2003-04 (BE) 61,894.43 crores.

3. **Other Accounts:** In this non-government provident fund is included. In the year 1950-1951 it was 16.00 crores which further increased in 1990-1991 to 45,336.43 crores. In 2000-2001 it was estimated around 1,44,019.61 and in 2002-2003 (BE) 1,77,466.60 crores and in 2003-2004 (BE) it is estimated 1,91,802.62.

Notes In 1950-51 only 336.87 crores was there as small saving which increased in 1990-91 to 50,100.18 crores.

4. **Reserve Funds and Deposits:** In this Annual Income tax saving Scheme and special saving planning, Railway and post office's Reserve fund on Interest are included. Except this Local funds of saving and private Saving-deposit are also included. In 1950-51 for this 36,305 crores debt was taken which increased in 1990-91 to 21,922.17 crores. In 2000-01 it was estimated around 58,535.19 crores. In 2002-03 (RE) it was again increased to a number of 86,035.48 crores and in the year 2003-04 (BE) it was estimated 1,01,250.87 crores.

Total Other Obligations (in crores)					
Year	**Small Savings**	**Public Prov. Fund and State Prov. Fund**	**Other A/C**	**Reserve fund and Savings**	**Total**
(1)	(2)	(3)	(4)	(5)	(6)
1950-1951	336.87	95.05	16.10	363.05	811.07
1960-1961	969.99	289.14	262.23	283.02	1,805.28
1990-1991	50,100.18	11,670.34	45,336.43	21.922.17	1,29,029.12
1998-1999	1,76,220.92	30,237.47	1,26,802.38	41,594.76	3,74,885.53
1999-2000	29,591.64	36,814.03	1,34,424.62	47,507.67	2,48,337.96
2000-2001	54,619.62	41,723.74	1,44,019.61	58,535.19	2,98,898.16
2001-2002	98,617.28	45,894.43	1,64,156.95	73,132.85	3,81,801.51
2002-2003	1,49,166.07	54,394.43	1,77,466.60	86,035.48	4,67,062.58
2003-2004	2,05,545.63	61,894.43	1,91,802.62	1,01,250.87	5,60,493.55

Burden of Public Debt on Indian Economy: The burden of Public debt is increasing in India. This is the topic of debate in parliament and legislatives assemblies that now it is the maximum limit of the burden, and this should not be increased further. This is based on the fact that the public debt is formed in a large Quantity. According to the Article 292 of the Constitution, Parliament should make a maximum limit of the Public debt. But unfortunately parliament did not make any law which abide the government to take loan. This type of question was raised by the Estimate committee in the 20th report. Related to this finance minister presented following points in favour of not making any law of this.

Notes

1. Government explains the quantity of debt in 5 year planning and in the budget whenever parliament argues on 5th year planning or on budget then at that point of time can control the public debt.
2. It is not possible to limit Public debt.
3. Internal debt limit can be fixed by the Reserve Bank but it is not possible in the case of external debt.

Burden of Interest of Internal Public Debt

We will examine whether the burden on economy from present structure of internal public debt is on it or not, in relation to national income, Public revenue and public expenditure.

1. **National Income and Public Debt:** National income is one of the important points of public Debt. If public debt increases with National income then it is not the thing to worry but if public debt increases but National income decreases then it is the burden on Economics. It is stated in the following table:

Estimation of national income in internal public debt. (in crores)			
Year	**Total internal public debt**	**National income on floating price GNP**	**Percentage National income in internal public debt**
(1)	(2)	(3)	(4)
1950-51	2,002.30	9,157.00	22.06%
1960-61	3,978.00	13,999.00	28.90%
1980-81	29,008.49	1,13,907.00	26.55%
1990-91	1,54,004.00	2,91,647.00	19.00%
1998-99	4,59,696.32	15,83,159.00	29.00%
1999-2000	7,14,254.23	17,46,501.00	40.00%
2000-2001	8,03,697.63	19,00,310.00	42.00%
2001-2002	9,13,061.13	20,81,350.00	43.00%

In 1951, National income of internal Public debt was 22% which increased in 1990-91 to 52%. One important point of this is that its ratio in 1950-51 is continuously increasing. It is compared by the developed countries like England (78.8%) Ireland (68%) USA (41.2%) and Australia (40.8%) then we come to know that the internal debt of India is not much. But India is a developing country and its comparison with the developed countries is not right. But some of the other economists said that if we compare National income and Public Debt then we can find that the percentage of public Debt is more which means on India the burden of public debt is too much. However Public debt is more than National income but the problem is not of increasing public debt but of decreasing national income. So to control the public debt National income has to increase.

2. **Interest on Internal Debt and National Income:** As for as internal on public debt and National Income is concern through Government in the form of National income Internal rate is increasing which is shown in the table given on next page.

Notes

In national Income, internal rate ratio of internal Public debt. (in crores)			
Year	Interest paid in internal public debt	National income (GNP)	National income and paid interest
(1)	(2)	(3)	(4)
1950-51	32.40	9,157.00	0.35
1960-61	118.80	13,999.00	0.75
1977-78	1,521.34	80,493.00	1.90
1980-81	2,604.00	1,13,882.00	2.34
1990-91	21,471.00	2,91,647.00	7.36
1998-99	77,882.00	15,83,159.00	5.0
1999-2000	90,249.00	17,46,501.00	5.2
2000-2001	99,314.00	19,00,310.00	5.1
2001-2002	1,07,460.00	20,81,350.00	5.1

It is clear from the above table that the National income and paid interest is increasing day by day. In 1950-51 ratio was 0.35% which increased in 1980-81 to 2.34% and in the next few years it increased like in 1990-91 it become 7.36%. In this way it is clear that the burden of external public debt is increasing but the burden of public debts interest is not much, because government borrows on low interest rate as compared to the market. But then also burden of public debt is more because national income is low and because of it national income and interest paid ratio or percentage is increasing.

Do You Know? In 1951, The internal public debt in national income was 22% which increased in 1990-91 to 52%.

3. **Tax revenue and debt services:** Public debt is helpful in the increase of Tax because to pay the debt, Government takes Tax from the public. This is the important factor Revenue to lower down the debt. It is clear from the table below:

Ratio of Interest to Tax Revenue (in crores)			
Year	Ratio of Interest Interest paid	To tax Revenue Revenue tax	Tax revenue and Interest paid%
(1)	(2)	(3)	(4)
1950-51	32.40	314.60	9.50
1960-61	118.00	703.60	16.90
1977-78	1,512.34	7,060.28	21.50
1980-81	2,604.00	9,358.00	27.05
1990-91	21,471.00	42,978.00	49.90
1997-98	65,637.00	95,672.00	60.10
1999-2000	90,249.00	1,71,752.00	53.00
2000-2001	99,314.00	1,88,603.00	52.00
2001-2002	1,07,460.00	1,87,060.00	56.00
2002-2003 (R.E)	1,15,994.00	2,21,918.00	52.00
2003-2004 (B.E)	1,23,223.00	2,51,527.00	48.00

Notes

It is clear from the table that the interest of Tax ratio is increasing from 1950-51. In 1950-51 the ratio was only 9.5% which increased in 1980-81 to 27.05%. In 1990-91 this ratio reached upto 49.9%. which in turn interested in 1997-98 to 60% and in 1999-2000 to 61.0%. This clearly indicates that the internal public debt is increasing. Now in the year 2000-2001 the burden is lowering down because interest rate also lower down on Government Securities. So a small part of revenue income is going in the payment of interest. This indicates that more the interest rate, more the burden of debt and vice versa if the interest rate is low.

But if the debt is using in the resources and economic development then the burden of debt feel less. So there is a need to lower down the burden of debt and it should be used in the developing work. and the work should increase the production of the country.

4. **Ratio of interest Payments to Public expenditure:** Public expenditure of Ratio of interest is one of the factor of debt services. It is clearly mentioned in the table below .In the table it is clear that the ratio of interest in revenue accounts is increasing. In 1950-51 this ratio was 9% which increased from 1980-81 to 18%. After this also the Ratios increasing. It is further increased in 1990-91 to 29.2%. In 1998-99 it again increased to 31.11% and in 1999-2000, 41%. In this way it indicates that the burden of public debt is increasing. The table also reflects that a large part of public expenditure is spending on the Ratio of interest. If it would not used in the above area then it would have been used in the developing work.

Ratio of interest payment and Revenue Public Expenditure (in crores)			
Year	**Payment of interest**	**Total public expenditure in Revenue Accent**	**Ratio of interest of Revenue Accent**
(1)	(2)	(3)	(4)
1950-51	32.40	346.00	9.00%
1960-61	118.80	926.00	9.84%
1965-66	183.20	1,947.00	9.20%
1977-78	1,521.34	9,362.29	16.20%
1980-81	2,604.00	14,410.00	18.00%
1990-91	21,471.00	73,516.00	29.20%
1996-97	59,478.00	1,58,933.00	36.80%
1999-2000	90,249.00	2,49,078.00	41.00%
2000-2001	99,314.00	2,77,839.00	39.50%
2001-2002	1,07,46.0.00	3,01,611.00	36.00%
2002-2003	1,15,994.00	3,41,648.00	35.00%
2003-2004	1,23,223.00	3,266,227.00	34.50%

In 2000-01 burden of debt seems lowering because the ratio of interest and Public expenditure's ratio is becoming less as lowering of interest rate led to the less ratio of interest.

5. **Public Debt and Assets creation:** On economy the burden of Public debt depends on their use. For instance if public debt creating the assets then it seems less. Most of the money of Internal debt is used in the public expenditure. In the table below it shows that in 1990-91 India's public debt of Total obligation was 3,14,257-81 crores, out of which 2,36,740.30 crores was used in the Assets. In this way total obligation remains 77,517.56. It is clear that public debt is not affecting Indian economy in a negative manner. This obligation is not estimated as a burden.

Notes

Task Explain Ratio of Interest Payments of Public expenditures.

Public Debt and Capital Expenditure (in Crores)				
Year	**Public debt and Total Obligation of public debt**	**Capital expenditure Debt and expenditure to states and U.T**	**Extra obligation on expenditure (given to the states and UT)**	**Total**
(1)	(2)	(3)	(4)	(5)
1950-51	2,565.40	1,709.69	856.71	2,566.40
1980-81	58,998.36	58,998.81		58,998.81
1990-91	3,14,257.81	2,36,740.30	77,517.56	3,14,257.86
1995-96	6,05,932.32	3,96,978.88	2,08,953.47	6,05,932.35
1996-97	6,68,518.99	4,33,129.57	2,42,246.31	6,75,375.88
1999-2000	10,20,729.00	6,07,705.47	4,13,023.91	10,20,729.38
2000-2001	11,68,241.02	6,76,581.12	4,91,659.90	11,68,241.02
2001-2002	13.66,108.43	7,60,592.44	6,05,515.99	13,66,108.4
2002-2003	15,61,575.51	8,54,760.81	7,06,815.33	15,61,575.51
2003-2004	17,79,763.00	9,56,444.48	8,23,319.39	17,79.763.87

Burden of External Debt

Like internal Debt, external debt also increased and because of this burden of interest of ratio is also increasing the ratio of interest of external debt is a complex Problem because it not only transfers goods and services to another country but it also led the cost price down which is used in the production of the country Except this it also affected budget activities. Changing of rupee into foreign currency led affected on the interest ratio balance. Whenever government needs to pay the external debt then it have to cut down its development programmers.

In the end of the 5 year plan external debt was 13.5 crores which increased in the 3rd 5 year planning to 237.00 crores during this period debt services charges increased from 23.6 crores to 542-6 crore. In 1989-90 total interest ratio increased to 3,566.00 crores and debt service charge to 8,864.00 crores. Different planning in year reflected in the table of external debt services.

External debt services			
Duration	**Rectification**	**Interest Ratio**	**Total debt services**
1. First planning	10.5	13.5	23.5
2. Second planning	55.2	64.2	119.4
3. Third planning	305.6	237.0	542.7
4. 1977-78	524.7	271.3	796.0
5. 1980-81	517.8	286.1	803.9
6. 1987-88	3,658.00	2,254.00	5,912.00
7. 1988-89	4,298.00	2,709.00	7,007.00
8. 1989-90	4,898.00	3,566.00	8,864.00

* *Economic survey*

Notes

From the table it is clear that the Quantity of external debt is increasing which affected on our paid balance. Indian government cannot afford more external debt on tough conditions to return the external debt Exports should be encouraged on which India is trying hard.

Self-Assessment

Multiple Choice Questions:

6. How much public debt was there on India in march 1947?
   (a) ₹ 2,381.39 crores (b) ₹ 3,381.39 crores
   (c) ₹ 4,381.39 crores (d) ₹ 5,381.39 crores
7. In how many categories India 's public debt has been divided?
   (a) One (b) Two
   (c) Three (d) Four
8. Permanent debt is known to which other form.
   (a) Temporary (b) Public
   (c) Funded (d) Permanent
9. What are the changes that are taking place because of public debt on Indian economy?
   (a) Decreasing (b) Equal
   (c) Not equal (d) Increasing
10. The burden of public debt is increasing which factor?
   (a) Tax (b) Income
   (c) Expenditure (d) Profit

24.3 Summary

- During second world war India got chance to repay its loan of sterling assets. However for this many developing work sacrificed which was a big thing. In the time of war India exported a large number of military and non-military commodities to England and in return we only get sterling assets to keep in the Reserve bank of India.
- In March, 1947 total public debt of India was 2,381.39 crores. In 1946 because of partition there was a problem of distributing assets and liabilities of un-partitioned India.
- The main aim of these is to fulfill the needs of finance in short term and to include the liquidity of banks. Their maturity period is of 6,9 or 12 months and they are only for banks and their interest rate is low.
- The internal public debt of India in 1950-51 was 2,022.36 crores which was increased in 1990-91 to 1,54,003.77 crores. It was increased almost 76%.
- In 1980-81 total market debt was 2,949.00 crores in which 270.00 crores were paid. In this way in 1980-81, internal debt increased upto 2,679.00 crores.
- A developed country needs external help in its initial stages of development. The help can be purchasing of resources and raw materials from foreign countries.
- In 1950-51, India's external debt was only 32.03 crores which increased in 1990-91 and become 31,524.94 crores. In this way the debt increase was 100%.

Notes

- In 1980-81, the total external debt of India was 1,72,8.00 crores out of which government, paid back 447.00 crores . In this way this year net external public debt was 1,281,00 crores.
- In India external Debt is found in many forms. These debts can be with conditions, paid in Rupees or foreign Currency etc. Generally Agricultural commodities is paid back in the form of money.
- India has also borrowed money from international agencies like International Monetary fund, International Agricultural development fund, Asian development bank etc.
- As far as the debt borrowed from different countries except international agencies, India received most of the debt from USA Debt which is borrowed from the international agencies has less political interference as compared to other external countries but the interest rate of International Reconstruction development bank is very high and on the other head international development commission provides debt in small amount but on less rate of interest.
- The burden of public debt is increasing on India, this is the topic of debate in parliament and legislative assemblies that now is the maximum limit of the burden and this should not be increased further. This is based on the fact that the public debt is borrowed in a large amount and is increasing day by day.
- In 1951, National income of internal public debt was 22% which increased in 1990-91 to 52%. One important factor of this is that its ratio in 1950-51 is continuously increasing. It is compared by the developed countries like England (78.8%), Ireland (68%), USA (41.2%) and Australia (40.8%) then we came to know that the internal Debt of India is not much.
- Like internal debt, external also increased and because of this burden of interest of ratio is also increasing .The ratio of interest of external debt is a complex problem because not only transfer goods and service to another country but it also led the cost price down which is used in the production of the country.

24.4 Keywords

- Legislature: Name of both the houses of the state.
- At par: Normal value.

24.5 Review Questions

1. Explain the history of public debt of India.
2. In how many categories public debt is divided? Explain briefly each of them.
3. Describe the structure of external public debt.
4. Explain Tax Revenue and Debt services.
5. What are small saving schemes?

Answers: Self Assessment

(1) War	(2) 1939	(3) 736	(4) Word war
(5) Sterling	(6) (a)	(7) (c)	(8) (c)
(9) (d)	(10) (a)		

24.6 Further Readings

Notes

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Notes

Unit-25: Indian Tax System

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know the Main Factor of the Indian Tax System
- Understand the Indian Tax Structure
- Understand the Sources of Income of Central Government
- Know the Information of main Taxes of the State Government
- Understand the Main Taxes of Local Government.

Introduction

After the independence, Socialism was established in Indian tax system to lower the gap of income inequality. For this objective Indian tax system was centralised on progressive taxation structure.

In India both direct and indirect taxes applies by which every individual is affected in one or the other way. In India there is a union finance arrangement according to which, central and state's sources of income clearly mention. Except agriculture tax, taxes which applies by the central government through other sources are called income–tax as far as the Question of Income–Tax distribution is concerned, it is accepted as an influential tax because it can become developing and can abolish the inequality. Also it is important in economic stability.

25.1 Salient Features of Indian Tax System

After independence Indian government established investigation commission and committee to improve Indian tax system. In 1953 under the chairmanship of **Dr John Mathai** investigation committee was set up to improve the tax system and abolished the inequality of income, after that to change the tax system a committee was made under the chairmanship of Cambridge economist. A professor **Koldar Kolder** suggested new ideas related to the tax system after that in June 1958 a committee was appointed under the leadership of **Mahavir Tyagi**. To make direct taxes more simple '**Bhutlingam Committee,** was appointed in March, 1968. To stop the tax evasion '**Vanchu committee**'

Notes

was also established in 1970. To improve the indirect taxes in July 1976 investigation committee was made under the leadership of **Shri L.K. Jha**. After that to simplify the rules of direct taxes another investigation committee established under the chairmanship of **Shri C.C. Choukasi.** Like this many committees were set up like **Raja Chailiya** Committee etc. Many amendment were made on the basis of suggestions given by above mentioned Rekhi commitee some of those are:

1. **In accordance of taxation principle:** Indian Tax system is according to the taxation principle. It includes the entire main principle like equality, progress, flexibility, production etc.
2. **Main source of income:** Indian tax system is the source of income in union for both central and state government.
3. **Decrease in the upper limit of tax:** Initially in India after a limit the upper limit of income tax was 97.75% but after the recommendation of '**Vanchu committee**' it become as low as 30% in present. Because of this decrease in tax, evasion of taxes stopped to an extent.
4. **Socialist aim to lessen the inequality of income:** After the independence, to establish socialist economy means to lower the gap of income inequality. For this aim Indian tax system centralised on progressive Taxation structure. Poor class get rid of the tax and the rich class get taxes on the basis of progressive rate. Except this these products which are used by the poor class are kept tax free and taxes applied on Comfortable and luxurious items were recuced to lower the gap of economic inequality.

Notes In March, 1968 Bhutlingam committee was set up.

But despite this Indian Tax system unable to lower the gap because of the following reasons.

- Direct taxes on Indian tax structure. In 1990 a little improvement took place.
- Number of tax payers are less. In the population of 100 crores, tax payers are not even 1%.
- Tax evasion on a large scale.
- In Gross Domestic product revenue is less than 20%. That is why tax unable to affect Gross income distribution.

5. **In comparison of direct taxes, indirect taxes are more:** direct taxes can be easily calculated but indirect taxes cannot. This is why to expand Indian Tax system indirect taxes are more than direct taxes.
6. **Maximum Social Profit:** The aim of Indian tax system is not only to receive income but also to ensure maximum social profit. In Indian Tax system one thing is important that is the effect of Taxation should not affect saving and production and people can get maximum satisfaction and welfare.
7. **Multi tax system:** Because of the Direct and indirect taxes Indian Tax system became a multi tax system.

Do Indian tax system have Qualities of a better Tax system?

Generally Indian tax system is a better tax system because of the following:

1. **Based on equality:** Indian taxes like Income tax, Property tax etc. are based on equality because of progressive nature.

Notes

2. **Different variety or category:** There are different categories in the Indian tax system like different tax are applies here-for instance can through central government-income tax, property tax, export import tax, Production tax etc. and state government also applies some taxes like entertainment tax, Vehicle tax etc.
3. **Principle of certainty:** There is a certainty in Indian tax system because while presenting the budget; every thing is mentioned like tax interest expected income of the government. Through media also government gives the information of paid method.
4. **Tax system is flexible:** The system is flexible because every year government changes its tax interest and revenue.
5. **Quality of Production:** The income received from the tax is increasing income received from the central government, union territory and state government (direct or indirect) is increasing continuously.
6. **Direct and Indirect taxes:** There are direct and indirect taxes in India every person effected by it. On one hand Direct taxes are for the rich class but on the other hand other sectors of the society also pays indirect taxes. The contribution of indirect taxes are more in India.
7. **Maximum social profit principle:** Before applying taxes, government takes care of the fact that it should not affect saving or production and people can get maximum social profit for welfare.

There are some weak Points in the Indian Tax system

Inspite of having some Qualities there are some disqualities also which put a Question mark on the qualities. There are:

1. **Not Extravagant:** In India, there are extra expense on taxes which in comparison of the revenue is growing. From Revenue not much taxes are recieving because of the corruption.
2. **Un-skilled administration:** Administration related to the Tax system is not able and because of that taxes are efficiently receiving by the administration.
3. **Tax Evasion:** Tax evasion is a common thing. The upper and rich class who do not get income from the government, mostly presents fake documents and becomes successful in tax evasion.
4. **Burden of Indirect Taxes:** In India direct taxes are taking a backseat, this is why Tax evasion is taking place on a large scale. According to the Estimates in the past year percentage of indirect taxes increased and this is the burden on the poor class. In opposite of this rich class is not paying tax according to their capability.
5. **Less Burden on Rural area:** In India Agriculture is tax free although it is the main source of income in rural area. In this land owners can pay the Agriculture Tax . In opposite, on urban area the burden is increasing day by day.
6. **Discrimination in Social justice:** In India taxes are considered as the weapon of social justice But taxation is not successful in India. On one side where the upper class can pay the tax but they avoid it and instead of than lower class have to tolerate the burden.

Despite having the above disqualities, India is still progressive in the improvement area. That is why Indian government time to time sets a committee and in present also it is still in the path of improvement.

Did You Know? Indian Tax system is practically a multi tax system.

Self-Assessment

Notes

Fill in the blanks:

1. In 1953 under the chairmanship of ..... an investigation committee was set up to improve the tax system and to abolish the inequality of income.
2. ..... suggested to apply new tax system in country.
3. To make direct taxes more simple in March ..... Bhutlingam committee was appointed.
4. Indian Tax System is according to the..... principles.
5. In India taxes are considered as the ..... of social justice.

25.2 Indian Tax Structure

In India there is a union government according to which central and state's sources of income are clearly distinguished. Constitutionally there are some rights given to the state and central government for applying taxes. Like this only Local agencies in state like Gram Panchayat, Municipal Corporation, District Board can also apply tax which is related to the local finance.

Sources of Revenue of Central Government
or
Major Taxes of the Central Government

Tax is the main source of income of the central government it can be divided into two parts:

(I) Tax Revenue

(II) Non-tax Revenue

I. Tax Revenue

1. Income Tax:

Except Agriculture tax, any income from any other sources of an individual comes under income tax and central government applies this it is known as income tax. From the income tax, which ever revenue is received is divided between state and central government. According to the 10th finance commission's recommendation from the revenue income tax of 77.5% is given to the states. Penalty on income tax cannot be divided as it is the right of the central government

Qualities of Income Tax: Following are the qualities of income tax.

1. Income tax is dependent on development. As the income increases, tax also increases. In the way this tax is based on the Ability to pay principle which means who have the capability to pay the tax, should pay more tax.
2. Income Tax does not apply on total income but on Not Revenue. Not Revenue is that which one get from all the wastages.
3. Income tax is applied on that income which one get in a year which is known as the financial year.
4. Income tax applies on regular income but the income which is received 'in sudden' also comes under the tax. This is categorised, under the 'Income from other sources'.
5. Up to a limit income tax does not apply which known as the discount limit. In present it is ₹ 200,000 in a year.

Notes

6. To develop taxation, a support of slab system of Taxation is taken and on higher income slab, high interest tax is taken.

For applying income tax, division of income: Income is divided into five parts-salary, property, Business, capital gain and any other source which includes profit.

Administration of Income tax: For income tax, income can be decided in two ways, **firstly** on source (like A government employee's salary is given only after deducting income tax) **Secondly** income receiver is allowed to present his income description on its basis income tax is decided.

Effects of income tax: If income tax is very progressive then it affects opposite on saving and investment and because of that production level lower down. When big part of people's income transforms into tax then people did not get interested in saving and other work. But government always tries to load this burden on strong shoulders. By looking at the finance need of the government opposite effect of the income tax cannot be described. As far as the distribution of income tax is concerned it is accepted as influential because through it inequality can be abolished. With this economic stability can be made up through this.

Merits of income Tax: In income tax following merits are there.

1. This tax in compare of other taxes is more able in interest ratio because it has deductions and extra taxes.
2. With the income tax inequality of income and property can be abolished because it can be made progressive.
3. Income tax cannot be transferred. So the burden of the tax lie only on that person on whom the government impose it.
4. Income tax can be used to maintain economic stability in the period of Boom and Depression.
5. Where other taxes forces consumers to cut down their expenses, income tax does not limit expense in any direction. Like if selling tax applies on sugar then the person will cut down its intake but because of export-import tax sugar consuming will not lower down.
6. Income tax is a producer because government gets heavy income from it.
7. Income tax is very flexible. A little increase of income tax means increase of income.

Demerit of Income tax: It does not encourage saving and investment.

1. Income tax discourages the savings and investment.
2. Sometimes it has the possibility of Double Taxation.
3. Tax evasion is more in Income tax, this means people who are capable of giving Taxes, they hide their income or give false account. In the year 1995-96 in India tax payers were only 120 lakhs who were less than 1.25% of the total population.

Task Write the Merits of Income tax.

1. Income Tax in India: A Critical Observation

Like in developed countries in India also Income tax is not the main source of Revenue. In even 1% population did not pay the tax. The reality is that the people who are capable of giving taxes cannot be identified and they are involved in tax evasion. It is estimated that in present time almost 2/3 tax

Notes

did not pay in the Country, Which is the highest number in tax evasion. To stop this government have made the maximum interest per person 30% and for partnership firm etc. it is 35%. In 1991 improvement procedure started and according to that income tax system because more simple as the rates declined. Now in (2010-11) following are the income tax rates-

Income scale	Rate (%)	
Upto ₹ 1,80,000	Zero	Except this income exceeding
1,80,001 to 5,00,000	10	60 thousand gets 5%
5,00,001 to 8.0 lakh	20	surcharge which was imposed
8.0 lakh (and above)	30	in 2002-03.

2. Corporation Tax

Corporation tax is that which is applied on Corporation and company's profit. In 1959-60, it is known as the Super Tax. After that it included in the tax of income and named as Corporation tax. After deducting interest, wages etc. they are paid during the year when the corporation gain that. Like an Individual tax, before appling corporation tax salary securities, property and income from other sources are included. Though incentives and deduction are also kept in mind. Surcharges and Taxes both can apply on the companies which can be declared in the budget.

In 1959-60 on the basis of 1956 **Koldar committee**, the corporation tax which was adopted is same as classical thought. According to this approach, identity of company or corporation is different and for this reason different corporation tax can be applied on the total profit of the company Chelyah committee (1991) had investigated corporation tax. This too supported classical approach's and recommended that in 1992–93 to 1994-95 corporation tax should be lowered down to 40 %. But in 1992-93 and 1993-94 no step was taken in this direction In 1994-95 on domestic company's corporation tax rate lowered down to 45% and 40% and for foreign company's 55%.

In 1996-97 budget, zero tax companies came under the minimum alternative Tax-Mat. In 1997-98 there taxes were further decreased to from 40 % to 38 % and 55 % to 48 % for domicile and foreign co' in 200-01 budget the rate of mat was declined from 10.5 % to 7.5 % in 2001-02 budget surcharges on corporation taxes were completely ended. and only 20 % Gujarat surchange remained. In 2002-03 Budget domestic company's corporation tax rate left on 35% and for foreign companies it became 40 %.

In present government received more revenue from corporation tax. In 1970-71 it got 371 crores which increased in 1991-92 in to 785 crores and in 2002-03 budget it became 48616 crores Total central tax of revenue estimated 20.62%.

3. Wealth Tax

Wealth Tax applied on an individual's wealth or money every year. This is applicable on both Business commercial Company and in corporations.

In India 1957 because of Prof. Koldar's recommendation it was started. According to him if property tax is applied then it can become a base for giving tax through which administration can easily be handled. Property tax doesn't affect saving as it does income tax.

Merits of the wealth tax

1. It is applied from the progressive rate.
2. This tax is applicable every year on individuals Hindu joint families and private commercial Company's net property.

Notes

3. Property's evaluation of done on Market rate which is done on basic rules.
4. It is administrated by income tax department.
5. Some properties are free from tax like Grant in properties agricultural property, Insurance policy, private furniture, jewellery etc.

Rates of Wealth Tax- The rated of wealth rate in present day are: Upto15 lakh–zero; above 15 lakhs-1%.

Criticism of wealth tax: these are the following.

1. It is criticised became it is applied every year which affects savings and investment but one thing is there that in comparison of income tax it has less negative effects.
2. It is also criticised as it is applied on companies but it is justified as the power of the company remain in few hands and have expanded money.
3. Evaluation of the company is a complex task that is why administration of wealth tax is difficult.
4. That property which does not include income seems burden on people because of the tax.

4. Capital Gains Tax

Capital gains tax means the increase of price of property in this way it means that gain which is higher of selling price than of cost price of any assets. If property does not sale out then this profit cannot be received. Capital gains tax is applied on realised capital gains. It is clear from an example. Suppose a man buys a house of 25 thousand and sells it at the price of 32 thousand now it gets the profit of 7 thousand and on this capital gain tax applies but one thing is that, that if a person involves in the business of buying and selling then this tax is not applicable to him.

5. Expenditure Tax

Expenditure tax is a direct tax which applies on people's expenditure on consuming goods. In India it is first suggested by professor. Koldar according to him as compared to income tax expenditure tax is far more better because it doesn't affect savings and it is also helpful in avoiding tax evasion. This tax is suggested to be progressive. In India expenditure tax applied in 1958 April but after looking its revenue which was not enough it was ended in 1962. In 1964-65 it was re applied but in 1996-67 again it was removed.

This tax was applied only on individuals and not on companies Before applying it some deduction in salary were given and some expenditures remained tax free

Expenditure tax regulation: In Nov. 1987 it was again started and this time it was applied on those people who spend money in big hotel's room, food – drink etc.

6. Interest Tax

Interest rate is a central direct tax – it was first applied in 1974 and in 1978 it was dismissed – again it came in light in 1980 and 1985 once more it was dismissed. Now third time it is appointed by finance regulation 1991, and applied in the year 1992-93 this tax is applied on banks. Public finance agencies, state finance corporation on their gross income which they got from India. Interest tax applied on 3% rate under income tax regulation through finance agency interest rate is considered as the gain of their business. The administration of this tax is done by the income tax official in 1993-94 budget to encourage export and import related loans are kept tax free.

7. Central Excise Duties

Notes

One of the main source of the income of Indian government is central excise duties. Central Government can apply taxes on all the production except alcohol, drugs and other alcoholic things in India. All the alcoholic things comes under state government production tax divides between the state and the central government which is done on the recommendation of finance commission.

Production tax is an indirect tax which is paid by the producer but after including them in prices they becomes the responsibility of consumers. Initially it was applied only on 15 goods but now it covers a large number of goods. At present, central excise duties are the only big contributer of revenue.

Notes Interest tax rate was first applied in 1974.

Aim of Central Excise Duties: This is one of the famous tax and it aims are as following:

(i) To increase finance resources as it is a production tax

(ii) Being an indirect tax its burden is on both rich and poor consumer

(iii) With these taxes small scale business can be encouraged because industry made product tax can be applied and with this small scale business become tax free.

(iv) This type of tax can control inflation.

Kinds of Excise Duties

Excise duties can be divided into three parts (1) based excise duty (2) special tax and (3) instead of setes tax, extra excise duty. The structure of excise duties changes time to time. In 1957 extra production tax applied which is distributed among the government.

In favour of excise duties

(i) These taxes are productive and flexible.

(ii) Tax applied more on luxurious items so that more tax can be given by rich class and with this inequality of income can be avoided.

(iii) Consuming can be controlled by applying tax on injurious items.

(iv) These are simple as they can be received by the consumers very easily.

Against excise duties

(i) These taxes affect negatively on production and appropriation.

(ii) By applying taxes on general items, consumption of the poor class becomes low.

(iii) If consuming of the goods becomes less, it will lower down the government revenue.

Central excise duty expanded in 1960 and 1970. In 1944-75 around 128 goods came under the tax which included ready goods, raw materials and intermediate goods tax effect is cascading. **L.K. Jha** committee long term revenue policy and Chelyah committee recommended that to avoid side effects of the tax it is essential to apply VAT. In 1986-87 in central budget MOD-VAT applied as the main aim of applying this was to lower down the effect of casecading.

In 2000-01 budget improvement was done in the central excise duties. On the first step of the production 16 % on one rate CENVAT applied on some special items it was 8% 16% and 24% on three rates. In 2002-03 where Presenting budget finance minister said that in the last 2 years improvement had lower down many cases. So this year many items were out from the list of 16% of special excise duties and it was applied only on 8 goods.

Notes

In 2002-03 the estimated cost of excise duties was expected 91,433 crorers but in the total centre tax revenue it was lowered down to 39 %.

8. Custom Duties

Custom duties applies on goods like any other tax – they are applied like **ad–valorem** or specific. These types of taxes are progressive which are based on ad-valorem and specific taxes are known as special taxes which applies according to the number, size and weight of the goods. Custom duties are of two types (i) Import duty and (ii) export duty. It is not definite to say that on which sector the burden of this tax lies. Actual situation is that the burden of custom duties on import duty and on flexibility of demand and supply.

Export duty: Goods which are sent to foreign countries from India, export duty applies on that. This is not only the main source of government – income infact it has some important economic effects like export duty on raw materials will lead to the availability of the cheap raw materials to the industries. On the annual budget export duty also announces.

Import duty: The aim of import duty is to discourage these items which affect the county's production. With this government also gets income. In India it is applied according to the Indian Tariff Regulation, 1934. Rates of 1934 first and second list it is applies differently on various items.

Like any other Interest rate improvement had also done in the of custom duty. In 1985 policy to control the import dependence on tariff increased in 1991 Chelyah committee suggested that on ready goods tax should be applied.

In the next years also improvement in custom duties continued. In 2002-03 in budget announcement was made that in the year 2004-05 the rate will be of two basic level on raw materials and intermediate it will be 10 % and 20 % on ready goods. Because of this in 2002-03 rate will be decreased to 3% from 35%.

9. Service Tax

Tax improvement committee (Chelyah committee) recommended service tax in its last report part 1(1991), the reason behind the tax was not only to increase economic development but also to increase percentage of gross domestic. Production tax and Revenue production will start decreasing. To increase the production service tax should be included. With this many weakness can be ended while choosing goods by the consumer. In the presence of service tax, people expense more on services and decrease savings. If service tax is not applied then consumer will not get the advantage of VAT credit. Chelyah committee suggested 10% service tax on many goods and services like advertisement, insurance, share market etc.

After looking into the matter central government applied tax in 1994-95 of 5% on three services – telephone, general insurance and stock middleman, with this 407 crores revenue received. In 1997-98 ten more services covered the tax which increased in 1998-99 to 12 services. In 2002-03 Budget ten more services were included.

Service tax applies on banking and non-banking finance Companies. In 2002-03 Budget services provided corporation also included in this area. After lowing at the tourist business which was lowering down in Dec 2001. Hotel service tax postponed to 31 March, 2002 which was further postponed in 2002-03 Budget to 31 March, 2003.

Notes

Revenue received from the service tax is as follows.

					(in crores)
	1994-95	**1997-98**	**1999-00**	**2001-02 (amended)**	**2002-03 (budget)**
Service tax Revenue	407	1586	2128	3600	6026
Central revenue %	0.7	1.1	1.3	1.8	2.5

From the following data it is clear that revenue received from the service tax increased. In 1994-95 and 2002-03 around 15 times increase is there central revenue % which was less then 1 % in starting increased to 2.5 % in 2002-03 there are 2 main factors of this increase.

1. In GDP, continue increase in service tax and
2. Services increases which comes under the service tax. Those service on which taxes applied are- chartered accountant, cost accountant, company secretary, life insurance, storage, railway journey agent, health club, beauty parlour, cable operator, dry cleaning etc.

Do You Know? Service tax applies on banking and non banking finance company through special services.

II Non–tax Revenue Sources

Non tax revenue sources of the central government are as following.

1. **Currency and mint:** Central government has right to make currency notes and coins thought which it gets good income every year.
2. **Post and telegraph:** Post and telegraph services are one of the main source of the income of central government. Every year government amends the rate of post and telegraph to increase the revenue.
3. **Administrative services:** Government gives different types of administrative service, citizen administration and to maintain peace and in return receives taxes.
4. **Profits of public enterprises:** Public enterprises are one of the main source of income though at present government faces loss due to public enterprises but enough income is contributing through it.
5. **Loan services:** Central government gives loan to states and other agencies from time to time and get interest in the form of revenue.
6. **Rail service:** At present rail service is one of the main source of income of the central government.
7. **Others:** River projects and other social service are also one of the main source of revenue.

Major Taxes of the State Governments

India has a union structure and every state prepares its income expense budget. State government is allowed to apply some taxes.

Notes

State's income which it gets from taxes can be divided into three parts i.e.

1. **Tax on Income –** (1) agricultural income tax (2) commercial tax
2. **On Property and Assets Buying and Selling Tax –** (3) stamped and registration tax (4) Land revenue (5) Urban fixed assets tax.
3. **Tax on Commodities and Services –** (6) Sales tax or trade tax (7) state excise duties (8) Entertainment tax (9) Vehicle tax.

(I) Taxes on Income

1. **Agricultural Income Tax:** Agricultural tax applies on the income produced by the agriculture. Before applying tax deductions take place in the peasants income; like expenses on irrigation, land revenue; local tax etc. Rates of these taxes are like same slab system as of individual tax these taxes are progressive – this is not applied on all the states – at present agriculture tax is in Assam Karnataka, Kerala, Tamilnadu, West Bengal, Orissa, Rajasthan, Bihar etc.

   This type of tax is different in every state. Bihar was the first state where agriculture tax was applied in 1938.

   A controversy related to agriculture income tax is always happened and there are some factors in favour in and against it one of the merit is that after looking at the growing work of states it get income from this tax Indian taxation investigation committee 1925 said "In income tax there is not any historical or theoretical point to make the income from agriculture free" one of main factor against it that on farmers it is a burden and its administration and arrangement is difficult. States does not get any income from, it as far as the question of burden is concerned only peasant class can tolerate its burden as they get maximum income from agriculture.
2. **Profession tax:** This is applied by the state government on different profession. On a limit it is discounted, rest of the income credited on progressive rate.

   Enough income is not received by this tax. That is why it is ended by many states. Madhya Pradesh government Announced in 1991-92 financial year to end this profession tax.

(II) Tax on Property and Assets Buying and Selling Tax

3. **Stamps and registration fees:** State government gets income from legal and non legal stamps. Except this before registry state government receives tax – this is one of the main sources of revenue.
4. **Land revenue:** Land revenue is also one of the main source of income and from the starting it was an important source. But at present selling tax is one of the tax which gives most of the revenue. It has rates different in different states but now because of land revenue it has getting some similarity.

To apply land revenue three strategies are applied

(i) **Net produce:** In Tamil Nadu on the basis of net production land revenue receives which means from net production agriculture tax deducted which results in net produce.

(ii) **Economic Rent:** From not production economic rent deducted and which is the base of land revenue. This is famous in Uttar Pradesh, Madhya Pradesh, Punjab, Himachal etc.

(iii) **Empirical basis:** In this some empirical things have to kept in mind to apply land revenue like situation on of land, market situation, kind of soil etc. It is mostly applied in Mumbai, Karnataka, Andhra Pradesh.

This is also appropriate that this kind of land revenue is postponed in these areas which comes under natural calamity like famine etc. The rate of land revenue is remain in ratio so mostly poor comes under this burden.

5. **Urban fixed property tax:** From this not much income received by the government.

Notes

(III) Tax on Commodities and Services

6. **Sales tax or trade tax:** Selling tax is important. For revenue because from this state gets most of its income the reason of this is that increasing of production led to the domestic business. In 1939 this tax was applied for the very fisst time. Except newspaper this tax is madras applied on all the goods which sells within, the country this tax applies on the sellers/shopkeepers which is mixed with the good's cost and received by the consumers. Here one need to differentiate between general sales tax and selective sales tax. If all the goods which sells by the shopkeeper comes with the tag of tax then it is general sales tax but if tax applies only on selected items then it is selective sales tax. Actually general sales tax does not applies in any state.

   In 1956 Indian government Passed the central sales tax regulation and applied tax on those goods which is exported Internationally from which state, goods goes out only that state can apply the tax and also gets revenue. Sales tax is a controversial topic and it is always opposed. It is also becomes an electoral topic but then also it is not ended because state opposed this as it is their one of the main source of income. In every state the rate of sales taxis different. From the sales tax, revenue could not be received as we have to be because it is not paid honestly and secondly government official who are involved in this does not work honestly.

   In 1991 tax improvement procedure started in which sales tax was one of them. Instead of sales tax, state applied VAT. In 1999 in the conference of state's chief ministers it was decided to apply VAT. in 2001-02 it and was decided that in April, 2003 VAT will be applied in the states.

7. **State excise duties:** State governments have every right to apply taxes on alcohol, drugs and things like that, tax applies on them in two conditions first when they are produced in the state and second when they enter in the state. The main aim to apply this tax is not only to receive revenue but also to limit their use. State excise duty applies on different rates in different states. In these states where no alcohol policy is still not alcohol is restricted fully or partially they get less revenue, it is one of the debateable topic that weather to ban then or not but government. Should not depend on them.

8. **Entertainment tax:** This tax applies on cinema, theatre, wrestling song- dance etc. This is an indirect tax which goes in the credit of the viewers. At present it is giving enough income to the state government.

9. **Tax on motor vehicles:** State government have right to apply tax on motor scooter and other vehicles. As the transport is increasing in India especially two-wheeler, the revenue is also increasing.

Task When did the decision take place to apply VAT?

Major Taxes of Local Self Government

In local government municipality gram, Panchayat and district board involved.

After looking at their expense state government has given then rights to apply some taxes. These taxes can be divided into two parts direct and indirect taxes.

Notes

(I) Direct Tax

1. **Property tax:** This an important tax of local agencies there are of four types – on houses, property transferred tax and on land and on its improvement. Property tax applies in two ways general and service tax.

   General tax: Tax which applies annually on property is known as general tax.

   Service tax: This applies on water, education, electricity etc.

   This applies on the basis of assets. It is applied on the progressive rate and it is flexible tax. But one of the Demerit of this tax is that it gives birth to corruption.
2. **Profession tax:** This is received in the form of license fee and different tax applies on different profession.
3. **Transport tax:** This tax applies of tonga, rickshaw, cycle, bullock cart etc. It is not applied on motor vehicle.
4. **Market tax:** This tax is applied by Municipalities or gram Panchayat on businessman who sells goods in the market.
5. **Road tax:** This tax applies those bridges which is constructed on high rates and on people and vehicles passing through it.
6. **Status tax:** This applies on individuals social status, economic status and on the bases of the number of family members

(II) Indirect Taxes

It is divided into two (1) Octroi tax (2) Terminal Tax.

1. **Octroi tax:** This is the main source of MCD and on that area of MCD which is used for production or selling on goods. Goods which are out of the MCD area does not pay this. octroi tax has a demerit that it increases corruption as most of the income did not go to the MCD, also the poor class gets its burden.
2. **Terminal tax:** Whenever goods enter in the boundary of MCD, goes out from the area of MCD or passes through its boundary.

   The difference between Octroi and terminal tax is that Octroi tax applies while entering in the area where as terminal tax applies in both the condition on entrance. and exit at that time of the train journey terminal tax included in the fare which goes to the MCD.

   In Indian constitution partition between state and central is done in such a way that most of the work goes in the credit of states. But they are not getting finance sources to complete the work.

   That is why in Indian union arrangement vertical financial inequity is there. This was also felt by the constitution assembly so finance commission arrangement was already done in the constitution so that financial inequality between state and central government can be avoided by the transfere of financial sources. This Transfere is done in two ways – by giving state its part in central tax revenue and by giving grant–in–aid.

Self-Assessment

Multiple Choice Questions:

6. Which of the finance arrangement is in India?

   (a) Union (b) District

   (c) State (d) None of the above

Notes

7. Except agriculture tax, personal income from other sources is allowed to apply which tax by central government?

   (a) Sales (b) Income tax

   (c) Corporation tax (d) Property tax

8. In 1959-60 corporation tax was known to which name-

   (a) Income tax (b) Property tax

   (c) Super tax (d) Tool tax

9. What is the meaning of Assets gain?

   (a) Decrease in property's price

   (b) Same property price

   (c) No change in the rate of property

   (d) Increase in property's price.

10. When was the interest applied first time?

   (a) 1974 (b) 1975

   (c) 1976 (d) 1980

25.3 Summary

- After independence Indian government established investigation commission and committee to improve Indian tax system. In 1953 under the chairmanship of Dr John Mathai an investigation committees was set up to improve the tax system and to abolish the in equality of income.
- To make direct taxes move simple 'Bhutlingam committees' was appointed in March 1968. To stop the tax evasion Vanchu committees was also established in 1970. To improve the indirect taxes in July 1976 investigation committee was made under the leadership of Shri L.K. Jha after that to simplify the rules of direct taxes another investigation committee was established under the chairmanship of Shri C.C. Chowki:
- After the independence, socialism was established in Indian tax system to lower the gap of income inequality for this objective Indian tax system was centralised on tax action structure.
- The aim of Indian tax system was not only to earn revenue but to establish socialist economy. It was also kept in mind in Indian tax system that taxation has no reverse effect on appropriation, saving and production and state governments were also given rights to impose certain taxes.
- In India both direct not affect and indirect taxes applies by which every individual affected in one or the other way. In India there is a union finance arrangement. In constitution there are some lights given to the state and central government for applying taxes.
- If income tax is very progressive then it affects opposite on savings and investigate and because of that production level lower down.
- Like in developed countries in India also Income tax is not the main source of Revenue. In total population even 1% did not pay the tax. Of the realm in that the people who are capable of giving taxes cannot be identified and they are involved in tax evasion.
- Corporation tax is that which applies an corporation and Company's profit in 1959-60 it is known as the super tax. After that it included in the tax of income and named as corporation tax.
- In 1959-60 through Coldar committee in 1956 the corporation tax which was adapted is as same as ' classical thought – according to this approached identify of co. or corporation is different and for this reason different corporation tax can be applied on the total profit of the co.

Notes

- Wealth tax is applied on individuals wealth or money every year. This is applicable on business commetical Company's and on corporations.
- One of the main source of the income of Indian government is central Excise duties – central government can apply taxes on all the production except alcohol drugs and other alcoholic things in India. All the alcoholic things comes under the state government.
- Central Excise duty expanded in 1960 and 1970 in 1944-75 around 128 goods came under the tax which included ready goods, raw materials and intermediate goods. On raw materials and intermediate goods tax effect is cascading which is not right according to economy.
- Tax improvement committee (Cheliyah Committee) recommended service tax in its last part (1991) The reason the tax only to increase economic development but also to increase percentage of gross domestic production tax and revenue production will start decreasing to increase the production service tax should be included. With this many weakness can be ended while choosing goods by the consumer.
- In 1956 Indian government passed the central sales tax Regulation and applied tax on these goods which is exported internationally. From which state, goods goes out only that state can apply the tax and also gets revenue State tax is a controversial topic and it is always opposed. It also becomes an electoral topic but then also it is not ended because state opposed this as it is their one of the main source of income.
- In local government Municipality, Gram Panchayat and district board improved. After looking at their expense state government has given then right to apply some taxes.

25.4 Keywords

- Surcharge – Extra tax
- Cascading – A rock whose edge is sharp and standing
- Lagaan – land revenue.

25.5 Review Questions

1. Explain the features of Indian tax system.
2. What are the good qualities of Indian tax system?
3. Write the sources of income of central government.
4. Comment on the following.
   (a) Corporation tax
   (b) Property tax
   (c) Service tax
5. What is income tax? Write its merits.
6. Explain the main taxes of state government.
7. Describe main taxes of the local agencies.

Answers: Self Assessment

(1) Dr. John Mathai		(2) Prof. Koldar	(3) 1968
(4) taxation		(5) Weapon	(6) (a)
(7) (b)	(8) (c)	(9) (d)	(10) (a)

25.6 Further Readings

Notes

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Notes

Unit-26: Recommendations of Shri L.K. Jha Committee

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Understand the conclusions and recommendations of Jha committee
- Know the findings of the committee.

Introduction

To improve indirect tax system central government setup a committee in July 19, 1976 under the chairmanship of Shri L.K. Jha. Other six members of the committee – Shri M.B. Arunactialam, Dr. Raja. J. Chelliah, Shri J. Sen Gupta, Shri J.V Nevalkar, Sri Manmohan Singh and Sri K Narsimaha were appointed. But in September, 1976 instead of Shri Manmohan Singh, Shri S.S Marathe – chairman, industrial cost and price bureau was appointed and Shri. K.N. Narsimha was appointed as the committee secretary.

Terms of Reference

Committee had to give its final recommendations after the discussion of the following:

1. Review of central, state and local agencies present indirect tax structure.
2. Contribution of indirect taxes to encourage complex resources used in economy use.
3. Production taxes structure and level, effect of these taxes on prices, cumulative effects of the tax, final burden of these taxes on different expense group and to check the flexibility of the area of tax.
4. To check the feasibility of applying value added tax and if they are found feasible then suggestions should be given about these taxes that in which situation these taxes can be applied on the whom – producers, wholesaler or retailer?

5. Whether to give grant of concessions in the form of indirect taxes to specific industry? If given then at which limit? To check all this.
6. To check the level of export – tax, structure of export central protection of country's industries and to limit the prices of goods. If necessary, suggestions should be given to change them.
7. Suggestion should be given to apply recommendations of the committee by the government (appointment of administration and party changes also included).
8. If necessary, changes in constitution and tax related suggestions can be given by which state and central government can fulfill their financial needs.
9. To balance between direct and indirect taxes in resources.
10. If any other thing is observed, it should also be recommended.

26.1 Summary of Conclusions and Recommendations

Indirect tax investigation committee which is known as L.K. Jha committee gave its report on April 1977, to the government Committee had completed its work. During their investigation what the committee experienced seen and their findings Summary, conclusions and recommendation are following:

Notes In April 1977, Jha Committee gave its report to the government.

Observation

Investigation committee of indirect taxes experienced that the main objective of the tax is to make resources available for social and economic development. But the way by which resources are available through it, only burden lies on the economy and on the society which is having bad effects. According to social viewpoint only that system will be considered better which is according to the social justice. In the view point of economy a better tax system is that which encourages economic activities. This can happen only when resources are available and they can be used efficiently without any wastage. So in this way before applying tax system these objectives should remain in mind. Taxes cannot be imposed blindly as they increase revenue or solutions can be made of the special producers. If Revenue need to increase then it has to be done in a way so that structural balance should remain balanced. In regard of this, Committee believed that it can be possible only if tax system is efficient and changes according to the recommendation.

Do You Know? Taxes should not be imposed blindly.

Self-Assessment

Fill in the blanks:

1. In ..... under the leadership of Shri L. K. Jha a committee was set up.
2. Indirect tax investigation committee is known as ..... gave its report on April, 1977.

Notes

3. In the Social view point only that system will be considered better which is ..... to the social justice.
4. In different states, distribution of taxes is also .....
5. In the Jha committee there were ..... members.

26.2 Findings of the Committee

Committee in its report threw light on their findings and also recommended some changes. Committee experienced that the present indirect tax system of India is defective and in central, state and local agencies there is no sign of coordination in indirect tax which is independently applied by them. There is no consistency in the structure of main taxes of the government and because of this, economy is affecting. According to the committee these objectives should be there to improve tax system. Tax system should be like, all the taxes cover each other and their internal structure should be fixed in a way with which same indirect tax system will apply in a country. **Committee mentioned following deficiencies in the tax system.**

1. Government imposes taxes on raw materials, exported items, production and selling only to increase Revenue. What will be the economic consequences of applying these taxes' government is less worried about this question.
2. Production and selling capable taxes covers each other. This means that there are so many items on which both production and selling tax applies.
3. In different states distribution of taxes is also different. The reason of this is a specific state, exports its taxes on another state.

Task What are the defect of Indirect tax system?

26.3 Recommendations of the Committee

Committee presented its report before the government in October, 1977. In which following recommendation were there to improve tax system:

In relation to the excise duties following recommendation are there:

(a) Rationalisation on final products should be done in such a way so that progression can be easily done and economic necessities can also be fulfilled.

(b) Rationalisation on raw materials should be done in such a way that same rule applies for its competitors also. Otherwise in economy there are some economic reasons in which competition is there. In the part if on any item tax rate is high then it will not let down then whole economy's production cost.

(c) The problem of production tax should be solved in the fixed period and some steps have to be taken like – in input taxation facilities should be increased and their area of scope also and on the construction stage tax should be imposed together as an amount.

Import duties: In related to this committee in take is that export tax is imposed mainly on raw materials, intermediate products and machines etc. with this cost price structure normally increases which is a limitation. This affects international market.

Self-Assessment

Notes

State whether the following statements are True or False:

6. Committee presented its report in Oct. 1977.
7. Export tax should be imposed mainly on raw materials, intermediate product and machines etc.
8. Rationalisation on final products should be done.

26.4 Summary

- Investigation committee of indirect taxes experienced that the main objective of the tax is to make resources available for social and economic development. But the way by which resources are available through it, burden lies only on the economy and on the society which is having bad effects. According. to social viewpoint only that system will be considered better which is according to social justice.
- Committee in its report threw light on their findings and also recommended some changes. It experienced that the present indirect tax system of India is defected and in central, state and local agencies there is no sign of coordination in indirect tax which is independently applied by them. There is no consistency in the structure of main taxes of the government and because of this economy is affecting.

26.5 Keywords

- Concession – economic help
- Feasibility – easily.

26.6 Review Questions

1. According to which thoughts committee gave its final recommendations?
2. To improve indirect tax system what were the recommendations presented by the Jha committee?
3. In related by the export tax what were the Jha committee's recommendations?
4. Throw light on Jha committee's findings.

Answers: Self Assessment

(1) 19 July 1976	(2) Jha	(3) Social	(4) different
(5) 6	(6) True	(7) False	(8) true

Notes

26.7 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Unit-27: Recommendations of Raja J. Chelliah Committee on Tax Reforms

Notes

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know the Chelliah committee recommendations
- Find information of the commission
- Understand Tax Bureau.

Introduction

After the independence tax system changed many times all most in every budget rates changes of taxes and also many rules were formed for tax evasion. But neither tax evasion stopped nor taxes were paid honestly. To remove these difficulties and to stop tax evasion a **Bar Committee** was set up under the chairmanship of **Dr. Raja Chelliah,** who submitted his report to the finance minister **Dr. Manmohan Singh** on 28 Aug.1992. Chelliah committee suggested many important and practical points for the improvement of country's tax system.

27.1 Recommendations

Committee recommended following recommendations to encourage direct or indirect tax, foreign investment and capital investment by non-residents of India:

Corporation Tax

Related to the direct taxes committee important recommendation is regarding to the corporation area. The committee recommended that the present rate of corporation tax should be deducted from 51.75% to 45% till 1993-94 and in the next year it should come down to 40%. Presently on foreign Companies Corporation tax is 65% and on Domestic companies it is 51.75%.On this Corporation tax committee recommended that this difference should be lower down to 75%. According to the committee foreign company's tax should be 47.5%. by deducting this tax from 65% to 47.5% means coming of foreign currency in the country.

Notes

Non-farmer's Agricultural Tax

Committee recommended tax on agriculture. From so many years it has been discussing about the agriculture tax, But because of political reasons no decision has been taken yet. According to the committee big farmers who don't do agriculture themselves but have enough land and keep other farmers to work on their land tax should be imposed on them on income exceeding ₹ 25,000.The committee recommended to add this income in non-agriculture and then tax imposed on them. According to the committee this can control black money and tax evasion and also increase revenue.

Ban on Frequent Changes of Taxation

The committee also recommended that every year in budget taxation should not be changed. It should be kept intact at least for 5 years so that industrialists can make their planning of expansion and development. According to the committee frequent change can led to the confusion and interference in economic development.

Notes Every year change should not takes place in Taxation.

Factual aim

According to the report of the committee, structure of tax becomes wrost because of high rates, repetition of Terminal Tax, changing of law without argument and deductions in taxes: Committee recommended to the government to keep its aim intact and that time increase the development rate of economy.

Settlement Commission

Income tax officials don't have the right to settle and it takes long time in court, that is why committee suggested to make settlement commission which solves the problems related to the taxes. But the committee also warned not to shield Tax evasion in this. According to the committee, commission should not avoid any cases of objections by main officials.

Tax Investigation Bureau

To make tax structure stable committee recommended to establish investigations Bureau. The work of this committee is to investigate work related to tax and to start common argument. After this these change which will be approved they should be applied in minimum number at least once in 5 years.

Administrative Weakness

While inspecting tax administration, committee mention in its report that the administration does not work properly because of lack of trained officials, not working of administration efficiently, interference of political leaders in the administration matters and without thinking nature of appeal takes place. Committee recommended official to be responsible in their work for the betterment of

administration. On one hand the committee suggested to reward the capable and honest officials and on the other hand it is recommended to take strict action against uncapable officials. According to the committee for the time being Instead of punishment under Tax act, there should be a provision of extra interest or late duty. Related to this, directors and commissioners should be given rights, this is the opinion of the committee.

Do You Know? Committee recommended officials to be responsible in their work for the betterment of administration.

Other Recommendations

Committee recommended to end the interest-rate. It is also recommended to computerise the whole tax system.

Conclusion

Chelliyah committee suggested some important recommendations to improve tax–system, if applied honestly they can prove important and practical. Committee recommended to lower down the corporation tax from 51.75% to 45% till 1993-94, this means that from the next year it is essential to pay 40%,this increase the capital investment in the country. Committee's suggestion is depend on the government's decision but if tax evasion have to stop than tax rate should be lower down. To make corporation tax rate 40% is reasonable because in developed and underdeveloped countries corporation tax is almost 35% which is given in the table:

Rate of corporation tax in different countries.

Country	Rate of corporation tax (in %)	Country	Rate of corporation Tax (in %)
Brazil	30	Sweden	30
Mexico	35	Peru	35
Malaysia	35	Pakistan	40-50
Indonesia	15-35	Taiwan	25
Britian	35	Thailand	35
America	35	Argentina	36

The difference between foreign companies and domestic companies cooperation tax encouraged to brought down 7.5%. In other words cooperation tax of foreign countries can lower down from 65% to 45% to increase foreign investment. This led to the encouragement of foreign companies and non-residents of India's investment. Committee's recommendations of coorporation tax is practical and useful according to the Indian circumstances.

There is nothing new recommendation to impose tax on non farmer's agriculture tax. India's first finance minister **Dr. John Mathai** in 1953 and in 1973 **K.N.** Committee already recommended that. So this is in discussion since very long But the government never dared to bring it under terminal Tax because of political vote. **Chelliyah** committee recommended a new way. In India there are mostly farmers who have small land and they are not in the position to give income tax this thing is clear but on the other hand where big farmers have workers on their land and not applying tax on them is a

Notes

debatable Question. The committee recommended that people who don't work themselves on their land and possess agricultural land should give tax on their annual income of ₹ 25,000. Those people who don't do agriculture themselves, they should not be counted as peasants. This creates economic and social instability. In the name of agriculture, black money is transforming in white money. Taxation is important to stop this. Another aspect is that central estate expense on electricity, water manure etc. for Agriculture. This is more beneficial for big farmers and non farmers of farm houses. In this situation investment of agriculture sector goes to the big farmers and owners of farm houses instead of small farmers. So the government should adopt the recommendation of **Chelliyah** committee to impose tax on non–farmers and on their agriculture income.

Task Who was the first Finance minister of India?

Committee's recommendation to establish investigation Bureau for stability in the system is also correct. But the sad part is that in this country tax payer consider tax evasior. To improve the system, mentality should be changed Tax evasion is considered a crime but if tax system itself is polluted and not practical than only indivisual cannot be blamed. Government should made the administration active honest and sensitive. So committee's recommendation of not changing taxation system frequently seems practical. Committee's other suggestions are also according to the Indian atmosphere. That is why the government should apply them with strong will power.

In the end it can only be said that, investment of capital in country, to attract foreign investment, increase of revenue should be applied in the country with the recommendations of Chelliyah committee. This can increase the revenue and can control the problems of tax- evasion and black money.

Self-Assessment

Fill in the blanks:

1. After the independence frequent changes take place in country's ..... .
2. ..... Committee recommended important and practical suggestions to improve tax system in its report.
3. According to the committee cooperation tax of foreign Companies should be ..... .
4. ..... committee suggested important and practical steps to improve tax–system.
5. Recommendation of applying ..... on non-farmer's agricultural income is not new.

27.2 Summary

- After the Independence there are frequent changes in tax system. Almost of every year's budget amendments take place in the rate of income tax to stop tax- evasion many strict laws are made which become complicated which resulted in not stopping tax evasion and also many hurdles come in the way of honest tax–payers.
- Committee's important suggestion regarding direct taxes is related to the cooperation sector. Committee recommended to lower down the present rate of cooperation tax from 51.75% to 45% till 1993-94 and from next year onwards it should be 40%.
- Committee also suggested to apply agricultural income tax. From last many years it has been discussing but because of political reason no decision has been taken yet.

- According to the report of the committee, structure of tax becomes wrost because of high rates, repetition of terminal tax, changing of law without argument and deductions in taxes while inspecting tax administration.
- Committee mentioned in its report that the administration does not work properly because of lack of trained officials, not working of administration efficiently, interference of political leaders in the administrative matters and without thinking nature of appeal takes place.
- Chelliah committee suggested some important recommendations to improve tax system, if applied honestly they can prove to be important and practical.

27.3 Keywords

- Taxation – To impose tax
- Investigation – To enquire

27.4 Review Questions

1. Describe recommendation of Chelliah's committee.
2. What do you understand by Settlement commission?
3. Describe weakness of administration stated in the committee's report.
4. Explain the rate of cooperation tax in different countries in the table form.

Answers: Self Assessment

(1) Tax system (2) Chelliah (3) 47.5

(4) Chelliah's Committee (5) Tax.

27.5 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
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6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

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Unit-28: Recommendations of Kelkar Committee on Direct and Indirect Tax

CONTENTS

Objectives

After Studying this unit, the students will be able to:

- Get Information of Revenue Gain from Service tax
- Understand Expenditure Reforms Commission.

Introduction

On direct and Indirect tax Kelkar Commission submitted its final report to that time Finance Minister **Jaswant Singh** on 27 Dec., 2002. Despite all the criticisation this committee submitted its report in Oct-Nov 2002 with few change in its advisory letter. According to the committee on one hand Middle class will get relief and on the other hand GDP ration can also increase after applying these recommendations. Important recommendations of the committee are the following:

1. Individual income tax limit of one lakh.
2. Proposal on the income tax of two rates, Annual income of 1 lakhs to 4 lakhs 20% and exceeding 4 lakhs 30%.
3. Ending of surcharge on income tax.
4. Recommendation to stop all the deductions or discounts in income tax.
5. Relief to senior citizens and widows.
6. On home loans instead of 1.50 lakhs discount 50 thousand income tax interest should be discounted and loan upto 5 lakhs interest relief should be of 20%.
7. Ending of long term investment profit on listed shares.
8. Rate of Cooperation tax deducted from 36.5% to 30%.
9. Ending of Minimum additional tax (MAT).
10. Change in Excise and Terminal duty and its structure.

Notes

11. Recommendation of deduction of San Vat from 16% to 14%.
12. Recommendation to expand the area of service tax.

Notes Kelkar commission submitted its final report to the Finance Minister Jaswant Singh on 27 Dec., 2002.

28.1 Revenue Gain from Service Tax

In 1994-95 first time service tax was imposed. Although Government received ₹ 407 crores. In the financial year 2003-04 receivings of service tax was ₹ 8300 crores which increased in 2004-05 to 14150 crores. In the year 2005-06 there was a proposal to collect the service tax upto ₹ 17,500 crores. In the financial year 2004-05 central finance minister proposed to introduce 13 new services under service tax. The 13 new services were – Trade Exhibitions, Airport services, Transport booking service of agents, sending of goods through Air, Survey and exploration, opinion poll, Except copy right, intellectual property services, brokers of forward contract, Tent house Contractor, Outdoor Caterer, producers of TV/Radio programmers, Commercial and industrial construction and risk premium till the limit of life insurance (savings of insurance does not attract tax).

In service tax already included services are- Telephone Service, Share brokers, General insurance, Advertising agency, Courier agency, Radio Pager service, Consulting engineers, Air travel agents, tour operators, Rent and Cab operator, Man power Recruitment agency. Architect, Interior Decorators, Management consultants, Practicing Chartered Accountant, Company Sectary, Cost Accountant, Real estate Agent consultants, Credit rating agency, private Security Agency, Market Research agency, Photography, Convention Telegraph, Tele fax, Online and Data Base service, Sound recording Broadcasting, Cargo Handling storage and ware housing, event Management, Cable operators, Beauty parlours, Health and fitness centers etc. service are included.

In the 2005-06 Budget service tax was stable at the rate of 10% in which small producers were excluded. In the Budget 2005-06, 21 more services were included.

At present, service tax is imposed and collected by the central government But in future state government can also do this. For this 95th amendment of constitution was passed in 2003 in Parliament.

Receivings from service tax (in Crores)	
Year	**Receivings**
1994-95	407
1995-96	862
1996-97	1059
1997-98	1586
1998-99	1957
1999-2000	2128
2000-2001	2613
2001-2002	3302
2002-2003	4122
2003-2004	8300
2004-2005 (amended)	14150
2005-2006 (estimated Budget)	17500

Notes

According to the amendment bill service tax is included in concurrent list, which is given in the 7th list of the constitution. To collect this, state and central government has given the right in the provision. There will be a bill introduced to collect the service tax. With the proposed bill it will be decided that service will be divided between central and state regarding revenue distribution.

One thing is important to mention that any provision related to the service tax is not there in concurrent, state list. After this in July 1st ,1994, through central government this tax is applied in the special category which says that, to apply service tax is the only right of the government

Do You Know? Service tax is included in concurrent list which is given in the 7th list of the Constitution.

Self-Assessment

Fill in the blanks:

1. Report of Kelkar committee was given to the ..... .
2. According to the report, individual ..... independent income's limit should be one lakh.
3. Changes should be done in ..... duty and terminal duty structure.
4. A suggestion was given to expand ..... tax.
5. On direct and indirect taxes ..... committee was established.

28.2 Expenditure Reforms Commission

For the central government expenditure a reform Commission was set up in 28 Feb, 2000 under the leadership of former Secretary of finance **Shri. K. P. Geetakrishnan.** This was set up to end the unimportant expenditure and to minimize other expenditure.

Commissions's work are as follows:

1. To stop the remission of different departments, ministries, importance of state government and work of central government to suggest the minimisation of activities and administration structure.
2. To inspect all types of subsidies and to continue them and also to maximize their use.
3. To suggest the structure of Departmental and Business property and to decide duties.
4. To inspect central government's ministry, related Departments and no. of staff in institution and also to suggest various services of Cader and staff to become useful.
5. To establish the procedure of giving financial help to NGO; by the government and to inspect the money utilized by them. To minimise their activities by giving not much financial aid.
6. To discuss other matters related to the expenditure and to give suggestions.

five member committee presented its first report on 10 July, 2000 and 6th report to central finance minister on 26 June, 2001. In this it presented report on Petroleum and natural gas, chemical and fertilizers departments.

Commission's 7th report was presented in July 2001 and 8th on Aug. 2001.

Procedure of Annual Budget

In parliament, central government's next financial year's expenditure and receiving presented which is known as 'Budget' or annual Financial Budget.

VAT Road Map–Main Points

- Applying of VAT in Entire Country from 1 April, 2005.
- Almost 550 products under 'VAT'
- Two main rates of VAT – 4% and 12.5%
- 46 products under Tax exempted category.
- 1% special rate for the jewellry of silver and gold.
- Petrol, Diesel, Alcohol, lottery tickets and ATF etc. are excluded from VAT, as their value is not decided on market power.
- Additional excise duties products *i.e.* sugar, Tobacco and cloth do not have VAT at least for a year.
- After applying VAT, state government went in loss which was fulfilled by the central government upto 100% and in second and third year it was 75% and 50%.

(To find out Revenue loss, a formula is set up. For this Revenue increase from sales tax before 2004-05, first three better years are calculated from the 5 years).

Task When was the 7th report presented by the commission?

Self-Assessment

Multiple Choice Questions:

6. When was the expenditure reform commission set up?

   (a) 28 Feb., 2000 (b) 28 Feb., 2001

   (c) 26 March, 2000 (d) 26 March, 2001

7. Commission presented solutions to end which type of expenditure and to minimize which one.

   (a) Important (b) Unimportant

   (c) Public (d) Governmental

8. How many products are there under VAT?

   (a) 650 (b) 750

   (c) 550 (d) 1050

28.3 Summary

- On Direct and Indirect tax, Kelkar commission submitted its final report to the Finance Minister Jaswant Singh on 27 Dec, 2002.

Notes

- In 1994-95 first time service tax was imposed. Although government received ₹ 407 crores and ₹ 8300 crores in the year 2003-04 which increased in 2004-05 to 14150 crores in the year 2005 -06 there is a proposal to collect the service tax upto ₹ 17,500 crores.
- In the 2005-06 Budget services tax was stable at the rate of 10% in which small producers were excluded. In the budget 2005-06, 21 more services were included.
- At present, service tax is imposed and collected by the central government but in future state govt. can also do this. For this 95th amendment of constitution was passed in 2003 in parliament.
- Five member committee presented its first report on 10 July,2000 and 6th report to central finance minister on 26 June,2001.In this it presented recommendations on petroleum and natural gas, chemicals and fertilizers departments.

28.4 Keywords

- Expenditure – spending
- Commission – authority granted for a particular action

28.5 Review Questions

1. What are the types of work of expenditure reforms commission?
2. How does revenue received from service tax?
3. When was the Kelkar report submitted and to whom?
4. What is the meaning of Annual Financial Budget?

Answers: Self Assessment

(1) 27 Dec., 2002	(2) Income Tax	(3) Production	(4) Service
(5) Kelkar	(6) (a)	(7) (b)	(8) (c)

28.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Unit - 29: States Finance

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Objectives

After studying this unit, the students will be able to:

- Understand types of Division.
- Know the functions and Resources.
- Understand Information of States Tax.
- Know the revenue Settlement Prevailing in Different States.
- Know the suspension and Remission.

Introduction

An important feature of a federal government is that in this division of power between state and central takes place, their work is also divided some work are under concurrent list like economic and social planning, Trade and industrial right, workers welfare in which their working planning is also included like – price control, education, irrigation and electricity, etc.

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These taxes on which states have right are—Land Revenue, Tax on Agriculture, Tax on house and resources and on opium, alcohol and on production of alcoholic medicines and Indian Bhaang.

In the British period Land administration was given the name of Land settlement and this was fixed after the survey and division of Business.

Those who earn same income and are under the category of Direct taxes they should be confirmed first the source and form of their money.

29.1 Types of Division

Tax jurisdiction is clearly divided between central and state government. It has been done in this way to try to stop duplication and expiration for this taxes were calculated and after that they were given to central and state governments. If any tax is left then it will be paid to the central government. Generally, these taxes which are of international level comes under legislative authority of central government and those which are of local level, come under legislative authority of states.

29.2 Functions and Resources

One of the important factors of central government is that function and resources are divided between states and central government. That is why in Indian constitution some works are given to the state. The main aim of this division is to do the work independently without any struggle. In this way it is clear that centre government should be given sufficient resources. It is also essential that state should not be dependent on centre for its income and also centre should not interfere in states autonomy.

So now we understand the functions and resources which are given to the states by the Constitution, to work independently and how far they are successful and what problems are they facing.

29.3 Functions

Discussions on Power and Resources are already took place but to clarify them more, here a brief description is given.

Functions of the Central Government

Work which are under centre are: Defence, foreign matters, trade, Railway, Currency, Post offices, and Telegraph, Regulations of international trade and Business, Regulations of international rivers and project progress, insurance, nuclear power, elections and audited account.

Functions of State Government

The responsibilities which are under state government are—establishment of law and order, water, Police, administration of justice, public health, Hospitals, Production of alcohol products, construction and sales, education, Agriculture and its related problems large and small scale industries like Handicraft etc. Forest and responsibility of social welfare and its laws.

Concurrent Functions

Some subjects are under concurrent list like—economic and social planning; Business and industrial Rights, Labour controversy and Welfare and work of workers are also included. Price control, education, irrigation and electricity etc. Some of the other works are also included in this list like to

make law on any subject which is also a part of parliament. This means the topics which are covered in this list are the responsibility of both centre and state. But behaviourly it is seen that mostly central government takes charge or give grants for these topics, but the responsibility of their control and progress is on the state government

Union Taxes

The heads of union list are divided in five categories (1) completely central head included customs duties, Corporation tax, tax on assets except individuals and Companies and Agricultural land According to the Article 271 surcharge of income tax is also a completely central head. (2) Except Agriculture income, taxes on other income. Centre imposed taxes and also collects them but it has to give apart of income tax to the states as per the finance commission recommendations (3) Except Alcohol and Drugs other taxes are collected by the federal excise duty and also collects them. But if parliament wants then it can distribute some part to the states. (4) There are also taxes which are collected by the union government and completely distributed by the parliament among and taxes like excise duty, terminal tax on products which comes or goes through Air and water ways, Train fare, Sale and purchase of newspapers and on international trade. (5) These taxes which are imposed by the centre but collected by the state and state itself keep them like cheques, stamped duty and alcohol used cosmetics excise duty.

29.4 States Taxes

On those taxes which have legislative power of states and have the right to collect taxes they are Land Revenue, Agriculture tax estate duty of Agricultural land, Tax on opium Indian Bhaang and Alcoholic medicines and products and Excise duty on Investment except this Tax on Consumer goods on local place, Tax on electricity consumption and Sales Tax, Tax on Vehicles, Animals and on Boats, Except newspaper Tax on other advertisements, on Roads or travellers, goods of internal water ways, Terminal Tax, Stamped duty and Tax on Employment, Capitation Tax, Tax on luxurious and entertainment items. States are also assessed stamped duty and Registration fee.

Notes According to the Article 270, 273, 275 and 280 of Indian constitution, Central government fulfil the resources of states and also provides grants–in-aid as per the suggestion of financial commission.

1. Land Revenue

From the olden times Land Revenue is one of the important sources of income of the state. In this way in states taxes it is considered as the oldest tax. When it was applied from then onwards system of Land Revenue and debit tax had a huge difference while calculating them between states. But then also it is one of the important taxes of states as it is one of the important tax so it creates an impact on different times.

Different System of Settlement

In the British time different Systems of settlement were popular in India which were (1) **Permanent settlement –** in which the interest rate fixed of Land Revenue. (2) **Temporary Settlement –** In this

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interest rate of land Revenue was fixed for a time period. This can be further divided into three parts (a) **Zamindari System –** In which interest rate was fixed by the Zamindars. (b) **Mahalwadi System –** In this interest rate of land revenue of a village or palace was different for the whole rural community. (c) **Raiyatwadi System –** In this land revenue was fixed according to the land size.

Self-Assessment

Fill in the blanks:

1. Those taxes whose base is expanded or International level they come under ..... .
2. The important factor of federal government is to divide function and work under ..... .
3. In federal government, states should be providing ..... to complete their work.
4. In the British time in India different types of ..... were popular.

29.5 Revenue Settlements Prevailing in Different States

In the British time, land administration was given the name of land revenue settlement and this was fixed after trade survey and categorisation. This was applied only in some princely states but in other estates there was not a regular or fixed settlement. Punjab, Maharashtra, Madras (now Tamil Nadu), Assam and Mysore (now Karnataka) came in that sector where land was measured and land revenue get fixed according to some fixed principles. On the other hand large parts of Rajasthan, Gujarat and Madhya Pradesh were without any survey and also their land revenue was not fixed. Besides these two sectors there was also one of the sectors like some parts of Madhya Pradesh and Uttar Pradesh where fixed land Revenue was there but because of zamindari system many middlemen came in between, because of permanent system in West Bengal, Bihar and Orissa there was no fixed settlement on lower level.

Methods of Assessment

Government takes support of different principles to fixe Land Revenue. Taxation Investigation commission described different following parts.

(1)Net Assets or Economic Rents: Definition of Net Assets is like this "**Annual surplus of an area or estate's group which was left after the assessed normal expenditure**." In other words it is expenditure of the remain. This was calculated after Gross produce and from this Zamindar's expenditure was deducted. Gross produce was evaluated with the changing Rupees which was left after the last twenty or more rupees of crops. In Punjab, Uttar Pradesh, Madhya Pradesh and Himachal Pradesh net Assets based of Tax-assessment.

(2) Net Produce or Annual Value: Net produce or Annual Value's Calculation, calculated from gross value after the deduction of fields' expenditure and deduction also given for bad weather after that it is calculated. In Agriculture following expenditures are included.

1. Animals ploughing in fields
2. Agriculture tools
3. Seeds
4. Manure
5. Planting small plants here and there and wages of farmers who cultivate the crops. In Tamil Nadu this policy is adopted.

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(3) Empirical: In many states assessment of Land Revenue is done on the basis of experience and on some other basics like Economic background of any area, Increase or decrease in irrigation, nearby market, facilities of transport and communication and changes of price etc. while fixing Land Revenue three factors are kept in mind. In this "**Firstly Land Revenue is estimated of the whole land and after that it is divided into villages and different Lands**." This is apply in the states like Maharashtra, Karnataka, and Manipur and Tripura.

(4) Rental Value: In this, first of all it is divided that how much tax a landlord receives and after some deductions Land revenue get fixed. Except Tamil Nadu, almost in every state stress is given on Rental Value.

(5) Capital Value: Capital value is not adopted in any state of this country as Land Revenue. But yes, practically it is essential in every state to keep in view of land sales and other mortgage values.

(6) Gross Produce: Earlier it was popular in every state but now it is limited to Assam. Under this system in Assam, only land revenue's limit is fixed on 10% of the Gross produce.

Do You Know? Firstly Land Revenue is estimated of the whole land and after that it is divided into villages and different lands.

29.6 Suspension and Remission

If in any year of any reason crops destroyed then states gets Remission or Concessions. These concessions are in the form of suspension and Remission. In the British time for these, there were no certain rules.

29.6.1 Land Revenue Administration

Form of Land Revenue administration is almost same in all the states. There is a Board of Revenue in every state. Generally an area is divided into District which further divided into Tehsil etc.

In 1901, as a result of the Famine Commission's report through all the states there is a settlement of suspension and Remission and they are applied through Government's order.

29.6.2 Trends in Land Revenue Receipts

It is evident that states does not impose more Revenue on land but it is also wrong to think that the Land Revenue remain stable with the table it can be clear

Year	Land Revenue (in crores)	Year	Land Revenue (in crores)
1950-51	40.00	1980-81	145.53
1960-61	90.04	1984-85	205.58
1970-71	122.06	1986-87	241.50

From the above data it is clear that the receiving of Land Revenue increased but in Total Tax-income they are decreased. There are some reasons of increasing Land Revenue especially in the second and third planning period - they are (1) direct increasing of Land Revenue. (2) applying Surcharge (3) applying of cess through local bodies or for local bodies. (4) Tax on Trading crops (5) Increase in

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irrigation or in rate of water (6) Re-assessment of Land Revenue and ending of middle men increase the Revenue. Different states adopted different methods. But instead of direct increase in Land Revenue they adopted those methods through which not much pressure lies on small farmers. For e.g. surcharge applies on a specific size of land. In this way Land Revenue goes in the credit of expanding education and people welfare. After applying Panchayati Raj System there was an increase in Land Revenue. Many states are assigned many cesses and a part of land Revenue for general work to Local bodies.

A small increase in Land Revenue shows that Agriculture tax applies according to its capacity but after Taxation investigation commission's report this was accepted that in rural areas Taxes are in small quantity and it is essential to increase Land Revenue.

29.6.3 Land Revenue as a Tax

It is said that land Revenue which is famous in India behaviourally does not act according to the Taxation and its principles, except one or two exceptions. In these exceptions one Principles is of **Adam Smith** and second is of facility to some extent. Now we will study the problems of land revenue in the form of a Tax.

29.7 Incidence of the Tax

Incidence of the tax only applies after looking at the source of money on the same sector people. In other words, whatever is the form of Taxation, but it should be applied equally. But except this in 1953-54, Taxation Enquiry Commission recently accepted the fact that the burden of taxes lies more on Agriculture sector as compared to non-agriculture sector. In many states Direct taxes applies on Agriculture. Like Land Revenue, Crop cess and Agriculture Income Tax these are only 1% of National income, where income from non- agriculture sector is of 2.75%. This is clear from the following table.

Burden of Direct Taxes on Agriculture and Non-Agriculture Sector.

S. No		1960-61	1965-66	1969-70	1970-71
1	Land Revenue and Agriculture Income Tax (in crores)	1.07	1.30	1.28	1.37
2	National Income from Agriculture source in %	1.61	1.37	0.37	0.85
3	Income tax (in crores)	1.69	2.72	4.48	4.73
4	National income from non-agricultural source in%	2.49	2.41	2.71	2.60

Source – finance ministry of Indian Government – Agriculture Income and Money Taxation Commission's report.

29.8 Variations in the Burden of Taxation

Less tax on Agriculture Sector is only considered when it compares to non-agriculture sector. But if it will be taken individually then the difference can be seen in state – state and district - district Agriculture Taxation. A wide difference can be spotted in state – state and in their systems. In this way there are many states like Rajasthan and Madhya Pradesh where rates are different, according to which land owners gives Revenue on their these holdings which are same on many important aspects. In this way Burden of Tax is not same on same types of hand. It is also said that states which applies Direct taxes on Agriculture are different state to state. In Orissa and Punjab it is 0.24% and in Rajasthan it is 1.34%. In this way Direct taxes are different in states.

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1. Ability to Pay

As far as the Question arises of the Ability principle, land revenue is the tax which is imposed by the same rate. An uneconomic holding farmer gives the same rate as an economic holding farmer. But here one thing should keep in mind that in India 6% holdings are less than 5 acres. In Utter Pradesh 81.2% holdings are less then 5 acre. The data is of first planning and from then the situation became worst. Same land Revenue applies on both small and big Holdings. In this way principle of progression applies while fixing land Revenue. Some states even make land free from Revenue which is less than 5 acres and also tried to apply the principle of Progression. But because of development in agriculture, capacity of farmers of giving Revenue is become more so it is not right to make land, Revenue free. In this situation also small farmers can not earn profit. So it is suggested that Instead of making land, revenue free, make them progression based and small farmers should be given agriculture related facilities so that their production capacity can increase.

Cost of Collection

It is not easy to find out the exact of collection of Land Revenue as Revenue officers are assigned other work also except this. But there is no doubt that the cost of collection of Land Revenue is much more and their administration is confusing. So in this situation neither principle of extravagance nor simply applies.

Concluding Remarks

In the opinion of society and state the system of land revenue proved inelastic and unproductive. There is a lack of variation and elasticity which makes negative effects. Though state's work is constantly expanding so they are in need of Revenue. In 1951-52 only 48 crores were received by Land Revenue whereas the production of Agriculture sector (current price basis is 4800 crores) was 10% of the total production. In the next few years it increased to 110 crores, at that time income of Agriculture sector become 15000 crores. In 1971-72 income received form Land Revenue was less than 1%. From 1951-1971 Agriculture price got additional increase up to 10200 crore from that states could collect 60 crores additional as Land Revenue.

In addition to this Agriculture sector which got imposed less interest rate also became safe from increasing taxation. Except this government also invested in irrigation fertilizers, productive seeds, New Agricultural tools, Tractor etc. with which Land production increased Not only this but farmers also got free or on less rates other services from the central and state government like – fertilizers, medicines, manure etc. But no serious attempt was made to receive some surpluses from Agriculture sector and from them increasing needs of the states could be fulfilled.

Only big farmers took advantage of the development of Agriculture and because of this gap became more widened between small and big farmers. So in that situation it became essential to impose tax on big farmers not only to increase the capacity of the states but also to lessen the gap of income in rural areas.

In the last it can only be said that as a tax Land Revenue was not fixed properly. This should be same for every holding. This is inelastic and unproductive in nature and contributes very less in the Total tax income of the states.

Task What is the meaning of Incidence of the Tax?

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2. Agricultural Income-Tax

It is already mentioned that the present land Revenue has two defects. Firstly it is not same in every part of the country and secondly assessment of Non-agriculture is same on every land so this system is not progressive. Many people believe that as compared to non-agriculture sector, Agriculture sector has less tax. But there is not a vast difference of low income group in both the sectors. In the words of Agriculture capital and Incomes Taxation commission, "In both the sectors there is not much difference. If any difference is there then it is slightly high in the rural areas. But as far as the Question arises of high income group of house hold, incidence of Agriculture is less and this gap widened more when the income of a person increases". So some people suggested to make taxation on Burden Normal and for the development of finance, taxes should be imposed on Agriculture income. Some sources also suggest imposing tax on farmers at that time when they sell their crops. Some also suggest to end the current land revenue system and instead of this Agriculture income tax and land tax on same rate should be applied.

But there are some loopholes in every suggestion. For e.g. while imposing tax on selling creates administrative and financial difficulties. In this way according to **Taxation Enquiry Commission** "if both Land Revenue and Agricultural income tax applies together then there is no doubt that it will make the land taxation more normal, but it can take the place of source of income of the state". Centre and state both are facing the difficulties of applying tax on Agriculture income, especially on these big farmer who get the maximum profit. Now we will discuss the steps taken by the central and state government in this direction.

Constitutional Position

According to the Indian Government Regulating Act in 1935, "Applying taxes on Agriculture Income was the responsibility of the states. In 1950 the situation remained the same. In this way where central government applies taxes on Non-agricultural sector, state government applies on Agricultural sector. Regarding this **Taxation Enquiry Commission** Suggested". When tax is imposed on any person then his agricultural income should also be seen which is better and useful as an administrative and practical point of view, Recently **Vanchu** commission suggested, "It is essential for the welfare of uniformity and stability that central government should have the power of applying and collecting agricultural tax.

Notes There is a lot of saying about imposing tax on agriculture income but central govt. can not do this until the constitution amendment takes place.

3. Agricultural Holding Tax

Under the leadership of **Dr. K.N. Raj** a commission was appointed which was named as Agricultural Capital and Income Taxation Commission. For it the topics of discussion were – On Agriculture capital and income enquiry of present Direct taxes, some suggestions through which extra resources can be received for development, to lessen economic inequality and to encourage available resources of land and labour. Commission presented its report on Oct 1972 and also recommended to mix a part of Agricultural and Non-agricultural Income. This means while facing non-agricultural income tax, agricultural income should also be considered. Commission's recommendation of this aspect has already been discussed in the taxes of central government chapter.

Notes

Self-Assessment

Multiple Choice Questions:

5. In British period whose administration is named as the settlement of Land Revenue?
   (a) Land (b) Capital
   (c) Labour (d) Group
6. In which principle it was first decided to fix that how much Revenue Zamindar receives?
   (a) Capital (b) Records
   (c) Total production (d) None of the above
7. According to the society and state whose system is unproductive and inelastic?
   (a) Capital (b) Records
   (c) Revenue (d) None of the above

29.9 Basis of Agricultural Holding Tax

Commission tried to apply taxes because of the following reasons: To remove the defects of Land Revenue, to burden the tax equally on different types of farmers, to receive resources for economic development. So the commission suggested keeping in mind the following points while fixing Agricultural Holding Tax.

(a) In different regions, districts and tracts every Land or water-receiving of Land.

(b) In different Regions, districts or tracts difference between soil and climate.

(c) Crops of every Land or tracts.

It is said that if the above points are followed then the taxes will not be different in different places. With these points if progressive principles mix then the burden of tax will be normal.

Concluding Remarks

Recommendation of applying Agricultural Holding Tax is suggested by the **Prof. K.N. Raj commission**. It seems useful in theoretical as because of difference of soil and climate, ways of water supply. In this way Tax assessment is made the base of the production of the Land Tax Equality and Principle of justice and capacity of giving tax all these are satisfied by this and in this progressive method is also included. In this way Burden of Tax increases with the size and production of the Land.

But this is a complex in nature so to apply it administratively seems doubtful. According to the commission if this tax applies on 2500 crores or more on all the holdings then 200 crores and additional income can be received from the available date it can be hope that if Agriculture Holding of ₹5000/- or more applies on all the holding then from it almost 200 crores annual income can be received. Its additional net Revenue will be around 156 crores and it will expand up to 2500 crores or to other Holdings so that approximately 200 crores will be received from the additional resources. But of every farmer's Holdings and its net productively and it estimation looks doubtful that whether so much of receiving can be received. There is a possibility of Red Tapeism, Bribery as integrity not always different from doubt. So whatever planning is applied but it is must to see that poor farmers should not be bothered by Revenue officers.

4. Stamp Duties, Court Fees and Registration

Stamp Duties is used in two ways, first in the form of taxation and secondly as a resource of collection of taxes. In Stamp duties, these duties are included in which applies on deeds and documents which

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are kept as a record. Stamp duties are popular in government but economists are not very impressed with this because on one side their collection and investigation is easy but on the other side there are some duties which are not capable to pay. The incidence of these taxes is difficult to become normal because on one deal a person has to pay a duty and second time has to pay by the second person or side. For e.g. when a land is sold or bought then a needy seller get ready to pay tax and on the other hand eager buyer also present for it. One Quality of stamp duty is that there are long cultures behind it. This is used normally in every country.

29.9.1 Constitutional Position and Kinds of Stamp Duties

In India stamp duties are divided into two parts – judicial and non-judicial. Judicial stamp duty imposed in 1870 under Court duty Regulation. These are those duties which are paid by people. Who are liked with Courts or government offices. These are also known as Court fees. Non-Judicial stamp duties introduced in 1899 under Indian stamp Regulation. In this amendment takes place time to time Bill of Exchange, cheque, Pin and Receipts are those stamp duties which comes under legislative competence but they are collected by the states and also distributed among themselves. Deals on immovable and other heads are applied by the states. Rates of some taxes are fixed where as others are advelarem. In the states like Tamil Nadu applies surcharges with stamp duty for the transfer of immovable property, which is collected by the state and give it to the local bodies.

Court Fees Before British period there was not a custom to apply fee by Court. It was introduced in 1795 in Bengal, Regulation Act No. 38 and from then onwards it was started. In 1870, Indian Court fees Act passed under which court fees applied. In April, 1944 many states in order to raise voice against inflation applied 33% of surcharge as Court fees. Later this surcharge included in the fees but it is different from state to state and also amended many times. Justice does not give free and its fees are taken by the people which they have to be paid in order to get the service. This is the principle under which this fees introduced. In a way it is economic punishment which is imposed on that person or party who harasses state in any way.

29.9.2 Revenue from Stamp Duties, Court Fees and Registration Fees

In 1922, stamp duty with some conditions transferred to the Provincial List from then, except some instruments for the central, state increased the rates of Duty. During the Second World War in order to show protest, stamp duty was increased. In Bombay, Bihar, Orissa, Uttar Pradesh and Madhya Pradesh this increase was done as a normal surcharge which later included in the duty in most of the states.

Government income is increasing because of stamped duty and Registration because of the reasons like – increasing economic activities, increasing of price and deals of Land and Land improvement. State too tries to increase stamp duty from time to time. During 5 year plan many states increased the court fees and in second and third year planning non-judicial stamp duty also increased. Following is the income received from it.

Year	Stamp Duty and Registration (in crores)	Year	Stamp Duty and Registration (in crores)
1951-52	55.06	1981-82	455.14
1960-61	43.05	1985-86	696.55
1970-71	121.08	1986-87	720.00

Do You Know? In 1922, Stamp Duty with some conditions transferred to the provincial list.

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29.9.3 Stamp Duties, Court Fees and Registration as Tax

These taxes are not related with the capability of the tax payer that is why they are not according to the two principles of canon of ability. This is according to the two principles. (a) **Canon of economy** because their rates are already fixed. (b) **Canon of economy** because it includes the cost of publishing stamp tickets and their distribution. In this officials have to take care that the documents are complete according to the stamp duty and as the work is incidental function so very less cost applies on them. There taxes also satisfied the principle of **canon of convenience** as they have to be given at that point of time on which a person contains money. This is one of an important Revenue source. But it is not wise to depend on it completely for the increasing need, of the states.

1. Taxes on Urban Immovable Property

When land is used for the agriculture work then the rate of land revenue of state is pre-decided. While deciding some points should be kept in view like – soil, production. prices, monsoon, data of Revenue, economic conditions etc. But when the land is used for non-agriculture work like residential building or to set up industry then land owner gets maximum profit because of the land price. Prices of land which increased they takes place because of expense of government or local bodies. So this tax should be different from Land Revenue.

Government wanted increasing price of land should be used as revenue and for this it evaluated lands in 1979 and in 1987 and fixed ground rent where rate did not exceeded 33%. Because of the urban development non-agricultural land got importance while fixing Tax. Some states are there which settled statutory provisions, some done under executive orders and some had never done this. Tax-assessment or fixing is somewhere annual value and somewhere gross value of market value or free hold value.

But most of the states did not paid attention of the income from non-agriculture. In the third planning it was tried to apply taxes reasonably in urban areas and it was the possibility that other states might follow it. But as a source of revenue it did not fulfil the needs of the state Ministry Commission which was set up to increase the resources in urban local bodies suggested that the receiving of the tax should be given to the local bodies. The income received from this source has a brief description which is as follows:-

Year	Tax on urban immovable property (in crores)	Year	Tax on urban immovable property (in crores)
1950-51	1.8	1980-81	5.69
1960-61	4.2	1985-86	6.50
1970-71	4.2	1986-87	6.80

2. Taxes on Trade, Profession, Callings and Employment

Before provincial autonomy there was no tax on trade, profession and employment. But with the Regulation Act of 1919 on some provinces, local tax was imposed. Tax of trade or business is described in 60th index of state list. In the article 276 there is a provision given that it is different from Income tax. It is applied not more than ₹250/- on any Local body or State. This is applied on all the professions and employment. But if there is an individual who is extremely poor that even income tax department does not bother him then normally he became free from this tax also. There are some discounts for poor in these taxes which is a good sign. But if discrimination is done among unearned income like pension receivers, income from investment or if Agricultural income does not considered as a profession then it is not justified. As it is applied on same rate so its burden lies more on poor class. This tax discriminate with the rich

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class as unearned are free from this Income received from this tax for the last twenty year increased 10% but it is not considered as one of the powerful source of revenue of the state. Taxation Enquiry Commission, in 1953-54 recommended to included it in these taxes, which are kept for local bodies.

In some selected years following is the income received from this source.

Year	Trade or Profession Tax (in crores)	Year	Trade or Profession Tax (in crores)
1950-51	0.1	1980-81	62.02
1960-61	0.4	1985-86	112.00
1970-71	3.1	1986-87	135.00

3. State Excise Duties

Excise Duties are those taxes which applies on things produced within the country to limit the consumption of that product. It is divided into two parts in India.

1. Those excise duties which applied during production. The aim of this is not to limit the consuming but to receive Revenue.
2. Those taxes apply on their products which considered injurious for health. Taxes are applied only on second category products. This Revenue which is assigned to the states in those sources Alcohol is also included for the human use under the 1919 Regulation Act, this was the situation, In 1935 the situation was same to some extent.

In this way under the constitution states are given the right that state can apply countervailing duties on products which are made or produced in the state which are as following:

(a) Alcohol – used for human consumption.

(b) Opium, Indian Bhaang and Alcoholic medicines but except medical and cosmetics things.

These are actually as Taxation enquiry Commission said in 1924-25 are restricted excises, they are meant to limit the use of **alcohol** but they are an important source of Revenue for the state.

Items under Excise Duties

In state production duties these heads are included – License fee of the imported liquor, filling liquor in Bottles and license fee of such things, spirit made in country, fermented liquor etc. also drugs, opium. These products made in government factories and if any individual want to produce it he need license first.

Importance

In most of the states there is a situation that their income from liquors is on second place. In some states land revenue is more. In the period of war almost in every state Excise Duty increased except Gujarat and Tamil Nadu where total prohibition is applied.

29.9.4 Excise Policy

Till 1921 Excise Policy of the government was to discourage people using Alcohol. After this prohibition of Revolution took place in the country. Between 1921-37 many states minimise the use of Alcohol. For this they had control the production and Distribution of Alcohol, increases excise duties, imposed

License fees. In 1931 when Mahatma Gandhi presented his list of demands before the government then first head was to prohibit liquor.

In 1937, when provinces were given the independence then also congress applied prohibition policy. After Second World War started Congress ministers gave their resignation. This was the shock for these states who had applied the prohibition policy. Receiving from Excise Duties increased during the war period. This situation became cause of inflation and also became of foreign soldiers who came to India and were using liquor in heavy quantity.

With the independence, the question of prohibition again arises. In the constitution Prohibition act also included and it is also said that state will try to restrict the use of liquor which is injurious to Health, but they can be used in medicines.

Conclusion

In this way it is clear that from the viewpoint of social religions and moral value there are many advantages of prohibition. But despite that because of financial and administration it was not successfully implemented. Many states disagreed with that. According to them because of prohibition no social improvement took place but many illegal things going on and also Revenue is going in loss. On 1 April, 1967, Haryana government and in 30 April, 1967 Kerala government disposes the policy of prohibition. Mysore (Karnataka) in 1967 also rejected after the election. Andhra Pradesh Chief Minister Shri. K. Brahmanand Reddy said that the policy was not successful in the entire nation.

Now in October, 1947 the situation is that except two states Gujarat and Tamil Nadu prohibition is not applied anywhere.

In the end it can only be said that the prohibition was rejected due to financial and administration difficulties. But state cannot favour this as no social welfare takes place or physical welfare until the level of people became high. If the policy becomes unsuccessful then it is the defects of means and not offends. State should not end the policy and take care that "consuming of Alcohol, slowing spreading in these sectors also who were not habitual of it especially the youth and females of high society".

There we agree of conclusions of **Shri. Tekchand's** Committee who said in 1964 that prohibition should be imposed once in the whole country. It has also suggested 12-year programme. But if state loses its faith in prohibition then it will be harmful for the Indian culture. In the enquiry report of Tamil Nadu's Salem District it was said that "Weavers of Kumar Palayam, spend their 50% of income on liquor. Their needs were fulfilled by children and Females". In this way Alcohol indirectly affects feminism and also negatively affect on children's mind and body. But still some economists believe that it is not wise to follow this policy.

4. Sales Tax

Constitutional Situation

Under the Indian government Regulation Act. 1935, states were assigned the Sales Tax. Indian Constitution also gives the rights to the states that they can impose tax on any - newspaper and also collects them. According to Article 286 states are abide for the following tax.

1. Selling and purchasing of goods of out of the boundary of India.
2. Selling of goods those given to other states for its use.
3. International Business and trade related selling except this if parliament wanted to impose tax which term as essential, it has to take permission of the President. For this in 1952 essential Good Act was passed.

Notes

After the recommendation of Taxation enquiry commission in 1956 amendment took place in Constitution which resulted in keeping international tax in concurrent list. So in 1956 another Act passed which was announced as special of International business and Trade.

Meaning of Sales Tax and Purchase Tax Sales tax is that Tax which is imposed on the sales of property and goods no matter it sold on Retail or whole sale price. In Uttar Pradesh Sales tax is applied on Total turnover of the Trader. Turnover means Total proceeds of the Total Sales. Meaning of sales is transfer of property or goods or deferred payment.

In this way Sales tax is that tax which is applied for a fixed period on Sales and its price. Whereas selling tax is that which is imposed on traders purchasing. In this way a registered trader's total sales and received from him is known as sales tax and on the other hand total quantity of sales of a trader is known as selling price.

Forms of Sales Tax

Sales tax is of many types like General Sales Tax and selected Sales tax, multipoint and single point Sales tax.

1. **General Sales Tax and Selective Sales Tax:** When in sales tax law selected items are kept then it is known as **selective sales Tax**. In other words when selective sales tax applies on selected items then it is known as Selective Sales Tax. This type of tax is imposed on high prices and luxurious goods. In opposite of this when law imposes tax and leave some goods then it is called General Sales Tax. In this way when the collection of tax is based on some sales then it is General Sales Tax.
2. **Multi-Point and Single-Point Sales Tax:** General Tax is of two types Multi Point and Single Point Sales Tax. Multi point is a sales tax and also known as one of the parts of single point sales tax.

Under Single Point Sales Tax: Special money add to the good which sold to the consumer this sales tax is collected on one level it is collected on that level which the producer sold to wholesaler or on that level also when retailer sold to consumer this single point sales tax imposed on producer these people gives sales tax to the government and taken back from the consumer in this way those traders who purchase goods from the producer they are not eligible for sales tax but have to give those prices in which sales tax is includes.

Multi Point Sales Tax: Tax applies on goods of all levels at one point it is applied when producer sold his books to the whole seller and secondly when whole seller sold it to the trader and in the end it is applied when retailer sold it to the consumer. The rate of this tax is low and taken by the consumer.

Task What is the meaning of Multi Point and Single Point Sales Tax.

29.9.5 Feasibility of Multi-point and Single-point System

If we discuss that how much multi-point and single point system are applied in different situation which are as following.

1. When government decides that only on some consuming goods taxes will be applied.
2. When government decides to apply tax in large quantity on middle and small traders.

Notes

3. When government decides to applying tax on low rate so that on one commodity taxes applying many times but no serious situation.

On the other hand single point system fits in the following situation.

1. When government decides that tax will be apply on varieties.
2. When government decides that to apply tax on limited number of traders.
3. When government decides to apply tax on higher rate.

Though Multipoint and Single Point are both criticised but in the view point of administration, finance, and economic it considered practical.

Turnover Tax

In India, in some states instead of sales tax, turnover tax term is used, but it has no importance as it has no qualities which differentiate between sales tax and Selling Tax.

Registration of Dealers

Registration of Dealers is essential for many reasons. There are many Dealers who are large in number. In the eyes of administration this work is difficult and expensive as it is not easy to find out Big, Medium and small Dealers and to collect their taxes. So it seems necessary to register dealers with the Sales Tax they can be benefitted later it becomes essential for a dealer to register themselves in tax assessment officials. Only Registered Dealers can take sales Tax from their consumers.

Development of the Sales Tax

In 1938, first of all Madhya Pradesh Government applied Sales Tax in the form of Petrol tax. General Sales Tax was first applied in 1939 by Madras Government, after that in 1941 in Bengal. For the past 10 years Multi point is adopting. In Uttar Pradesh in April 1948 Sales tax was applied and Multi point was adopted. At present, in all the states Sales Tax is there in different forms in some states selling tax is also applied in limited quantity goods related to the international trade had sales tax by different states to bring uniformity in it. In 1956 central sales tax act was passed. The administration of this tax was given to the states and also it was received and collected from them. There are many things in this list which are important as a trade like coal, jute, cotton, cotton thread iron, oil, seed and metal etc.

Essential Goods Act, 1952 and Central Sales Tax Act, 1956

As it has mentioned earlier that essential goods act passed in 1952 under this system state imposes tax on those goods which the Parliament announced essential for this permission have to be taken from the President. The aim of this tax to bring uniformity in goods and to save them from imposing tax but under the act of 1956 central government imposes tax on those goods which have specific importance in international trade only states collects and receives these taxes.

Importance of Sales Tax

Sales tax plays an important role in the finance of states. This tax is the form of Revenue which has liquidity and elastic during the period of planning income of sales tax is as following.

Year	General Sales Tax	Year	General Sales Tax
1950-51	54.4	1980-81	3837.58
1960-61	142.4	1985-86	7074.00
1970-71	708.4	1986-87	7150.00

Notes

In sales tax increase rate is more than national income. In this tax there is a power of simple and elastic. If tax evasion would have been stopped then Revenue increase in the income of states is limited so it is essential to stop tax evasion.

Sales Tax in Under Developed Countries

In under developed countries, on one hand states needs financial settlement for their resources and on the other hand most of the population is poor and also the scope of taxes is limited. In this condition sales tax which is an indirect tax is helpful for the state government sales tax is generally included in the price of a goods and it is -to the principle of colvert scratch duck wings in this way so that it makes less noise. If sales tax is applies on luxurious items then it will indirectly encourages saving as the increasing price makes it demand down. In this way this tax lessen propensity to consume and also encourages savings. So sales tax is one of an important source of revenue especially in under developed countries.

Effects on Production

Now, we will discuss that what are the effects of sales tax on production; means-

(a) On ability to do work

(b) On ability to save and invest

(c) On desire to work and save

(a) Effect on the Ability to Work: decreases when it affects negatively on the work of a person. So poor class always against it. In this way if sales tax applies on those things which are consumed by the poor class then it will affect their work and capacity. So sales tax has negative effects. But it general consuming goods will be tax free or used by the rich class like luxurious items then it will not affect negatively. This encourages saving. So it is necessary to make general consumption goods tax free or to apply low interest rate and the burden of sales tax must be on such goods which are generally used by rich category, such as the goods of luxuries then there is no possibility of adverse effect of sale tax on production. Not only this, it can also ecourage more savings. Therefore, it is necessary that the goods of general consumption must be either kept tax-free or taxes must be imposed on them at lower rates and taxes must be imposed at higher rates at the goods of luxuries.

(b) Effect on Ability to Save: As far as the question arise of capacity this is less than all the taxes. But there is a different intake of those people who don't have excess income from which they can do there saving. This type of income and burden lies on the poor class which have no extra means of savings. So sales tax lies on those sectors which don't have the capacity of savings. But being a sales tax it is included in the price of a thing, so this discourages both consumption and saving. But if its rates become low than savings can be increased and also if it applies on luxurious items then it will not create serious effects.

(c) Effect on Desire to work and Save: As far as the question arise of the work of the people and wish to save, discussion of goods taxes have been already done. But those people who have to earn for their dependents should do saving but become helpless with the increasing burden of the taxes. In this situation applying sales tax discourages savings as these types of people are more concern for their future and earning.

Effect on Distribution

Sales tax imposes on those items which are purchased by the poor class of the society in this way its nature become regressive. In this situation it increases the inequity between income and money

distribution. But to remove this defect it can be applied on selected and luxurious items but in that condition it will not remain the source of Revenue. One of the fundamental defects of sales tax is that it is not related to the consumer's capacity. Rich and the poor pay this on the same rates. Not only this there is no discount for domestic situations and in this way it lies burden on the same income group which have large quantity dependents. In this way, general sales tax is of regressive nature one thing is there that production increase and money distribution are parts of economic welfare. Here, this is mentionable that production growth and best distribution of money are undivided friends of economic welfare. So sales tax should be applied in a manner with which countries production increases. In the end it can only be said that in the form of revenue source sales tax performed better and also gives resources in some states it is one of the big and in some is the biggest sources.

29.10 Justification of Sales Tax in the Present System

At present there are debates whether to keep sales tax or not. Earlier it was produced by the states as it was one of their only sources of revenue. It is clear from an amendment that central government did not accept it neither as a political nor economic point of view. To remove Sales tax changes should be done which is not possible. But in this case state can fulfil the Revenue loss.

29.11 Motor Vehicle Taxation

Motor Vehicle Taxation was first applied in 1914 at all India level under the Motor Vehicle Taxation Act. The main aim is to control Motor Vehicle under this Registration permit, Licence etc. comes with fees which increases time to time.

Constitutional Aspect: Under the Constitution in state list 57 taxes on Vehicles started whether they are technical or other type. This is included in concurrent list. So the Parliament has right to make laws on technical motors. But Parliament does not apply laws on any principle. At present the situation is that in India all the states applies taxes on Motor Vehicles, but their rates are different in all the states.

Forms of Motor Vehicles Taxation: There are three types of Motor Vehicles Taxation.

(a) Motor Vehicle Tax.

(b) Tax on goods and Passengers.

(c) Local tax like Terminal, Road tax and Tyre tax.

Here we are more concerned about the Motor Vehicle Tax which is applied by all the states on the state vehicles and the basis of tax is different in all the states. In some states it is applied on goods vehicles and according to the weight and in some on the basis of seats. In first and second planning period many states applied taxes on passengers. This was applied on the fare. From then three types on taxes are included especially in the third planning.

It is said that in many states it became a burden. It is estimated that the 50% of buses has taken in any form. Indian Road development association estimated that ₹ 11,000 as taxes are taken from Trucks Annually. In these taxes Diesel oil taxes are also included. For the states, it is one of an attractive tax but its elasticity is limited. With the new point of state government it is useful as the production increases in the country of motor vehicles.

But, if we examine it from the point of view of finance of state government then it seems quite appropriate and necessary that the production of motor-vehicles must be increased rapidly in the country.

The serial of growth in last few years in last few years in income received from this source is as follows—

Notes

Year	Motor Vehicle Tax	Year	Motor Vehicle Tax in ₹ crores
1950-51	10.1	1980-81	414.93
1960-61	30.9	1985-86	680.50
1970-71	104.1	1986-87	740.50

29.12 Entertainment Tax

Entertainment tax was first imposed in Bengal in 1922. State government has given the right to impose this tax under the act of 1919 and 1935. Indian Constitution (1950) in its second list (list II) 62nd entry state contains the power.

Entertainment tax is very simple, which applies on the places of Entertainment, on their tickets like Race courses, theatre, cinema hall, circus and sports etc. In this way, it is limited to some places. One of the biggest shares of it comes from cinema halls show tax is that tax which is imposed by the exhibitor on every show but the burden of this show lies on the shoulders of people. It is collected either in cash or sometimes in tickets. Some Entertainment is free from this tax for e.g. religious entertainment, educated related and Agriculture related entertainment. As far as the question arises of tax-evasion, this problem is serious in entertainment. This tax transfers in every state to local bodies. Distribution of this tax is given below:

Year	Entertainment Tax (in crores)	Year	Entertainment Tax (in crores)
1950-51	6.4	1980-81	25.38
1960-61	9.8	1985-86	401.50
1970-71	57.5	1986-87	420.50

Self-Assessment

State whether the following statements are True or False:

8. Agricultural Holding Tax recommended by Prof. K.N. Raj Commission on the basis of Agriculture money and Taxation income.
9. Judicial stamp duty in 1970 imposed by judicial stamp Act.
10. Non-Judicial stamp duty was started by Indian stamp Act 1899.
11. Present Judicial duty started in 1795 in Bengal by Act no. 38 from then onwards it is running.
12. Before provincial independence Taxes were imposed on Trade, Business, Callings and Employment.

29.13 Summary

- Tax jurisdiction is clearly divided between central and state government.
- One of the important factors of central government that function and resources are divided between states and central government that is why in Indian constitution some work is given to the state.
- Work which is under centre are: Defence foreign matters, trade, Railway, currency, Post officer and Telegraph regulations of international trade and Business, Regulations of international Rivers and project progress, insurance, nuclear power, elections and audited accounts.
- Some are under concurrent list like economic and social planning, Business and industrial right and labour controversy and welfare and work of workers are also included. Price control education irrigation and electricity etc.

Notes

- On those taxes which have legislative power of states and have the right to collect taxes they are land Revenue, Agriculture tax estate duty of agricultural land, Tax on opium, Indian Bhaang and alcoholic medicines and products and excise duty on investment.
- In the British time, land administration was given the name of land revenue settlement and this was fixed after trade survey and categorisation.
- Annual surplus of an area or estates group which was left after the assessed normal expenditure.
- In 1901, as a result of the famine commission's report through all the states there is a settlement of a suspension and remission and they are applied through government order.
- Incidence of the tax only applies after working at the sources of money on the same sector people.
- As far as the question arises of the ability principle land revenue is that tax which is imposed by the same rate.
- According to the Indian Government Regulation Act. 1935 applying taxes on agriculture income was the responsibility of the states. Till 1950 the situation remained the same.
- Recommendation of applying agricultural holding tax was suggested by the Prof. K.N. Raj Commission.
- Stamp duties is used in two ways, first in the form of taxation and secondly as a resources of collection of taxes. In stamp duties, these duties are included those which applies on deeds and documents which are kept as a record.
- Consuming of alcohol and slowing spreading in those sectors also who were not habitual of it especially the youth and females of high society.
- Entertainment tax was imposed firstly in Bengal in 1922 state government were given right to impose this tax under 1999 and 1935 Government of India Act. Indian constitution (1950) provides power to imposed this tax to state Government under. Its 60th entry of list (II) of its seventh article.

29.14 Keywords

- Estate –Area
- Princely State –State

29.15 Review Questions

1. Write the main sources of income of state government and history of sales tax, importance and write their present status.
2. Explain the history of land revenue in India and what are the methods to fixed land revenue?
3. Check the recent sources of finance of state government in India.
4. What are the main sources of income of state government? Are they enough? Suggest the ways to improve state finance.
5. Should Prohibition policy be implemented? Write with reasons. What are the effects of applying it in different states?

Notes

Answers: Self-Assessment

(1) Legislative Authorities	(2) Centre and States	(3) Resource
(4) Land-settlement	(5) (a)	(6) (b)
(7) (c)	(8) True	(9) False
(10) True	(11) True	(12) False

29.16 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Unit-30: Local Finance

Notes

CONTENTS

Objectives

After studying this unit, the students will be able to:

- Know the Sources of income of Municipal Corporation, Financial status etc.
- Know the Taxes imposed by Municipal Corporation.
- Understand the Finance of Village Panchayats, Panchayat Committee and District Councils.

Introduction

Financial problems related to the central and state government discussed in the earlier chapter. Now we will study the problems of local bodies like Municipalities, Municipal Corporation, District Councils and finance of village panchayat. This study is important because the last aim of central and state government is to satisfy and balance the needs of local bodies. Though needs of central and state government are different but difference between them is based on their satisfaction and not their aims. Related to this last aim is to fulfil the needs by available resources so that people can get maximum economic and social welfare. Those needs which are of local nature and are fulfilled by local administration they are related to the local construction of roads and maintenance, electricity and water supply, cleaning and arrangement of primary education. To complete these work efficiently a talented and able system is important. So local government is assigned a part of taxes and income and other resources, now we will discuss resources and work of local government.

Notes

30.1 Municipalities

Important work of municipalities are –To maintain and construct local roads, arrangement of street lights, water supply, cleaning of roads and streets, hospitals, maintenance of animal hospitals, cleaning and arranging drainage system, immunisation, arranging of primary education, construction of parks and gardens, control on hatred profession, forming of fair and exhibition etc. But all these work are done by municipalities in the vigilance of state government.

Source of Revenue

Main sources of income of municipalities are: Taxation grants from state government taxes collected by the state government and a part of it and non-tax revenue from the sources of municipalities.

Taxes Levied by Municipalities

Main taxes imposed by municipalities in different states are:

1. Tax on property: Tax on plots and land, house, general tax and service tax, tax on transfer of property.
2. Tax on goods –Terminal tax.
3. Individual Tax, taxes on trade, profession, callings and employment, terminal tax on passengers which also include religious travel.
4. Tax on motor vehicles and animals.
5. Tax on theatre and exhibition.

Notes All the work done by municipalities in the vigilance of state government.

Financial Position

Taxation Enquiry Commission went through the total income of municipalities in different states and came to a conclusion that the increase in the income of municipalities is not enough. The commission also said that almost in all the states budgets of municipalities are hardly imbalanced. Not only is this but there is a huge difference between income and expense of municipalities in different states. Their expense level is very low because of low income. Actually the situation is that because of lack of resources municipalities are unable to complete their work. There are some services which are needed to be expanded like water supply, cleaning, public health, help of doctors, etc. But the reality is that with the increasing of expense and wages of labour it becomes difficult to maintain the service level. Taxation enquiry commission said this before 20 years but its seems realistic in today's time. There is no doubt that the finance of municipalities has been improved in the 20 years but it is the difference of quantity and not of quality. So it is suggested that municipalities should get sufficient resources either in the form of grant or a part of tax.

Recommendation of the Commission: Taxation enquiry commission recommended following taxes used by the local bodies.

1. Land and House Tax.
2. Tax on goods comes on local place for sales or consumption normally known as octoria.

Notes

3. Except Technical Vehicles Tax on other vehicles.
4. Tax on animals and boats.
5. Tax on Trade, profession and employment.
6. Tax on advertisements except ads in the newspaper.

Above taxes are applied by the municipality but the income of these taxes is very low. The main reason of this is the low interest rate. So it is suggested that Municipalities should increase their rate of tax. Also tax-system which is adopted by municipality should be progressive and not regressive. One thing is also there that the income sources of municipalities should be clearly mentioned to avoid overlapping and uncoordinated form.

Do You Know? For the past 20 years finance of municipalities has improved?

30.2 Municipal Corporation

Corporation is a different type of civil organisation. As compared to municipalities the work of Municipal Corporation is more expand. They not only have the power to apply tax but also they have freedom to form budget and in some matters they are free from the control of state government The difference between municipalities and Municipal Corporation is based on executive functions and deliberate functions and the whole municipal Corporation is based on municipal commissioner. The structure and formation of Municipal Corporation is same in all the states.

Taxes Levied by Municipal Corporations

The power of applying taxes by municipal corporation is limited it is easy to explain them differently. For e.g. Bombay Municipal Corporation imposed tax on property, service tax, tax on animals and vehicles theatre tax, education cess and on small tax known as dog tax. Those taxes which Madras government can apply are—property tax, trade tax, and profession and employment tax, tax on companies, consumption, tax on goods bought in the city for sale or purchase, transfer of property, tax on animals, vehicles and on advertisement. Kolkata Municipal corporation imposed taxes property tax trade, profession and employment tax, tax on animals and vehicles.

From the above description, it is clear that the power of imposing tax is different in states. For e.g. in Bombay and Madras municipal corporation property tax are both maximum and minimum and other taxes are minimum where is in Kolkata municipal corporation property tax is maximum. These corporations are free to apply taxes on different acts according. to their wish, there is no need to take permission from the government.

Financial Position

In municipal services level of expense is high as compared to Municipal Corporation. This is because Municipal Corporation has more resources. But with this population increased because of industrialisation during and after war period which also led to town planning, cleaning of town, water supply etc. Panchayati Raj or democratic decentralisation panchayat committees, village panchayat and district councils are assigned the development work or rural, Block and district level and they have been also given powers. This is one of the revolutionary changes. The importance of these bodies are clear from the fact that the rural properly take place under the guidance of the state government and it is the responsibility of Block Development Samiti which work to maintain balance between village panchayat and district council.

Notes

30.3 Finances of Village Panchayats, Panchayat Committees and District Councils

As far as the question arises of village panchayats, panchayat committees and district council charges are made in their power after the independence. These are connected with each other and work according to the places and maintain balance. Not only this they are also free in financial administration. In other works through taxation they are free to use their reprices.

Objective in Plans

In the first year planning following words were used for the importance of panchayat. Panchayat plays an indispensable role in rural area. In second year planning stress was given on panchayats and it is said that to develop local bodies. Should made plan's with help of government and their hard work themselves. It was felt that the needs of the village should be keep in mind so that weaker section can get the advantage like farmers, Labours etc.

Democratic Decentralisation

In the direction to implement the programme of democratic decentralization for speeding up the best planning at village level, good administration and human resources appropriate steps have been taken. In third plan, the importance of this programme has been mentioned in these words— "Under Community Development Movement in Village areas, a new programme has been started which is called **Panchayti Raj** or **Democratic Decentralisation**. The responsibility of development works at village, bloke and zonal level has been given to Gram Panchayats, Panchayat Committees and Zonal Council and they have been given enough powers in this regard. This can been called a revolutionary change in the structure of administration of zone and as a resemblance to village development.

The importance of these organisations can be visible from this fact that Block Development Samiti now has the responsibility to implement village programmes under guidance and supervision of state government which works with the coordination of Panchayats in villages and with Zonal Councils at Zonal level.

One of the important aspects of this showed Panchayat Raj Minister Shri. M.K. Dey that the meaning of Panchayat Raj is not decentralisation of democracy but it is the decentralisation of the economic power. This was also said because democratic decentralisation is the balance with democratic structure. Present system of decentralisation is based on the recommendation of Balwant Ray Mehta committee which is the following.

1. Local bodies should be of tri-level structure which should be expanded till the village and different bodies related to each other.
2. Power and responsibilities of these bodies should be transferred.
3. They should be given sufficient resources.
4. All the development programmes on this level should be run by these bodies.

Task What were the aims of first planning?

Notes

Self-Assessment

Fill in the blanks:

1. To maintain balance with the democratic structure, decentralisation of administration is ..... Raj.
2. The work of development on rural, Block and District level assigned to the village panchayat, panchayat commission and .....
3. As compared to Municipal Corporation expense level of ..... services are higher.

30.4 Village Panchayats

Functions

Roughly the work of village panchayat can be divided into two Parts—Obligatory and Discretionary. Their area of scope is wide. In which town-administration and cultural, social, agriculture* and development related activities are included. Except this there is a position is Panchayati Raj under which state government can force panchayat to do extra work.

Obligatory Functions: These are included in the essential work—construction of public roads, their maintenance, changing, Light arrangement, medical help, to stop spreading diseases, to adopt curative and preventive measures, registration of birth, death and marriage, primary schools for girls and boys, their maintains, public wells for washing clothes and bathing, construction of ponds, protection from natural calamity, welfare of mother and child, construction of walls, dams etc.

Discretionary Function: Village panchyat can make discretionary functions like planting trees on the road side and caring them, improved breeding of animals, arrangement of medical help, establishment of libraries, collection of manure maintain harmony among various communities.

Resources: In the all the states village panchayat have been given the right to apply taxes through there are some difference in all states. The main sources of income of village panchayat are –property tax, cess on land, tax on vehicle, profession tax. These are obligatory. They have also the right to impose some other taxes like – terminal, tax on shops, tax on water, light etc. But they can be applied only there, where these services are available.

30.5 Panchayat Samities

Panchyat Samities are established in the middle level of panchayat Raj in except Gujarat, Maharashtra and Karnataka in all the states they are formed on block-level. The medival organisation is formed at taaluk level in these states.

In Andhra Pradesh, Bihar, Maharashtra, Orissa, Punjab and Rajasthan these are known as Panchayat Samiti. In Assam, Aanchlik Panchayat. In Madhya Predesh Janpad Panchayat, Tamil Nadu –Panchayat union council, In U.P area committee. In Gujarat and Karnataka it is known as Taaluk Development Board. In the same way, the Chairman of this committee is known by various names. The Chairman of this committee is called Head in U.P.

Functions

Panchayat samities are assigned development work in all the states. They are indirectly responsible for applying community development programmes. Except this they were also given development

Notes

planning of blocks. Primary education, health, means of transports and communications and they have specific executive responsibilities. In Gujarat, these committees also investigates Panchayat and they have the right to inquire about budget of panchayat. But in Andhra Pradesh, Assam, Bihar, Orissa, Rajasthan, Maharashtra and U.P. these committees are approved on the Budget of the village Panchayat.

In U.P, the work which are assigned to the area committee are –Primary Health centre's establishment and maintenance, welfare of mother and child, primary school, water supply, small irrigation work, planning for blocks, agriculture, corporation, husbandry and investigation of planning made by the rural commission, development of small scale industries etc.

Finances

Money which is received by the Panchayat Committee, their sources are –funds from the Budget of block, money from state government for the work which they are assigned for, Part of a land Revenue and grants from state government. Except this it has the right to impose tax also. For example In Gujarat committee can apply all these taxes which Village Panchayat can impose.

In U.P there are important sources like grants and apart from community development programme. Except this they can also borrow money from the state government

There are also some tax-level sources like licence on brokers, tolls on vehicles, animals sold in fairs, market fee on shopkeepers, agricultural and industrial exhibition fee etc.

30.6 Zila Parishad

Except Assam, in every state Zila Parishad is established on the third level. In Assam it is on sub-division level. In Tamil Nadu to establish Zila Parishad, 13 districts 22 Development districts were bounded. In Andhra Pradesh, Bihar, Maharashtra, Orissa, Punjab, Rajasthan and U.P it is known as Zila Parishad. But in Gujarat it is named as District Panchayat. In Tamil Nadu and Karnataka it is District Development Council. In Assam it is Mahkuma Parishad.

Zila Parishad's chairman in Andhra Pradesh, Madhya Pradesh, Tamil Nadu, Punjab, Orissa, West Bengal known as only 'Chairman', In Assam, Gujarat, Maharashtra and Karnataka it is President.

Functions in Different States

In Karnataka and **Tamil Nadu** Zila Parishad is a coordinating body who looks after Panchayat Samiti and also advises government for development programme. Except this, in **Andhra Pradesh** it is responsible for middle, professional and industrial school's setting and maintenance and also for executive work. In **Maharashtra** Zila Parishad is powerful than Panchayati Raj and also advises government for executive functions. In Uttar Pradesh West Bengal and U.P they are assigned many administrative functions. In Assam, Bihar and Orissa they approved the term budget. In other states they have no executive functions but are only an investigating and co-ordinating body.

Functions in Uttar Pradesh

In U.P. and same other states following functions and responsibilities have to be fulfilled to Zila Parishad.

1. Division of festivals, fairs, roads etc.
2. General investigation of village Panchayat and maintenance.
3. Construction and maintenance of public bridges, roads and junior high school.

Notes

4. Administration of primary education and maintenance of libraries.
5. Water supply.
6. Planning of Zila planning and balance between block and area committee.

Sources of Income

Main sources of income of Zila Parishad are:

1. Taxes on circumstances and property and other taxes which state government apply.
2. Grants from state government.
3. Road tax and fee etc., imposed by Zila Parishad.
4. Income from property and loan from state government.
5. Grant for construction and other programme.
6. Non-planning help of state.
7. Income from fair and exhibition.
8. Land cesses.

These are the main sources of income. In some states panchayat have the power to impose tax. Land Revenue is that charge which state government collects for local bodies. In U.P after the abolition of Zamindari system land cess included in the land revenue and instead of it Zila Parishad were given grants from the state government In Bihar and West Bengal cess applies annually. But there is no other opinion that the local bodies don't have sufficient resources to fulfil their functions and obligations.

Self-Assessment

Multiple Choice Questions:

4. In how many parts is village panchayat divided?
   (a) One (b) Two
   (c) Three (d) Four
5. Village panchayat arrange which functions in their area.
   (a) Non-Discreationary (b) Discreationary
   (c) Obligatory (d) None of the above
6. In Maharashtra, which term is used for the chairman of Zila parishad.
   (a) Chairman (b) Speaker
   (c) President (d) All of the above

30.7 Summary

- Main sources of income of municipalities are –Taxation grants from state government, taxes collected by the state government and a part of it and non-tax revenue revenue from the sources of municipalities.
- Taxation enquiry commission went through the total income of municipalities' indifferent states and came to a conclusion that the increase in the income of municipalities is not enough.

Notes

- As compared to municipalities the work of Municipal Corporation is more expanded. They not only have the power to impose tax but also they have freedom to form budget and in some matters they are free from the control of state government.
- In municipal services level of expense is high as compared to Municipal Corporation. This is because Municipal Corporation has more resources.
- As far as the question areas of village panchayats, panchayat committees and district council's changes are made in their power after the independence. These are connected with each other and work according to the plans and maintain balance.
- In the first year planning following words were used for the importance of panchayat 'Panchayat plays an in dispensable role in rural area,
- Roughly the work of village panchayats can be divided into two parts—obligatory and Discretionary. Their area of scope is wide in which town administration and cultural, social; Agriculture and Development related activities are included.
- Panchayat Samities are established in the middle level of Panchayat Raj except Gujarat, Maharashtra and Karnataka in all the states they are formed on block level.
- Except Assam, in every state Zila Parishad is established on the third level. In Assam, it is on sub-division level. In Tamil Nadu to establish Zila Parishad, 13 districts 22 Development Districts were founded in Andhra Pradesh, Bihar, Maharashtra, Orissa, Punjab, Rajasthan and U.P it is known as Zila Parishad.

30.8 Keywords

- Act–Rule made under Legislature
- Body–Institution

30.9 Review Questions

1. Write the sources of income of Municipalities.
2. Write the taxes imposed by Municipal Corporation.
3. Describe the functions of Village Panchayat.
4. Discuss the functions of Panchayat Samiti.
5. Explain the functions of Zila Parishad.

Answers : Self Assessment

(1) Panchayati	(2) Zila Parishad	(3) Municipalities
(4) (b)	(5) (b)	(6) (c)

30.10 Further Readings

Notes

Books

1. Public Finance—*New Royal Book Company.*
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