ECONOMICS

PUBLIC FINANCE

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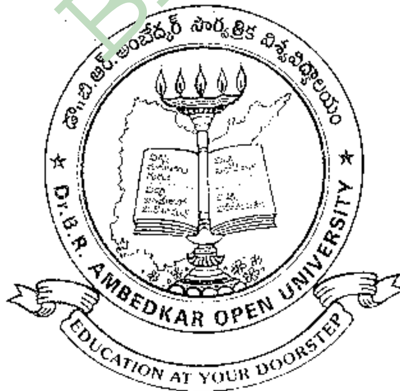

Dr. B.R. Ambedkar Open University
Hyderabad
1994

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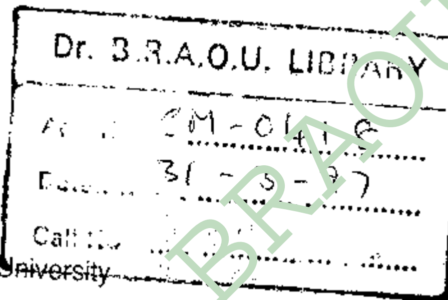

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INTRODUCTION TO THE COURSE

In the Post-Second World War period the function of the State has been subject to unprecedented change. Its compass is so enlarged that the State is now required to make society work, provide justice to its subjects and involve itself in development activities. The State requires funds to carry out its multifarious and multifaceted activities. Issues concerning how the Government should raise its resources by using alternative policy instruments, how it should allocate funds to finance its various activities and how it should regulate the Private Sector are generally viewed from three points : welfare, development, and stability. The choice of instruments for Government revenue mobilisation and the composition of Government expenditure invite normative judgement.

The primary objective of this course is to discuss the economic principles that govern public finance principles such as those of Welfare Economics and Micro and Macro Economics. It pays particular attention to the examination of Indian Government's revenue and expenditure at the Central and State levels.

This book deals with the topics in Public Finance included in the syllabus for the Third Year of the undergraduate course offered by the Andhra Pradesh Open University. These topics cover the specialised area to be studied in the Third Year of the Three Year Degree Course in Economics. The Syllabus for the sake of convenience is divided into blocks, each of which comprises a number of units. Each block generally covers a specific area of the subject.

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The course in Public Finance is covered in seven blocks. The first block provided an introduction to the course on Public Finance. The second block dealt with Public Revenue. The third block discussed the Indian Tax Structure and fourth block Public Expenditure. The fifth block focussed on Public Debt. In this part the sixth and seventh blocks are devoted to the Functional, Developmental and Federal Finance.

The units are prepared by specialists in accordance with a format so designed as to enable the student to read and understand them without much difficulty. Each unit begins with contents and a statement of its objectives followed by introduction and subject matter and at the end of each unit are given model examination questions to test the student's comprehension of the subject matter.

The University hopes that this material will help the student to get acquainted with the principal issues in Public Finance which make for its distinctiveness and significance.

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BLOCK I

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INTRODUCTION TO PUBLIC FINANCE

This block introduces the nature and subject matter of Public Finance. You will also know the main divisions of Public Finance. A comparison between Public finance and Private Finance is dealt with in another unit. This block also explains the basis for public finance operations through the priciple of maximum social advantage'.

This block contains the following 3 units:

Unit 1. The Nature of Public Finance

Unit 2. Public Finance Vs. Private Finance

Unit 3. The Principle of Maximum Social Advantage

UNIT-1 : THE NATURE OF PUBLIC FINANCE

Contents

1.0 Aims and Objectives
1.1 Introduction
1.2 The scope of Government Activity
1.3 Public vs. Private Goods - The Exclusion Principle
 1.3.1 Important Characteristics of Merit
 1.3.2 Other Distinctions between Public Goods and Private Goods
1.4 Other Considerations
 1.4.1 Source of Initiative to Private Sector
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 1.4.3 Means of Redistributing income
1.5 Interrelationship between various Economic Activities
 1.5.1 Unilateral and Bilateral Flows
 1.5.2 Positive and Negative Transfers
1.6 Deflinitions of Public Finance
1.7 Main Divisions of Public Finance
 1.7.1 Public Revenue
 1.7.2 Public Expenditure
 1.7.3 Public debt
 1.7.4 Financial Administration
 1.7.5 Stabilisation and Growth
1.8 Summary/Conclusion
1.9 Suggested Books
1.10 Model Examination Questions

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1.0 AIMS AND OBJECTIVES

This unit explains the nature of Public Finance and also main divisions of Public Finance.

After reading the unit, you will be able to

- describe the scope of government activity,
- explain the subject matter of Public Finance,
- define public finance, and
- list the branches of public finance.

1.1 INTRODUCTION

Public finance is an important branch of economics. It deals with the study of various financial activities of the state such as public revenue, public expenditure, public debt, etc., of the state. In this unit, let us try to introduce the subject matter of Public Finance. In this modern

world, the role of the State has enormously increased, there by increasing the nature of Public finance. The scope of public finance has widened due to the momentum given to the idea of welfare state. Different definitions given to the Public Finance are explained in this unit. Later at the end, we try to divide the subject matter of Public Finance in to many branches such as public revenue, public expenditure, pbulic debt, etc.,

1.2 THE SCOPE OF GOVERNMENT ACTIVITY

Public finance is an important branch of economics and deals with the study of the various financial activities of the State such as public revenue, public expenditure, public debt, financial administration etc., of the State. Before we understand the nature of Public finance, it is necessary to find out the scope of government acitivity in an economy. In olden days, the classical economists believed that the functions of State should be confined to protection of people from external aggression and from internal disorders. Such functions were known as 'Police State' functions. In course of item, epecially after the Second World War, the functions of State have enormously increased encompoassing production and distribution of certain key and strategic commodities, providing social justice to the people and rational allocation of the nation's scarce resources. In a capitalist economy, the market mechanism is supposed to guide all the economic activities of consumers and producers. But experience of many countries in the world has amply revealed that the economic operations, if left completely to market mechanism, may result in the growth of private economic power which will be detrimental to the public interest. Disparities in income and wealth between the rich and the poor might increase. Resources may be wasted. They may be either underutilised or unutilised or more often mis-utilised. Economies run completely on market mechanism are prone to serious fluctuations due to booms and depressions. Therefore, the need to expand government activities has been very much felt in order to overcome some of the shortcomings of market mechanism. Among the countries in the world – apart from the capitalist economies – we have the other group belongiang to socialist economies, where the market mechanism is assigned a very marginal role. The public sector dominates in teh major activities of production and distribution in such economies. Between these two economic systems, there are the mixed economies like the one we have for India. The activities of both private and public sectors have considerable impact on the functioning of such economies.

Now a pertinent question is what should be the scope of government activity in an economy? This question seems more relevant to captilist and mixed economies rather than to the socialist economies. The socialist approach to the scope of government holds the view that every economic activity shall be performed by the State only. The problems of Public finance in socialist countries widely differ from those in capitalist or mixed economies. As the means of production are owned by the State, the government determines the economy's price and production policies.

Price policies of the government play an important role in Public finance in the socialist countries. Resources to finance the various activities of the government are raised mostly by way of mark ups on costs rather than resorting to additional taxation in such countries. Now, how about government activity in capitalist and mixed economies? In these economies we are guided mostly by two considerations namely,

(a) government action is needed only when the private sector can not perform its functions satisfactorily, and

(b) a more active role of government to control, supervise and regulate the activities of private sector in order to achieve certain specific objectives in the egalitarian point of view.

1.3 PUBLIC VS. PRIVATE GOODS - THE EXCLUSION PRINCIPLE

To understand more fully the first consideration, we shall have to know the distinction

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between what are called Public and Private goods. Better an example is taken to elaborate this point. The life and property of all the people are protected by National Security, provided by the State, the services of which cannot be priced by market mechanism. Every person in the country whether he wants it or not is given protection by the State. Such a service (or good) is known as a *"collective good"*. It is enjoyed by all people in the country. So, it is also called *'Public good'*. On the other hand, we have *Private goods* like bread, cloth, fan etc., which are priced in the market. One cannot have such a good without paying its market price. The person who desires to get it will have to pay its price. If he does not pay, he will not get it. So, he is excluded from those who would desire to have the good. In other words, market mechanism excludes those who are not willing to purchase the good by paying its price. This characteristics of the good is attributed to what is called the *"exclusion principle"*. Goods which are priced by market mechanism are covered by the exclusion principle. If goods are not priced but commonly enjoyed by all people irrespective of their willingness to have them or not do not come under the *'exclusion principle'*. It is not possible to exclude any person from the benefit of a collective good, provide by the government, but not by the private sector. In this context, it may be stated that R.A.Musgrave supports government activity for the fulfilment of *'merit wants'*. For instance, all people may need educational and health services etc., which could be provided even by the private sector but in that case, only on the basis of *'exclusion principle'*. Those who will not pay for the services cannot have it. So, in the interests of society at large, it is desirable that government shall provide such services to the public.

1.3.1 Important Characteristics of Merit Wants

i. Interferance with consumer preference

ii. Rival in consumption

iii. Subject to exclusion

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Both social wants and merit wants are public wants and fall within the scope of normative theory of Public finance. The satisfaction of social wants and merit wants forms part of the normative theory of Public finance.

1.3.2 Other Distinctions between Public Goods and Private Goods

(a) Basis of Marginal Cost

Also, viewed from the point of marginal cost, government activity can be supported. The marginal cost of public good (unlike a private good) may be sometimes zero or nearer to zero which means that there will not be any appreciable cost-increase to provide the facility to an additional person. It should, however, be remembered that it may not always be possible even for the government to supply a public good to an unlimited extent without increase in its marginal cost.

(b) Basis of Externalities

The scope of government activity is supported on some other grounds also. In the production or use of a good, there may be flow of certain effects to others which are called *'Externalities"*. The effects on account of externalities may result in an economic gain or loss to others. Besides they may involve social costs or benefits also. For instance, a paper mill in a locality may pollute a river which is a cost on the society for which the mill may not be paying anything extra towards penality. Being a unit in the private sector, the social cost is not considered in its profit maximising calculations. So, in such of those activities where the social loss or gain are to be considered, it is more desirable that they shall be under the government control instead of leaving them to private enterprise.

(c) Basis of Market Mechanism

In studies making comparisons between private and public (or social) goods, it is generally recognised that in the case of the former the market mechanism works effectively, while in the case of the latter, it is associated with the failure of market mechanism. For a private good market mechanism works effectively because of (i) application of *exclusion principle'* and (ii) consumption of such a good being *'rival'* so that exclusion may be applied with effciency loss. It should be noted that where market mechanism fails, we have a strong argument for social or public goods. And market mechanism fails whenever exclusion is not applicable or if there is absence of competition or both. As long as there is rival consumption, we can say that the good is effeciently used. If consumption becomes *'non-rival'*, there is no point in applying the exclusion principle. Goods of which consumption is non-rival are referred to as *"social goods"*.

(d) Business of Risk

Government activity may be supported on still another count. Private enterprise cannot shoulder certain types of risks. For instance, in areas where sophisticated technology and heavy investment are involved, it is not possible for the private sector to undertake production and supply of goods.

CHECK YOUR PROGRESS - I

1. What is exclusion principle ?

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2. Define collective good or public good.

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3. What do you mean by merit wants ?

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4. What are social goods?

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1.4 OTHER CONSIDERATIONS

We may now deal with the second consideration namely the scope of government activity to achieve certain additional objectives, which may be the following;

(a) As a competing source of initiative

(b) To influence the pattern of private consumption/production

(c) As a means of redistribution of income

We now elaborate these objectives.

1.4.1 Source of Initiative to Private Sector

It is believed that the government can act *as a source of initiative to private sector.* Public sector may have an opportunity to produce and supply a commodity or service in a better way than the private sector. All the government programmes are not strictly based on commercial profitability just like private enterprises, yet it is possible to introduce the same in some areas like generation of power, transport and production of certain strategic commodities etc. The position in developed countries is some what different. In the developed countries, we notice that many private enterprises also function more efficiently than even the government units. But,in the developing countries, where the number of potential enterprises is very small, we can expect government to play an important role as a competing source of initiative. Today, we find many public sector units competing with the private sector units. Such competition leads to improve the operational efficiency of the private enterprises. However, in some of the developing countries, like India, there has been criticism that the public sector units are worse than their counterparts in the private enterprises. Here, we must know that the criticism is not valid in so far as the very basic principle of government acting as a source of competing initiative is concerned. The malfunctioning of the public sector units if any, could be attributed more to the ineffciency of the persons managing the unit rather than the scope of government activity itself. There is, therefore no doubt that public sector especially in underdeveloped or developing countries provides initiative and innovation to the private enterprises.

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1.4.2 Changing the Pattern of Private Consumption/Production

The second object namely *"changing the pattern of private consumption or production"* can now be elaborated. Government may by direction prohibit the consumption of goods like harmful drugs, liquor etc., which would reduce social welfare. Some times it is also possible for the government to levy heavy taxation on such goods so that private consumption can be reduced by market mechanism. When a tax is imposed, the price of the commodity goes up, thus the demand for it may decline. If on the other hand government desires that private consumption should be encouraged, instead of taxing the goods, even subsidies might be granted. The purpose is to see that the prices of such goods fall so that demand for them would increase. Similarly, government may by direction prohibit the production of certain goods in the economy that are considered detrimental to the public welfare. The tax mechanism can play an important role to discourage the production of such goods. If on the other hand, government desires to increase the production of certain goods either to boost up domestic demand or to improve exports, the same tax mechanism could be applied reducing the tax rates like reducing the excise duties or export tariffs. A part from the tax mechanism, it is open for the government to

regulated. However it shall be remembered that monetary measures, strictly speaking do come under the category of banking system and thus do not form a part of Public Finance.

1.4.3 Measures of Redistributing Income

The third objective namely *as a means of redistributing income'* is meant to reduce the existing glaring inequalities of income and wealth between the rich and the poor. Some examples may be cited in this context. Government activities like social security, unemployment insurance ect., are designed to provide additional income to those whose earned income is very small. Sometimes, government may grant subsidies in certain areas of production with a view to benefit a particular section of the population. Similarly, public works constructed by the government would also benefit those who utilise them. The fiscal policy adopted by the government may also be aimed at redistributing the income in the society. Redistribution of income is considered to be a major policy measure in most of developing countries as it is justified broadly on two grounds namely (i) to usher in an egalitarian society and (ii) to generate effective demand.

By having an *egalitarian society,* the general welfare of the people in the country would improve and the fruits of economic development can be reaped by all sections of the society. If the inequalities continue to grow beyond certain proportions, goods produced for mass consumption do not find adequate demand in the market. This is a sitution when we find on one side luxuries goods being demanded by the upper income classes while the low income classes would not have the adequate purchasing power to demand the necessaries on the other. So redistribution of income through appropriate fiscal policy helps to increase the *effective demand* for mass consumption goods. Resoruces instead of being used for producing more of luxurious goods can also be utilised for producing consumption goods.

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1.5 INTERRELATIONSHIP BETWEEN VARIOUS ECONOMIC ACTIVITIES

1.5.1 Unilateral and Bilateal Flows

Thus, from the foregoing discussion we very much realise the need for government intervention in the economic activities of the people. We may now deal with the interrelationship between various economic activities performed by the government and the private sector. A.R Prest calssified all the economic activities into two categories namely (i) unilaeral flows and (ii) bilateral flows. If governemnt purchases goods and services sold by the private sector via market mechanism, it comes under a *bilateral flow.* This involves movement of goods and services from the private sector to the public sector and at the same time there is a corresponding movement of funds from the public sector to the private sector. Price and money are both involved in this kind of transaction. On the otehr hand, there may be flows unilateral where money only may be involved but not price. In other words the transaction may not have any direct association with the market mechanism. Items like old age pensions, ex-gratia payments made by the government do belong to this kind of transaction. Such payments are generally called *'transfer payments'* which are not linked to the market or price mechanism.

1.5.2 Positive and Negative Transfers

Again, we may distinguish between *positive transfers* when the money flows government to private individuals just like the old age pensions etc., and *negative transfers* when private individuals pay taxes to the government. For instance, personal income tax may be paid by private individuals to the government without getting any direct return of benefit. This involves a negative transfer payment. In government transactions, we have another term called *'subsidies'.* What is the distinction between *transfer payments'* and *'subsidies'?* If subsidy is granted by government in respect of a commodity, it results in the reduction of market price by the amount

proportionately falls. So, subsidies have the effect of negative indirect taxes. In other words, while we can understand that transfer payments like the old age pensions could be considered as negative direct tax. Subsidies could be thought of as a negative indirect tax. Transfer payments would increase the income of the people directly while subsides would reduce the prices of goods in the market. The unilateral and bilateral flows, so important in the operations of public finance, would change the pattern of resource allocation in the economy in the manner desired by the government. These flows are effected when ever there are changes either in the tax structure or in the public expenditure or both.

So questions relevant to understand the operations of public finance in a State are the following.

(a) How far the unilteral and bilateral flows i.e., the operations of Public finance are capable of making allocation of resources efficient?

(b) How far the tax expenditure and debt policies of the government are successful in attaining price stability and full employment?

(c) To waht extent the operations of Public finance could influence the distribution of income among different sections of the society?

In the subsequent units, these have been dealt with separately.

CHECK YOUR PROGRESS - II

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5. What do you mean by 'unilateral flow'?

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6. Explain the concept of 'bilateral flow'?

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7. Distinguish between positive transfers and negative transfers.

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1.5 DE[illegible]S OF PUBLIC FINANCE

[illegible]ists have defined the subject matter of Public Finance differently. [illegible]

deal here only a few of them. It may be stated that the definition given to the subject of public finance has been changing, following the developments in State activities and the corresponding economic philosophy. We find from the writings of the classical economists that the role of government should be kept to the minimum level. So, J.B. Say says "that the very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount". This view was on the basis of the old economic philosophy of *'Laissez faire'* advocated at that time.

Carl C. Plehm says that "Public finance has come, by accepted usage to be confined to a study of funds raised by governments to meet the costs of government. It was considered that Public finance dealt mostly with the operations of government treasury and how they would interfere with the working of the private sector of the economy".

According to Bastable 'for all States – however-whether crude or highly developed – some provisions of the kind are necessary and therefore, the supply and application of State resources constitute the subject matter of a study which is best entitled in English 'Public Finance'. It is clear from this definition that Bastable emphasises State's intervention to supply certain kind of goods to the people. According to Mrs. U.K. Hicks, there is a fundamental difference between private and public activities. She believes that public activities are aimed at providing goods or services, not determined by the direct wishes of consumers. Public finance is the study exclusively concerned with such activities. It is clear from this definition that Public finance is related to public activities which are not governed by market mechanism.

According to Dalton "Public finance is concerned with the income and expenditure of Public authorities and with the adjustment of the one to the other". He believes that the subject of Public finance lies on the borderline between economics and politics. It can be seen from this definition that Dalton was more concerned with the adjustment of government budget rather than how it influences public policy.

But in modern days, the idea of welfare state has gained momentum. Consequently, *the scope of public finance* has also widened. One would expect that modern governments should be capable of reducing unemployment; providing distributional justice and of fostering economic growth. This is the new approach to the scope of Public finance. Economists like Musgrave and Buchanan have opined that the basic problems of Public finance are not 'issues of finance' but rather those relating to the economic policy that arise in the operation of public budget. So, how taxes and public expenditure would influence resource allocation, productivity, price levels, distribution of income and wealth among different sections of the community and administrative efficiency are the most important aspects of Public finance. Such a study is also known as the national income or employment approach to Public finance. As already stated earlier, in olden days it was believed that the economy of a country would function more efficiently only if there was no government intervention. Such a view was supported on the basis of Say's Law of the market. But after the great depression and more so after the publication of the *General Theory* of J.M. Keynes, Public finance assumed a functional character. Instead of having 'balanced budgets' most of the countries in the world shared interest to adopt 'unbalanced budget' does not always mean that expenditure exceeds income. It could even mean that income might exceed expenditure. An unbalanced budget is adopted as a corrective to the prevailing problems at the time. Even in India also, we find unbalanced budgets being presented in almost all the recent years. In a federal set up, Public finance looks into the financial problems and policies of Central, State and local level governments.

1.7 MAIN DIVISIONS OF PUBLIC FINANCE

The subject matter of Public finance can be broadly divided into the following main branches:

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1.7.1 Public Revenue

This branch deals with the various methods by which government can raise revenue. Broadly, public revenue consists of (a) Tax Revenue, (b) Non-tax Revenue. Again, tax revenue can be divided into two kinds viz., Direct Tax Revenue and Indirect Tax Revenue. Under non-tax Revenue there are a variety of items which among other thing include fees, fines etc. In this branch we study the incidence and effects of taxation. When taxes are imposed there is transfer of purchasing power from people to the government. Therefore taxes would influence production, distribution and employment in the economy. Public revenue can be raised even by borrowing from the people internally or externally. It is known as public debt which can be separately studied.

1.7.2 Public Expenditure

In this branch we study the pattern and quantity of the expenditure incurred by the government. Public expenditure would influence the supply and demand of certain goods or services. It would also inlfuence the functioning of private sector in the economy. Public expenditrue aims at not only increasing economic growth but also to achieve stabilisation and maximum social welfare in the country. In recent times public expenditure has been increasing due to many reasons. The principles governing public expenditure and their impact on the economy are also studied in this branch.

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1.7.3 Public Debt

Public debt refers to the borrowing of the government from the people internally and externally. Therefore strictly speaking public debt forms a part of public revenue. However, as modern governments have been borrowing heavily to meet thier ever growing public expenditure, it is worthwhile to study public debt separately to find out its effects on the economy. In this branch we study the different methods adopted by the government to borrow money from others. We also study various methods for the repayment of public debt.

1.7.4 Financial Administration

In this branch we study the various techniques adopted to account for the transactions relating to the financial activities of the government. In this branch we learn how the budgets are prepared, presented to the legislature or Parliament, and implemented. Financial administration deals with the ex-ante and ex-post situation of public revenue as well as public expenditure. It also deals with the auditing procedure, performance budgeting etc.

1.7.5 Stabilisation and Growth

In recent times much improtance is given to those aspects of economic policy which can help achievement of stabilisation and growth in the economy. For a long time these aspects were not included as a part of the study of Public finance. But, with the increase in the economic activities of the government it has become necessary to know as to what impact would be there on stabilisation and growth. Therefore, this branch also is studied separately.

1.8 SUMMARY CONCLUSION

This is the introductory unit for this course in 'Public Finance'. So we have tried to understand the basic concept of public finance. The nature and subject matter of Public Finance is discussed. Some of the definitions given on public finance by economists are analysed. At the end, the subject matter of public finance is broadly divided into public revenue, public

this unit. In the next unit, we try to compare public finance with private finance.

— Dr. [illegible] Rao

1.9 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*

1.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the nature and scope of public finance?
2. Define public finance. Classify the public finance into various branches.
3. Distinguish between public vs. private goods.

II. Answer the following questions in about 15 lines each.

1. Distinguish between unilateral flows and bilateral flows.
2. What are the three important branches of public finance?
3. Explain the exclusion principle.

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UNIT-2 : PUBLIC FINANCE VERSUS PRIVATE FINANCE

Contents

2.0 Aims and Objectives

2.1 Introduction

2.2 Comparison between Public and Private Finances

2.3 Summary/Conclusion

2.4 Suggested Books

2.5 Model Examination Questions

2.0 AIMS AND OBJECTIVES

This unit brings out the similarities and dissimilarities between public and private finaces.

After reading the unit, you will be able to

- compare the public finance with private finance.

2.1 INTRODUCTION

It is instructive to know the differences between Public and Private finances. Public finances refer to the financial problems and policies of a public authority (government or any unit run by the Public sector) while private finance refer to that of an individual economic unit, belonging to private sector. There are some similarities and dis-similarities between the two.

It may be stated that the activities of both public as well as private sectors need money with which many transactions relating to purchase and sale of goods and services, production, exchange, investment, etc. are regulated. In modern days all the economies in the world are monetised. All the activities involve the creation and use of financial claims. Again, the activities of both the sectors produce goods and services which would satisfy the wants of the people. To a large extent, one can see that both the sectors face resource constraint and therefore have to carefully use the limited resources at their disposal. All these points clearly indicate that the finances of both the sectors have some similarities. Nevertheless, the dis-similarities between Public and Private finances seem to be more important and also relevant for understanding the policy measures that ought to be adopted in the modern welfare states. Then, what are the major dis-similarities?

2.2 COMPARISON BETWEEN PUBLIC AND PRIVATE FINANCES

2.2.1 Adjustment between Income and Expenditure

Firstly, as Dalton puts it 'while an individual's income determines the amount of his possible expenditure, a public authority's expenditure determines the amount of its necessary income'. To put it simply, we can say that an individual adjusts expenditure to income while a public authority adjusts income to expenditure. This difference between Public and private finances has however been subjected to much debate. Often it has been argued that it is not always possible for an individual to adjust expenditure to his income. For example, if he becomes responsible for more number of dependants, he may decide to increase his income by working more hours and sacrificing leisure. On the other hand, when his children have become self supporting, his expenditure may likely fall as a result of which, he may prefer to work less and take more leisure. Even for a public authority also, it may not always be possible to plan expenditure first and raise resources to match the same. Excessive taxation and borrowing will have certain adverse affects

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on saving and investment in the economy. Also, in developing economies, raising resources by the government is a difficult task. Most of the people are poor and their taxable capacity is less. While it may not be possible to get large sums by way of internal borrowing, excessive external borrowing may lead to dangerous consequences at a later time. Even limited deficit financing may have serious repercussions like inflation etc., not at all conducive for acclerate economic development. Taking all these points into consideration, we may say that even for a public authority or government it may become necessary to adjust expenditure to its income depending upon the situation at the time. Nevertheless, for making deliberate changes in its income and expenditure, a public authority is generally in a much better position than an individual. Hence, there is difference between public and private finances in this aspect.

2.2.2 Market/Budget Principle

Secondly, it is often stated that private finances are governed by the market principle while Public finances follow the budget principle. The essence of market principle is based on economic rationality, in that profit considerations are given importance. But in the case of budget principle, the allocations of public expenditure as also of raising public revenue etc., are not, strictly speaking, made keeping in view profit expecations. The decisions made by public authority are reached though political and administrative procedures giving importance to the welfare of the society.

Here, again, it has been argued by some economists that certain public sector units have to run on commercial lines otherwise they would not be viable. Even then, the broad consideration of the financial operations of a public authority is to achieve common social objectives.

2.2.3 Interest of the Society/Individual

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Thirdly, the operations of Public finances would consider the interests of the economy as a whole. This makes the State to consider not only the short run but long run problems also. Some of the investments made by the State to build up economic and social overheads may not have immediate economic return but they are justified keeping in view the long run benefits. For example-large amounts spent on afforestation, soil conservation, education, public health etc., do not have immediate return but they are important in the long run point of view of the community. In the case of an individual, short run benefits are more important than those in the long run. Dalton rightly states, in so far as future conditions can be reasonably foreseen, statesmen should sometimes aim at making a more generous provision for the future than would be made by private individuals left to themselves'.

2.2.4 Internal and External Borrowings

Fourthly, in the case of an individual, it is not possible to resort to internal borrowing but for a State both internal as well as external borrowing is quite possible. It is not possible for an individual to borrow internally. All his borrowings are external. It is possible for the State to borrow from the people living in the same country. This is known as 'internal borrowing'. Whenever it is necessary, a public authority can float loans and borrow money internally. Also, the rate of interest on the borrowings of the State is generally lesser than the rate at which tthe borrowings of an individual are charged. This is obvious as the State has more credit worthiness than an individual. The State can draw upon the facilities provided by the Central Bank of the country as well as other financial institutions more liberally to raise loans internally from the public.

2.2.5 Creation of Legal Tender

Fifthly, an important difference between public and

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the exclusive power to create the legal tender which an individual or any economic unit held by private sector does not have. When money was in metallic form, there was some restriction on the part of the State to create money. But with the emergence of paper currency, there is practically no restriction for the creation of legal tender by the government. Whenever government wants more revenue, it could resort to creation of money. But such an act by the government may have serious repercussions. When government spending is increased on these lines, it means a larger volume of goods and services being purchased (demanded) by the government in the market as a result of which the rest of the economy may be left with lesser supply of goods and more money. This gives raise to a plethora of questions: (i) How the goods and services purchased by the government are utilised? Have they been used for public distribution system or for capital formation or merely for social consumption? (ii) Whether the increased government demand for goods and services could succeed in bringing out price stability in the market? (iii) What are the short run as well as long run effects of financing public expenditure by creation of money? If one considers all these aspects, it becomes clear that even for a Public authority, it is not always desirable to expand paper currency in order to meet its public expenditure. Even then, the exclusive powers that the State has in the matter of creating legal tender still remains as a fundamental difference between Public and Private Finances

2.2.6 Public Welfare or Individual Marginal Utility

Sixthly, it is generally stated that an individual so distributes his expenditure on various commodities and services that the marginal utility of all these expenditures are equal by which the total utility becomes maximum. This is nothing but *'Law of equi-marginal utility'*. In respect of estimating the marginal utility of any form public expenditure the State takes an objective standard of public welfare or social advantage but for an individual, it is the subjective standard of utility linked with an objective standard of price. There are, however, some constraints placed on different items of State's spending by which it may not be possible for equating marginal utility in terms of Public welfare. Demand from rival spending departments, pressures from elected or organised persons etc., make the State to deviate from the rule of equating marginal utilities in practice.

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2.2.7 Methods of Raising Revenue

Seventhly, some economists pointed out that government has the coercive authority to raise revenue. Taxes imposed by the government cannot be refused by the people. They are liable to pay them. Private individuals and business houses have no such powers so as to force others to pay them money. It may, however, be argued that a person can avoid payment of tax by opting to some alternatives open to him. For instance, commodity taxes can be avoided by not purchasing them. Similarly income tax can be avoided by reducing one's earnings'. Wealth duties can be avoided by avoiding accumulation of property etc. But in practice, it may not be possible to opt to these alternatives. Similarly, in the case of business houses one may argue that sometimes it may be possible to force buyers to pay higher prices for the commodities (or services) in the production of which they have monopoly power. Nevertheless, a public authority has more coercive power than an individual or private business houses.

2.2.8 Secrecy and Publicity

Lastly, an important difference between Public and Private finances is that which relates to secrecy and publicity. Private finance is not exposed to others. It is shrouded in secrecy. One may not like others to know his financial affairs. In the case of a public authority like government the financial transactions are fully exposed to all. Government budgets are open for public criticism. However, this view of government finances cannot always be correct. Expenditure incurred by the government for its defence requirements is not fully exposed to the public. Even then,

compared to an individual, the details of State finances can be known by anybody whosoever is interested.

2.2.9 Allocation of Existing Resources

Thus far, we have broadly learnt the differences between public and private finance. Now our task is to know how the private finance operations differ from that of public finance operations in respect of allocation of existing re-sources among different uses. For the sake of simplicity, we may assume a given supply of all productive resources in the economy. In the private sector, the concept of perfect competition is given very much importance for efficient distribution of resources among their end-uses. For instance, ideal output is supposed to have been attained with respect to any one single firm when marginal revenue from sales equals the marginal cost of production. This implies that the marginal cost of any one factor is equal to the value of the marginal net product of that factor. The allocation of resources by the operations of private finance does not take into consideration the social costs and benefits involved in the process of production or consumption of the goods. In other words, the equality of relative marginal private products to relative factor prices will not give us an optimum distribution of factors from the social point of view. On the other hand, public finance operations take into consideration the social costs and benefits so that the resources are optimally used.

In the case of private finance operations, resources are allocated on the basis of their relative prices. For example, a private enterpreneur charges the goods and services according to their consumption. The benefits received by the consumers are measurable. But in the case of certain public finance operations, it is imposibble to allocate the resources on the basis of price mechanism. It is not possible to say how much benefit any one individual derives from defence expenditure. Similarly, it may be undesirable to charge people fully for the amount of education they receive. If the allocation of resources are made according to private costs and benefits, it would be more satisfactory to rely on prices (or charges) rather than taxes. But where social costs and benefits are involved, allocation of resources through public finance operations is made by changing the existing tax or public expenditure system. From this, it follows that the main source of income to the private sector is derived from prices on the basis of consumer demand and cost of production. But for public finance operations, the main source of income is normally derwed from taxes.

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2.2.10 Transfers and Subsidies

Another distinction which may be found between public and private finance operations is with respect to transfers and subsidies. This relates to the distribution of expenditures in the Public sector. Transfers and subsidies are meant to divert resources from one use to the other. Private expenditure does not contain items like transfer payments and subsidies.

2.2.11 Regulation and Supervision

Still another point in this context is that in a mixed economy, the private finance operations are regulated by the government. In other words, the public finance operations always aim at regulating the various economic activities in order to attain maximum welfare in the economy and in doing so, the economic activities carried by the private sector have to be directly or indirectly supervised. In capitalist countries like U.K., USA etc., where market mechanism assumes prominence, the private finance operations are controlled to a less extent by the government.

2.3 SUMMARY/CONCLUSION

From the foregoing discussion, it is clear that dissimilarities are more pronounced between Public and Private Finance. In modern days, even the private companies also are able to mobilise

the resources more or less on the same lines just like the government. For instance, a private enterprise by floating bonds, shares, debentures etc., is capable of raising substantial resources required for its functioning. But the coercive powers exercised by the government in the form of taxation are not vested with a private organisation. Moreover, the social accountability is much greater in the operations of Public finance compared to that of the private finance.

– Dr. T. Diwakara Rao

2.4 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*

2.5 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Compare the Public finance with Private finance.

II. Answer the following questions in about 15 lines each.

1. List the differences between Public finance and Private finance.

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UNIT - 3 : THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

Contents

3.0	Aims and Objectives
3.1	Introduction
3.2	The Principle of Maximum Social Advantage
3.2.1	Assumptions
3.2.2	The Principle
3.2.3	Allocation of Public Expenditure and Public Revenue
3.2.4	Limitations
3.3	Test of the Maximum Social Advantage
3.4	Summary/Conclusions
3.5	Suggested Books
3.6	Model Examination Questions

3.0 AIMS AND OBJECTIVES

This unit aims to explain the basis for public finance operations in a State, that is, through the principle of maximum social advantage.

After reading the unit, you will be able to

- list the assumptions on which the analysis of principle of maximum social advantage depends,
- explain the principle of maximum social advantage ,
- describe the limitations of the principle, and
- analyse the test of the maximum social advantage.

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3.1 INTRODUCTION

In the previous lessons, we have seen that government intervention has become necessary to regulate the economy. As the activites of the State have enormously increased the public expenditure component of government budgets has also tremendously increased. To meet a large volume of public expenditure, large sums of revenue have to be raised either by additional taxation or by resorting to more quantum of public debt. So raising money by way of taxation or public debt will have the effect of reducing the money with the individuals in the economy. In other words resources are transferred from being used by private individuals to the government for using the same on different items of the public expenditure. In this process, how the people are affected or benefited matters very much. When government entertains a large public expenditure programme, money will flow from the government to the owners of factors of production. Government may spend money for the creation of productive assets or simply as a transfer of payments in the form of old age pensions etc. Whatever be the type of government spending, it provides certain benefits to the community. The benefit and costs of the financial transanctions of government have to be evaluated carefully keeping in view how they are helpful to regulate the economy.

3.2 THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

In olden days, when functions of government were kept at minimum, the activities of spending and raising money by the government did not receive much attention. Because of limited functions (known as police state functions) less amount used to be raised by way of taxes and less money used to be spent on public expenditure programme. In the words of J.B. Say "the very best of all plans to finance is to spend and the best of all taxes is that which is least in amount". This statement clearly supports the minimum role of government in the economy. It was imagined by early economists including Adam Smith and Ricardo that most of the private expenditure which taxation checked was productive while all public expenditure which taxes paid for was 'unproductive'. But as Dalton rightly says "this supposed distincition has long been discredited. The only economic test of the productiveness of any expenditure is its productiveness of economic welfare and public expenditure on education and health is often more productive in this sense than private expenditure on luxuries". As modern welfare states have to perform innumerable functions, the argument that public expenditure is unproductive or all taxes are an evil is not valid now. In modern economies, budgetary and debt policies have assumed prominence for regulating the economy. The demand and supply factors for important goods and services are being influenced by the operations of public finance, which intrun influence the National Income of the country. Therefore public finance operations should be so designed as to provide maximum advantage or welfare to the people of the society. The criterion adopted to achieve this objective is know as 'principle of public finance' or 'principle of maximum social advantage'.

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CHECK YOUR PROGRESS - I

1. What is the principle of maximum social advantage?

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3.2.1 Assumptions

At the outset, we make the following simplifying assumptions to analyse the principle of maximum social advantage. *Firstly* is assumed that the public revenue of the government consists of only taxes but not the other forms of revenue like gifts, loans, fees, etc. *Secondly,* it is assumed that taxes are subject to increasing marginal sacrifice (marginal social disutility) while public expenditure is subejct to diminishing marginal utility (marginal social benefit). By making this assumption, we mean that collection of more and more taxes from the public results in greater marginal social disutility and spending more and more money by the government results in lower marginal social benefit to the people. In other words, while the taxes will drain away resources from the private individuals to the government, public expenditure will be first directed on those items which are most beneficial to the society.

3.2.2 The Principle

Through the operations of public finance, it is possible to make changes in the total purchasing power in the economy. For instance, when the budget shows a deficit, it results in a net increase in the purchasing power and vice-verca. As a result of changes in the purchasing power, the distribution of wealth among different classes may also be affected. So it is very essential result

in greater economic welfare to the people, they are justified. If not, they are not justified. To cite the opinion given by Dalton in this context "the best system of Public Finance is that which secures the maximum social advantage from the operations whcih it conducts."

On this basis, it may be stated that the social benefit from each addtional rupee spent falls while the disutility from each additional rupee taxed increases. A situation is reached in this process that the marignal benefit from the operations of Public expenditure will be jsut equal to the marginal dissatisfaction (disutility or sacrifice) from out of taxation. At this stage, the society gets maximum advantage from the operations of public finance. It indicates the optimum tax and expenditure activity of the state. This view can be depicted by the following diagram:

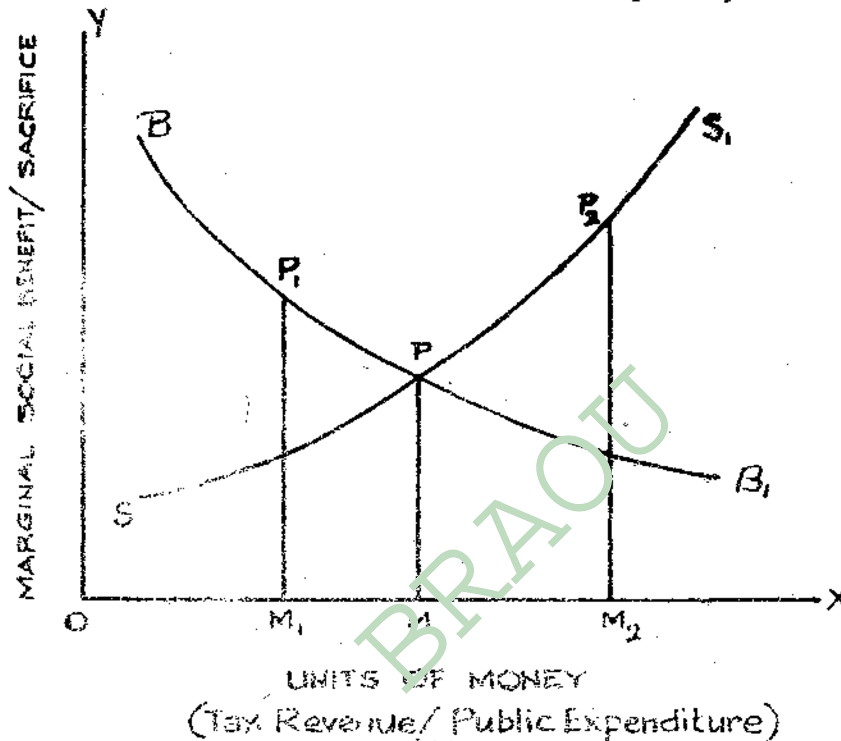

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Fig. 3.1

In the diagram, OX-axis shows the amount raised by taxes as well as the amount spent by the government towards public expenditure. OY axis shows marginal social benefit from the operations of public expenditure as well as marginal social disutility (i.e. sacrifice) due to payment of taxes to the government. As already analysed, more and more taxes involve greater marginal sacrifice. This is represented by the upward sloping SS_1 curve in the diagram. Similarly, more and more money spent towards Public expenditure operations diminishes the marginal social benefit. This is represented by the down ward sloping BB_1 curve. Both the curves interesect each other, when OM amount of money has been raised by taxation and the same is spent by public expenditure operations. At this stage, the society gets maximum advantage from the operations of public finance.

What will happen if the state raises OM_1 units of money and spends the same? The marginal sacrifice or disutility from taxation is less than the marginal benefit enjoyed by the people from the public expenditure operations. This indicates that some more resources can be withdrawn from the private individuals by taxation and spent. If on the other hand, the state desires to raise OM_2 units of money by taxation and spends the same. Obviously, it can be seen from the diagram that the marginal social benefit is less than the marginal sacrifice undergone by the people for paying additional taxes. Therefore, when State raised OM units of money and spends the same, an optimum situation is reached, in that the marginal sacrifice from taxation is just equal to the marginal benefits. This represents 'maximum social advantage' to the community.

The principle of maximum social advantage not only explains upto what extent the public finance operations should be undertaken but it also expalins how public revenue should be raised or public expenditure allocated on different items. We may now deal with these matters.

Public expenditure should be so designed that the marginal social benefit from each item of expenditure should be equal so that the total social benefit becomes maximum. This is in accordance with the principle of equi-marginal utility. If the marginal benefit from one use is greater than the other, the total benefit would not be maximum. The government should increase the expenditure on the first item and reduce the expenditure on the second item. This is depicted in the following diagram:

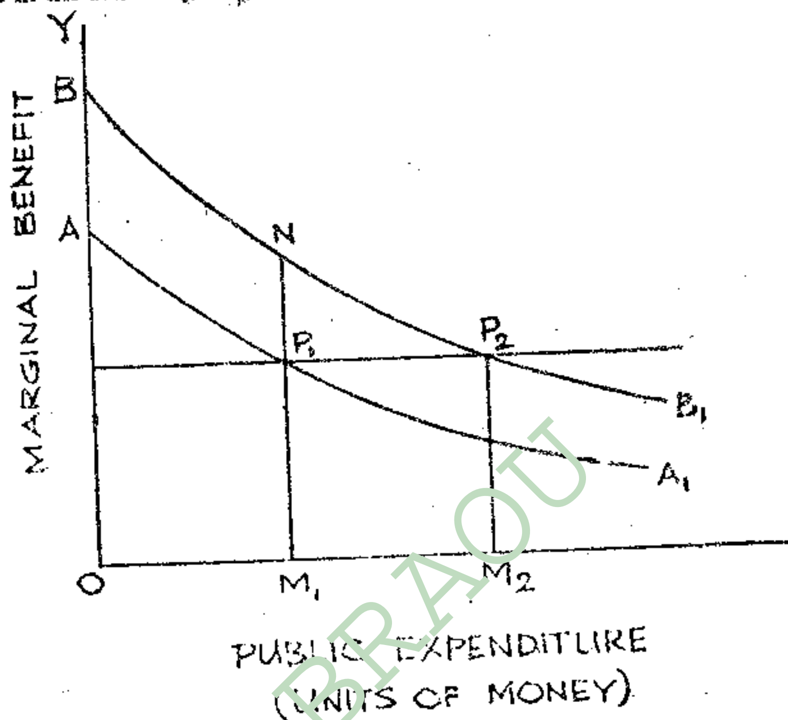

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Fig. 3.2

In the above diagram (Fig.3.2) AA_1 shows the diminishing marginal benefit of the expenditure incurred on item A. Similarly BB_1 shows the diminishing marginal benefit relating to item B. The government spends OM_2 units of money on item A and OM_1 units of money on item B, so that the marginal benefit from 'A' will be equal to that of 'B'. In such situation, the total benefit to the society will be maximum. If on the other hand, let us reverse the pattern of spending. What will happen? The marginal benefit from B will be greater than the marginal benefit from A. Earlier, the total utility as shown in the diagram was OM_1P_1 plus OM_2P_2B. But now the total utility, will be OM_1NB plus OM_2DA. Thus, the total utility is decreased by P_1DP_2N. So, in order to attain maximum total utility, it is necessary that the expenditure ought to be so designed that the marginal utility from A becomes equal to the marginal utility from B.

In regard to taxation also, the principle of maximum social advantage requires that taxes on different items should be so imposed that the marginal sacrifice on each items is more or less equal. In such a case, the total sacrifice would be maximum. This can also be depicted by a diagram:

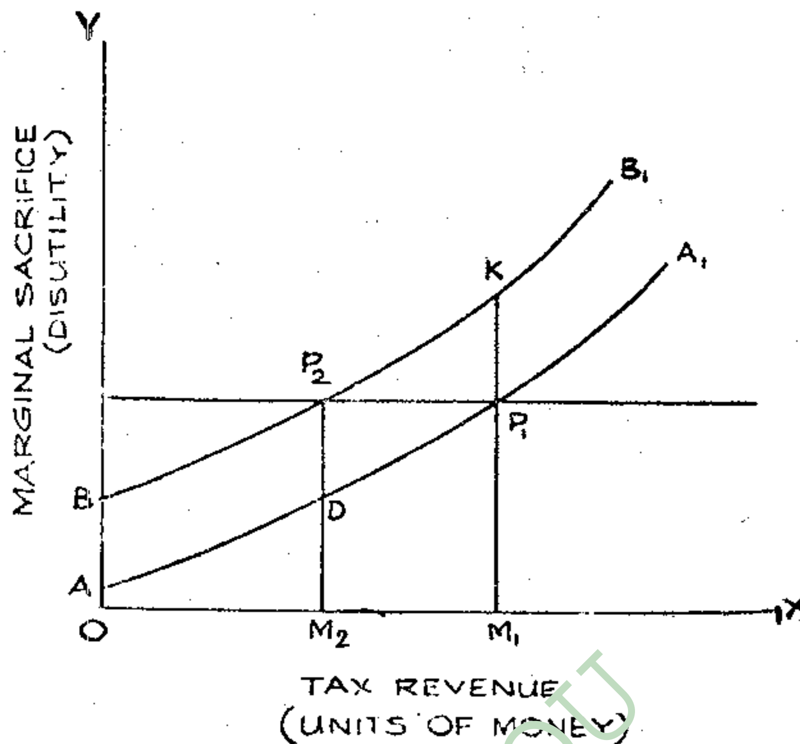

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Fig. 3.3

In the above diagram (Fig. 3.3) taxes are measured along OX axis. The marginal sacrifice is shown along OY axis. The government ought to raise OM_1 from item A and OM_2 from item B, so that the total sacrifice undergone by the community would be the least. The total sacrifice as shown in the diagram is equal to OM_1P_1A (from A item) plus OM_2P_2B (from B item). If supposing the government reverses the pattern of raising taxes from A and B. What will happen? the total sacrifice will be equal to OM_1KP (from B) plus OM_2DA (from A). Obviously, the total sacrifice has increased by DP_1KP_2.

3.2.4 Limitations

The principle of maximum social advantage suffers from many limitations.

Firstly, it may not be possible for us to measure the benefits or the sacrifices from the operations of public finance as some of them involve subjective elements. Even agreeing that State should be there to protect people from both external aggression and internal disorders, the benefits to the society are more than the cost of maintaining the state. Obviously, it is not possible for the private individuals to carry on any productive activity without the protection given by the State. So, it is not always appropriate to compare the benefits with that of the sacrifices arising out of various public finance operations.

Secondly, principle of maximum social advantage assumes that every tax imposes a burden on the society and that every public expenditure provides benefit to it. But, we cannot generalise the view. For example, a tax on the consumption of narcotics and other harmful drugs cannot be considered burdensome to the society. Similarly expenditure on unnecessary wars is an obvious evil.

Thridly, it may not always be possible to evaluate the benefit of every public expenditure in the short period. The benefits may spread over a longer period, and help economic development

and public utilities may lead to the emergence of external economies which in turn might benefit production activity to speed up and ultimately to break the vacious arch of poverty of an under developed country.

Fourthly, if the government expenditure is financed not by taxation but by deficit financing, one should not think that the society will get benefited as there are no sacrifice on the point of the tax payers. Deficit financing by itself may adversly affect the economic development of the country.

Lastly, while analysing the principle of maximum social advantage, we have considered only the tax revenues. But public revenue includes not only tax revenues but also fines, fees, profits of public sector undertakings, market borrowings etc.

CHECK YOUR PROGRESS - II

2. List the assumptions under which the principle of maximum social advantage operate.

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3. What are the limitations of the principle?

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3.3 TEST OF THE MAXIMUM SOCIAL ADVANTAGE

Inspite of the above limitations, the principle of maximum social advantage helps one to know whether the operations of public finance could benefit the community at large. As already mentioned the argument to limit the budgetary activities of the State to minimum possible level stems from the view that resources left in the hands of private individuals are more efficiently used to attain full employment and accelerated economic growth. This view fully supports the working of market mechanism in all it fairness. But if the market mechanism is not that efficient (which has been the experience of many countries in the world) the results obtained by having the resources at the disposal of the private sector would not be optimal. Resources left to the private sector generate inequalities of income and wealth. Thus the demand pattern does not really reflect the true needs of the society. For instance, luxuries may be more demanded in the market at the cost of necessaries which the poor people cannot buy due to lack of adequate purchasing power. Also, market competition may culminate in more and more the working and which results in wastage of resources, unutilisation of productive capacity etc. evils. It becomes, then, necessary for the state to interfere in order to prevent all these defects. In other words, the State cannot remain indifference to the working of the economy. As far as the principle of maximum social advantage is concerned, we shall not be very rigid to take the total tax revenue and compare the same with that of total public expenditure. It is necessary to look into the composition and magnitudes of all the taxes and all items of public expenditure. Same Taxes may be justified for curbing inequalities of income and wealth. They should not be considered an evil.

The incidence and effects of taxation as also of public expenditure should be carefully analysed to evaluate the benefits and sacrifices involved in the various operations of public finance. We must however be aware of that certain activities of the State cannot be measured in quantity terms.

Objectives Tests

Despite of the difficulties involved in making an objective assessment of public finance operations, Dalton has suggested certain objective tests to determine whether the State's activites are in confirmity with the principle of maximum social advantage. These tests are formulated on the basis of certain assumptions. Every society has certain desirable objectives to achieve. If they could be achieved through the activities of the State, then it may be conlcuded that the State's public finance operations fulfil the principle of maximum social advantage. The desirable objectives spelt out by Dalton for which the society tries to achieve are not disputed by any body. Then, what are those objectives?

The first objective relates to **preserving the society**. The subjects of every State should be protected from external aggressions and from internal diorders. If the public finance operations of the State are so directed as to protect and preserve the society, it indicates adding to the social advantage. This is the first objective test to the principle of public finance.

The Second objective relates to **increasing the economic welfare of the community.** For this Dalton has suggested that there should be (a) an improvement in production and (b) an improvement in the distribution of national income. By **improvement in production** we mean that the productive capacity of the economy should have expanded. It does not mean an increase in the current output through capital consumption. If there is expansion of the productive capacity, it indicates more capital accumulation, better utilisation of resources an increase in the effeciency of the workers and reduction in unemployment and so on. According to Dalton if there is improvement in production due to public finance operations one can infer that the government has followed the principle of public finance.

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The second objectives test suggested by Dalton namely **'an improvement in the distribution of National Income'** is more complicated than the first test. This test is associated with efficiency and equity aspects of the distribution. Many a time decisions taken to improve efficiency in distribution go against the principle of equity and vice-versa. Efficiency in distribution implies aggregate of satisfaction while equality relates to the redistribution of satisfaction so that one party gains at the expense of the other. There are, however, some common indicators to this test on which there is no disagreement. They are - (i) reduction in inequalities of income and wealth, (ii) reduction in unemployment (iii) improving the standard of living of the people (iv) increase in the rate of economic growth and (V) bringing about economic stability etc.

Mr Ursula Hicks also has suggested some tests to judge whether the public finance operations do fulfill the principle of maximum social advantage. She has given two criteria namely (a) production optimum and (b) utility optimum. The output of any commodity can be changed by re-allocation of productive resources. According to Mrs. Hicks, **production optimum** is reached when it is not possible to increase the output of a commodity without reducing the output of any other commodity. In practice, it is not possible to achieve such a kind of optimum level. The production optimum stated by Mrs. Hicks is satisfied only under conditions of full employment and if there is not wastage of production resources. Normally, public finance operations may not satisfy these conditions. The second test namely **'utility optimum'** stated by her relates to the composition of the national output and the relative importance attached to the various component elements of it. According to Mrs. Hicks it is possible to change the total utility of the goods of the people by varying the composiion of the national output. So, a situation may be reached when the total utility to the society is maximised with a given composition of the national output. To that situation, she calls it 'utility optimum'.

And in such a situation, it is not possible to increase the satisfaction of one individual without diminishing the satisfaction of another. Is it possible to reach such a 'utility optimum' in practice? Strictly speaking, it is not as we know that utility cannot be measured and therefore, objective measrurement of relative importance of different goods and services cannot be made. Even if utility optimum could be measured by using some sophisticated mathematical tools, yet we cannot ignore that it changes over time.

In public finance operations, the tests suggested by Dalton and Hicks are more important from the analytic point of view rather than to put them into practice. Nevertheless, these tests given us some idea to judge whether the operations of Public Finance at a particular time do really promote economic and social welfare of the people.

3.4 SUMMARY/CONCLUSIONS

The last two units explained the increasing role of the States. As modern welfare states have to perform innumerable functions, the public expenditure component of government budgets has tremendously increased. Public finance operations should be designed to provide maximum advantage or welfare to the people of the society. As we learnt in this unit, the criteria adopted to achieve this objective is known as 'principle of maximum social advantage ". This principle has based on some assumptions. It has some limiations . We have tried to analyse these issues in this unit. Inspite of the limitations, the principle has a major role to play in the modern welfare world.

– Dr. T. Divakara Rao

3.5 SUGGESTED BOOKS

1. B.P. Tyagi : *Public Finance*
2. H.L. Bhatia : *Public Finacne*
3. Hugh Dalton : *Principles of Public Finance*

MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. State and explain the tests of maximum social advantage.
2. Critically examine the principle of maximum social advantage.

II. Answer the following questions in about 15 lines each.

1. Explain the limitations of the principle of maximum social advantage.
2. Describe Dalton's tests of maximum social advantage.

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BLOCK II

PUBLIC REVENUE

This block covers theoretical aspects of taxation which is one of the sources of Public revenue. Different types of taxes are discussed. The block explains the various canons of taxation on the basis of which taxes are imposed. It also explains different concepts relating to impact, incidence, effects and burden of taxation and also measurement of incidence and of burden of taxation. In one of the Units, various concepts of taxable capacity and tax effort are discussed.

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The Block consistss of the following nine(9) Units:

Unit 4. Sources and Classification of Public Revenue

Unit 5. Direct and Indirect Taxes

Unit 6. Progressive, Proportional and Regressive Taxes

Unit 7. Canons of Taxation

Unit 8. Justice in Taxation Various Theories

Unit 9. Impact and Incidence of Taxation Methods of Measurement

Unit 10. Effects of Taxation With Special Reference to a Developing Economy

Unit 11. Taxable Capacity - Determinants of Tax Effort

Unit 12. Burden of Taxation - Various Concepts and Measurements

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UNIT - 4 : SOURCES AND CLASSIFICATION OF PUBLIC REVENUE

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4.2 Various Sources of Public Revenue
4.3 Classification of Public Revenue
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    4.3.2 Contractual Revenue
    4.3.3 Compulsory Revenue
    Fee, Tax, Special Assessement
4.4 Difference Between a Tax and a Fee
4.5 Difference Between a Tax and a Special Assessment
4.6 Difference Between a Fee and Special Assessment
4.7 Other Categories of Revenue
4.8 Various Sources of Public Revenue - A Broad Classification
4.9 Main Objectives of a Tax
4.10 Basic Characteristics of a Tax
    4.10.1 Compulsory Contribution
    4.10.2 Sacrificing Nature
    4.10.3 Defraying the Cost of Public Service
    4.10.4 No Quid Proquo
    4.10.5 Transfer of Purchasing Power
4.11 Summar/Conclusion
4.12 Suggested Books
4.13 Model Examination Questions

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4.0 AIMS AND OBJECTIVES

The purpose of this unit is to deal with the various sources from which the State raises revenue in order to perform its various functions.

After reading the unit, you will be able to

- list the various sources of public revenue
- classify the public revenue into different categories.
- explain different public revenue concepts such as tax, fee, special assessment, fine, penalty, donation, escheat, etc., and
- identify the characteristics of taxes.

4.1 INTRODUCTION

There are many sources for public authority to get revenue. Modern States have many functions to perform and therefore, there is every need to raise adequate public revenue from various sources. The revenue of a public authroity may be defined either in a broad and or in a narrow sense. The income of public authroity in a broad sense includes all receipts while in the narrow sense it includes only such of those receipts which are commonly attributed to taxes, fees etc. These receipts increses the assets of the government without increasing its liabilties. In the broad sense, the revenue of the State includes not only the amount realised through taxes of all kinds but also revenues obtained from the sale of commodities produced by the State as well as the earnings from the departmental undertakings such as the Railways, the Post Office etc., and also receipts from public borrowings and paper money created.

4.2 VARIOUS SOURCES OF PUBLIC REVENUE

In the modern times, the various sources of public revenue are: (1) the taxes of various types, (ii) fines imposed by the government on the offenders, (iii) compulsory loans, (iv) tributes and indemnities arising out of war or from other reasons, (v) income from public such as lease of government lands, (vi) profits of the public enterprieses, (vii) fees for the services rendered by the government, (viii) receipts from voluntary public loans, (ix) betterment levy and other assessment, (x) voluntary gifts etc.

4.3 CLASSIFICATION OF PUBLIC REVENUE

Now, we may deal with the classification of public revenue. Public revenue has been classified into different categories by different economists. For instance **Adam Smith** classified public revenue into two classess (a) income derived from the State property and (b) income derived from the Public. In the first category we may have the revenuye from public sector undertaings while in the second category, the revenue received from taxation. According to **Bastable** also, it has been divided into two categories, namely (a) the income which the State receives as a large corporation for providing commodities and services to the people and b) the income which it receives due to its sovereign power. It can be seen that the first category is similar to that of an individual or a company receiving income by way of selling goods and services. The second category refers to taxation. According to **H.C. Adams,** public revenue is divided into three categories namely (a) Direct revenue which consists of income from public industries, gifts, railways, post offices etc., (b) Derivative revenue which refers to taxes, fees, fines etc. and (c) Anticipating revenue which refers to the income received due to sale of bonds or other forms of government securities. This last category mainly deals with public debt.

Dalton has classified public revenue into twelve main categories: (1) tax (2) tributes and indemnities whether arising out of war or otherwise (3) forced loans which were prevalent in olden days (4) pecuniary penalties for offences imposed by courts of justice (5) receipts from public property passively held like public lands leased out to tenants (6) income received from public industries charging not more than the competitive price (7) fees or payments made for services, not in the nature of business services peformed by public officials such as the registration of births (8) receipts from voluntary public loans (9) receipts from those industries where the government charges monopoly price (10) receipts from special assessment (11) receipts from the use of the printing press for the purpose of meeting public expenditure by the issue of paper money and (12) voluntary gifts. After giving this long list, Dalton observed that the most of the cases, the distinction is not clear because one kind of revenue overlaps gradually into another.

For a better perspective, we may first deal with the classification given by **Seligman** a noted writer of Public Finance, and later find out its relevance to modern times. Public Finance

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has been broadly divided into three categories namely, (a) Gratutions revenue (b) contractual revenue and (c) compulsory revenue.

4.3.1 Gratuitions Revenue

According to Seligman the first category of gratutions income consists of gifts, donations, etc., For obtaining such incomes the State does not direct any institution or individual. They are gratuitously made. We must however know that the importance of this kind of income has considerably reduced during the recent time. But grouping all such incomes as a class by themselves is justified as they differ from all the rest of the revenues the State is supposed to get. There is no obligation on the part of the state to provide some thing (service or good) in return to the persons who pay them. Dews included in this categoy items like gifts etc. which are neither very certain nor uniform in amout from year to year. It may also be observed that the incidence of gifts is not always proportional to the ability of the persons who make payments in the form of gifts.

4.3.2 Contractual Revenue

The second category relates to contractual revenue. It includes the revenues in the form of rents, sale proceeds from the goods/services sold by the State to the public etc. The State owns property in the form of land and buildings which are normally leased out to the people on certain contractual terms. Similarly, the sale of goods produced by the government enterprises as also of services like the Railways, Post Office etc. provide the state with certain revenue. For all such type of contractual incomes, Seligman calls them as 'prices', as they resemble very much the prices of goods or services charged by private individuals. How ever, in modern welfare status the pricing of such public utilites has been a matter of controversy unlike those private goods determined by market mechanism.

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4.3.3 Compulsory Revenue

The third category relates to compulsory revenue which broadly includes taxes, fees and fines, special assessment etc. The state derives revenues from its domain, penal and taxing powers. The state has the powers of eminent domain in the sense that it can expropriate the property of its citizens, if necessary. But normally this power is not exercised by the state. The state is empowered to exercise its penal power and therefore, can impose fines and penalties which should be paid. The taxing power is very important from the revenue point of view. It was not given importance in olden days when the State's activities were kept at minimum and all taxes were considered as evil. But it modern days, most of the State's revenue comes from various types of taxes imposed on the public.

Seligman defines certain important items of revenues included under this compulsory category:

Fee, Tax, Special Assessment

Fee: A fee is a payment to defray the cost of each recurring service undertaken by the government primarily in the public interest but conferring a measurable special advantage on the fee-payer.

Tax: A tax is compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefit conferred.

Special Assessment : A special Assessment is a payment made once and for all to defray the cost of a specific improvement to property under-taken in the the public interest and levied by the government in proportion to the particular benefit accruing to the property owner.

CHECK YOUR PROGRESS - I

1. List any four sources of public revenue.

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2. Explain Adams' classification of the public revenue.

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3. Recall the three categores of public revenue as exaplained by Seligman.

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4.4 DIFFERENCE BETWEEN A TAX AND FEE

From the the above, what distinction do we find between certain kinds of revenue? Take for example the main difference between a fee and a tax.

i) A tax is levied to defray a part of the expenses incurred by the government in providing general services to the public. A tax payer does not get a direct return of benefit (i.e. there is no quid pro quo). A fee is a payment for receiving a specific service from the government. So, a fee payer is directly benefitted.

ii) Taxes are imposed on the basis of the 'ability to pay'. A fee is impoised taking into consideration the special benefit according to the fee-payer.

iii) A fee is adjusted either partly or wholly to the cost of service provided by the government to the fee payer. But not such measurement is possible individually in the case of a tax.

It must however be remembered that in respect of both fees as well as taxes, the primary intention of the government is to provide benefit to the whole society. But taken individually, we can see that fees confer a special and measurable advantage on the fee payers. Examples are the court fees, registration fees etc. Such individual benefit is not provided for the tax payers. The intention of the government in chariging a fee is to regulate the conduct of the people who are willing to receive the service or benefit from the operations of state activties.

4.5 DIFFERENCE BETWEEN A TAX AND A SPECIAL ASSESSMENT

Similarly We may see some differences between a special assessment and a tax...

i) In the case of a special assessment, the element of public purpose is clearly seen. It must be possible to identify the beneficiaries. The assessment imposed should not be arbitrary.

ii) While taxes are compulsory contributions to defray the expenses incurred by the government in the common interest of all, a special assessment is compulsory contribution paid by a beneficiary for the special benefit enjoyed by him.

iii) Special assessment is always proportional to the benefits enjoyed by the beneficiaries. For example, if a specific project has increased the property value in a locality, the special assessment is paid in proportion to the properties shared by the people. But in the case of taxes, they may be either proportional or progressive.

iv) Special assessment is a payment made once and for all. But taxes may be of recurring nature.

When we compare a special assessment with that of a tax, we find that although both are compulsory, a special benefit is associated with the former. So, a special assessment resembles a fee. But even then, there are some differences between a fee and a special assessment.

4.6 DIFFERENCE BETWEEN FEE AND SPECIAL ASSESSMENT

Firstly, special assessment is levied only for a specific local improvement while fees could be levied for any service provided by the government. Some of the fees paid to the government are simply meant to get permission to perform a particular activity. The field of operation of special assessment is therefore limited whereas that of a fee unlimited.

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Secondly, fees have to be paid for every successive service rendered by the government to the people. But a special assessment is paid once for all.

Thirdly, in the case of a special assessment, it is paid by the individual as a memeber of class which could receive the benefit. For a fee, it is not the case.

Lastly, we can see that special assessment always is associated with the benefits of real estate where as a fee may benefit other elements also.

4.7 OTHER CATEGORIES OF REVENUE

Besides fees, taxes and special assessment, we have some minor sources of revenue such as fines, penalties and donations.

Fines are imposed to prevent people from doing something prohibited by Law. If anybody violates the rules and regulations laid down by the government fines are imposed.

Penalties and forfeitures also are some kind of fines imposed on the people for the non-fulfilment of certain conditions. For instance, if a contract work is not completed within the stipulated time, government may impose a penalty on the contractor. Fines, penalties and forfeitures do not yield much revenue to the exchequer. These are imposed to regulate the behaviour of private individuals.

Donations are a kind of gifts the payment of which is quite uncertain. The government cannot expect much revenue from this source.

Similarly, the revenue from escheats is also very samll. They refer to the properties of people who die without legal heirs or wills. Such properties are appropriated by the government.

CHECK YOUR PROGRESS - II

... the following terms relating to public revenue :

(a) Fee, (b) Tax, (c) Special Assessment, (d) Fines, (e) Penalties, and (f) Escheats.

4.8 VARIOUS SOURCES OF PUBLIC REVENUE A BROAD CLASSIFICATION

The various sources of revenue discussed so far can be broadly classified in the modern sense into (1) taxes (2) administrative revenues (3) public domain and commercial revenues and (4) grants and gifts. The administrative revenues consist of fees, fines and penalties, escheats, special assessment etc. Under public domain and commercial revenues, we have the income from public property and the proceedings of departmental undertaking etc. As far as grants and gifts are concerned, they are usually made by one government to the other in order to enable the later to perform certain specific functions. For instance in a federal set up, the Central Government provide the constituent states with certain grants. They need not be repaid. Gifts are voluntary contributions.

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4.9 MAIN OBJECTIVES OF TAXES

Whatever be the classification of public revenue, it should be remembered that the various activities of state are aimed at regulating the economy so that the resources are more productively used to maximise economic and social welfare of the people. As far as public revenue is concerned, all the taxes as well as non-taxes are imposed to achieve two main objectives. **First,** the state wants to get money for carrying out its function. This is the revenue objective. **Second,** and more important objective is to change the existing pattern of economic behaviour of the people. For instance, in order to discourage production (or consumption) of commodities or services produced by private agencies government may impose a duty, and in order to discourage the consumption of the commodities or services performed by the state, government may impose a 'fee'.

4.10 BASIC CHARACTERISTICS OF TAXES

In every economy there may be different kinds of taxes such as direct and indirect taxes; proportional and progressive taxes and so on. More about taxes will be learnt in the subsequent lessons and therefore, we may refrain from making a detailed analysis of them here. However, some of the basic characteristics of a tax are given hereunder :

4.10.1 Compulsory Contribution

On the basis of Seligman's definition of a tax, already mentioned in the forgoing paragraphs it is clear that a tax is compulsory contribution. It is the duty of every citizen to contribute something to the government for enabling the later perform its functions properly. The compulsory element

of a tax has been a subject of controversy among some economists. For instance it has been a subject of controversy among some economists. For instance it has been argued that a person can avoid payment of personal income tax by not increasing his earnings. Similarly, indirect tax, on goods and services, can be avoided by not consuming them. Nevertheless, where a tax is to be paid legally, one cannot escape payment of it.

4.10.2 Sacrificing Nature

The second characteristic of a tax is that it involves some sacrifice on the part of the tax payer. Whenever a person pays the tax, his income is reduced by the amount of the tax. So, the tax payer undergoes some amount of sacrifice.

4.10.3 Defraying the Cost of Public Service

Thirdly, the government collect taxes to defray the cost of public services rendered in the common interests of the society.

4.10.4 No quid pro quo

Fourthly, it can be seen that a tax is not like a price paid to the commodity. It is also different from a fee. The basic characteristic of a tax is that there is no *'quid pro quo'* i.e., a direct return of benefit to the tax payer.

4.10.5 Transfer of Purchasing Power

Fifthly, another feature which we notice in the case of a tax is that it is paid out of the income of the payer. So, whenever a tax is paid, there is a transfer of purchasing power from the tax payer to the government.

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Lastly, it may be discerned that taxes are paid by persons and not by things. Even in the case of taxes imposed on goods and services consumed by the people, the taxes have to be paid by the persons only.

4.11 SUMMARY/CONCLUSIONS

To sum up we can say that there are various sources of public revenue and they have been classified into different forms by different economists. By classifying into different forms, it is possible for us to know how these various sources of income resemble one another and in what ways they differ. Also, in the general application of a principle, it is essential for us to know whether it can be applied to all kinds of revenue or only to certain categories of them. The effects and incidence of different kinds of revenue do often differ from one another. So, a careful understanding of the various sources and their classification enable us to know all such things.

– Dr. T. Diwakara Rao

4.12 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*

4.13 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Classify public revenue into various categories.
2. Explain the characteristics of a tax.

II. Answer the following questions in about 15 lines each.

1. List the various sources of public revenue.
2. Discuss the characteristics of a tax.
3. Explain the following concepts :

   (a) Tax (b) Fee (c) Special Assessment

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UNIT-5 : DIRECT AND INDIRECT TAXES

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5.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss the clasification of taxes and merits and demerits of direct and indirect taxes.

After reading the unit, you will be able to

* classify the taxes,
* examine the merits and demerits of direct taxes,
* analyse the mertis and demerits of indirect taxes,
* discuss the role of these taxes in the developing and developed countries, and
* list the important direct and indirect taxes.

5.1 INTRODUCTION

In the previous unit, we have already dealt with the classification of Public Revenue. We have stated therein that taxes constitute the major portion of Public Revenue.

We have also explained the difference between tax and a fee and also with special assessment. Characteristics of taxes are also dealt with in the previous unit. In this unit, we try to analyse one classification of taxes viz., direct and indirect taxes. For any type of tax, there will be some advantages and some disadvantages. Direct and indirect taxes also have merits and demerits. Let us explain them in detail in this unit. Developed countries are depending mostly on direct taxes, where as indirect taxes are the mainstay in the tax structure of many developing countries.

examples of indirect taxes are excise duties, sales tax, customs duties, etc. Let us try to understand these things in this unit.

5.2 CLASSIFICATION OF TAXES : DIRECT AND INDIRECT TAXES

Taxes can be classified into many kinds. There are direct and indirect taxes; personal taxes and impersonal taxes; income taxes and property taxes; taxes on consumption and taxes on production; specific and advalorem taxes and so on. Whatever be the classification, every tax can be classified either as a direct tax or as an indirect tax in the broad sense. So it is therefore, necessary for us to understand the characteristics of direct and indirect taxes.

Whenever a tax is imposed, it results in transfer of purchasing power from the individuals to the government. For instance, the income of a person paying the income tax will get reduced by the amount of tax. It is a transfer of purchasing power from the person, who paid the tax to the government. Therefore, it involves some amount of pain or sacrifice undergone by the tax-payer. Now, is it possible for the person who paid the tax to the government at the first instance to shift its burden on to others? If so, it is known as the shifting of money burden of tax to other persons. For example, an indirect tax like the Union Excise Duty, let us suppose, has been paid by the manufacturer of a commodity, who obviously shifts its money burden to the wholeseller, who again may shift it to the retailer. Finally, it is the consumer, who purchases the commodity bears the money burden of excise duties. It depends on many factors, whether shifting of tax is possible or not. Presently, we have refrained from a discussion on such factors; which are eloborated in the subsequent lessons. As far as the characteristics of a direct or an indirect tax are concerned, it is commonly stated by many economists that those taxes are direct, where shifting of the burden is not possible and where it is possible, those are called as indirect taxes. In other words, in the case of a direct tax, the person, who pays the amount to the government, at the first instance ultimately bears it. The impact and incidence are on the same person. On the other hand, in the case of indirect taxes, the amount is paid first by some persons, who in turn shift their burden to others. Consequently, the impact is on one set of persons, while the incidence is on the other set of persons. It means in the case of indirect taxes, the impact and the incidence are not on the same persons/ (or person). So far, we understood the meaning of direct and indirect taxes on the basis of the 'principle of tax shifting'.

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According to J.S. Mill, direct taxes are those taxes which are imposed on the basis of economic status - income, property and wealth etc. Indirect taxes are those taxes which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another (such as excise or customs). As a matter of fact, the definition of a direct and an indirect tax is not very clear and there is no unanimity even among eminent economists. In economic literature, we often come across many other bases of the distinction between a direct and an indirect tax. For instance, one way of distinguishing these two types of taxes could be that while taxes on production are considered as 'direct' those taxes on consumption are considered as 'indirect'. Similarly, some economists claimed that taxes on income are direct while those on expenditure are indirect.

Dalton's distinction between direct and indirect taxes may also be explained here. A direct tax is really paid by a person on whom it is legally imposed, while an indirect tax is imposed on one person, but paid partly or wholly by another, owing to a consequential change in the terms of some contract or bargaining between them.

Validity of the Classification

The modern economists question the validity of such a classification of direct and indirect taxes. Why should taxes on production be treated as direct taxes while those on consumption

the other. Similarly, there is no concensus to distinguish taxes on the basis of income and expenditure. Both the activities viewed in terms of flow of funds in the economy represent the revenue and expenditure transactions. In modern times the economic basis to distinguish the direct and indirect taxes can be formed in terms of the tax-paying ability of the tax-payer either assessed directly or indirectly. For example personal income tax is considered as a direct tax. Here, assuming that income is the right indicator to show one's ability to pay, a tax is imposed on the person on the basis of his assessed income. Similarly certain taxes like the gift tax, the corporation tax, the wealth tax etc., are classified as the direct taxes.

In the case of indirect taxes, the ability to pay is assessed indirectly. For instance, an excise duty on a ratio is an indirect tax. It is assumed that a person who purchases the radio has the ability to pay the tax. A person who pruchases costlier foods is prepared to pay more amount towards indirect tax. It is on account of this reason, luxuries are taxed heavily so that their richer sections of the society are capable of paying them. It may however be stated that there is no concensus among economists whether income or expenditure is to be taken as an indicator for ability to pay. Whatever be the basis, in every economy we find direct and indirect taxes. The classification given by J.S. Mill (as stated earlier) may taken to distinguish the direct and indirect taxes.

Specific or Advalorem Indirect Taxes

Indirect taxes may either be specific or advalorem. They are called *'specific'* if the taxes are imposed on the basis of the physical quantity like 'per unit' or 'per item'. On the other hand, if they are imposed on the basis of the money value of the item and tax being expressed in terms of percentages of its value like two percent or three percent, they are called *'ad valorem' taxes.* Most of the indirect taxes now-a-days are ad valorem. The advantage in having ad valorem taxes is that the tax revenue would automatically increase whenever there is an increase in the money value of the physical food. For example, a 5% levy on article worth Rs. 20/- yields tax revenue of Rs. 1/-. Then, if the price of the article (before tax) goes up to Rs. 40/- the tax revenue obtained would also increase to Rs. 2/-.

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5.3 MERITS OF DIRECT TAXES

5.3.1 Ability to Pay Criterion

One of the important merits of direct taxes is that they are levied on the basis of ability to pay criterion. As the person on whom the tax is imposed bears its burden without shifting the same to any other person or persons, the ability to pay of the tax payer is directly judged by the government. Taxes imposed on the persons keeping in view the ability to pay criterion are considered to satisfy the canon of equity. Although it is said that even in the case of indirect taxes also, the criterion of ability to pay is satisfied by imposing levies on luxurious goods, yet there are chances of making an error of judgment.

5.3.2 Degree of Progression

Another merit of direct taxes is that which relates to the degree of progression. Direct taxes are progressive taxes in the sense that the rate of tax also increase whenever the base of it increases. If the rates of direct taxes are properly chosen, the ability to pay criterion can be fulfilled. The tax system as far as direct taxes are concerned would also satisfy the principle of least aggregate sacrifice.

5.3.3 Reducing Inequalities

income and wealth inequalities. Many social evils can be minimised as a result of reducing the income and wealth inequalities. To what extent direct taxes have been successful to achieve this objective is an issue which however needs separate treatment.

5.3.4 No Distortion in the Resource Allocation

Another point in favour of direct taxes is that they do not cause distortion in the resource allocation of the economy, and therefore, considered better than indirect taxes in the welfare point of view. But this view is based upon certain unrealistic assumptions.

5.3.5 Productive and Elastic

Direct taxes are favoured is they are productive and elastic. In other words, as income of the community goes up, the tax revenue from direct taxes also increases. This is a claim which can be made even for indirect taxes also. And in some cases of direct taxes, if properly formulated, are productive as well as elastic. Apart from revenue consideration, there are other social and economic considerations which justify imposition of direct taxes in the economy.

5.3.6 Sense of Civic Responsibility Among Tax Payers

Still another point put forward by the advocates of direct taxes is that these taxes inculcate a sense of civic responsibility among the tax payers who may closely watch the revenue and expenditure activities of the government. As indirect taxes are paid without knowing as to how much they are paying, the tax payers may not evince interest on the income and expenditure opeations of the government. But this point is not without criticism. The direct tax payers may try to evade (or avoid) payment of tax as they know the details of direct tax, the amount to be paid by them etc.

From all the points discussed above, it can be seen that direct taxes are favoured as they satisfy the principle of ability to pay may be used to remove or reduce inequalities of income and wealth among different sections of the society; may yield more revenue and thus enable the state to perform its functions efficiently. Then, what are the main demerits of direct taxes?

5.4 DEMERITS OF DIRECT TAXES

5.4.1 Violation of Canon of Convenience

The most important demerit or disadvantage of direct taxes is that they generally violate the canon of convenience. Unlike indirect taxes, direct taxes are payable in lumpsum or sometimes even in advance.

5.4.2 Adverse Effects on Savings & Investment

Another disadvantage of direct taxes is their adverse effects on saving and investment. For instance, an increase in the personal income tax may adversely affect the tax-payers willingness to work and they may show more preference to leisure rather than to work for more hours and to earn more income. This is not however always true with every tax payer. Many factors like the family circumstances of the tax payer, his income elasticity etc., have to be taken into account. Similarly, it is often said that taxes on property and inheritance etc., affect the tax-payers willingness to save and invest.

5.4.3 Complexity of Tax Laws

Still another point against direct taxes relates to the complexity of the tax laws. The tax payers do not know the rules of direct taxes. They have to employ many people to maintain

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records and submit their returns promptly to the tax-authorities. All this is a cumbersome procedure.

5.4.4 Tax Evasion

In modern days, direct taxes are becoming less productive and elastic income of time. It is because of high percentage of tax evasion. Often there are many complaints of harrasment by the officials of tax- administration.

CHECK YOUR PROGRESS - I

1. What do you mean by direct tax?

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2. What is 'ad valorem' tax?

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3. List the merits of direct taxes.

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4. Identify the disadvantages of direct taxes.

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5.5 MERITS OF INDIRECT TAXES

Some of the important merits of indirect taxes are mentioned below.

5.5.1 Not So inconvenient

Firstly, they are less inconvenient in the sense that they are mostly collected by the tax authorities when transactions of sale and purchase of goods and services occur. An indirect tax is included in the price of the commodity the tax payer pays it without having a feeling of paying the tax.

5.5.2 Less Evasive

Secondly, another merit of indirect taxes, is that the chances of tax evasion are less. For instance, if the government machinery is vigilant and proper checks are made at the points of production, it is quite difficult to evade payment of excise duty on a good. Ofcourse, we should not generalise this point. Some taxes like the sales tax are very difficult to be administrated. Evasion could be more in respect of sales tax rather than that of an excise duty. There may however be a good number of other indirect taxes which can be conveniently collected by the government, and in such taxes the evasion part would be much smaller.

5.5.3 More Revenue

Thirdly, in developing economies, due to lack of adequate savings, the government depends upon taxation for financing capital accumulation. As the amount obtained by way of direct taxes being less, the government tries to mobilise more of the resources by indirect taxes.

5.5.4 Reducing conspicuous consumption

Fourthly, indirect taxes reduce conspicious consumption, and this will increase household savings which can be utilised for economic development. Indirect taxes are used as a tool to regulate production and consumption activities in the economy. For example, if a high rate of excise duty is imposed on a commodity, the price of it will go up, this adversely affects it demand. So production of such commodity may be reduced and resources diverted to produce some other commodities where the taxes are less. Similarly, employment and consumption activity also can be regulated by indirect taxes.

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5.5.5 Fulfilment of Principle of Equity

Lastly, indirect taxes can be imposed on such of those goods generally consumed by the rich, so that the principle of equity is fulfilled in the area of indirect taxation. Such type of indirect taxes are useful to get the inequalities of consumption among different sections of the society reduced also.

5.6 DEMERITS OF INDIRECT TAXES

We may now turn our attention to some of the important disadvantages of indirect taxes.

5.6.1 Regressive Nature

An important disadvantage of most of the indirect taxes is that they have been attributed as regressive. The poor and rich pay an equal amount of tax while buying a commodity. Therefore it has been often criticised that the indirect tax negate the principle of 'ability to pay'. In other words, indirect tax normally do not fulfill the cannon of equity.

5.6.2 Inflationary character

Another disadvantage of indirect taxes relates to their inflationary character.Indirect taxes imposed on several goods and services add up to the prices of the goods, thus generating inflationary forces. In recent times the imposition of heavy indirect taxes on a large number of

commodities is stated to be one of the reasons for pushing up inflation. In result, economic development of the country may be retarded.

5.6.3 Uncertainity in Collections

Added to these points, it may be mentioned that it is uncertain for the government to predict the yield of these taxes. If heavy indirect taxes are imposed, there may be shift in the demand for such goods, as a result of which the total yield gets reduced.

5.6.4 Evasion is possible

Even for indirect taxes also, it has been argued against than that tax evasion is possible. For instance by resorting to unfair practices like smuggling and maintaining duplicate accounts, it is possible to evade payment of sales tax.

5.6.5 Uneconomical

Sometimes the collection and administrative charges of indirect taxes may be quite uneconomical also.

CHECK YOUR PROGRESS - II

4. What is meant by indirect tax?

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5. Identify the merits of indirect tax.

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6. List the demerits of indirect taxes.

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5.7 COMPARISON OF DIRECT & INDIRECT TAXES

From the above discussion we understand that both for direct and indirect taxes there are advantages and dis-advantages. Every tax system will have both these taxes. Keeping in view a

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variety of objectives to be relieved we may now deal with a specific question whether direct taxes are less burdensome than the indirect taxes.

According to Hicks direct taxes are superior to indirect taxes as the tax-payers may undergo lesser amount of sacrifice in the case of the former rather than in the case of the latter. It can be explained below diagramatically.

There is no concensus among the economists about the superiority of direct taxes over the indirect taxes. Always taxation should be analysed in terms of its efficients on production and distribution. The effects of public expenditure also have to be taken into account to judge whether or not taxes imposed by a government are burdensome, let alone. Whether they are direct taxes or indirect taxes.

5.8 DIRECT AND INDIRECT TAXES IN DEVELOPING AND DEVELOPED ECONOMICS

In order to achieve accelerated economic develpment, it is necessary to break the vicious circle of poverty in the under-developed economies. Government has to embark upon large scale investment programmes to augment resources for capital formation. In this context, taxes play a very important role not only in providing the much needed revenues to the government, but also bringing about economic stability, allocative efficiency and optimum income distribution in the developing countries. If the consumption of the people is not curtailed, most of the raising income will be consumed and very little will be left for savings. By imposing suitable taxes, it is aimed to restrain the consumption of the people so that the resources are transformed to the government. But it should be remembered that such a transfer of resources should not be at the cost of curtailment of effective demand. In order to fulfill the objectives of taxation in the developing countries, what should be the appropriate tax structure? What should be the mix of direct and indirect taxes?

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Almost all the developed countries in the world placed more reliance on direct taxes rather than on indirect taxes. But we find that indirect taxes are the mainstay in the tax-structure of many developing countries. Even in the developed countries also, like U.K., U.S.A., we find that in the early stages of their development, direct taxes did not dominate their tax structures. But in course of time, with the advancement of their economies, there is a clear shift from indirect to direct taxation.

Role played By Direct/Indirect Taxes in Developing Countries

In this connection, it may however be pointed out that what is important is not so much the choice between direct and indirect taxes but rather the role played by direct or indirect taxes to achieve the various objectives of planned by direct or indirect taxes to achieve the various objectives of planned economic development in underdeveloped countries. The direct or indirect tax choice has led to lot of controversy. In fact for making the tax system fully comprehensive, both the types of taxes are necessary and they should be viewed as complementary rather than contradictory.

As explained earlier, many economists believed that a given amount of tax collected from an individual by an indirect tax would leave him in a welfare position inferior to the position which would have obtained, had the same amount been collected by a direct tax. Marshall, J.R.Hicks, etc., are the are the economists who held this kind of view. According to Marshall, a commodity tax reduces consumers' surplus by more than the gross tax yield. Similarly, J.R.Hicks viewed that a tax on commodities lays a greater burden on consumers than an income tax.

Impact of Indirect Taxes on Allocation of Resources

The most serious defeat of indirect taxes, generally pointed out by many economists is with regard to their impact upon allocation of resources. Indirect taxes may change relative prices of the commodities and consequently, the resources may move out of the taxed industries into other lines of production. It is believed by the critics of indirect taxes that such a shift of resources may change the production pattern inferior to that which would have prevailed in the absence of such taxes. This argument presupposes that the relative quantities of various commodity produced in the economy are ideal in the absense of indirect taxes. But the reallocation of resources due to imposition of indirect taxes need not necessarily be regarded as undesirable. Some times a resource-shift may seem to be desirable to regulate production and consumption of certain harmful drugs and norcotics, the aim is to see that their production as well as consumption are reduced which adds to the welfare of the people. The 'excess burden' argument to pinpoint that indirect taxes are inferrior to direct taxes cannot be sustained always.

Even in the case of direct taxes like the personal income tax also, one can argue on the basis of 'excess burden' argument. For instance, an income tax may also involve an excess burden to the tax payers in so far as it disturbs the preferences of an individual with respect to his investment decisions. His preference as between work and leisure may also get affected. All this is to say that the controversy whether to have direct taxes or indirct taxes has occupied so much in the literature of Public Finance that hardly a concensus has been reached on this problem.

But one thing seems to be clearly relevant in the empirical point of view. The percentage of direct taxes in the developed countries measured as a ratio of direct tax revenue to total revenue is much higher than that of the developing countries.

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TABLE 1

Direct and Indirect Tax Revenue as Percentage of Total Tax Revenue

S.No	Country	Share of Direct Taxes (%)	Share of Indirect Taxes (%)
1.	USA	92.3	7.7
2.	UK	66.6	33.4
3.	Australia	72.4	27.6
4.	Japan	73.4	26.6
5.	India	22.3	77.7
6.	Philippines	23.4	76.6
7.	Pakistan	14.6	85.4

Source : U.N.Statistical Year Book, 1976.

Reasons for the Significant Role of Direct Taxes in Developed Countries

It can be seen that direct taxes play an important role in the tax structure of developed countries. Some reasons can be attributed to such a kind of situation. **Firstly**, in developed countries, a high level of per capita income keeps the people much above the subsitence level and therefore, direct taxes are more convenient to reach the higher incomes and push up the elasticity in the revenue system. **Secondly**, the coverage of direct taxes in the tax structre of developed

countries is much higher than in the underdeveloped countries. Thirdly, the conditions for raising more resources by way of direct taxes are very favourable in the developed countries. According to Richard Goode, they are (i) the existence of a predominantly money economy (ii) a high standard of literacy among tax payers (iii) prevalence of accounting records honestly and reliably maintained (iv) a large degree of voluntary compliance on the part of the tax payers (v) healthy political conditions and (vi) honest and efficient tax administration.

Reasons for Minor Role of Direct Taxes in Developing Countries

On the other hand, in the underdeveloped countries all these conditions are not seen. There is a vast non-monessed sector coupled with a large number of substence farmers which stand in the way for successful introduction of direct taxes. According to John. H. Adler the most important reasons for the minor role played by the direct taxes in the underdeveloped countries are the following:

(a) the political influence of land owners and owners of urban property,
(b) the erosion of the tax base through inflation (which is concern for the under developed countries) and the failure to correct excessively low valuation bases through higher rates, and
(c) the difficulty of making property assessment and keeping then upto date.

According to **Kaldor** successful implementation of direct taxation of income or profits presupposes the existence of large-scale enterprises and a large number of employees working therein. In under-developed countries where the economy largely consists of small enterprises, such taxes are not convenient or efficient instruments for taxing either the profits of the employer or the wages and salaries of the employees. All these arguments tell us the reasons for the minor role played by direct taxes in the under-developed countries.

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Reliance on Indirect Taxes in Russia and Japan

Among developed countries, Russia and Japan, however, relied more on indirect taxes rather than on direct taxes. In the case of Soviet Union, the government attached more importance to the 'money illusion' effect on the work incentives of the workers. It is believed that workers are more senstive to changes in wages rather than to changes in prices. So, they are more interested in their take-home pay. Although indirect taxes affect the prices, the money illusion effect is considered to be stronger among the workers especially in a country like U.S.S.R. The Russian government relied more on commodity taxes (i.e., indirect taxation) due to administrative reasons also. In the early stages of developement, the turnover tax (which is an indirect tax) was collected from State industrial enterprises and wholesale organisations which were few in number and which used to maintain realiable accounts. Thus the collection of tax was cheap and also provided very little possibility for tax evasion.

In the case of Japan, government expenditure and taxes were kept low. More reliance has been placed on private sector for capital formation along with public sector investment. There were shifts in the labour force from low productivity sectors like agriculture, small business etc., to high productivity sectors which helped speedy capital formation during the years of Japan's development. Government gave some direct tax concessions which impact helped boost up personal and private corporate savings. But it was realised that more concessions given by the government in the matter of direct taxes had some adverse redistributive effects. So, if distibutive justices to be aimed, Japan's model cannot be emulated especially by the developing economies.

In other words, more reliance on indirect taxation especially in the early stages of development might adversely effect the redistribution of income and wealth in the under-developed countries. But more tax revenues, which is very much needed in the early stages of development cannot be raised by placing more reliance on direct taxes in these countries. So, infact under-developed

countries are caught up with two problems. First how to raise adequate financial resources that the exchequer needs for various development programmes in the backward countries? Second, while achieving this objective how about the redistributive effects in the social justice point of view? Both indirect as well as direct taxes seem to play their due role in the under-developed economies. Now, let us see some of the arguments in favour of both indirect and direct taxes.

5.8.6 Justification of Indirect Taxes in Developing Countries

Indirect taxes are justified in the underdeveloped countries on the following rounds.

Fistly, indirect taxes remain **hidden in the prices of goods.** So, they are supposed to produce less disincentive effect rather than the direct taxes, known for their progression. In the words of Arthur Lewis "the tax payer usually does not know how much tax is included in the prices of the article he buys, so in so far as the disincentive effect of taxation is psychological, it can be avoided by using indirect rather than direct taxes".

Secondly, the per capita income in under-developed countries being low, there is less scope to raise adequate amounts of revenue by direct taxation. So as a matter of logical necessity, it is only through indirect taxes, the ex-chequer can **raise more resources.**

Thirdly, in the early stages of development there is every need to **curtail conspicuous consumption.** When the incomes of the people raise, they are prove to more and more luxurious spending which should be curbed by indirect taxes. However, care should be taken to see that while imposing indirect taxes the actual consumption of the people are not affected. According to Raja J. Chelliah "indirect taxes should be used for checking potential increase of consumption rather than for curatailing the actual consumption of the masses".

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Fourthly, indirect taxes are generally considered to be regressive, But **more progressiveness** can be introduced into the indirect taxes also by taxing such of those commodities consumed by the rich at higher rates than those consumed by the common man.

Lastly, indirect taxes are also regarded **anti-inflationary** according to some economists like Mrs. U.K. Hicks, B. Misra etc. As these taxes curtail consumption, the total spending is reduced and hence they are viewed as anti-inflationary.

All these points give us an impression that indirect taxes are much superior to direct taxes, keeping in view the conditions of underdeveloped economies. But equally there are strong arguments in favour of direct taxes also.

Arguments in Favour of Direct Taxes

Firstly, although indirect taxes have major role to play in under developed countries, it should be thought of only as a short run measure to provide adequate resources to the government. Fiscal policy should aim at creating a situation to tap more of direct taxes in course of time as the country reaches certain levels of development. Even in the present developed countries like U.K. and U.S.A. also we find such a shift from indirect to direct taxation.

Secondly, direct taxes are capable of **imparting built-in-flexibility** in the tax structure of these countries. As the national income grows, it should be possible for the government to obtain more and more tax-revenue. Direct taxes being progressive are very much suited to increase the tax revenue as a sequel increases in national income.

Thirdly, direct taxes fulfill the objectives of **progressivity and equity** in taxation.

Fourthly, although the most common criticism against direct taxes is that they would adversely affect the private capital formation, still this view is not correct if proper care is taken while imposing direct taxes. Certain steps like the following can be taken while levying direct

taxes. (a) the average load of direct taxes can be kept at minimum so that the marginal burden is not very progressive (b) it is necessary to indentify the sources on which direct taxes can be levied without producing adverse effects on production and private capital formation. (c) tax concessions can be given to such an extent so that their effects on private capital formation are not adverse.

Fifthly, it has also been stated in favour of the direct taxes that private investment may not be adversely affected simply because of direct taxes. If other factors like availability of institutional finance, possibility of a higher return on investment, better industrial climate etc., are favourable, private investment, would go on increasing.

Lastly, as compared to indirect taxes, the direct taxes seem to be powerful instruments to **reduce the inequalities of incomes** between the rich and the poor. Indirect taxes being more regressive in nature are known to accentuate the inequalities between the rich and the poor.

5.9 SOME EXAMPLES OF DIRECT TAXES

5.9.1 Personal Income Tax

The conceptual basis and scope of income tax differs among different countries in the world. Income taxes are either universal or partial. The exemption limit is placed so low in the case of universal income tax that almost even household pays income tax. Such a mass income tax was initiated in countries like Australia, the U.K. and the U.S.A. during World War II. In the case of partial income tax, only a minority of households pay tax. Personal exemptions are largely granted. In some countries, income originating in the country (**source principle**) is only taxed while in some other countries, income paid to residents of the country i.e., including income earned abroad is taxed **(residence principle)**. Modern economists define income for tax purpose in three ways namely (i) income as "Service-flow" in consumption (ii) income as "re-current" receipts and (iii) income "as the net additions to an individuals economic power, within a" specified period of time.

'Service Flow in Consumption' Concept

Income is treated as the value of goods and services consumed by an individual in a given period of time in the first category. It becomes equal to the money expenditure for personal and family consumption (of non-durable goods and services) plus the estimated money value of services received from durable consumer's good and from the unpaid labour of individual and family members for their own comfort and welfare. Under this definition of income, expenditures on durable goods whether capital or consumer goods, would constitute savings. If this concept is applied, a large portion of current money incomes of upper income groups would escape personal income taxation. Also, the'service-flow' concept for income taxation would by and large convert income tax into a spending or consumption tax.

'Re-current Consumable Receipts' Concept

This second concept relates to **"re-current, consumable receipts".** This idea was advocated by Carl Plehn. He stressed three charactristics of income namely (i) receipt (ii) anticipated revenue and (iii) expendability. On the basis of these characteristics, he included in income items like wages and salaries, interests and rents, annuities and pensions, and dividends of corporations. This concept of income clearly excludes gains and losses arising out of capital transactions as they are considered non-recurrent. Some economists criticised this concept of income on the following grounds.

Firstly, it is not always correct to say that interest and dividends be considered as a recurrent

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Secondly, capital gains and losses are excluded from taxable income, treating them as non-current.

'Net Accretion' Concept

The third concept namely the "net accretion" is generally taken as reasonably a good interpretation of income for tax purposes. All types of receipts or accrual in purchasing power to the individual between two points of time would be included in income for tax purposes. This way of looking at income has the advantage of judging one's personal ability to pay. This concept includes all the items of the other two categories for the purposes of income tax.

A personal income tax is therefore a tax collected from an income receiver and based on the size of this income, viewed in the 'net accretion' concept. Normally, the rates of income tax are progressive, in the sense that people earning higher incomes are made to pay tax more proportionately than others. It means, the rate of tax increases with the increase in the assessed income. For instance, the following is the schedule of personal income tax in India for the year 1990-91.

Table 2 : Rate of Income Tax

	Net Income Range	Rate of Income Tax
1.	Upto Rs. 22,000/-	Nil
2.	Above Rs. 22,000/- and Up to Rs. 30,000/-	20% of the Amount by which the total income exceeds Rs. 22,000/-
3.	Above Rs. 30,000/- and Up to Rs. 50,000/-	Rs. 1,600/- plus 30% of the amount by which the total income exceeds Rs. 30,000
4.	Above Rs. 50,000 and Up to Rs 1,00,000/-	Rs. 7,600/- plus 40% of the amount by which the total income exceeds Rs. 50,000/-
5.	Above Rs. 1,00,000/-	Rs. 27,600/- plus 50% of the amount by which the total income exceeds Rs. 1,00,000/-

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It can be seen from the above table, that the rates of tax for each slab has been increasing as we go up the income scale. In addition to the tax levied at the above rates, there will be surcharges also at 8% where the total taxable income exceeds Rs. 75,000/-

5.9.2 Corporation Income Tax

Taxing business or company incomes is known as 'corporation income tax'. It is justified on the following grounds (a) corporation is a separate entity and therefore has a separate ability to pay apart from the ability of the share-holders. (b) that the shareholders enjoy benefits of Incorporation and could justifiably be subjected to additional taxation and (c) that without a corporation tax, the distributed profits of companies will escape taxation. Just like the personal income tax, even in the case of corporation tax also certain concessions and relates are granted by the government.

5.9.3 Expenditure Tax

The personal expenditure tax, commonly called as simply 'expenditure tax' is a direct tax

payable by tax payer on the basis of expenditure incurred with previous year. This tax had been orignally suggested by Hobbes Mill, Fisher and more recently by Kaldor who argued that one's personal expenditure rather than his personal income is a better index of ability to pay. This tax has been experimented in many countries in the world but very few have retained it in their tax structure even now.

The first justification for taxing an individual on his consumption is that it is more just to tax someone on the value of what he takes out of society in terms of the goods and services which he consumes, than on the value of what he contributes to society, whether in the form of earnings in return for labour service or interest in return for the supply for capital services. The second justification for expenditure tax relates to the treatment of 'saving'. There is no discrimination between those who prefer to spend while young and active, and those who prefer to spend in retirement. An income tax, on the other hand discriminates against saving because it gives rise to "double taxation saving". For instance, let us supppose that there are two individuals who earn the same amount and hence pay the same income tax. The first individual decides to spend every thing during the same year while the second saves a part of his income for future years, on which he may be receiving interest. As the interest also is taxed by income tax, it is generally said that income tax discrimintes against savings. It also means that taxing interest discriminates between immediate consumption and defered consumption.

Expenditure tax has been experimented in some countries in the world including India, although it now remains in a very limited number of countries.

5.10 SOME EXAMPLES OF INDIRECT TAXES

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5.10.1 Excise Duties

Excise duties are imposed on goods and services produced within the country for sale or consumption. Some of them are advalorem i.e., imposed on the basis of the value of goods while some others are imposed on a unit basis (i.e., specific). These duties are unlike the general sales tax are levied only once mostly at the manufacture's level. For instance, in India we have two types of excise duties namely the union excise duties imposed by the central government and the State excise duties imposed by the State Governments on liquor, drugs and medicine etc. In recent years, excise duties has become an importance source of revenue to the government.

5.10.2 Sales Tax

It is a tax levied on the sale of goods and services. In some countries 'services' are not completely taxed. Whenever there is a transaction, sales tax has to be paid to the government. The tax could be either advalorem or specific. But in recent times, sales tax in almost all countries in the world are in the form of advalorem taxes. Sales tax may take several forms like (i) Single point tax (ii) Double point tax or (iii) Multi point tax. If it is a single point, the tax is levied only once at some point in the chain of transactions. If it is a double point, the tax is levied at two points in the chain of transactions. If it is multi-point, whenever there is a transaction, the tax is imposed.

5.10.3 Customs Duties

These are indirect taxes relating to imports and exports. Every country imposes certain duties on the goods imported into the country. They are known as **import duties** (or tariff). Similarly, duties levied on exports are called **Export duties** (or tariff). These duties are imposed to serve a number of objectives like (i) to regulate the foreign trade (ii) to earn more foreign exchange (iii) to give protection to the indegenuous manufacturer and so on.

5.10.4 Value Added Tax (VAT)

Strictly speaking, value-added tax (VAT) belongs to the family of sales taxes. Value added tax is not levied on the total value of the goods sold but only on the value added in the process of various transactions. The value added component can be calculated as the defference between the gross value of the goods minus the value of the materials purchased from other firms etc. The usual practice in the computation of VAT from the last seller of the good is to give him credit for the taxes paid by the earlier sellers at different stages of production and trade. Some countries in the world (like U.K., E.E.C., etc.,) have introduced this tax as one of the major indirect taxes in their tax strucutre. So far in India this has not been introduced and there is active consideration to resort to VAT instead of other indirect taxes like the slaes tax or the excise duties. Explanation of MODVAT (modified system of value added tax) is explained in the next Block.

5.11 TAXES IMPOSED BY LOCAL GOVERNMENTS

In addition to the above direct and indirect taxes, there are some taxes imposed at local level in a federal setup. The local bodies in federal governments are empowered to tax certain terms with the objective of not only raising revenues but also to regulate the production and consumption activity of such goods or services. A few of them may be mentioned.

5.11.1 Profession Tax

It is a tax imposed on the persons holding different professions and earning income from such professions.

5.11.2 Octroi

These are duties levied on goods entering into a local area for consumption, use or sale. The tax falls on all types of goods entering into the local area. As the inputs like raw materials, intermediate goods etc., are also subjected to Octroi, it is generally criticised to be very regressive and has cascading effects.

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5.11.3 Entry Tax

This is a form of Octroi but with less adverse effects. A uniform rate of tax is imposed at all places and even the commodities brought under the tax fold could be on selective basis. This tax has been imposed in some of the States in India.

5.11.4 House Tax

For local bodies, house tax is one of the major sources of revenue. It is an annual tax imposed normally on the basis of the rental value of house property.

CHECK YOUR PROGRESS - III

7. Explain the following concepts in about 4 lines each.

(a) Personal Income Tax.

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(b) Corporate Income Tax.

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(c) Expenditure Tax.

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(d) Octroi.

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(e) Entry Tax.

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(f) Excise Duties.

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(g) Sales Tax.

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(h) Customs Duties.

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(i) Vlaue Added Tax (VAT).

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5.12 SUMMARY/CONCLUSION

We have seen from the various aspects of direct and indirect taxes and that both these forms of taxation should not be viewed as contradictory to one another but they should be viewed only as complementary to each other. Both direct and indirect taxes are important in the tax structure of any country.

– Dr. T. Divakara Rao

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5.13 SUGGESTED BOOKS

1. B.P. Tyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*

5.14 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What is meant by direct taxes? Explain its advantages and disadvantages.
2. What do you mean by indirect taxes? Discuss the merits and demerits of indirect taxes.
3. Compare the indirect taxes with direct taxes. Under what conditions the indirect taxes may seem to be superior over the direct taxes.

II. Answer the following questions in about 15 lines each.

1. Distinguish between the direct and indirect taxes.
2. Give some examples of direct and indirect taxes. Explain any two of them.

UNIT - 6 : PROGRESSIVE, PROPORTIONAL AND REGRESSIVE TAXES

Contents

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6.9 Summary/Conclusion

6.10 Suggested Books

6.11 Model Examination Questions

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6.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the meaning of progressive, proportional and regressive taxes.

After reading the unit, you will be able to

- explain progressive tax system and its merits and demerits,
- discuss proportional tax system and its advantages and disadvantages, and

- identify the concepts of regressive tax and degressive taxation.

6.1 INTRODUCTION

We have already learnt that a tax is a compulsory contribution paid by the person to the government without a *quid pro quo* benefit. Many theories have been formulated for imposing taxes. Although most of the economists agreed that taxes should be imposed on the basis of ability to pay criterion, there was no concensus about the measurement and interpretation of 'ability to pay' as far as taxation is concerned. Some have argued for progressive taxation while some others for proportional taxation.

6.2 MEANING OF PROPORTIONAL, PROGRESSIVE, REGRESSIVE AND DEGRESSIVE TAXES

Taxes are classified in many ways. One of the common classification of taxes is to divide them on the basis of degree of progression. A tax is called **progressive** when the tax liability increases more than the proportionate increase in the tax base. The tax base is the legal description of the variable or parameter to which the tax applies. For instance, in the case of personal income tax, the net income of an individual, is taken as the tax base. Similarly, for wealth taxation, the tax base is the value of property. In the case of progressive taxses, the tax base is the value of property. In the case of progressive taxes, the tax liability as a proportion of tax base goes on increasing. If on the other hand, the tax liability decreases with the increase in the tax base, the taxes are termed as **'regressive'**. Accordingly, therefore, if the tax rate remains unchanged whatever be the tax base, the tax is called **'proportional'**.

Generally, direct taxes are believed to possess progression where as indierect taxes are believed to have proportional tax rates. But it is possible to make even an indirect tax to have progression. If direct taxes are levied in such a manner as to make away more money of the rich rather than that of the poor, they can be said to possess progression. For example indirect taxes at higher rates are imposed on such of those goods consumed by the rich, and if the goods consumed by the poor are relatively taxed little, such taxes do possess progression. On the other hand, if necessaries of which the poor consume the most are taxed heavily, such taxes are termed as 'regressive'. The rich as well as the poor pay the same amount of tax for the same amount of consumption of the commodity or service. From this we can say that the sacrifice undergone by the poor is relatively more than that undergone by the rich. Therefore, proportional taxes on essential items of consumption being repressive are not justified. In indirect taxes also, as stand in the above example, if the efective tax rate falls as the tax base (income or wealth etc.) increases, they are termed as 'regressive'. It is necessary to remove the regressive element of direct or indirect taxes by suitably changing the rate structure. But in practice, it may not always be possible to avoid completely the regressive element in all taxes administered by the government.

Sometimes, aother term known as **'degressive taxation'** is used to mean that there is declining degree of progression as the tax base increases. Normally, degression could be seen in two ways. First, a certain amount of the tax base is exempted from payment of tax while for the remaining amount, an uniform tax rate is applied. On the other hand, if the rate shcedule does not move up as fast as the tax base increases, we find the second type of degression. In brief, therefore, we may state that taxes can be viewed as proportional, progressive and regressive in terms of their rate structure.

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2. What is meant by proportional tax?

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3. What do you mean by regressive tax?

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4. Explain degressive tax system.

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6.3 LITERATURE ON THESE TAXES

The argument for progressive taxation, as a matter of fact, could be traced back to an essay by Guicciardini, published in the first half of the sixteenth century while for porportional taxation by Bodin towards the end of the same century. Since then, the principle has been restated and amended by numerous writers of widely differing philosophical backgrounds. According to J.S. Mill, equality in taxation means equality of sacrifice. So, for the interpretation of 'ability to pay'concept, importance has to be given to principle of equality of sacrifice. Here, we must, however, remember that sacrifice is highly a subjective term which is very difficult of being measured objectively. There distinct concepts of equal sacrifice were advanced by Cohen-Stuart and Edgeworth. They are (i) Equal absolute sacrifice (ii) Equal proportional sacrifice and (iii) Equal marignal sacrifice. Imposing taxes on the basis of measurment of sacrifice, requires a very important assumption namely interpersonal utility comparisons are possible.

In the canon of 'ability to pay' stated by Adam Smith, there was reference to both proportional taxation as well as progressive taxation. Although three concepts of 'equal' sacrifice were stated by different economists, there remained some confusions with respect to (i) choosing appropriate concept of sacrifice and (ii) determining the

In other words, there was no agreement as to the mertis of the various concepts of sacrifice. For instance, Cohen Stuart argued for equal proportional sacrifice while Sidg Wick and Marshall favoured equal absolute sacrifice. Edgeworth and Pigou argued that on welfare grounds equal marginal sacrifice whcih would lead to 'least aggregate sacrifice', should only be choosen. (The mertis and demerits of each of the three equal sacrifice concepts have been discussed in another unit).

6.4 INTER-CONNECTIONS

When we consider progressivness of a tax structure, we mean the money burden of it only but not its real burden. Real burden is measured in terms of the sacrifice undergone by the tax payers. Viewed in this manner, sometimes if a progressive tax does not have the much needed progressive at certain upper income levels, it could even be considered as a 'regressive tax'. Likewise, we may come across situations where a proportional tax could be treated as a regressive tax in terms of its real burden. The lower income brackets may have to bear greater real burden (i.e. sacrifice) in the case of proportional taxation. As already explained, the basic argument for progression very much depends upon the marginal utility of income, declining at higher levels of income.

In order to determine whether we have to choose progressive taxation or proportional taxation, it all depends upon the slope of the income-utility curve. Progression is based on the assumption of declining marginal utility. There is fairly general agreement among many writers on public finance that the marginal utility schedule declines when moving up the income scale. The declining marginal income utility differs from that of the principle of diminishing marginal utiliity as applied to the consumption of any particular commodity. The marginal utility cannot become zero or negative although the marginal utility from a commodity could become zero or negative. If the marginal utility cannot become negative, what should be its shape? According to Trend the marginal utility curve must run horizontally beyond certain point while according to Linden, it must continue to decline. The proposition that marginal utility of income declines with the increase in income has been criticised on a number of grounds. Firstly, it has been stated that rising needs may develop with rising income; and therefore, the marginal income utility schedule shifts upwards as his income rises. Secondly, it has been argued that sometimes the marginal utilities derived by various income receipients are interdependent. And thirdly, although most people accept the hypothesis of declining marginal utility, there is less agreement regarding the rate at which it declines when we move up the income scale. In this connection,three situations may have relevance to choose the type of rate structure that can be chosen.

First:- If the slope of the income utility schedule is such that marginal income utility declines at the same percentage rate at which income increases.

Second:- If the marginal income utility falls off more rapidly than the percentage increase in income.

Third:- If the marginal income utility falls off less sharply than the percentage increse in income.

For the first case, the justification is to have a proportional rate of tax; For the second, a progressive tax schedule while for the third, regressive is needed.

6.5 BASIS OF ARGUMENTS ON PROGRESSIVE OR PROPORTIONAL TAXATIONS

The Argument for and against progressive of proportional taxation are based mainly on the following considerations:

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justification or otherwise of a tax can be made in terms of measurment of the sacrifice undergone by the tax payer.

Second, when a tax is imposed, it may result in economic and social effect. For instance how it influences economic growth, saving, investment etc.

6.6 ARGUMENTS FOR PROGRESSIVE TAXATION

Progressive tax is a tax, whose rate increases with every increase in its base. The best example of a progressive tax is the personal income tax. In the words of Taylor "As taxable incomes rise under progressive taxation, the effective rate of tax rises, for margial increaments of income became subject to higher tax rates. This means that the rise in tax liability is more than proportional to the rise in income. Conversely, as personal incomes fall, the effective rates of tax fall and the decrease in taxes is more than proportional to the decrease in income (Philip E. Taylor. 'The Economics of Public Finance P. 532). Progressive taxes are seen in every country and are considered proper and just on the following grounds.

6.6.1 Principle of Ability to Pay

Firstly, it may be stated that these taxes are in accordance with the principle of capacity to pay. Most of the economists had agreed that taxes should be based on a person's 'ability to pay'. This concept as already explained is based on the law of diminishing marginal utility as applied to money. As the rich possess larger amounts of money, the utility derived from the marginal units would be less. So, if a tax is levied in such a manner as to take away more proportionately than the increase in the tax payer's income, it is based on the principle of ability to pay which is justified.

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The precise measurment of marginal utility of income as also of the possibility of interpersonal comparisons is infact very difficult. If we are able to make such measurment by some method, it enables us to construct precise schedule of tax rates in such a manner that the principle of aggregate sacrifice is attained in taxation. But our inability to measure margial utility of income need not stand in the way of supporting progressive taxes. The reason is the rich are made to pay more amount towards taxes and also bear greater money burden. So, progressive taxes are justified.

6.6.2 Reduction of Inequalities

Secondly, progressive taxation is supported on the ground that it would help reduction of inequalities of wealth and income existing among different sections of the society. In a capitalist system, the working of market mechanism lead to create glaring inequalities of income among different people. So, Adolph Wagner emphasises the role of tax system as a powerful instrument for correcting the distribution of income and wealth as determined by the market forces and also the institution of inferiatance. A fair degree of progression is therefore advocated to fulfil this social objective.

6.6.3 Reduction of Conspicuous Consumption

Thirdly, another argument in favour of progressive taxation is based on taxing the potential savings of the rich people. In a developing economy, the rich can save more than the poor. If the State does not tax the rich more heavily (by a progressive taxation) there is very likelihood of their consumption of luxuries etc., increasing which means using up the scarce productive resources of the society wastefully. So in order to prevent the rich from conspicuous consumption, progressive taxation is very much advocated.

6.6.4 More Revenue to the Exchange

Fourthly, after it has been said in favour of progressive taxation th

obtained by the exchequer in the form of progressive taxes where as the expenditure incurred by the government on tax administration is very less. So these taxes are considered to be economical.

6.6.5 More Elastic

Fifthly, a tax structure based on the principle of 'progressiveness is more elastic'. When the government is in need of additional money, it may be very easy to mobilise the same by way of increase in the rates of progressive taxes. Also, such an increase in the tax rates may not be increasing the burden of taxation on the poor.

6.6.6 Satisfying the Canon of Fiscal Adequacy

Sixthly, progressve taxes satisfy the canon of fiscal adequacy. Modern goverments are obliged to perfom many functions today. Unless sufficient amount is available with the government, it would not be possible to perform many socio-economic activities. So progressive taxation is supported.

6.6.7 Ensuring Economic Stability

Lastly, it has also been argued that by progressive taxation economic stability could be ensured. In other words inflation and depression can be tackled by regulating the volume of purchasing power in the economy. The effective demand can be reduced by increasing the rates of progressive taxation to combat an inflationary situation, while by reducing the rates of tax a situation of recession can be overcome. Although, as stated above, there are several arguments in favour of progressive taxation, there are also many apponents to it. We shall now discuss the argumets against progressive taxation.

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6.7 DEMERITS OF PROGRESSIVE TAXATION

6.7.1 Discourages Savings & Investment

Firstly, progressive taxes discourage accumulation of capital. When incomes and wealth are taxed at higher rates, people may not be in a position to save more and thus capital accumulation is adversely affected. If the tax rates are very progressive, people may invest their money in some other places or countries where the tax rates are comparatively lower. It leads to a fall in capital accumulation on account of the tax system being progressive. We may also witness capital flight to other countries. Normally, this can be seen when the direct tax rates are high (i.e., direct taxes being generally progressive taxes also). Another disadvantage of progressive taxation is that it may adversely affect the willingness to save and work of the people and consequently economic development might be retarded. Acquisition of more income or wealth is possible if one works hard. Due to progressive taxation additional incomes or wealth are subjected to higher rates of taxation. Unless people are able to enjoy the fruits of their labour, they would prefer to work less and consequently, productivity in general might decline.

This argument against progressive taxation cannot be held totally valid in the sense that State can introduce the much needed incentives in the tax system for improving efficiency and thereby improving saving and investment in the economy. Nevertheless the arguments suggest us that too much progression may have certain adverse affect especially as far as saving and investment are concerned.

6.7.2 Punishes the Thrift and Hardwork

Secondly, it has been criticised that progressive taxation punished the thrifty and hardwork which laziness and extravagance are encouraged. As already stated earlier, people who do hardwork acquire more wealth and income by thier ability and intelligence and they are taxed [illegible] On the other hand, people who are lazy and earn less incomes remain tax-free. In other

words, the burden of serving the society is more borne by those who make large contributions in the form of tax payments to the government. Therefore, J.S. Mill was of the opinion that there should be a limit to progression beyond which further taxation would be entirely unjustified.

But this criticism is also not totally correct. One may accumulate income or wealth, not only by his own hard work but also by the facilities provided by the government in the form of infrastructure etc., in the economic system. Viewed in this manner, this criticism does not seem to be very serious.

6.7.3 Marginal Utility of Income Cannot be Measured

Thirdly, many opponents to progressive taxation base their argument on the point that as marginal utility of income can be strictly measured in objective terms, it would not be possible to construct correct rate structure. The rates of progressive taxes are fixed arbitrarily.

6.7.4 Arbitrariness in the Rate Structure

There is some element of arbitrariness in the rate structure of progressive taxes. But it should not dissuade us to implement progressive taxes by adopting an appropriate slab system. Modern economists believe that although marginal utility of income cannot be strictly measured objectively, yet the rich may be made to bear greater burden of taxation in the egalitarian point of view.

6.7.5 Encourages Tax Evasion

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Lastly, the critics often point out that progressive taxes encourage tax evasion, which leads to generation of black income in the economy. If the tax rates are high, the tax payer is tempted to conceal a part of his income for tax purposes by showing false accounts and making wrong declarations. There is some element of truth in this argument. In recent times, it has been found that tax evasion is the direct outcome of having high personal income tax rates. In India also, the latest report on black income generation supports this view point. However, if the government's administrative machinery is streamlined, tax evasion can be minimised.

6.8 ARGUMENTS FOR AND AGAINST PROPORTIONAL TAXATION

6.8.1 Construction of Rate Schedule

Proportional taxation has been advocated mainly on grounds of our inability to measure the marginal utility of income objectively. It has been argued that measurement of marginal utility of income is highly a subjective one. Therefore, it is not possible to make interpersonel comparison of utility derived by different persons from their incomes. So proportional taxation has been favoured as this does not necetitates to construct a rate schedule to tax different levels of income at different rates.

This argument in favour of proportional taxation is not tenable. It is the commonly known fact that marginal ultility of income like the marginal utility of any other commodity falls as income increases. Therefore, it can be safely assumed that the marginal utility of income to a poor man would be higher than that of a rich man. Therefore, there is every justification that the rates structure of taxation should be progressive.

6.8.2 No Changes in Relative Positions of Tax Payers - Neutral

Another argument in favour of proportional taxation is that it does not change the relative positions or status of the tax payers. It means that the relative position among the tax payers before and after taxation would remain same. This point can be understood by a simple example.

For instance, a 5% income tax is imposed on all net incomes in such a case persons with the different incomes shown below are left with the same relative status even after the payment of tax.

Income of	Rs. 100 will pay	Rs. 5;	Income after tax	Rs. 95
"	Rs. 1,000 "	Rs. 50;	"	Rs. 950
"	Rs. 10,000 "	Rs. 500;	"	Rs. 9,500
"	Rs. 1,00,000 "	Rs. 5,000;	"	Rs. 95,000

It can be seen that the relative status among different individuals having an initial difference of 10 times between any two of themselves remains the same before and after payment of the tax.

On the basis of this argument it has been claimed that a proportional tax is 'neutral' in terms of the allocation of resources of the enconomy to different uses. In other words, a proportional tax does not change the relative demand and supply positions and consequently does not affect the course of development of the economy. This is, however, depends upon the elasticities of demand an supply.

Although there seems to be some element of truth in this argument, it can be seen that the real income positions of the tax do not remain the same. For instance, in the above example a man with an income of Rs. 100 finds it more burdensome to pay an amount of Rs. 5 rather than a man with Rs. 10,000 to pay an amount of Rs. 500. It may, therefore, be seen that in the case of a rich person his consumption standard would not be affected, while in the case of a poor man his consumption standard would be affected. Therefore, if it is not correct to view that a proportional tax is 'neutral' when saving and consumption are affected, the tax would not remain neutral. Therefore, the relative positions although not affected in money terms will definitely be altered in real terms.

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6.8.3 No Adverse Effects on Savings and Investment

Still another argument in favour of proportional taxation is that it is not subjected to the mistake and pitfalls often attributed to progressive taxation. High rates of progressive taxation adversely affects saivng and investment in the economy. Therefore, proportional taxation had been advocated.

This argument is not always valid. The saving and investment are affected not only by high rates of progression but even by high rate of proportional taxation also. Therefore, it is not correct to think that proportional taxes do not affect saving and investment in the economy.

6.8.4 Administrative Simplicity

Finally, the argument in favour of proportional taxation stems from its administrative simplicity. It has been argued that proportional taxation is simple and uniformly applicable. The rate structure is not complicated and therefore, overcomes the difficulties involved in determing the graduation of tax rates. The supporters of proportional taxation are of the view that the structure of porgressive taxation are fixed on arbitrary grounds depending upon the vagaries of the government in power.

It is true that proportional taxes are simple and convenient. But it is not correct to think that administratively they are always manageable and convenient. For instance, if a proportional income tax is imposed on all the people in the society irrespective of the income level, it would involve a big task of estimating the taxable income of a very large number of tax payers. In such a case it can not be said that a proportional tax system is simple. Similarly, the points at which tax collection should be made are numerous and therefore it is adminsitratively unmanageable. However, as far as fixing the rate schedule is concerned a proportional tax is not subjected to the arbitrariness as that of a progressive tax.

6.9 SUMMARY / CONCLUSIONS

We find that there are many arguments as stated above in favour of and against proportional taxation. It may be stated that in the nineteenth century many writers favoured proportional taxation which in the twentieth century the emphasis has shifted to favour progression. The basic question today is not one of proportional versus progressive taxation but rather one of moderate versus high rates of progression. In every tax system there is justification to have a proper mix of both proportional and progressive taxation.

-- Dr. T. Divakara Rao.

6.10 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*

6.11 MODEL EXAMINATION QUESTIONS

I. **Answer the following questions in about 30 lines each.**

1. What is meant by progressive taxation? Examine its advantages and disadvantages.
2. What do you mean by proportional taxation. Analyse its merits and demerits.

II. **Answer the following questions in about 15 lines each.**

1. Explain regressive and degressive taxes.
2. Distinguish between progressive and proportional taxes.

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UNIT-7 : CANONS OF TAXATION

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7.0 AIMS AND OBJECTIVES

The aims of this unit is to discuss the various canons of taxation on the basis of which taxes are imposed.

After reading the unit you will be able to

- analyse different canons of taxation,
- discuss the objectives of tax structure in developing countries,
- identify the characteristics of a good tax system, and
- list the principles which are attributed to a good tax system.

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7.1 INTRODUCTION

We have seen in the previous lessons that government needs funds to perform its various activities. There are many sources of public revenue. Important and common sources of public revenue are taxes, income from currency, market borrowings, sales of public assets, income from Public sector undertakings, fees, fines, gifts and donations etc., of these, taxes happen to be a very important source of public revenue. A tax is a compulsory levy without any direct return of benefit to the tax payers. It is not a price paid by the tax payer for any definite service rendered by the government. It should, however, be recommended that the tax payer also gets benefitted, although indirectly, when government spends the tax revenue on various items of expenditure in the economy. The characteristics of a tax system changes over time in the sense that what was once considered as the most important function of State must have undergone a thorough change during the subsequent periods. For instance, during the 19th century, the functions of State were very limited to protecting the people from extended aggression and internal disorders. The revenues required by the state to carry out its limited activities usually remained small. But in 20th century, especially after the second world war, there has been a tremendous increase in state activities which need substantial revenues and hence the importance attached to taxation in the field of Public Finance. When once we realise the importance of taxation as the main source of public revenue, it is worth while for us to know the manner in which taxes ought to be imposed. It has been argued by some economists that there should be a single tax only instead of having many taxes. Some have favoured taxes on consumption while others have favoured taxes on income, wealth and property. Likewise, in regard to the rate structure there is hardly any concensus among many economists. While progressive taxation had been supported

by certain economists, proportional taxation also was considered important in the tax structure of an economy. Amidst all these divergent opinions, What should be the guidelines, on the basis of which taxes can be imposed? It becomes therefore necessary to study and understand the canons of taxation.

7.2 CANONS OF TAXATION

At the outset, it is customary for us to learn the four canons of taxation as propounded by **Adam Smith.**

7.2.1 Canon of 'Ability to Pay' or Equality

The canon runs as follows: "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State." In the observation or neglect of the maximum consists what is called the equality or inequality of taxation."

It can be seen that this canon lays more emphasis on the objective of economic justice. The subjects or citizens of every state have to make tax payments to support the government, under whose protection their lives and properties are quite secure. If the government does not protect the properties of the citizens, it is not possible for them to carry out any economic activity and earn income. Further, as the rich generally own more property which is protected by the government, it is fully justified in terms of sacrifice that they should pay more taxes than the poor. Adam Smith's canon of equity or equality gives importance to both progressive as well as proportionate taxation. Taxes should be paid according to one's 'ability to pay'. Equality of sacrifice in the payment of taxes can be achieved if the rich pay more proportionately than the poor. In other words, this canon underlines progressive taxation. Direct taxes being normally progressive satisfy this canon rather than the indirect taxes.

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According to some economists it has been argued that this canon suggests even 'proportional taxation' also. If we carefully analyse the canon. We find that Adam Smith was in favour of taxing people "in proportion to their respective abilities" which leads to progressive taxation. In the latter part of canon, it has also been mentioned as "that is-in proportion to the revenues which they respectively enjoy under the protection of the State". If this part of the canon is taken into consideration, it gives meaning although that Adam Smith favoured proportional taxation. However, as justice in taxation is more based on the ability to pay interior, many of the opinion that this canon gives importance to progressive taxation only. This canon has, however been criticised on certain grounds. First, it is difficult to measure one's 'ability to pay', as sacrifice is something which is subjective. Second, the canon is partly ethical and partly economic. Despite this criticism, the canon of 'ability to pay' is very basic in the formulation of tax structure in any economy. We find that different taxes are imposed on the basis of 'ability to pay' criterion, measured in terms of income, wealth or property.

7.2.2 Canon of Certainity

This canon is as follows:

"The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought to be clear to the contributor and to every other person". This canon is intended to remove ambiguity in the payment of tax. According to Adam Smith uncertainity encourages insolence and corruption. So, the tax payer must know in advance as to how much he has to pay, to whom he should pay and when he has to pay etc. From the administration point of view also, this canon is very important in as much as the government would be able to know how much tax revenue could be

obtained from whom and at what time etc. If the tax payer knows in advance how much he has to pay towards taxes, he can adjust his expenditure accordingly. There is an old maxim which can learn in this context. It is often said that 'an old tax is no tax'. It is because of the fact that old taxes are already known and they are certain. Old taxes do no pinch the tax payer like an old shoe as he must have already adjusted his budget for them. On the other hand, a new tax is viewed burdensome because the tax payer does not know its details.

7.2.3 Canon of Convenience

According to Adam Smith "Every tax ought to be levied at a time or in a manner in which it is most likely to be convenient for the contributor to pay it". This canon also, just like the canon of certainity, is aimed at achieving administration convenience. The canon lays emphasis on the time and mode of payment. Taxes should be collected at a time and in a manner most convenient for the tax payer to pay. For instance, tax on land should be collected after harvesting time because the agriculturists would have enough money with them to pay it. Similarly, best and easy manner to collect personal income tax is at a time when salaries are paid to the employees. So, income tax deductions are made from the salaries by which method the tax payers would not feel its pinch very much. Indirect taxes, say, for instance sales tax is collected when the goods are sold to the consumers. Suppose, an almyrah is sold to a consumer by the manufacturer of steel products. The sales tax on the good is realised from the consumer at the time of its sale. The consumers pay the indirect taxes included in the price of the commodities, without having a feeling that they would be paying so much tax. If this canon is satisfied, there would not be resistance for payment of taxes from the tax payers. It is also easier for the government to realise taxes promptly.

7.2.4 Canon of Economy

According to Adam Smith, the yield from tax revenue must be more than the tax administration charges. The canon is stated as follows :

"Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the Public Treasury of the State".

By this canon, we mean that a tax should not involve complicated and large machinery for its administration and collection. As a matter of fact, this canon is of greater significance in the present day tax administration rather than when it was laid down by Adam Smith. We find that the tax administration charges have been increasing over time in respect of certain taxes. This canon has been interpreted in a different way also. In order to achieve higher levels of output in the economy, productive capacity of the people should increase. Taxes should not diminish the productive capacity of the people. Therefore, certain taxes on dangerous drugs etc., are meant to restrict their consumption by the people rather than yielding more revenue to the exchequer. In respect of such taxes, there is a possibility of the collection charges exceeding their revenue yield. The canon of economy should therefore, take into account not only the charges of administration and the corresponding revenue yield from the tax but also how its effect would be on the economy. As long as the productive capacity of the economy is increased, a tax justified irrespective of its immediate revenue yield to the exchequer.

In addition to the above four canons propounded by Adam Smith, some other economists have laid down canons of taxation from time to time. Although they are not so fundamental compared to those stated by Adam Smith, yet we may learn them as they are of some practical importance. Those additional canons are (i) Canon of Productivity, (ii) Canon of Elasticity, (iii) Canon of Simplicity, (iv) Canon of Diversity etc.

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7.2.5 Canon of Productivity

According to Bestable, taxes should be productive. It means that by taxation sufficient revenues should be obtained by the state. The state cannot perform its various activities without having adequate revenues. So taxes should provide sufficient revenues to the government. According to Gladstone, "The very object for which the revenue system exists is to provide for the maintenance of the state and therefore, the Minister in charge of the finance naturally estimates the merits of a tax by the amount of its yield".

7.2.6 Canon of Elasticity

Whenever there is increase in national income, we can expect that the tax revenues also would correspondingly increase. If the tax revenues increase more proportionately than the increase in the national income, it may be called **'elastic'**. If the increase in the tax revenues is less proportinate than the increase in the national income, it is called **'inelastic'**. In this connection, it may be stated that the revenue from a particular tax depends upon (i) base changes (ii) rate changes and (iii) changes in national income. A tax is called 'elastic' if without base and rate changes, we notice the tax revenue increasing more proportionately than the increase in national income. If base and rate changes also are included while calculating the increase in the tax revenues vis-a-vis the national income, it represents the buoyancy of tax. According to this canon, elastic taxes are better than inelastic taxes. bastable also laid emphasis on the principle of elasticity.

7.2.7 Canon of Simplicity

The tax system should be simple, plain and intelligible so that there would not be any difficulty for the tax payer to understand it, this canon helps the administration as well as the tax payers. The tax laws should be framed in such a manner that they can be understood easily even by a common man.

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7.2.8 Canon of Diversity

This canon tells us that a tax system should have all sorts of taxes such as direct and indirect; Progressive and proportional; taxes on income, consumption and property; advalorem and specific taxes etc. If there are all sorts of taxes in an economy, the defects and frictional forces among them might cancel out each other. Due to imposition of a tax, the existing economic equilibrium would normally be disturbed. It is possible to have frictional forces like resistance to taxation, shifting, diffusion, evasion, capitalisation of taxes etc. If a tax system has all kinds of taxes, these frictional forces can be minimised. For instance, if a person evades payment of personal income tax which is a direct tax, it is possible to expect that he would be spending a part of the tax evaded money on luxurious consumption. So, if an indirect tax is imposed on luxurious commodities, a part of tax-evaded income is obtained by the exchequer. So having all kinds of taxes is considered good according to this canon. But caution should be taken that which we can support the view to have all kinds of taxes the number of taxes imposed on the commodity should not be very large. Administratively also, it is difficult to manage many taxes.

From all the canons so far discussed, it is clear that some of them are contradictory with one another. For instance, the canon of productivity may come into conflict with the canon of ability to pay or canon of convenience. Similarly sometimes the canon of economy may conflict with productivity. When there is conflict between two canons, it is customary to adopt the most important canon that serves better the objectives of taxation. Therefore, Shirras lays golden rule which states "In case where conflict arise, choose the more important".

CHECK YOUR PROGRESS - I

1. List the canons of taxation propounded by Adam Smith.

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2. What are the other canons of taxation?

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7.3 CANONS OF TAXATION IN DEVELOPING COUNTRIES

In an under-developed country, what should be the canons of taxation? The canons discussed already equally apply to all types of economies both developed as well as the underdeveloped. However, in under-developed economy, the main objective of fiscal policy is to promote the growth process which is mainly a function of capital formation. So the following aspects should be given importance in the tax structure of an under-developed economy.

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7.3.1 Mobilisation of Economic Surpluses

One of the main objective of taxation in underdeveloped economies should be to locate surpluses and channels their taxation so that government can use the same for investment purposes. In other words taxation should be such as to help faster rapid capital accumulation. In doing so, it is however, necessary to take enough care that taxes should not discourage the very generation of surpluses by the individuals or the enterprise. The following example makes the point clear. When government imposes a personal income tax the disposal income of the tax payer is reduced by the extent of the tax amount. If very high rates of taxation are adopted, they may adversely affect the individual tax payer's initiative to work more and earn more. It is obvious for him to think that by putting more effort, whatever extra income he earns is taken away by the high rates of personal income tax. So, his preference to generate more income is adversely affected. Therefore, the most difficult aspect is to identify or locate the surpluses generated in the economy during the process of economic development. When once the surpluses are located, it is possible to mobilise them by suitable taxation.

7.3.2 Reducing Conspicuous Consumption

The people of an under-developed country are generally poor. In the process of economic development, it is but natural that their incomes are increased. In the initial stages of economic development, we notice that their consumption expenditure registers an increase along with increase in their incomes. But greater consumption means lesser availability of resources for investment. As the country's progress depends very much on rate of investment, it is necessary to curb the increase in their consumption by imposing taxes on commodities other than necessaries. Indirect taxes imposed mostly on luxurious goods are effective in reducing their consumption to

that resources are released for investment purposes.

7.3.3 The Canon of Income Elasticity of Taxation

It has been found in most of underdeveloped economies that the increase in tax revenues is less than the proportionate increase in national income. It means that the income elasticity of taxation is less than one or to put the same in a different way is to say that the tax system in these countries is "inelastic". So, the tax structure should be such that an increasing proportion of the increments to national income should get automatically syphoned off into the Public exchequer without any additional tax effort by the government. If this feature is seen in a tax system, we can say that it possesses the needed flexibility. To satisfy this canon it is necessary to tax such of those goods which have a high income elasticity of demand. If the tax system is progressive, it is possible to achieve this canon.

7.3.4 Canon of Equity

In so far as an underdeveloped country is concerned, the burden of taxation should be distributed equitably among different classes of people. They should help in getting the inequalities of income and wealth reduced. The rich should be taxed more as their 'ability to pay' is also more than that of the poor. At the same time, care should be taken that taxation in these countries does not adversely affect the incentives for higher production and savings.

CHECK YOUR PROGRESS - II

1. What are the aspects to be considered in the tax structure of developing countries?

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7.4 CHARACTERISTICS OF A GOOD TAX SYSTEM

Generally it is believed that if a tax system in a country satisfied a good number of the canons stated above, it may be considered as a good tax system. It may however be stated that no tax system would be in a position to satisfy all the aforesaid canons in as much as there are certain conflicts with each other. Therefore, importance should be given to see that the majority of the canons of taxation are fulfilled. Another point which is essential to know is that the canons of taxation may not be common for all countries at all times. Depending upon the level of economic development already reached by an individual country, it must be judged which of the canons are better suited to its tax system. Various aspects of taxation have to be analysed. For instance, some of the problems of tax system have to be viewed from administrative angle; while some have to be viewed from different angles like the various kinds, forms, rates and timings of taxation. The following points have to be kept in mind while analysing the tax system of a country.

7.4.1 Effects of Tax on the Economy

Firstly, it must be remembered that a tax system has to be judged from its effects on the economy. So, strictly speaking it is not correct to look at taxation in isolation ignoring completely the non-tax elements as well as the items of Public Expenditure in the budget. We cannot say whether it is a good tax system or not unless we look into the benefits of Public expenditure

also simultaneously. But as the revenue obtained from taxation is mixed up with all other kinds of revenues like non-tax revenues; public borrowing, deficit financing etc., it, however, becomes very difficult to measure the burdens of taxation in comparison with the benefits of Public Expenditure. In a limited sense, we may look into the various aspects of taxation like forms, rates and timings of taxation, assuming all other variables remain unchanged. So, when we talk of a good tax system, we normally look at taxation only in isolation.

7.4.2 Comparison of Different Tax Systems

Secondly, while analysing a tax system we have to look into many dimensions of it. Alternatively tax systems yielding more or less the same revenue but having less economic ills may have to be chosen. Each system may have its merits and demerits in terms of economic as well as social effects. As there may be conflicting objectives among different tax systems, it is very difficult to make a choice of them. So one has to compare the merits and demerits of one tax system with that of the other. In other words it is necessary to attach much importance to the "trade off" between different objectives. The country may opt for a particular tax system depending upon its own preference to such system.

7.4.3 Practicality

Thirdly, it may be seen that what is theoretically the best need not necessarily be the best in practice also. In abstract theory, marginal utility and disutility of various tax measures are comparable. But in practice measurement of marginal utility of money is faught with many difficulties. There may also be difficulties in actual implementation of the so-called good taxes due to administrative, political and other reasons. Therefore, it is essential on the part of the government to carefully think of practical problems when taxes are formulated.

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7.4.4 Attitude of the Tax Payers

Fourthly, it is the view of some scholars on Public Finance that the attitude of the tax payers should be taken as an important variable in judging a tax system. Every tax payer prefers to bear less of the tax burden by himself, no matter whether others bear heavy burden. It is essential to see that the tax burden is distributed equitably among all the tax payers. No tax payer should feel that he bears unduly more burden than others. In practice, the attitude of tax payers is influenced by many factors, of which some of them may even be non-economic such as the political situation in the country, natural calamities like floods and droughts etc. Therefore, it is necessary to make the tax laws flexible so as to accommodate such situations.

7.4.5 Time Consideration for Changes in Tax System

Fifthly, it is also necessary to understand that changes in a tax system cannot be brought all of a sudden. An individual tax can be newly introduced or an existing tax can be dropped altogether or got amended. But for the entire tax system as a whole, it may take quite a long time to bring out the necessary changes.

All these aforesaid aspects have to be carefully looked into when we analyse a tax systsem. By and large, a good tax system is expected to be in harmony with important national objectives. Many modern writers on Public Finance are of the opinion that a good tax system should be based on the principle of progression. In other words, the rate of tax should increase correspondingly with every increase in the national income. If this principle is fulfilled, the tax burden would be more borne by the richer sections of the society rather than the poor. Proportional and regressive taxes should be kept at the minimum.

Musgrave has explained same of the characteristics of a good tax system. They are as follows:

i) The distribution of the tax burden should be equitable

ii) Minimum interference with economic decisions

iii) Minimum interference with the equity of the system

iv) It should facilitate the use of fiscal policy for stabilisation and growth objectives

v) Fair and non-arbitrary administration

vi) Administration and compliance costs should be as low as possible.

Among direct and indirect taxes, the preference of the modern writers is on the former. A diversified tax system consisting of all sorts of taxes is preferred to a single tax system. This should not, however, mean multiplicity of taxes which is not good in any tax system. According to Mrs. Hicks a good tax system shoud possess mainly three important characteristics. Firstly, taxation should be able to provide adequate revenues to meet the expenditure on public services. Secondly, the general public should be taxed according to their 'ability to pay' (i.e. canon of equity) which depends upon the tax payers income and family circumstances. And Thirdly, taxes should be universal in the sense that persons similarly positioned should be treated alike without any discrimination. Some other writers have given importance to the development of trade and industry. The tax system should be such as to promote economic development of the country.

In conclusion, we may state that a good tax system should possess the following characteristics:

1. The tax system should be diversified. Multiplicity of taxes is not desirable.
2. It should be equitable.
3. It should be simple.
4. The tax system should be efficient from the administrative point of view in the sense that there should be hardly be any scope for tax evasion and corruption.
5. It should be elastic and buoyant.
6. The cost of administration should be fairly low.
7. It should be capable of reducing the inequalities of income and wealth.
8. It should help the growth process by encouraging trade and industry. It means, sufficient incentives should be provided for hard work.
9. The entire tax system should be properly integrated.

7.5 OBJECTIVES OF TAXATION

The objectives of taxation are closely related to the characteristics of a good tax system. They are nothing but the various canons of taxation. In older days the main objective of taxation is to raise revenue to the government. The classical economists have given little importance to the role of government in the economic life of the people. So, taxation was also not given much importance. But in modern times, the functions of government have enormously increased. Taxation is not simply meant to raise revenue to the exchequer. Taxation is now used to regulate the economic activity in the country. Taxation in modern days aims at the following:

(i) To mobilise resources for economic development.

(ii) To regulate and control conspicuous consumption. Indirect taxes on certain commodities are meant to reduce their consumption and to regulate their production also.

(iii) To check inflation and deflation.

(iv) To reduce inequalities of wealth and income among different sections of the people.

It may be noted that these objectives of taxation have already been dealt with by us when we learnt the canons of taxation as well as the characteristics of a good tax system.

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CHECK YOUR PROGRESS - III

1. Identify the major characteristics of a good tax system.

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2. What are the objectives of taxation?

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7.6 PRINCIPLES FOR A GOOD TAX SYSTEM

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Generally, the following four principles are attributed to a good (or sound) tax system :

(1) The tax burdens should be distributed equitably

(2) The tax system should be productive

(3) There should be appreciation of the rights and problems of the tax payers and

(4) Flexibility of the tax structure to meet the changing needs of the economy.

We may elaborate these points a little further.

7.6.1 Tax Burdens to be Distributed Equitably

Equity or justice in taxation has been accepted as the main objective to be achieved in any tax system. There is, ofcourse, no consensus among economists to objectively measure what exactly equity is and how it can be attained without any element of subjectiveness. Equity can be viewed in two different ways. One way of looking at the problem of equity is "equal treatment of equals". It means that persons placed in similar circumstances should bear the same amount of burden of taxation. Another way of looking at equity is the desirbale relative treatment of persons placed in different circumstances. According to this interpretation of equity, the rich should bear a greater burden of taxation than the poor.

7.6.2 Tax System should be Productive

The tax system should be productive so that adequate revenues are obtained by the exchequer to spend the same on various items of public expenditure. In modern times, government do need more money to perform their various functions. If the system is productive, the government may easily mobilise the required financial resources. If the system is unproductive, it is difficult for the government to carry out its plan programmes. Tax productivity includes not only getting more revenues to the exchequer but having regularity and flexibility also. It should, however, be [illegible] is a relative concept depending upon the general economic trends

7.6.3 Rights and Problems of Tax Payers

This aspect is directly connected with tax payer's morale and to have efficient tax administration. The interests and rights of the tax payers should be given adequate importance. Tax administration can not run efficiently in a democratic set up without improving the tax payer's morale. It is therefore, necessary for the government to take the following steps:-

First :- Efforts shall be put forward so as to make the tax payers understand clearly of particular tax measures.

Second :- Efforts should be made to reduce the inconvenience and interference associated with tax payment and collection.

Third :- The complaints made by the tax payers should be promptly attended to by the authorities and their grievances redressed.

It can be easily seen that the first aspect is associated with the canon of simplicity while the second with the canon of convenience. In modern days, tax payers generally make many complaints relating to payment and collection of taxes. The tax payers would be very much satisfied if the complaints made by them are promptly attended by the concerned authorities. This would boost up the morale of the tax payers and in result tax collection becomes much easier. It is only with the cooperation of tax payers the functioning of tax administration can become efficient.

7.6.4 Flexibility of the Tax Structure to Changing Needs of the Economy

Many aspects are included in this. A sound tax system is aimed at fulfilling the objectives of development planning. For an underdeveloped economy, growth with stability is normally given importance. So, for the growth process, the tax system should be helpful to foster rapid capital formation. Surpluses generated in the economy should be identified and the same have to be channelised for productive investment. Resource mobilisation is given top priority in the growth process. The other goal is achieving "stability" which implies that the tax system should be able to counter-act inflationary and deflationary tendencies. In under developed economies, inflationary tendencies are more common and therefore, taxation should curb the effective demand and thereby certain inflation. In developed countries, more importance is given to boost up public expenditure to overcome the problems of deflation. So, taxation suitably administered is supposed to meet these challenges, namely inflation as well as deflation. Another objective of a good tax system should be to reduce the inequalities of income and wealth among different sections of the society. A redistribution of income by taxation helps to increase the economic welfare of the people. This objective is more associated with achieving social justice.

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CHECK YOUR PROGRESS - IV

1. What are the principles for a good tax system?

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7.7 SUMMARY/CONCLUSIONS

We have already learnt that tax is a compulsory levy by which public revenue is accrued to

the State. The features of a tax system changes over time. Therefore the need arises to have guidelines, on the basis of which taxes can be imposed. So in this unit, we tried to analyse the canons of taxation in general and for developing economies in particular. A good tax system should possess some characteristics which are related to the objectives and principles of taxation. An effort is made in this unit to explain the characteristics, objectives and principles of a good tax system.

– Dr.T. Divakara Rao

7.8 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Musgrave, R.A. : *Theory of Public Finance*

7.9 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Critically examine the canons of taxation.
2. What are the characteristics of a sound tax system?

II. Answer the following questions in about 15 lines each.

1. Explain the objectives of taxation.
2. Analyse the principles for a good tax system.
3. Identify the characteristics of a good tax system.
4. Discuss the canon of ability to pay
5. Explain the canons of economy and elasticity.
6. What should be canons of taxation in developing countries?

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UNIT-8 : JUSTICE IN TAXATION - VARIOUS THEORIES

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8.0 AIMS AND OBJECTIVES

The purpose of this unit is to discuss various principles of taxation.

After reading the unit, you will be able to

- explain the benefit approache of taxation,
- analyse the cost of service principle of taxation,
- discuss the ability to pay principle of taxation, and
- identify the subjective and objective tests relating to ability to pay principle.

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8.1 INTRODUCTION

In this lesson we learnt about justice in taxation which deals with how the tax liability has to be determined. We know that a tax is a compulsory contribution made by the person to the government and there is no direct quid Pro quo. How the money burden of taxation is to be distibuted? What principles should be followed to make the system more equitable? What is the relationship between the tax payers and the government? Answers to the questions are found when we analyse various factors governing justice in taxation. There are many theories to explain as to how the tax burden is to be distributed. Broadly, we may study three theories namely 'the benefit theory or approach 'the cost of service' theory and the 'ability to pay' theory. The first theory links the tax liability to the benefits received by the tax payers from the goods and services supplied by the State. In the second theory, the tax liability is linked to the cost of providing the goods or services by the State. The third is the most important theory which links tax liability to the individual's capacity to pay tax.

8.2 EARLIER VIEWS : BENEFIT AND ABILITY TO PAY THEORIES

As rightly pointed out by Musgrave, views on the principles of taxation may be found in the writings of innumerable authors-philosphers, economists and political thinkers right from the Middle ages to date. The duty to pay taxes or the power to tax is among the most tangible of all links between subject and sovereign. As far as the Benefit theory is concerned, the basic assumption is that there exists an exchequer or contract type of relationship between the tax payers and the State.

Arguments For and Against Benefit Theory

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During the 17th and 18th centuries, many economists and political thinkers thought that taxation as a price for the services rendered by the State was a natural complement to the contract theory of State. According to the benefit theory, members of the society who receive various goods and services from the state activities should contribute in proportion to the benefits received by them. So, J.S. Mill thought that the relationship between the tax payer and the State was on quid-pro-quo terms. If taxes are to be paid in proportion to the benefits derived from the State services, it means that this theory does not attach importance to the problem of bringing about equitable distribution of income and wealth. Similarly it ignores the problems of growth and stabilisation by making use of the tax policy. It concentrates mainly on how 'goods and services are supplied by the state and how they should be paid for by the members of the society who enjoy them'.

In Terms of Protection-Benefit Theory

Most of the earlier writers who supported the benefit principle argued in terms of protection. In other words State provides protection to the life and prorerty of the people. The general opinion was that the need for protection should be measured in proportion to income or wealth, which is protected by the State. Therefore, proportional taxation was favoured and the benefit principle was very much supported by them. Some writers like Roussean, Sismondi etc., did not subscribe to this view point. For instance Roussean felt that the wealthy would benefit more from protection than the poor. Similarly, Sismondi was of the opinon that the need for protection increases more rapidly than income and hence argued for progressive taxation.

Marginal Utility-Benefit Theory

Some writers had taken 'marginal utility' concept to substantiate their arguement in support of the benefit theory. For example, Mazzola opined that each consumer should be called upon

to pay a price equal to the marginal utility that he personally derives from the service rendered by the State.

Another economist Emile Sax made a distinction between 'personal collective wants' and 'collective wants proper'. It is clear that the principle of exclusion applies to the former but not to the latter. No individual can be deprived of having the benefit of the state services. So, according to Sax, a good proxy to measure the relative benefit received by an individual would be the proportional income tax. Similarly, Knut Wicksell advocated that taxes should be imposed *on the basis of voluntary and unanimous action* of the individuals to have state services. If this view is implemented, the role of the tax system to bring about equitable distribution of income and wealth is ruled out. But to treat that state services should be consumed on the basis of voluntary demand is not correct in as much as there would not generally be equitable distribution of income in the economy. Similarly Erik Lindah also did not give importance to tax system, to bring about equitable distribution of income in the economy. He supported the benefit theory *in terms of voluntary exchange* between the taxes paid and the state services received by the tax payers on the bsis of their preferences.

Distribution Aspects-Ability to Pay Theory

On the other hand, if we attach importance to the *distribution aspects* of the economy, we find that the ability to pay approach of taxation is more justified. This principle received a good deal of support from the socialist thinkers. Adam Smith in his cannon of equity gave more importance to the ability to pay concept of taxation. Modern welfare states have also attached much importance to the ability to pay approach of taxation.

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Approaches to Taxation

All this discussion amply reveals that broadly there are two approaches to taxation: namely whether taxes should be imposed in proportion to the benefits received from the state activities or whether taxes have to be paid in accordance with the tax payer's capacity or ability to pay. If *benefit appraoch* is taken, there is a quid-pro-quo relationship between the tax payers and the state. Taxes would not be treated as compulsory payments. But if *ability to pay approach* is taken, taxes are to be considered as compulsory contributions to the public exchequer. In such a case, there is no quid-pro-quo element in taxation. We may now deal with the merits and demerits of those approaches.

8.3 BENEFIT PRINCIPLE OF TAXATION

As already discussed, this theory tells us that for the benefits conferred on the community through the various activities of the State, it is necessary and justified that the cost of government services are made good by the members of the society in proportion to the benefits received by them.

8.3.1 Advantages of the Benefit Theory

The following are the merits of the benefit prinicple.

Fistly, the theory is based on the assumption that there is justification to tax those who have benefitted from the Public services.

Secondly, this theory gives importance to both the revenue and expenditure sides of the budget. When government provides certain goods and services, it involves the cost aspect or public expenditure side of the budget. When taxes are imposed on the community, it relates to public revenue of the budget. The benefit theory determines not only the public expenditure side but also the relative tax shares that should be paid by the tax payers. In other words benefit

theory simultaenously determines both the public services as well as tax shares.

Thirdly, the benefit theory is favoured on the ground that it helps efficient allocation of resources.

Finally, the theory is applicable in respect of those cases where the benefit received can be measured. For example local property taxes to finance policy adminsitration, special assessment to finance local public works etc.

8.3.2 Disadvantages of the Principle

There are many demerits of the benefit theory. Some of them may now be discussed.

At the out set, it may be seen that benefits derived individually cannot be accurately separated and measured. The functions of government are varied and complex. The community in general would be benefitted from the various activities performed by the government. It is very difficult, rather impossible, to calculate and assess the indiviudal benefits so that each person should be called upon to contribute in proportion to the benefit received by him. So, there are many theoretical and practical difficulties to implement this principle.

Secondly, the quid-pro-quo relationship between the tax payer and the government has been subjected to much criticism. In the past, writers on Public Finance thought that the relationship between the tax payer and the government was anologeous to the satisfaction of private wants. Taxes are treated just like prices. But many services provided by the government are meant to satisfy the collective wants. In modern days, State provides certain services for the welfare of the community in general but not for the welfare of an individual person. Therefore, a quid-pro-quo type of exchange relationship does not exist between the State and the individuals with respect to most of the Public services.

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Thirdly, as the benefits cannot be separated on individual basis, taxation should be taken as a collective instrument to finance the various activities performed by the government. So it is not possible to tax people in proportion to the benefits enjoyed by them.

Fourthly, the benefit approach sometimes gives peculiar results. For example, if everyone has to pay to the government according to the benefits received, take the case of a pensioner. The amount of pension granted by the government to a retired employee is definite sum which represents the benefit received by him. If he asked to pay a sum equal to the pension, by way of taxes; it is very rediculous. So, in practice we should not express people to pay taxes proportionate to the benefits received.

Fifthly, if we follow the benefit approach, the burden of tax on the poor would be much more than the rich. In a welfare state, most of the public revenues are meant to benefit to the poor rather than the rich. Some public services may be common to all where the exclusion principle would not be applicable. If the poor are called upon to pay taxes in proportion to the benefits enjoyed by them, it leads to regression. In other words, the benefit theory which supports proportional taxation is regressive in nature. J.S. MIll rejected the benefit theory because it would lead to regressive taxation.

Sixthly, as already stated this principle does not attach importance to the problems of distribution and stabilisation. In modern days distribution and stabilisation aspects are very essential to be looked upon in the development planning point of view.

Finally, it may be seen that the benefit theory has very limited application. When a special or direct service is provided by the State, it may perhaps be possible to calculate the individual benefits and people can be asked to pay taxes in proportion to the benefits received by them. A direct service provided by the government should be run on commercial lines, if at all the benefit principle can be made applicable. But most of the activities of a welfare State are not

performed on commercial lines. So, to treat all taxes in the economy on the basis of the benefit principle is illogical.

From the criticism it is clear that the benefit theory cannot be put into practice as it is not possible to calculate individual benefit shares arising out of Public services provided by the State.

8.4 COST OF SERVICE PRINCIPLE OF TAXATION

This principle is closely associated with the benefit theory. While in the benefit theory, taxes should be paid in proportion to the individual benefits derived from the various state services, the cost of service theory attaches importance to the cost of rendering the service to the tax payers. The state is considered just like a seller in the market. The cost of the good or service supplied by the State should be realised by way of taxation from those people who utilise the same. According to this theory the citizens ae not entitled to any benefits from the State. If at all anybody receives a benefit, he should pay its cost. The theory does not attach importance to the protective and welfare functions of the State. Nor does it concern with the problems of income distribution. The thoery implies a balanced budget policy. If this theory is implemented, quite a few sources of public revenue do not find place in taxation. For example taxes on windfall gains, capital gains, unearned investments, inheritance and gifts etc. As the individual has to pay the cost of the service supported by the State, this theory rules out all sorts of welfare activities (e.g. relief activities etc.,) also.

Just like the benefit theory, even the cost of service principle also cannot be actually put into practice. The problem of measuring the cost of State services and assigning them to various beneficiaries is a very difficult task.

State may be supplying quite a few services to which the exclusion principle cannot be applied as in the case of Private goods. All the members of the society are entitled to benefit from the State services. In other words one cannot be denied a share in the consumption of Public goods and therefore the cost of service cannot be apportioned between different members of the society.

Another objection to the cost-of-service approach is that it is not possible to calculate the cost with enough conceptual clarirty. For example, if the resources are used inefficiently, the cost of the service provided by the State would naturally be higher. It is not justified that the consumers be asked to pay by way of taxes even for the inefficiency in production.

Similarly, this theory is inadequate to explain the problem of externalities. There would be social benefits and social costs on account of externalities. This theory is applicable if the State confines itself to only the commercial costs just like the private enterpreneurs. But this view is not correct. While determining the tax liability, the State is supposed to estimate the net social cost.

Finally, a very serious question concerning this theory is as to what extent and nature the State services are to be provided. It is not proper to think that the State itself decides what services are to be provided to the citizens who would be called upon to pay for them. How to ascertain the preferences of the citizens for the State services? There are many practical difficulties in ascertaining the true preferences of the people for the State services.

Although the aforesaid draw backs are there this theory, yet it may be useful in some limited number of cases. Where a service is specially provided, it is possible for the State to recover its cost from its beneficiaries. For instance the charges for water supply, railways etc. But by and large this principle is inappropriate to determine justice in taxation. Many services like free education or medical aid for the poor cannot be explained on the basis of this theory. Also, it may be noted that this principle goes against the very definition of a tax, as we know that a tax is a compulsory payment without quid-pro-quo. This principle is not in accordance with the

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character of a tax, viz., quid-pro-quo. But according to this theory, the payment of a tax is in return of the cost of the service.

CHECK YOUR PROGRESS - I

1. What is the principle of cost of service of taxation?

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2. What is the benefit approach of taxation?

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8.5 PRINCIPLE OF ABILITY TO PAY OF TAXATION

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8.5.1 The Principle

Unlike the benefit theory or the cost-of-service theory, this approach is completely in accordance with the definition of tax. The theory does not assume any quid-pro-quo relationship between the citizens and the State. In other words, there is no any commercial or semi commercial relationship between the state and the citizens. It is the collective responsiblity of the citizens to pay taxes to government without direct quid-pro-quo. The 'ability to pay' doctrine items from the idea that the burden of taxation should be shared among the members of the society so as to uphold the principle of justice and equity. This theory tells us that taxes should be levied according to the ability of the tax payers. Adam Smith embodied this principle while explaining his canon of equity, which state "the subjects of every State ought to contribute towards the support of the government as much as possible according to their respective abilities".

As rightly opined by Musgrave and Musgrave the application of the benefit principle was very much limited to certain specific government functions only and therefore, was not useful to explain the general problem of tax structure. The re-distributive function of the tax payers process could not be explained by the benefit theory. So, in order to achieve equitable taxation, people should contribute to the cost of government in proportion to their respective abilities to pay.

8.5.2 Merits

Teh protponents of ability to pay principle of taxation advance their arguments on the following points :

Fistly, ability to pay approach has been supported in the terms of what is known as 'sacrifice interpretation of ability'. As the concept of sacrifice being subjective, different formulations have been suggested to measure one's ability in terms of sacrifice. Broadly, there are three interpretations of sacrifice, namely (i) equal sacrifice (ii) proportional sacrifice and (iii) minimum

sacrifice (this is also known as the principle of marginal sacrifice). In sacrifice terms, the rich are justified to bear more burden of taxation.

Secondly, this principle is justified on the basis of diminishing marginal utility as applied to income. When we move up the income scale, the utility of marginal income is assumed to be declining. So, it is justified that the rich should bear tax burden more proportionately than the poor.

Thirdly, the ability to pay principle of often justified on the basis of what is known as 'Faculty'. After meeting certain basic needs, more resources are left at the disposal of a rich man compared to that of a poor man. So it is justified that the rich should bear greater burden of taxation rather than the poor.

8.5.3 Criticism

A careful look at the above three grounds advanced in support of 'ability to pay' principle amply reveals that they are, strictly speaking, not realistic. The main difficulty is on account of the very nature that sacrifice or marginal utility of income being subjective.

8.6 ABILITY TO PAY AND SUBJECTIVE TESTS

Since the time of J.S. Mill, the ability to pay principle has been viewed in terms of equal sacrifice. On the assumption that the income utility schedule is the same for all tax payers, it is justified that people with equal income i.e., equal ability to pay should contribute equal amounts of tax. While understanding the principle of equity, there are two situations namely Horizontal and Vertical equity which we should know. Equal taxes for people in equal positions is referred to as **'Horizontal equity'** while unequal taxes for people with unequal incomes is referred to as **'Vertical equity'**. Of the two Horizontal equity is less controversial. If equality is to be interpreted not in terms of equal loss of income but in terms of equal loss of utility, then equal treatment calls for unequal taxes for unequal incomes. Horizontal equality is met if we make two important assumptions, namely (a) that income utility is measurable in cardinal terms and (b) that the income utility schedule is the same for all people. But how about meeting the requirements of vertical equity? The answer to this question depends on both the shape of the income utility schedule and by what role "equality of sacrifice" is defined. As stated already, equal sacrifice can be interpreted in terms of (i) equal absolute sacrifice (ii) equal proprotional sacrifice and (iii) equal marginal sacrifice. According to Dalton there is a fourth possible interpretation of equality of sacrifice. He calls it as 'constant equality of incomes'. It means that the relative income position among the tax payers should remain the same before and after payment of tax. The most ticklish aspect is how to measure the marginal utility of income when the income of a tax payer changes. Still more difficult is to make interpersonal comparisons of mrginal utility of income. Although there is no consensus in respect of measurment of marginal utility of income, the assumption of similarity of income-utility schedules among the tax payers has been accepted to analyse the different interpretations of equal sacrifice. We now discuss the above three interpretation of sacrifice.

8.6.1 Equal Absolute Sacrifice

This interpretation of sacrifice tells us that the loss of utility is the same among different tax payers. If this doctrine is applied, each member of the society will have to pay some amount towards tax and nobody would be exempted. However the amount of tax varies among the tax payers with different incomes since the marginal utility of income depends upon the income level. For instance, let us suppose that there are two tax payers with different incomes. The person with more income pays more tax while the person with less income pays less tax. But the sacrifice or loss of utility would be the same to both as a result of the tax.

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8.6.2 Equal Proprotional Sacrifice

It means that the loss of utility as a result of a tax should be proportional to the total income of tax payers. In this principle, the ratio of sacrifice of each tax payer to his total income should be one and be the same among all the tax payers. Although people with higher incomes would pay more amount towards tax, the ratio of sacrifice to the total income would be same for all. The principle of equal proprotional sacrifice can be shown as follows :

Let us suppose that satisfaction is measured in terms of income possessed by different individuals, say, A, B, etc.

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

It is clear from the above formula that each tax payer under this principle undergoes sacrifice equal to the same percentage of his total satisfaction. What would be the rate structure of equal proprotional sacrifice principle is adopted? If the marginal utility of income remains constant this principle would lead to a proprotional taxation. But if the marginal utility of income falls, it is necessary to know these relative percentage shifts in the marginal and average utilities. If the rate of fall of both marginal and average utilities is the same, then proprotional tax would satisfy this principle. If on the other hand, the marginal utility of income falls at a faster rate than its average utility, progressive 'taxation is called for to satisfy this objective. Similarly if the marginal utility of the income falls at a smaller rate than its average utility, regressive taxation would be necessary to fulfil this principle.

8.6.3 Equal Marginal Sacrifice or The Least Aggregate Sacrifice

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Another interpretation of equity is given by the equal marginal sacrifice. This means that the tax burden should be borne in such a manner that the marginal sacrifice of each tax payer would be the same. This principle is given importance in the welfare point of view. If marginal sacrifice is equal among the tax payers the total sacrifice of the community would be the least or minimum.

The equal marginal sacrifice principle is more attributed as an efficiency rule rather than an equity rule. Edgeworth and Pigou supported this principle so that the loss of welfare for the community as a woole is minimised.

8.6.4 Concluding Remarks

In this contex it is more appropriate to interpret the three versions of sacrifice in the words of Dalton. "According to the principle of equal sacrifice, the direct money burden of taxation should be so distributed that the direct real burden on all tax payers is equal; (ii) according to the principle of proprotional sacrifice the direct real burden on every tax payer is proportionate to the economic welfare which he derives from his income; (iii) according to the principle of minimum sacrifice; total direct real burden on the tax payers as a whole is as small as possible".

Of all the three types of sacrifice, the principle of equi marginal sacrifice has been widely accepted. In this context, it is very essential for us to remember that 'sacrifice' itself is a subjective concept and we are not sure of estimating correctly the shape of the marginal utility of income curve. Ability to pay, expressed in terms of sacrifice is not free from arbitrairness and ambiguity. So the need to state the ability to pay in terms of certain objective criteria arises.

CHECK YOUR PROGRESS - II

3. What do you mean by ability to pay?

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4. Interprete one of the equal sacrifices.

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8.7 ABILITY TO PAY AND OBJECTIVE TESTS

What is the right index of ability to pay? In older days the term 'ability' or faculty in the Elizabettan Poor Law referred to 'property'. So the persons who possess more property are supposed to have more ability to pay. But in course of time as the society advanced, the emphasis has been shifted from property to income. Adam Smith formulated his cannon of ability in terms of income. In recent times, some economists have advocated consumption as an index of one's ability to pay.

We shall now examine the implication of each one them.

8.7.1 Property

If property is taken as the basis of one's ability to pay, there are some weaknesses. Although a person may be earning substantial income, he may not possess property. He may not come under the property taxation. Some properties may not be yielding current income. For instance the ability to pay of a man with an annual income of Rs. 10 lakhs is much more than that of widow who possesses a house but not earning any current income at all. So, property sometimes may not represent one's ability to pay.

8.7.2 Income

Income is regarded as a fair test of ability to pay in modern times. Therefore, many economits favoured progressive taxation of income so that the rich may contribute more to the exchequer by way of taxes rather than the poor. By considering income as index of one's ability to pay, there is possibility of including income from all sources. In other words income from salaries, property, investment, shares and debentures etc., could be taxed. But according to some thinkers income cannot always represent a fair test of ability to pay. So, what are the reasons?

(i) It is necessary to differentiate between earned and unearned incomes. It is necessary for us to known whether the income is obtained from the property or from one's personal effort. The former should be taxed at a higher rate rather than the latter type of income in order to make taxation more equitiable.

(ii) The family circumstances also have to be taken care of. A family may earn more income but the number of dependents also may be quite large. So, a bachelor may be taxed at a higher rate than a married person with a number of children.

(iii) All income should not be taxed. It is necessary to have a minimum exemption limit which should be determined by the current standard of living of the community.

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(iv) The principle of progression is normally applied if income is taken as the basis of taxation. But we know that there is very much arbitrariness in the formulation of rate structure of progressive taxation.

Despite these limitations, income is regarded as the best index of 'ability to pay' for the purposes of taxation in many countries in the world.

8.7.3 Expenditure

More recently, Prof. Kaldor, an eminent economist, favoured **expenditure** as the basis of taxation. According to him income as the test of ability to pay is defective. He feels that one's spending power is the true index of ability to pay. As income tax is not imposed on the basis of one's true ability to pay and as it leads to corruption and tax evasion etc., he feels that income should not be taken as the basis of taxation. Income tax adversely affects incentives to work and save and thus discourages private capital formation. So, Kaldor favoured consumption as the basis of taxation.

But some economists feel that to take consumption as one's ability to pay is not correct. Taxes on consumption hit the poor more than the rich. They are generally regressive taxes. A person may be spending more due to his fmaily circumstances although his income may be low. So to conclude that he has a greater capacity to pay taxes is not correct.

8.8 SUMMARY/CONCLUSION

We have seen that the three objective tests to represent one's ability to pay are not free from defects. Therefore the right way is to have a tax system which gives representation of various taxes imposed on property, income and consumption. In such a case it is possible to attain near approximation of satisfying the principle of equity in taxation. Therefore, modern tax system includes taxes on income, property and consumption. It may be noted that the burden of taxation should be judged taking the system as a whole but not on the basis of individual taxes. Some taxes may not conform to the principle of euqity. But the inequity of one tax can be got corrected by the equity of some other taxes. Different people have different ideas regarding what constitutes equity in taxaton. It is a concept which is very difficult to put into practice. Therefore Dalton is right when he says "Equity is an elusive mistress whom perhaps it is only worth the while of philosophers to pursue ardently and of politicians to watch wally".

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– Dr.T. Divakara Rao

8.9 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. Hugh Dalton : *Principles of Public Finance*
3. H.L. Bhatia : *Public Finance*
4. Musgrave : *Theory of Public Finance*

8.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain, critically, the benefit principle of taxation.
2. Describe the principle of ability to pay.
3. Analyse the subjective and objective tests of the principle of ability to pay.

II. Answer the following questions in about 15 lines each.

1. Explain, in brief, the two approaches of taxation.
2. Discuss the cost of service principle of taxation.
3. Explain the concept of "equality of sacrifice"
4. What are the three objective tests of 'ability to pay' theory.

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UNIT-9 : IMPACT AND INCIDENCE OF TAXATION METHODS OF MEASUREMENT

Contents

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9.2 The Impact of Tax
9.3 The Incidence of Tax
9.4 Shifting of Tax
- 9.4.1 Forward Shifting of Tax
- 9.4.2 Backward Shifting of Tax
- 9.4.3 Tax Capitalisation

9.5 Theories of Incidence of Taxation
- 9.5.1 The Concentration Theory
- 9.5.2 The Diffusion Theory
- 9.5.3 Demand Supply Theory

9.6 Demand Supply Theory of Incidence of Taxation
9.7 Incidence of Some Particular Taxes
- 9.7.1 A Tax on Monopoly Profits
- 9.7.2 Incidence of Income Tax
- 9.7.3 Incidence of Tax on Property

9.8 Double Taxation
9.9 Certain Concepts of Incidence
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9.12 Model Examination Questions

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9.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain different concepts relating to impact, incidence and shifting of taxation and analyse different theories pertaining to the measurement of incidence.

After reading the unit, you will be able to

- identify the concepts of impact, incidence, shifting, tax capitalisation and double taxation,
- explain the theories of incidence of taxation,
- analyse, graphically the demand supply theory,
- discuss the incidence of few particular taxes.

9.1 INTRODUCTION

When government imposes a tax, it is paid by the person or the economic unit which is bound to do so. Every tax reduces the disposable income of the tax paying unit. So, if there is any possibility, the tax payer tries to shift the tax burden to others. In practice, every economic

the tax payer not to bear its burden. In this context certain terms have been coined so as to understand how the tax paid by the tax paying unit impossible of being shifted. Broadly, there are three such terms - (1) the impact of tax (2) the incidence of tax and (3) the shifting of tax. We may now try to understand these terms.

9.2 THE IMPACT OF TAX

When government imposes a tax, the money burden of it is borne in the first instance by the person (or tax paying unit) who is legally bound to pay the amount of tax to the government. This is called the impact of tax. In other words, the legal responsibility is on that person. This represents only the money burden. For example, the union excise duties in India are paid by the manufacturer of the product on which the government imposes the duty. But obviously it is not the final resting place of the tax. The manufacturer who paid the union excise duty always tries to shift the burden to others. So in the chain of transactions we may notice that the duty is passed on from manufacturer to wholesaler and then to retailer but finally to consumer who purchases the product. Therefore, although the manufacturer paid the amount of tax at the first instance as he is legally bound to do so, he did not ultimately bear the burden of it. Sometimes it may not be possible for the tax paying unit to pass on the burden to others. Sometimes would it be possible only to partially shift the burden to others?

9.3 THE INCIDENCE OF TAX

While the impact of a tax is on a person who pays it in the first instance, the term 'incidence' refers to the ultimate burden of a tax. The incidence is on a person or group of persons who bear the ultimate burden of the tax. According to Seligman incidence is defined as "the settlement of the tax burden on the ultimate tax payer". In other words it is the final resting place of the tax. The person who bears the incidence cannot shift the burden any further. In the words of Musgrave "the term incidence as commonly used refers to the location of the ultimate or the direct money burden of the tax as such. It is said to occur when a particular price of the tax comes to rest with the final payee".

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9.4 SHIFTING OF TAX

The process of transferring the money burden of a tax is called 'shifting'. It refers to the various processes by which the direct money burden on account of tax is passed on through price adjournments (or cost adjustments) from the point of impact to the final resting place. The process of shifting goes on continuing till the incidence of the tax is reached. It may be noted that shifting of the money burden is legal where as tax evasion is illegal. Shifting is normally done by suitable price adjustments. The tax is included in the price of the commodity. It is passed on from the manufacturer to the wholesaler and then to retailer and finally to the consumer. Sometimes, it is also possible to shift the burden by making suitable adjustments of the prices paid to the factors of production. Similarly, sometimes if the price of the goods on which tax is imposed remains the same, shifting may still take place in the form of change in the quality of the good.

9.4.1 Forward Shifting of Tax

As stated earlier, price of the commodity normally constitutes the vehicle for shifting the direct money burden of a tax. Assuming that all other factors in the process of shifting remain unchanged, if a tax is completely shifted, the price of the taxed commodity would be higher by the amount of the tax. If the tax is shifted from manufacturer to wholesaler and then to retailer and finally to consuenmr, it is known as **'forward shifting'**. Price of the commodity is increased in the case of forward shifting. Some times complete shifting of the tax is possible. Some times

partial shifting may take place. There may be occasions also when it would not be possible for the tax paying unit to shift the money burden to others. In such a case, there is no shifting. The impact and incidence would be on one and the same tax paying unit.

9.4.2 Backward Shifting of Tax

If the price paid to the factors of production is affected due to shifting of a tax, it is known as **'Backward Shifting'**. In other words, the price of the commodity would remain the same even after imposition of tax as far as the consumers are concerned. But the remuneration of prices paid to the various factors of production which have been made use of in the making of the goods will be less. An example makes this point clear. Let us suppose that the supply of raw material to an industry is inelastic. It means, the supply cannot be reduced even if the industry reduces the price of the raw material. So, when a tax is imposed on the industry, it is possible to shift it backwards by reducing the prices of the raw material. On the other hand, if the supply of the raw material is elastic, it is not possible for the manufacturer to shift the money burden of the tax backwards. Similarly, in a locality let us suppose there is inelastic supply of labour. The manufacturer can shift the tax to the labourers by reducing their wage. We, however assume that other factors (like the trade union's pressure etc.) do not influence the process of shifting of the tax.

9.4.3 Tax Capitalisation

One special type of backward shifting of tax is often attributed to what is known as **'tax capitalisation'** when certain permanent assets yielding certain percentage of their value as annual income are sold, the buyers will calculate the future burden of the tax and try to shift the entire or part of the burden backward to the sellers. The person who desires to purchase such durable assets pays a lower price at the time of purchase itself. He will discount the value of property or security by capitalisation of tax in order to escape from the payment of tax. An example of tax capitalisation is follows.

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Suppose a land is valued at Rs. 1,000/- and it yields an annual income of Rs. 50/-. Let us also suppose that there is a specific tax of Rs. 10/- on it per annum. The owner of the land would be getting a net income of Rs. 40/- per annum. It can be seen that without tax the land yields an income of 5% of its value. If the buyer desires to maintain a 5% return on value of the property which he proposes to purchase even after payment of the tax, he would be willing to take the land for Rs. 800/- only. In other words, a 5% return on Rs. 800/- would be Rs. 40/- per annum. Although the asset value is at Rs. 1,000/-, the buyer would be escaping from the future tax payments, if he gets the same at Rs. 800/-. In other words, a lumpsum of Rs. 200/- is reduced which represents the entire money burden of the tax. It may, however, be noted that tax capitalisation is possible under **certain conditions** only. The value of the asset as well as the annual income from it should be stable. The buyer should have alternative avenues of investment. Capitalisation is possible in such of those cases where property has both capital value as well as annual income.

CHECK YOUR PROGRESS - I

1. What is the impact of tax?

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2. What is the incidence of tax?

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3. What is meant by shifting of tax?

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4. Identify forward shifting and backward shifting?

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5. What do you mean by tax capitalisation?

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9.5 THEORIES OF INCIDENCE OF TAXATION

These theories can be classified into classical theories and modern theories. Concentration theory and diffusion theory are part of classical theory and demand supply theory pertains to modern theory.

9.5.1 The Concentration Theory

According to Physiocrats, a school of French thinkers in the 19th century all taxation except on rent was necessarily shifted. They believed that agriculture was the only productive occupation and all other occupations were sterile and unproductive. So, all the non-agricultural occupations do not produce a surplus. They favoured a single tax on land and did not favour any tax on the other occupations. They thought that even if some other taxes are imposed on non-agriculturist they would necessarily shift the same ultimately to the agriculturists. It is because, no surplus is generated with the non-agriculturists. This view of the physiocrats cannot be taken as correct. Surplus could be generated in occupations other than agriculture also. In modern days, as

we have aleady seen in the canons of taxation, that single tax system is not favoured. But the thinking of Physiocrats makes a point clear in that if surplus is not generated, the money burden of the tax cannot be borned and tax paying unit tries to paidways and means in order to pass on the burden to others. In their view all taxes are shifted and get concentrated on agricultural rent.

According to the classical economists, surpluses generated in the economy one of two types namely rent and profit. Land rent arises, according to Ricardian theory, due to the operation of law of diminishing returns in agriculture and Malthusian theory of population. Now if a tax is imposed on agricultural produce what will happen? Agricultural prices go up which increases the cost of subsistence of the workers. Consequently, wages would have to increase, which means profits would decline. Agricultural rent would not be affected as the land lords would pay the tax out of higher sale proceeds collected by them through higher agricultural prices. So, the incidence is on profits. But what will happen if a tax is imposed on wages? Even then also, the incidence would be on the profits but not on the rents. Additional money wages have to be paid to the workers to maintain a given real subsistence. If a tax is imposed on the profits itself, it is not possible to shift the same by lowering wages which are aleady at subsistence level. But if a tax is imposed on agricultural rent itself, the landlords will have to bear it and there is no possibility of its being shifted to others as rent does not form part of the cost of production (according to classical economists).

The concentration theory could not provide a satisfactory explanation to the problem of incidence of taxes.

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9.5.2 The Diffusion Theory

According to this theory, the incidence of taxation is diffused in the economic system. As there is interdependence of various economic units, a tax imposed at one place could be shifted many times in such a manner that it becomes very difficult to locate the ultimate resting place of it. So, the supporters of the theory like Mansfield and Canard argued that it was not possible to investigate the ultimate incidence of a tax. They believed that every tax was shifted and reshifted till the burden get eventually distributed over the whole society equitably. This theory has been criticised by many economists. According to Dalton, the diffusion theory simply runs away from the basic problem of ascertaining the incidence and the effects of a tax. Although in respect of some taxes, it is very difficult to estimate both the incidence as well as the effects, it is not correct to view that they are diffused equitably in the whole of the economy. Diffusion theory assumes perfect competition and perfect mobility of the factors of production from one employment to another without cost differences. In practice the situation is, however, different. Markets are seldom adequately competitive. Also, factor mobilities are restricted by more than one reason. Musgrave also did not subscribe to the views of the diffusion theory. The assumption of the diffusion theory that all taxes enter into cost of production and are thus diffused is not correct. There are certain taxes like those imposed on property, interest and wages do not always form part of cost of production. Diffusion thoery has, therefore, been discarded.

9.5.3 Demand Supply Theory

This theory can be stated to be the modern theory of incidence of taxation. According to this theory, incidence of tax resembles the determination of value which is influenced by the demand and supply forces in market. We have already seen that shifting can take place through price transactions. And price transactions are obviously determined by the market forces of demand and supply. In other words, factors which influence the market situation also influence the process of tax shifting. Certian factors like the conditions of the market, mobility of factors of production, the elasticity of supply and demand etc. often influence tax-shifting.

CHECK YOUR PROGRESS - II

6. **What is diffusion theory?**

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7. **What do you learn from demand supply theory of incidence?**

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9.6 DEMAND SUPPLY THEORY OF INCIDENCE OF TAXATION

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At the outset, it may be stated that when a tax is imposed, the price of the commodity increases. If the price of the commodity increases by the full amount of tax, the incidence is wholly on the consumer. If the price does not rise at all, this incidence is wholly on the producer (or seller). If on the other hand, price has increased less than the full amount of the tax, the incidence is shared between the sellers and buyers. Elasticity of demand is taken for 'forward shifting' while elasticity of supply is taken for 'backward shifting'. Tax on a commodity having inelastic demand is passed on to the consumer. For instance, taxes imposed on necessaries are passed on to the consumers. It is because, the demand for necessaries is relatively inelastic and, therefore, the consumers cannot very much reduce their demand. In other words, the sales are not very much declined in the producer's or seller's point of view. On the other hand, if taxes are imposed on comforts and luxuries, what will be the position? As these commodities have relatively elastic demand, the incidence of taxation cannot be completely shifted to the consumers. A part of the incidence has to be borne by the sellers. It is because, goods having elastic demand if taxed affect the sales of the producer (or seller). From this, it is clear that tax shifting depends upon the comparative resistance of the buyers as well as the sellers to bear the money burden of tax. The buyers tries to avoid the incendece; while the seller tries to shift the incidence to the buyer. The incidence of taxation is, therefore, determined on the basis of the relative elasticity of the demand and supply curves. When the demand curve is perfectly elastic, the incidence of tax will be wholly on the seller. Any increase in the price on account of the tax, adversely affects the demand for the commodity. So, shifting to the consumer (i.e. buyer) is not possible. If the demand curve is vertical i.e., perfectly inelastic, the incidence will be completely on the buyers. Although the price of the goods increases on account of the tax, the buyers cannot reduce their demand. It is easy for the seller to shift the tax burden to the buyers. Similarly, if the supply is perfectly elastic, the tax is wholly borne by the buyers. If it is perfectly inelastic, the incidence will be wholly on the seller. These situations are shown now diagrammatically:

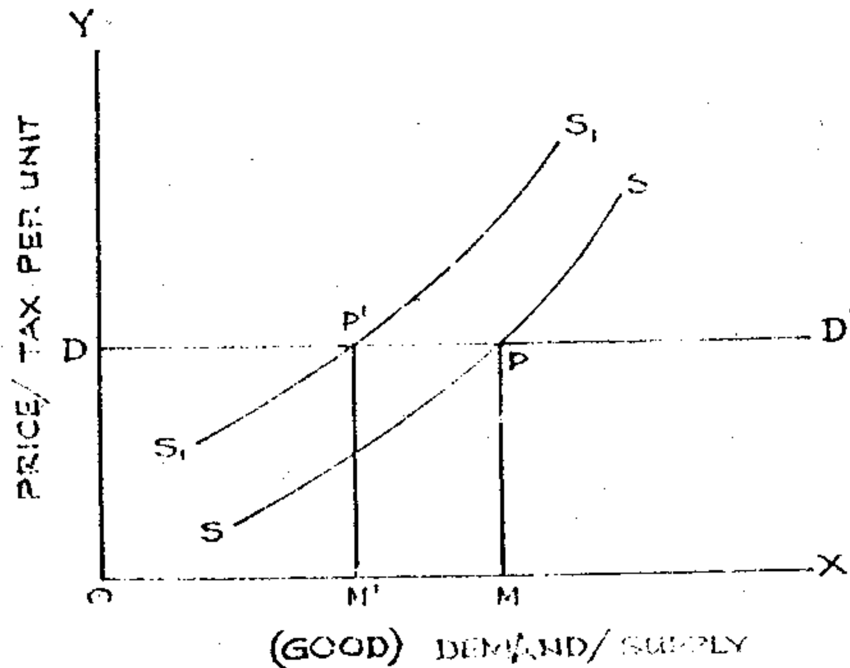

Fig. 9.1

In the above diagram, DD^1 is the demand curve for the product. The price is PM before imposition of tax. Suppose a tax has been imposed and consequently the supply curve SS has shifted left wards. The new price P^1M^1 is also the same as PM, the before tax price of the good. The entire incidence of the tax is completely borne by the sellers. The demand curve is perfectly inelastic shown in the diagram.

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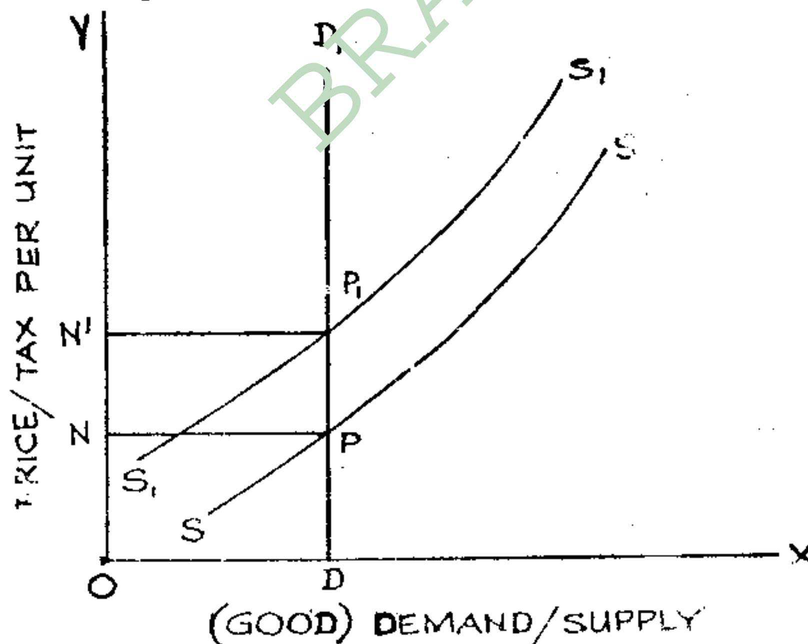

Fig. 9.2

In Fig. 9.2 we have shown that if the demand curve is perfectly elastic, the complete burden is borne by the buyers. D_1D is the vertical demand curve. SS is the supply curve. After imposition of the tax, it moved towards left (S_1 S_1). The price of the commodity before the imposition of tax was PD and after the imposition of the tax, it has risen to P_1D. As the demand is perfectly inelastic, it was not possible for the buyers to avoid the tax. The sellers in this case can shift the burden to the buyers completely. P_1P represents the tax.

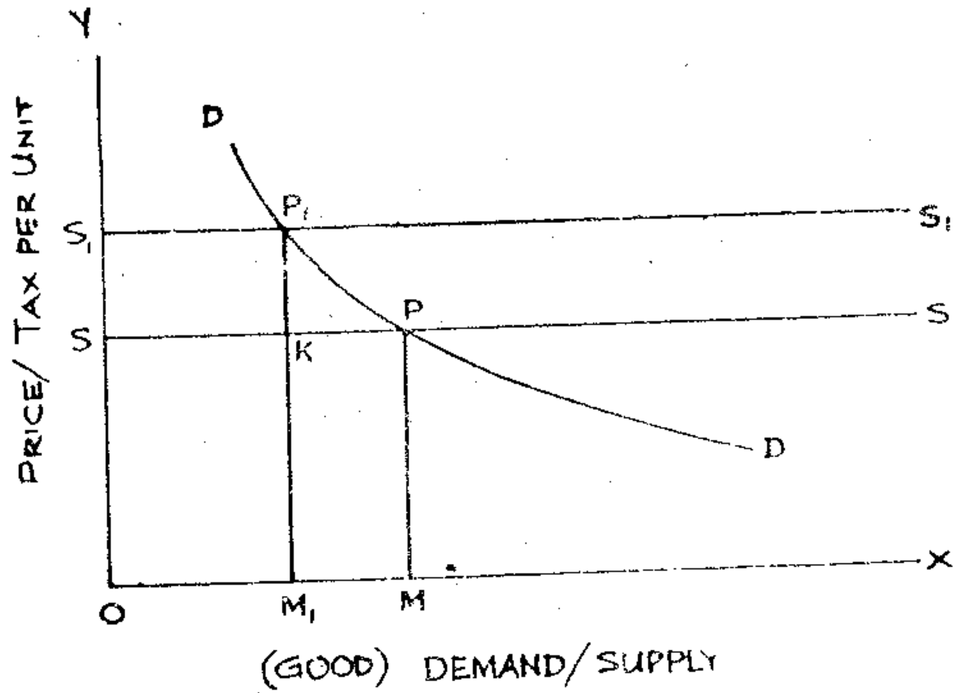

Fig. 9.3

In Fig. 9.3 the supply curve is perfectly elastic. If a tax is imposed, it shifts upwards (S_1S_1). The entire tax P_1K is borne by the buyers.

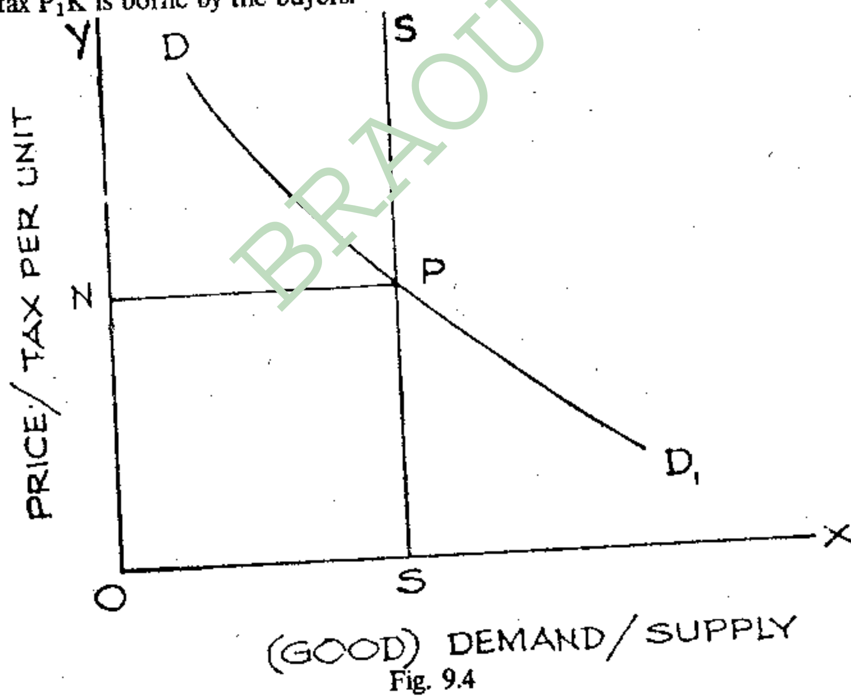

Fig. 9.4

In Fig. 9.4 we have shown a perfectly inelastic supply. The price before tax is PS. After imposition of the tax also, it is not possible for the price to go up. The supply being fixed with the demand DD_1 the same price would prevail even after the tax is levied. So, the entire tax is borne by the sellers. In actual practice, the demand and supply curves would not be either perfectly elastic or perfectly inelastic. So, what would be the position, if we consider a situation with the usual shapes of the demand and supply curves? The demand curve normally slopes downwards from the left to right. Similarly, supply curve normally slopes upward, from left to right. In Fig. 9.5 we have shown the usual demand and supply curves and found out what would happen if a tax is imposed.

BRAOU

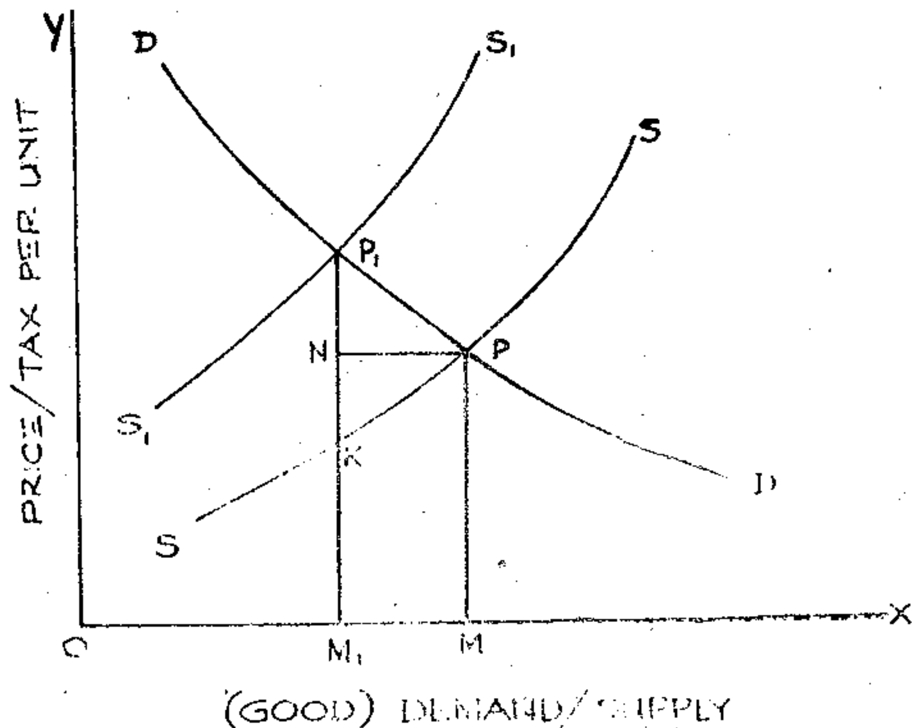

Fig. 9.5

In Fig. 9.5 DD and SS are the usual demand and supply curves of a commodity. PM is the equilibrium price. If a tax is imposed, the supply curve shifts upwards towards left (S_1S_1). The new equilibrium price is P_1M_1. Therefore, the price of the goods has increased by P_1N. The tax per unit is represented by the vertical distance between SS and S_1S_1. Therefore, the incidence of tax is given by P_1K, which is equal to P_1N on the buyer and NK on the seller. In other words, the tax incidence is shared between the buyer and the seller in proprotion to the elasticities of supply and demand.

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$$\text{Elasticity of Demand (ed)} = \frac{\text{Proportionate Change in Demand}}{\text{Proportionate Change in the Price to the Buyers}}$$

$$\text{Elasticity of Supply (es)} = \frac{\text{Proportionate Change in Supply}}{\text{Proportionate Change in the Price to the Sellers}}$$

It may be noted that elasticity of demand is given by proportionate change in demand divided by the proportionate change in the price to the buyers. Elasticity of supply is given by the proportionate change in supply divided by the proportionate change in the price to the sellers. Out of the total tax, the increase in price is P_1N which is done by the buyers. So, the remaining portion NK is borne by the sellers. According to the supply schedule SS, the selelr is prepared to sell OM quantity at PM price. After the imposition of tax, the supply schedule is shifted upwards which means the seller is willing to produce the supply of the commodity. In the seller's point of view, the change in supply price is given by NK. From the above two equations (1) and (2), we can find out the ratio of elasticity of supply (e_s) to elasticity of demand (e_d).

$$\frac{es}{ed} = \frac{P_1N}{NK} = \frac{\text{Incidence of buyers}}{\text{Incidence on sellers}}$$

This can be elaborated as follows :

a) If es = ed, the burden of the tax is equally divided between buyers and sellers. Price of the commodity increases by 50%.

b) If es > ed, incidence will be more on the buyers. Price increases by more than 50%.

c) If es < ed, the burden of the tax is more on the seller. (The price increases by less than 50 percent.)

If we take a tax whose rate goes on increasing as output increase, then the incidence of

supply schedule shifts in such a way that the more the output, the more is the vertical distance between the original supply schedule and the new supply schedule. Similarly, in the case of a regressive tax, the rate decreases as the output increases. The incidence would be more on the consumers rather than on the sellers.

9.7 INCIDENCE OF SOME PARTICULAR TAXES

9.7.1 A Tax on Monopoly Profits

A monopolist fixes his output and price in such manner that profits are maximised. It is possible when he attains the profit maximising rule namely marginal cost (MC) must be equal to marginal revenue (MR). Suppose a tax is imposed on the monopolist profits, who would bear the incidence? Actually he is supposed to have chosen the profit maximising position even if no tax on his profits is imposed. So, it is generally believed that the monopolist bears the incidence of tax as he cannot shift the burden on to the consumers (i.e. buyers of his goods). It may be noted that a monopolist gets profits after selling his good and a tax on profits cannot be shifted to the buyers. As rightly shown by R.A. Musgrave and Peggy B. Musgrave, the monopolist finds his profits reduced by the tax and cannot pass it on to the consumer via higher prices if he is to remain a profit maximiser.

If TR is total revenue and TC is total cost, then profits P would equal TR - TC. Profits are maximised at a level of output where dp/dq=0 i.e. where [d (TR)]/dq-[d (TC)]/dq = 0. This situation shows MR = MC. After imposition of a profits tax at rate 't' the monopolist seeks to maximise (l-t)(TR-TC). Differentiating with respect to Q and selling equal to Zero gives as

$$(l-t)\frac{d(TR)}{dQ} - (l-t)\frac{d(TC)}{dQ} = 0$$

Dividing by (l-t) again leaves us with MR = MC.

Monopoly profits would get reduced by the amount of the tax. The situation can be shown diagrammatically also.

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Fig. 9.6

In Fig. 9.6 AR and MR are the average and marginal revenue curves, downward sloping as is the usual case with a monopoly market. Before tax, OM is the output produced and OP is the monopoly price. Monopolist gets maximum profits represented by CDEP; when MC = MR. If a tax is imposed, as shown earlier it cannot be shifted. So the total profits CDEP get reduced. After the imposition of tax, still he maximises his profit with MC = MR. But his profits

are reduced to CDE_1P_1.

If, however, a tax is imposed on the states, the supply curve will shift according and as explained earlier, the tax incidence will be shared between the monopolist and the buyers in proportion to the elasticities of demand and supply.

9.7.2 Incidence of Income Tax

A tax imposed on the personal incomes of people is known as 'Income Tax' which is generally not shifted. Income Tax is not associated with exchange transactions which are necessary for shifting the incidence of tax to others. In other words, income tax cannot raise cost or price of any good. All costs incurred in the generation of income are normally deducted before net income is subjected to taxation. In the case of salaried class, the gross income is taken first and later all permissible deductions are made to arrive at assessed income for tax purpose. Income tax is a direct tax. The tax rates are different for different states of income. In some countries, income taxation discrimination between 'earned' and 'unearned' incomes.

9.7.3 Incidene of Tax on Property

Property may be used for either consumption or for production. Suppose a tax is imposed on the owner of property which is used for consumption. The incidence of the tax cannot be shifted as there is no price vehicle for forward shifting. For example tax imposed on a house or a residential land cannot be shifted. But sometimes it is noticed that house tax is indirectly shifted by raising the rents from the tenants. Such a situation calls for sharing of the tax incidence of demand and supply which we have already discussed. In the case of the property tax there is a possibility of backward shifting which is known as capitalisation. The purchaser of the property discounts it's value for future payments of tax. This aspect also has been dealt with by us earlier.

What will happen to the incidence of tax on property if it is used for production? Suppose a building is used for manufacturing certain products. It is possible to shift the tax incidence on those who will purchase the products. There is therefore forward shifting of the tax, which again depends upon the elasticities of demand and supply of the product.

In addition to the main factors that determine tax shifting as the basis of elasticities of demand and supply, there are some more factors which might influence the incidence of taxation. They are more related to the usual practice adopted in the market. For instance, consumers may not be aware of the actual price fixed for a product by several producers. An incidental seller may quote a price inclusive of the tax and shift the burden on to the buyer. Sometimes due to market imperfections, it is possible to increase the price more than the actual amount of tax. Due to taxation of inputs entering into the making of a goods, there may be what is known as 'cascading' effect. The price of the goods increases much more than the amount of tax due to cascading effect also. In some occasions when the tax is very small, the producers (or sellers) may absorb the tax by themselves without increasing the price of the goods so that they would not loose the goodwill of the buyers. In the case of commodity for which there are a good number of substitutes, tax shifting becomes difficult. The consumer may prefer to shift their demand from the taxed commodity to such of those goods which are either not taxed or taxed at a lower rate.

9.8 DOUBLE TAXATION

If the same taxable resoures are taxed more than once, it is called 'Double Taxation'. The government of a country may tax not only its own subjects securing their incomes from within the national territories but even the foreigners who earn certain incomes from within the taxing country. Different countries adopt diffeent tax laws and thus rise to double taxation. Suppose

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only by the government of country A but also by the government of country B. Some times, it has been argued that double taxation may arise not only due to earnings incomes elsewhere but also within the same country. For example, in a parternship firm not only the profits of the company are taxed under the corporation tax but the dividends of the shareholders are brought under the fold of the personal income tax. But more often double taxation is referred to taxing incomes by two or more governments. Double taxation may adversely affect the incentives of the people to hard work. In recent time the problems of double taxation have been recognised by the taxing countries. Certain concessions are given to the persons from payment of income tax in both the countries.

CHECK YOUR PROGRESS - III

8. Can income tax be shifted?

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9. What are the determining factors of tax shifting?

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10. What is meant by double taxation?

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9.9 CERTAIN CONCEPTS OF INCIDENCE

In recent times, economists like Mrs. Ursula Hicks, R.A. Musgrave etc. have interpreted tax incidence in terms of changes in the distribution of income in the economy. According to these writers, there are mainly three important effects on account of changes in the budget policy of a government. (i) There would be changes in the resource transfer from Public to the government (ii) output effects and (iii) effects on the income distribution. The term 'incidence' may be taken to mean only the 'money burden'. As far as interpreting tax incidence in terms of distribution changes, we have certain concepts like specific tax incidence; differential tax incidence; the incidenced of public expenditure and balanced budget incidence. These concepts have been dealt with elaborately in a subsequent lesson 'burden of taxation'.

According to Dalton the incidence of tax can be analysed broadly under two types. First is the direct money burden. Second is the real burden of a tax. We have already dealt with the first

kind of tax incidence relating to the direct money burden. When a tax is imposed it is shifted to other depending upon the conditions of the market, nature of the product, elasticities of demand and supply etc. In thewordsof Dalton. "To every shilling of revenue raised, there corresponds a shilling of direct money burden or incidence falling upon some one". The problem of incidence is to locate the person who ultimately pays the tax. So far as the second version of Dalton is concerned, it may be noted that payment of a tax may result in loss of economic welfare. Strictly speaking this is not a problem of incidence (i.e. direct money burden) but a problem connected to the real burden of the tax. There may be direct as well as indirect real burden of a tax. Real burdens are measured in the form of changes in consumption, income distribution etc.,

Mrs. Hicks also makes a distribution between formal and effective incidence of a tax. Formal incidence according to her is the direct money burden, while effective incidence is in the nature of broad effects of the tax. So, Mrs. Hicks formal incidence more or less resembles the direct money burden stated by Dalton. According to R.A. Musgrave the effects of the imposition of a tax may be on a number of important economic variables. They may be influencing consumption, production, employment and distribution of wealth and income in a country. In the words of Musgrave "The effects are defined as residual, including both changes in output and those changes in distribution which are not considered a part of the direct money burden".

9.10 SUMMARY/CONCLUSION

It may be noted from the foregoing discussions that in taxation as far as incidence is concerned it is necessary to keep in mind two fundamental aspects. Firstly, all taxes are paid from the income stream of the individuals. So it involves a transfer of purchasing power from the individuals or tax paying units to the Public authority. Secondly, the person on whom the tax is imposed need not necessarily bear its incidence. He may pay the tax to the public autnority at the first instance but later tries to shift the money burden of it either forward or backward which again depends upon many factors. The effects of tax are related to the real burden while incidence is to the direct money burden of tax.

– Dr.T. Divakara Rao

9.11 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Musgrave R.A. : *Theory of Public Finance*

9.12 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the incidence of taxation.
2. Briefly discuss the theories of incidence of taxation.
3. Examine the demand supply theory of incidence of taxation.

II. Answer the following questions in about 15 lines each.

1. Distinguish between impact and incidence of a tax.
2. Describe the shifting methods of a tax.
3. Explain the concentration theory and the diffusion theory.
4. Explain the following concepts :
   a) Tax capitalisation
   b) Double taxation

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UNIT-10 : EFFECTS OF TAXATION WITH SPECIAL REFERENCE TO A DEVELOPING ECONOMY

Contents

10.0	Aims and Objectives
10.1	Introduction
10.2	Effects of Taxation on Production
10.3	Effects of Taxation on Distribution
10.4	Effects of Taxation in Developing Economy
10.4.1	Revenue Effect
10.4.2	Diversion Effect
10.4.3	Price Effect
10.4.4	Distribution Effect
10.5	Conclusion
10.6	Suggested Books
10.7	Model Examination Questions

10.0 AIMS AND OBJECTIVES

This unit explains the effects of taxation on production and distribution and also the effects of taxation in developing countries.

After reading this unit, you will be able to

- examine the effects of taxation on production and distribution, and
- discuss the effects of taxation in a developing economy.

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10.1 INTRODUCTION

In a laissez faire economy, it was believed that government's interventions in the economic life of the people be restricted to very limited functions such as protecting the people from external aggression and internal disorders etc. Government used to raise revenues through taxation to perform its activities. As Government's activities were limited under a laissez faire economy, taxation was considered to bring revenues only to exchequer. According to the proponents of laissez faire theory, taxes should be neutral in the sense that taxation should not distort the economic parameters generated by the market forces. Such a reasoning was based on what was known as 'general fiscal rationality'. It means that by the fiscal action of the government, the resource allocation pattern of the economy should not be disturbed. In other words, this type of thinking believes that resource allocation and production, effected through market mechanism would be fulfilling the social needs and was therefore, optimum. But in course of time, it has been amply demonstrated that market mechanism does not rationally allocate the scare resources so as to attain social as well as production optimum. Now-a-days we find that markets are not perfectly competitive. The allocation of resources as well as the production pattern may not be said to be optimum so that a neutral tax policy could be advocated. Modern Governments perform various activities for which adequate revenues are needed. By imposing taxes, production and consumption pattern in the economy cannot remain undisturbed. As a matter of fact, it is to bringout certain much needed changes, government imposes a variety of taxes on the people. It should not be understood that taxation is meant to destroy the market forces. Rather, the objective of taxation is to guide and regulate the working of the market. Therefore, all tax

measures introduced by the government would influence the demand and supply forces in the market. Due to taxation certain important variables like consumption, production, distributiuon of wealth and income etc., would get influenced.

In the light of the changing role of the modern governments to provide social and economic welfare to the people, taxation not only provides the much needed revenues to the exchequer but also helps in augmenting savings, promoting exports and providing necessary incentives for the private sector to develop. According to Pigou, taxation influences both demand and supply forces of the market, so that there would be many distortions in the market behaviour. Such distorties, he calls them as "announcement effects". The effects of taxation can be analysed with respect to individual taxes or for all taxes taken together as a whole. If we take all the taxes (i.e., the tax system) as a whole, we look at the aggregate effects on the economy in a macro angle. According to Dalton, "the best system of taxation from the economic point of view is that which has the best or the least bad economic effects".

10.2 EFFECTS OF TAXATION ON PRODUCTION

According to Dalton, the effects of taxation on production and growth may be understood under (a) ability or capacity to work, save and invest (b) willingness to work, save and invest. Let us take up the first aspect.

10.2.1 Ability to Work

We are aware that taxation reduces the disposable income of the tax payers. Ability or capacity to work depends upon certain factors like the consumption, health and efficiency of the population etc. It also depends upon the type of training and education received by the individuals. This can referred to as investment in human resources. So, one's ability to work is the outcome of all these factors. Now, therefore, it is necessary for us to know which taxes are helpful to promote the ability or capacity to work of the people? Progressive taxes hit the richer sections of the society while proportional taxes, mostly the indirect taxes hit the poorer sections. If an indirect tax is imposed, the poor man's consumption is affected. Where as rich man does not reduce his consumption because he has adequate incomes to pay the taxes and still maintain his consumption standards. In other words, progressive taxation is to be preferred if we desire that 'ability to work' of the people is not adversely affected by taxation. The rich can pay taxes out of their savings and try to maintain their consumption, health, efficiency etc. This does not mean that indirect taxes are totally bad. If indirect taxes are imposed on commodities having high income elasticity of demand like luxuries, comforts etc., the consumption standards may not be affected. Care should be taken that mass consumption goods are not heavily taxed so that the ability or capacity to work is otherwise hit detrimental to the interest of the society.

10.2.2 Ability of Capacity to Save

Taxation to what extent is able to improve one's ability or capacity to save? In under developed economies, poor may not have adequate incomes to save. It is only the rich who are able to make some savings. In the process of economic development, the income of the rich may grow faster than the incomes of the poor. By imposing progressive or direct taxes, it is possible for the government to tax their savings. In such a case, taxation if progressive (or direct taxes) adversely hits the ability or capacity to save of the people. This is one of the common criticism levelled against progressive taxes. Therefore, if our objective is to see that individuals savings should not be very much affected, less reliance should be placed on progressive taxes. Then, by what means government can raise the revenue resources? Obviously, the alternative is to depend more on the indirect taxes which are known for their regressive character. If saving is under taxed on account of adopting more of indirect taxes is an economy, how about the objective of reducing inequalities of wealth and income among different sections of the society, especially in

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an under developed country? In the equalitarian point of view, the objective of reducing income and wealth equalities assume importance. Also, if more dependence is no indirect taxation, it would as we have seen earlier, adversely affect the capacity or ability to work of the people. So, while we cannot give up the objective of reducing income inequalities, we do not subscribe to the excessive dependence on indirect taxation that his the ability to work of people. It is, therefore, for the government to carefully analyse all these effects. Here the point is indirect taxes affect consumption and therefore, the capacity to work while direct taxes affect savings and therefore, the capacity to invest.

10.2.3 Capacity to Invest

Obviously capacity to invest depends upon the ability to save, which has been discussed earlier. The factors which stimulate investment may be different from those which influence savings. In the individual point of view, investment need not necessarily depend on the current or past savings. If the investment climate is favourable which may bring attractive rates of return, it is possible for an individual to borrow money from banking institution and then, to invest the same. But this may happen if we take the case of an individual saver or investor. This is not very much possible if the whole of the economy is considered. Expansion of credit by the banking system has many limitations, in the sense that without adequate deposits it may not be possible for the banks take up credit expansion on a large scale it leads to inflationary trends which are again harmful to the society. Inflation would again hit the consumption of the poor and as a consequent their ability to work. Some times, inflation may however help promote forced savings by reducing consumption of certain goods. But it should be remembered that credit expansion by banks may be inflationary, if certain limit is exceeded. An individual may save a portion of his income by tax evasion but he may not be in a position to openly invest the same. Although an individual has the ability to invest, yet it may not actually take place, because of present and future consideration. For instance, the present environment may not be conductive for investment. As far as future is concerned, the investor is bothered of the future yield or returns on investment. If again, investments are also taxed, it acts as a disincentive. Similarly, if future returns on investments are also taxed, one may not be willing to invest his money. The rate of tax, the mode of payment etc., also influence one's capacity to invest.

If the money collected by taxation is used for investment by the government, the economic growth of the country may not be affected. Here the important consideration is shall we allow private individuals to make investment and thereby help the growth process or shall the public authority (government) mop up the savings by taxation and invest the same in most desirble manner so as to achieve rapid economic development. Private investment is always guided by profit motive. So, if the government desires to bringout regional balanced development, the savings of the individuals have to be chanelled by taxation into desired spheres of investment. Therefore, to what extent private investment out of private savings is to be encouraged or regulated depends on the Government's policy. In any way, capital accumulation should be for the development of a developing country. It should be stepped up either by government using the tax money for public investment or allowing the private individuals to increase their capacity to invest by adopting a less progressive taxation.

Now, the second aspect for discussion by us is willingness to work, save and invest. It may be stated at the outset that the capacity to work, save and invest obviously depends upon the willingness to work, save and invest. This aspect is however subjective. One's willingness depends upon many factors which cannot be strictly quantified. For instance, the landlords in our country during the British rule were rich benefitted but they used their savings not for capital accumulation but for conspicuous consumption. They did not desire to invest savings for productive purpose. It is the environment which stimulates one's desire to work save and invest. So, the tax system should provide necessary incentives for promoting the people's desire

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to work, save and invest.

10.2.4 Willing to Work

The 'will to work' obviously motivated to have higher income. If an individual works more, his income increases. So, it is nothing but the reward for supply effort. We have seen already that taxation would reduce the disposable income of the tax payer. So, if progressive taxes with steep rates of progression are introduced, the individuals may reduce their supply effort to earn higher incomes. Their apprehension is although they put mere effort to earn additional incomes, a large of it may be taken away by direct taxes like income tax, wealth tax etc. Therefore one way of looking at the efforts of taxation, especially those of direct taxes in on economy is the adverse effect on the willingness to work. But this kind of view is not totally correct. Some times an individual may have to put more hours of work to compensate his family income. For instance, poor people may not be in position to reduce their consumption from the existing standards which are already very lows. If indirect taxes are imposed on some of the goods consumed by the poor, they adversely affect their present consumption. In order to maintain the same level of consumption, it becomes necessary for them to earn more income, which is possible only by putting forth more work. In this way, it may be possible to see the positive effect of taxation towards the willingness to work. This situation may differ from individual to individual. It all depends upon the income elasticity of demand of the individuals. The family needs of the tax payer, rates of taxation etc., normally influence the willingness to work. But one thing seems to be clear. If highly progressive taxes are imposed, more people may be affected and their willingness to work may be adverse.

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10.2.5 Willingness to Save

This aspect is closely related to the ability to save. Although one may have good capacity to save, he may not be willing to save. This means a person with higher income (i.e., ability) is supposed to save more. But if he does not have the willingness to save, the quantum of savings would be lesser than what is expected of from such higher income. All direct taxes or progressive taxes cannot be treated to be discouraging the individuals willingness to save. For example instead of an income tax, if an expenditure tax is imposed, what would be the effects of taxation on the willingness to save? Expenditure tax, although progressive like the personal income tax, encourages savings. So the individuals savings would be boosted up. Instead, an income tax with steep rates of progression is imposed, the willingness to save would be less. The tax payer knows in advance that he would not be able to save, although he may earn more income. How much a person is willing to save depends upon the entire tax system taken as a whole. All taxes imposed on the earning may have some effect on the savings, consumption and incomes of the individuals either directly or indirectly. So, judged in this way, it is improper to earmark particular tax adversely affecting the willingness to save. Necessary incentives have to be provided for promoting individual saving. For instance, in the Indian Income Tax, savings made in the form of Provident Fund Contributions, Life Insurance Premium etc., are exempt from taxation. If individuals are not psychologically encouraged to increase their savings, taxation may advesely hit the work effort also. So, people must be encouraged to increase their savings. If savings are not increased in the Private sector, its investment also would decline, thus adversely hitting economic development. Another point, in this context, is that the willingness to save can be strengthened if the rates of interest offered by the banking system in the country are attractive. Similarly, one may desire to save more and deposit more in the form of government bonds, securities etc. It should not be forgotten that savings on one hand is a function of income and on the other a function of rate of return on investment. The classical economists believed that one may save more, if the rate of interest is high. So, saving has been attributed to be interest elastic. But according to Keynes, the volume of savings in a country depends upon the level of National income.

10.2.6 Willingness to Invest

How taxation affects willingness to investment? The classical theory of interest says that the lessser the rate of interest, the more the investment. According to Keynes investment depends upon the Marginal efficiency of capital (MEC) also. The person who wants to invest always calculates the future returns on the investment made at present. For investment to take place, as we have already explained, saving must be mobilised. So, strictly speaking the willingness to save and invest are interrelated. They should not be looked into in isolation. People who will save a part of their income desire to make investment in many forms. Some of them are productive while others are not. For example - if an individual saves in the form of gold, silver etc., it is not creating any productive asset in the sense of investment. Some investments may be in the form of property, financial investments, investment in business etc. What is the effect of taxation on the willingness to invest very much depends upon how the earnings from investment are heavily taxed, it would have a disincentive effect on the willingness to invest. Earnings from different investments should be treated differently. It is necessary for the government to tax heavily those earnings from investments, that are undesirable in the socio-economic point of view. For instance, if the objective of the government is to encourage a particular industry, taxation should not be heavily imposed on investments made in that industry. If certain concessions are given in some cases, investment may be stimulated. For example, depreciation allowance, if exempted from corporate taxation, will increase the net profitability of the companies and investment can be stimulated. Similarly tax holidays or other tax concessions etc., are aimed at providing incentives to investment in certain industries. The willingness to invest is, therefore, related not only to the present incentives offered by the government and the investment climate but also the future prospects of profitability.

10.3 EFFECTS OF TAXATION ON DISTRIBUTION

We have so far analysed the effects of taxation on production. Now we may turn over attention to the effects of taxation on distribution. When we have dealt with certain aspects of taxation as related to production, we made some observations how taxation could affect the purchasing power of the individuals, how the rich would be affected and how the poor would suffer and so on. When we examine the distributional impact of taxation, it is more concerned with as to how far the inequalities of wealth and income prevailing in most of the developing economies could be reduced? We are aware that production and distribution, if left to market forces, accumulate the inequalities. The poor may become still poorer and the rich may grow more richer. This is commonly experienced in capitalist way of economic development. Therefore government desired to reduce the inequalities of wealth and income by adopting appropriate taxation. In other words, taxation is used as an instrument to bringout redistribution of income among different sections of the society. In order that taxation serves the objective of redistribution of income, it is essential that the taxes should be progressive. Direct taxes like income tax, wealth tax, corporation tax etc., are supposed to redistribute the income in the society. Indirect taxes having high income elasticity of demand also serve the same purpose. But redistributive role of taxation hits the rich very much more than the poor, the private savings may be adversely affected. Similarly, imposition of indirect taxes may hit the willingness or ability to work and save etc. In an economy, redistribution of income can be viewed both in the short term and in the long term. In the short period, taxation used as a redistributive instrument may not adversely affect the existing production. But in the long term, taxation may affect the people's income and savings. In the short period it is not possible to achieve the objective of redistribution of income by tax measures. There may be many institutional bottle-necks to achieve this objective unless the ownership of assets is changed suitable by other measures, taxation alone may take quite a long period to bring out redistribution of income in the economy. Taxation at best may help redistribution of income in the long run. In other words, in the short run, the effects of taxation on the distribution seems to be less significant. It is necessary to

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identify the areas where surpluses are generated in the process of economic development. Such surpluses if allowed accentuate the income inequalities. So, taxes should be imposed to mop up such surpluses. Certain progressive taxes are aimed to achieve this objective. The effects of taxation can also be seen as far as bring about economic stabilisation is concerned.

In market economy, there are strong tendencies to have trade cycles which will influence important economic parameters like income, output, employment and prices etc. Taxation is used to curtail inflation and also to regulate the economy so that stable economic growth is attained. In developing economies, it is common experience that in the initial stages of development more public expenditure has to be incurred to finance various projects etc. All this leads to be inflationary trends. Inflation helps the enterprenuerial class and adversely hits the low and fixed income groups, thereby helps the inequalities to grows. the measures are useful to certain such inflationary trends. Such measures do come under the name 'functional finance' which was supported very much by economists like A.P. Lerner etc.

CHECK YOUR PROGRESS - I

1. How production is affected by taxation?

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2. What are the effects of taxation on distribution?

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10.4 EFFECTS OF TAXATION IN DEVELOPING ECONOMIES

Raja J. Chelliah analysed the effects of indirect taxation in under developed countries in his book 'Fiscal Policy in Under-developed Countries'. From the point of view of economic development there are three main objectives of indirect taxation. They are (a) raising resources for Public investment (b) raising the rate of investment in the economy by curtailing consumption of luxuries and (c) raising the incremental saving ratio. In order to achieve these objectives, it is necessary that diversion of resources as well as purchasing power should be effected with the help of taxation. Diversion of resources can be made by three ways (a) diversion of resources from the private to the public sector (b) diversion of resources from consumption goods industries to investment goods industries within the private sector and (c) diversion of demand from imports to domestically produced goods. Whenever a tax is imposed, there is transfer of resources from the private use to the use of them by the public sector. Differential taxation is very much suited to effect diversion of resources from one industry to the other. By taxing luxuries and exempting capital goods, it is possible to get the resources diverted from consumption goods sector to Capital goods (or investment goods) sector. In respect of the third category of diversion, it may be stated that import duties may be levied as part of a programme of development to protect and support domestic industries from foreign competition. These duties are levied to restrict the

consumption of impated luxuries. They are effective only in so far as the domestic production of luxuries is simultaneously reduced. In periods of balance of payments difficulties also, these duties tend to restrict the imports; and also curtail inflationary trends. However the effect of import duties very much depends upon how the other foreign countries (trading countries) react to the tax measures adopted by a particular country. In the case of 'diversion of resources' we notice two kinds of resource transfers. First is the one where the purchasing power from the private individuals is transferred to the State. This may help reduce the effective demand in the economy and thereby curtail inflation to some extent. The second is the purchase of goods and services by the State for various developmental activities. The resources received from the private sector are again used through the mechanism of Public expenditure. Then, there is transfer of purchasing power from the State to the individuals. The transfer may lead to inflationary pressures. But if the tax money is used for financing the developmental activities, the output may increase. In such a case the effects of taxation are positive for increasing the output or production in the economy. In other words, the ultimate economic effects of taxes depend not only on the nature of taxes but also how the revenue raised by taxation has been spent; and in what manner. For analytical purpose, the effects of taxation can be split into (a) revenue effect (b) diversion effect (c) price effect and (d) distribution effect. We may now deal with these effects in some detail:

10.4.1 Revenue Effect

Generally it is known that when a tax is levied on a commodity, there is a flow of revenue to the government. This is the case of an indirect tax; like the main excise duties, sales tax etc. Some times, it may however be noticed that even inspite of imposing a tax on a commodity, adequate revenue may not flow to the government. For example, a high protective duty may not help in getting more revenue to the exchequer. But in such cases, the main objective is to protect the domestic industry from foreign competition. If a good, if taxed, would be little. Along with price elasticity of demand, it is necessary to examine the income elasticity of demand of the good likely to be taxed by the government. The price elasticity of demand for the same commodity may be different for different income groups. So, there is justification for taxes on goods with a high income elasticity of demand. In the case of direct taxes, like the personal income tax, corporation tax etc., the revenue effect depends upon the rates and gradation of such taxes. If the exemption and concessions are more, direct taxes may hit only the richer sections of the society. As we have already seen that such taxes might produce adverse effects on one's ability to work, save and invest. The revenue flow to the government may some times, be adversely affected by having high marginal rates of direct taxation. If appropriate rate and gradation structure is chosen, the revenue effect may be substantial.

10.4.2 Diversion Effect

Resources are diverted from one use to the other by taxation. The extent of the diversion would depend on the relative elasticities of demand and supply. The more inelastic the demand or supply is, the less is likely to be the diversion caused by the change of tax. Diversion of resources may have their impact on employment also. As long as the revenue obtained by taxes are spent on such of those programmes, which may generate additional demand for the same commodities which have been taxed, there will not be net diversion of resources. An example makes this point clear. Suppose, taxes are imposed on wage goods but the tax revenue so raised, is again spent on schemes to employ workers hitherto unemployed. The net effect on diversion of resources may not be significant. The reduction is demand due to taxation is counter balanced by the increase in additional demand created for the same goods by additional employment. In this way, we may notice that taxation has an effect on employment generation in the economy. The effects of taxation always, as stated earlier are to be looked into with reference to the benefits flowing from public expenditure, financed from tax revenues.

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10.4.3 Price Effect

When a tax is imposed, the price of the commodity goes up. It affects the supply and demand quantities. To what extent the reduction in output influences the price of the commodity to raise and how it changes the incomes of factors engaged in producing the commodity obviously depend upon the relative elasticities of demand and supply. We have already seen that either backward or forward shifting of a tax depends on elasticities of demand and supply.

If the intention of the government is to siphon off the excess purchasing power, the price effect can be considered desirable in the socio-economic point of view. But sometimes price effect may distort resources and all the evil effects of inflation may have to be experienced by the people. So, price effect should be carefully analysed especially in developing countries where vast masses live below the subsistence level. The type of commodities, the degree of competition in the market, the way in which the taxed revenue would be spent by the government all these aspects have to be analysed to understand the price effects of taxation.

10.4.4 Distribution Effect

By imposing taxes on commodities having high income elasticity of demand, it has been often argued that it would be possible to reduce the glaring inequalities of wealth and income. Both direct as indirect taxes are used for achieving this objective. Here the idea is that the burden (money burden) is borne by the tax payer, who may belong to the rich sections of the society. The real burden of tax is not given importance. Also, the benefits of public expenditure also have not been considered. So, if we want redistribution of income via taxation, we have to consider who bears the money as well as real burden of the tax as also of the benefits that might accrue to the people out of public expenditure. Simply by taxing some rich people, this objective may not achieved satisfactorily. Along with taxation, certain administrative measures to bring out changes in the ownership distribution of assets have to be introduced. Nevertheless, taxation if selectively used may to some extent reduce the inequalities of wealth and income, among different sections of the society.

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CHECK YOUR PROGRESS - II

1. List the effects of taxation.

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10.5 CONCLUSION

Different opinions expressed by various writers on Public Finance with regard to the effects of taxation may be summarised at follows:-

Taxation is not only meant to bring revenue to the government but also to act as in instrument for regulating whole of the employment. In an under developed country, taxation has to be used for mobilisation of resources to finance the development programmes, curb conspicuous consumption so that resources are diverted from the production of consumer goods to the production of investment goods : certain inflationary tendencies and also to reduce inequalities of wealth and income among different sections of the society. Taxation, whether direct or indirect has to be selectively used. The effects of taxation, strictly speaking should not be analysed in

isolation. Always, the benefits of public expenditure although difficult to be objectively measured they being subjective, should be linked up with the effects of taxation.

– Dr.T. Divakara Rao

10.6 SUGGESTED BOOKS

1. B.P. Thyagi	:	*Public Finance*
2. H.L. Bhatia	:	*Public Finance*
3. Hugh Dalton	:	*Principles of Public Finance*
4. Musgrave	:	*Theory of Public Finance*

10.7 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the effects of taxation on production and distribution?
2. Explain the effects of taxation in bringing down the inequalities of income in a developing economy.

II. Answer the following questions in about 15 lines each.

1. How ability to work, save and invest are affected by the taxation?
2. Do you agree with the view that willingness to work is affected by the taxation? Explain.
3. Explain the revenue and diversion effects of taxation in a developing country.

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UNIT-11 : TAXABLE CAPACITY - DETERMINANTS OF TAX EFFORT

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11.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss the various concepts of taxable capacity and tax effort.

After reading the unit, you will be able to

- explain the different concepts of taxable capcity,
- identify the determinants of taxable capacity,
- discuss the taxable capacity in India, and
- recognise different concepts of tax effort and tax potential.

11.1 INTRODUCTION

We have seen in the earlier lessons that taxes are imposed by the government to achieve a number of objectives. When a tax is imposed, the disposable income of the tax payer is reduced. Taxes cannot be imposed indefinitely to raise unlimited quantity of revenues. The people must be in a position to pay them, otherwise taxes would have adverse effects on the economy. In all discussions of taxation, the people's capacity to pay taxes, popularly termed as 'taxable capacity,' assumes importance. If the taxable capacity is already reached, it has been generally argued that

no further taxes or raising the rates of existing taxes be desirable. Taxable capacity is a very important concept in the context of additional resource mobilisation by the modern governments which always try to increase the revenue resources with a veiw to spend more money towards various schemes. It is necessary for the state to correctly assess the limits upto which it can tax the people without adversely affecting their incentives.

11.2 DIFFERENT CONCEPTS OF TAXABLE CAPACITY

Different writers on Public Finance defined taxable capacity in different ways. We may exmaine a few important of them. The earliest attempts to analyse the concept of taxable capacity were made by British economists. The concept of 'absolute taxable capacity' was popularised in U.K. by Sir Josiah Stamp in early 20th century. He defined taxable capacity as the amount which the citizen of the country can contribute towards the expenses of the Public authorities, without having a really unhappy and down-trodden existence and without dislocating the economic organisation too much. So, according to his interpretation absolute taxable capacity is equal to the total production minus the amount required to maintain the population at subsistence level. According to Findley Shirras "taxable capacity is the limit of squeezability". It is the total surplus of production over the minimum of consumption required to produce that volume of production, the standard of living remaining intact". Still another writer Sir Drummond Frazer says "taxable capacity of a nation is surely reached when tax payers are forced to borrow from the banks to pay taxes". According to Kimmal taxable capacity is stated as follows – "In an economy organised mainly on private enterprise principle, taxable capacity may be defined as the capacity to raise revenues without extreme interference with the productive activity on the operation of the economy". Almost all the writers agreed that the measurement of taxable capacity is a very difficult task. Therefore, Dalton distinguished between 'absolute taxable capacity and relative taxable capacity'.

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11.2.1 Absolute Taxable Capacity

Aboslute taxable capacity implies that over and above what is really required for a citizen to survive, the entire surplus can be appropriated by the state. It means that nothing is left to the individual after meeting the expenditure on bare necessaries. Theoretically, absolute taxable capacity appears valid but there are many practical difficulties in its actual measurement. It is very difficult to say what is the minimum expenditure necessary for a citizen to maintain a mere subsistence living. If taxes do not have anything with the individuals, how about their incentives to work, save and invest? Therefore, Dalton dismissed theconcept of absolute taxable capacity by criticising it as vague and dim concept. He says that the phrase absolute taxable capacity should be banished from all serious discussions of Public Finance. He regards 'relative taxable capacity a reality'.

11.2.2 Relative Taxable capacity

This concept refers to the taxable capacity of one community as compared to that of another. An example makes this point clear. A rich community has more income, wealth had property. So, its capacity to bear tax burden is more than that of a poor community. Suppose government wants to spend certain amount of expenditure which should be financed by taxation. Relative taxable capacity advocates that taxes should be imposed in such a way that the rich may bear proportionately a higher burden of tax than the poor. But the problem is how to determine the relative capacity among different sections of a society. The relative taxable capacity depends upon many factors like the size of the population, the rate at which the income grows, the distribution of national product, standard of living of various sections of population and so on.

CHECK YOUR PROGRESS - I

1. What is absolute taxable capacity?

2. What do you meant by relative taxable capacity?

11.3 LIMITS TO TAXATION

In order to calculate the limits to taxation; it is necessary for us to know how taxable capacity is to be measured. One of the attempts to find out the maximum limit to taxation was that of Colin Clark in his book 'welfare and taxation', which placed the limit at 25% of the national product. If taxes are imposed more than 25% of the national product, Colin Clark felt that it would adversely affects the willingness to work, save and invest. In other words, more than 25% of GNP, if taken towards taxes would adversely affects capital formation and production of income. He also belived that a high rate of taxation would have same adverse effects on the political system of the country. Therefore, the safe upper limit of taxation was place at 25% of the national prduction especially for countries like UK, USA, etc. The measurement of taxable capacity for a country at 25% of its national income was however Criticised by crtain writers.

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It is generally believed that the proportion of national income which a poor country can divert to the public purposes through taxation without settting up intolerable political and social pressures, is much smaller than that in a rich country. The proportion of tax revenue to gross national product in under developed countries may be typically around 8-15 percent, whereas in developed countries this percentage is 25-30. No doubt, the 'taxation potential' in under developed countries is low, not solely because of mass poverty but because of what Kaldar described of the failure to exploit potential effectively.

Another criticism is that what is applicable to the advanced economy may not be applicable to underdeveloped economies. There may be adverse effects of taxation in some countries much before even reaching the 25% level suggested by Colin Calrk.

Still another criticism is that taxes alone should not be considered for determining the taxable capacity. The favourable efforts of the public expenditure should also be taken into account to judge as to how far the people can bare certain degree of taxation. Therefore, Musgrave makes a plea for discording the concept of taxable capacity in favour of a concept of optimal budget. According to some writers on Public Finance, taxation does not have inflationary effects as is contended by Colin Clark. On the other hand it is public expenditure which has an inflationary effect. So, it is wrong to state that the upper limit to taxation for any country could be 25% of GNP for all time. In the words of Dalton, "it is imposible to fix any definite sum which could be said to represent the limits of the country's taxable capacity at any particular time".

CHECK YOUR PROGRESS - II

3. Do you agree with Colin Clarks opinion on the upper limit of taxation? If not why?

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11.4 FACTORS DETERMINING TAXABLE CAPACITY

At the outset, it is necessary for us to know that there is no specific level of taxation that is commonly applicable to all countries in the world. It depends upon the particular features of a country. So taxable capacity depends upon the socio, economic and political factors of a country. The following are the important factors on which taxable capacity depends.

11.4.1 Size of National Income

The size of National Income is normally taken as one of the important indicators to interpret the level of economic development in the country. If people are rich, they will be in a position to pay more taxes and therefore, their taxable capacity will be more. National Income is a function of many factors such as the availability of physical resources, the degree of utilisation of them, the state of technology etc. The higher the size of National Income, the more the taxable capacity of the people. Viewed in this manner, the taxable capacity of less developed countries will not be much as that of more developed countries.

11.4.2 Distribution of Income

It is not sufficient if the size of national income is large to say that the country's taxable capacity is more. How about its distribution among the owners of the factors of production? We have two types of distribution of national income. The first relates to the personal income distribution and the second, the functional distribution. Data on personal income distribution are very inadequate in many countries in the world. So, it is not possible to say whether a particular country has more taxable capacity or not. But data on functional distribution of national income are available in almost all the countries in the world. As we know that the rich will have higher capacity to pay taxes, a skewed distribution of income in favour of the rich is favourable to a higher taxable capacity in the country. But such a distribution is not desirable in the egalitarian point of view, especially in modern days when the thinking of all governments is aimed at reducing the income and wealth inequalities. It has been, however, argued that with an even distribution of income, there would not be much pressure on increasing government expenditure on many welfare schemes etc., and in consequence, the level of taxation can even be reduced. Any way, as far as taxable capacity is concerned, greater inequalities seem to be a favourable situation.

11.4.3 Size and Rate of Growth of Population

Taxable capacity of a country depends upon not only the size of its population but also the rate at which the population has been growing over time. Given the National Income, the larger the population, the lesser would be the taxable capacity. In other words, taxable capacity depends on per capital real income. The per capita real income falls if the population grows at a faster rate than that of the GNP. An increase in National Income with a lesser size and increase

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of population is a favourable sign to boost up taxable capacity.

11.4.4 Patterns of Taxation

This aspect relates to the type of tax structure adopted in a country. It is not how much percentage of G.N.P. representing the tax revenue of a country is important but rather what type of taxes are there in the economy. How people react to the tax system? The tax structure should be carefully designed so that people can pay taxes conveniently without any irksomeness.

11.4.5 Nature and Extent of Public Expenditure

As already stated, taxable capacity always has to be linked up with the benefits of public expenditure. For example, it is possible for the government to spend money towards public investment which helps to increase the national product. We have already stated that the more the size of nationl product, the more the taxable capacity of the people. If government desires to spend the tax revenues for public investment, it favourably influences the taxable capacity. So, in general, it may be stated that all such public expenditure which promotes capital formation and thereby accelerates economic growth and development raise taxable capacity. Certain types of public expenditure which are unproductive will have tendency to reduce taxable capacity.

11.4.6 Standard of Living of the People

As already stated, taxable capacity of an individual depends upon the surplus that is left out of his inocme after meeting the minimum standard of living. For a country as a whole, it is nothing but total national income minus the amount required to maintain the people as well as to maintain the capacity stock intact. So, given a standard of living an increase in the national income will raise the taxable capacity. But one important problem in this context is that standard of living is subjective and varies with communities and times. So when national income goes in increasing, we may expect the standard of living also is fixed, any further increase in national income helps to raise the taxable capacity.

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11.4.7 Non-Economic Factors

Taxable capacity may be influenced by certain non-economic factors. For instance, it may depend on political factors also. People may be willing to bear more taxes in times of war and crisis. They should have proper understanding of the working of the government. Taxable capacity will be more, if people are phsychologically prepared to pay taxes. So, it is the responsibility of the government to educate the people as to why they are asked to pay more taxes and what benefit they are likely to get by public spending.

11.5 TAXABLE CAPACITY OF INDIA

If the ratio of tax revenue to the national income is to represent the taxable capacity, its value has been very less in India for a good number of years since independence. For many years it was around 11-14% of the national product only. In recent times, this ratio has been, however, increasing. It is around 18-20% of the Gross National Product at factor list. Some economists feel that India has already reached the maximum taxable capacity. But this, view is not totally correct. We have already seen that taxable capacity is not a state concept; it depends upon many factors which do change over time. So, what was considered at one time as the taxable limit might be changed. The scope for further taxation may be increased or decreased. But the features of Indian economy reveal certain important factors relating to he scope of having further taxation.

At the outset, India is an over populated country with mainly 40% of her population living

below the poverty line. The poor people cannot bear further impact of taxation as their incomes are very low. So, when new taxes or the rates of existing taxes are to be raised, it is very essential to analyse the effects of such steps. Good which are consumed by the vast masses of poor people should be given a preferential treatment in taxation. Further, the existing of non monetary sector limits the scope of further taxation. The non-monetary transactions should be converted into monetary transactions so that taxes spending through various Five Year Plans substantial amounts : for the expansion of social services and for economic development. Consequently, the incomes of the people are raising. Although some sections of the society could not get their due share from the benefits of economic development, yet one can say that, by and large, the incomes of the people have increased. So, keeping in view the benefits of public expenditure one may find that there is scope for further taxation. Whether to impose more taxes or not very much depends upon the thinking of the State and Union Governments. We may discuss the individual taxes of Indian tax structure in subsequent lessons.

11.6 THE CONCEPT OF TAX POTENTIAL

The concept of tax potential is synonymous to relative taxable capacity. In America the concept of taxable capacity as propounded by British economists received little attention due to its limited application in so far as policy formulation was concerned. So, a new term 'tax Potential' has been coined by American scholars to use the same in guiding policy decisions instead of the traditional concept 'taxable capacity'. But as far as an understanding is concerned, we may say that both the terms mean more or less the same. Some economic determinates are used to measure the existing true tax potential of a country.

11.7 TAX EFFORT AND ITS DETERMINANTS

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We have already mentioned the two concepts namely (i) taxable capacity and (ii) tax potential. Now we try to understand what is meant by the term 'tax effort'. Tax effort of a government can be expressed as the relationship or ratio between the actual amount of its tax collection and some measure of taxable capacity. Therefore, it refers to the ratio of actual tax revenue realised to the estimated potential tax revenue. According to Raymond. J. Krazniewski the relative tax effort is the "percent relationship between tax revenue and estimated tax capacity". As we have already seen that taxable capacity cannot be measured in absolute terms. It can be measured to some extent only in 'relative terms'. So, tax effort is also not to be measured in absolute terms but only in relative terms. Therefore in tax effort measurement, the average performance of a few states forming a zone is taken and compared. The tax performance of a state is judged against the performance of other states after making due allowance for variation in factors affecting their taxable capacity. Such a comparison helps us to have an idea whether and to what extent the level of taxation in a particular state could be further increased.

Indian Case

For better understanding, let us find out the determinants of tax effort with respect to Indian tax system. It has been found by statistical methods that inter-state tax effort differences are explained by the following economic variables.

(1) State income/Percapita income (2) Inter-sectoral distribution of incomes (3) degree of urbanisation (4) literacy rates of population (5) degree of industrialisation (6) ratio of working population to total population (7) size of the deficits incurred in the previous years and (8) amount of federal transfers and the effect of inflation. Empirically, the National Council of Applied Economic Research (NCAER) found that the inter state variation in sales tax are least explained by per capita income, per capital value added by manufacture the proportion of urban population to total population variables. In some studies, it has been found that share of non agricultural income, percentage of people above the subsistence level, and percapita

development expenditure also explain the interstate variation in tax effort.

The determinatns of tax effort is better analysed by taking the individual taxes instead of taking all taxes together. Every tax has its own features. The factors which influence these features are different for different taxes.

11.8 SUMMARY CONCLUSION

There are a number of difinitions emphasising the different aspects of the concept 'taxable capacity'. It may be briefly stated as the capacity to raise revenues without extreme interference with the productive capacity and the operation of the economy. In underdeveloped economies, it is not possible for the government to take away the entire savings of the people by way of taxes as such a measure would discourage the investment in private sector. The concept of absolute taxable capacity is a myth and the concept of relative taxable capacity a reality. Relative taxable capacity depends on many factors of which (i) real income per head, (ii) the degree of inequality in the distribution of income (iii) sectoral distribution of national income (iv) scope and character of Public expenditure (v) the base of the tax (vi) the existence of monetary sector in the economy (vii) psychology of the people and (viii) tax administration are important. The term 'tax potential' is newly coined by American scholars like taxable capacity, tax potential also is a relative concept. Tax effort is an important concept in this discussion. It represents the ratio between the actual amount of tax collection and some measure of taxable capacity. The determinants of tax effort are different for different taxes. But by and large, the per capita state domestic product can be taken as an important explanatory variable.

All this discussion lead us to know as to how far the tax potential can be accurately estimated and of that to what extent could be exploited by taxation. It also gives us an idea, whether tax effort can be further increased in a State without the adverse affect on work, savings and investment etc. Measurement to tax effort is very essential in modern days when governments are eager to explore new avenues of resource mobilisation by taxation with a view to spend more money on development programmes.

– Dr.T. Divakara Rao

11.9 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*

11.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Define the concept of taxable capacity. Discuss the factors which determine the taxable capacity of a country.
2. Write a critical note on the taxable capacity in India.

II. Answer the following questions in about 15 lines each.

1. Explain the different concept of taxable capacity.
2. Explain the concepts of 'tax potential' and tax 'effort'
3. What are he determinants of tax effort in India?

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UNIT-12 : BURDEN OF TAXATION-VARIOUS CONCEPTS OF MEASUREMENTS

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12.2	Concepts of Tax Burden
12.3	Nature of Tax Burden
12.3.1	Resource Transer
12.3.2	Excess Burden
12.3.3	Output Effects
12.3.4	Employment Effects
12.4	Measuring Tax Burden
12.4.1	Absolute Tax Incidence
12.4.2	Differential Tax Incidence
12.5	Distribution of Tax Burden
12.6	Progressive, Proportional and Regressive Distribution of Incidence
12.7	Limitations of Tax Burden
12.8	Summary/Conclusions
12.9	Suggested Books
12.10	Model Examination Questions

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12.0 AIMS AND OBJECTIVES

This unit aims to explain the meaning of tax burden, the various concepts and measurments of it.

After reading the unit you will be able to

- identify the concepts of tax burden,
- recognise the components of tax burden,
- explain the process of measuring tax burden,
- discuss the distribution effects of tax burden, and
- list the limitations of tax burden.

12.1 INTRODUCTION

In this lesson, we make an attempt to understand the meaning of 'Tax Burden' the various concepts associated with it and the problems involved in its measurement. The meaning of two important terms namely 'incidence' and 'input' has already been explained in the earlier lessons. Now, what is the difference between 'incidence of tax' and 'burden of tax'? In the literature on taxation, some writers had used these two terms interchangeably, while some others made a distinction between them. According to Pechman and others, the two terms mean the same while according to writers like J.F. Due, the term burden of tax refers to reduction in real income while the term 'Incidence of tax' refers to the distributional aspect of tax burden. On the basis

of the distributional aspect of tax burden, it is possible to find out whether a tax is regressive, proprtional or progressive with respect to either income or consumption, taken as the tax base. In the earlier lessons, we have explained regressive, proportional or progressive taxation with reference to the rate and base structure of a tax. Now, these terms viz., regressive, proportional or progressive are explained with reference to the distribution of tax burden. This unit is to supplement what we had already learnt on tax incidence and effects of taxation.

The distribution effects could be analysed in terms of income changes or in terms of changes in output, employment, prices and growth. Again, it is important to note that all these effects do interact each other. Before the distributional effects are explained, it would be worth while to learn the different concepts of tax burden.

12.2 CONCEPTS OF TAX BURDEN

According to Dalton, tax burden can be either in the form of money burden or real burden. The amount of tax paid in the form of money to the exchequer is the extent of **direct money burden.** Similarly, the **direct real burden** is represented by the sacrifice of economic well being undergone by the tax payer. It can be seen that the former comes under the incidence of tax while the latter relates to the effects of it. Some time a distinction is made between indirect money burden and indirect real burden also. An example can make the point clear. When a tax is imposed, it is first collected, say, from the distributor of the proudct who ultimately shifts the money burden on to the consumers. But normally some time would elapse between the payment of tax by him to the state and its realisation from the consumers. During this period, there may be loss of interest on the amount of tax who first paid the tax to the state. This loss of interest sometimes is attributed as **indirect money burden.** If the interest could be calculated in advance, the distributor (in the present example) may pass on even this amount also to the consumers, by way of increase in the price of the commodity. Now, what is indirect real burden?

Direct real burden, as stated already, is the loss of economic welfare undergone by the tax payer; while **indirect real burden** is the loss of economic welfare undergone by the people who are forced to buy less the commodity due to imposition of tax. Whether the people buy less or not, however, depends on the elasticities of demand.

According to Mrs. Ursula Hicks, there are two terms namely (i) Formal incidence and (ii) Effective incidence. **Formal incidence** refers to the distribution of money burden of tax by different income groups. **Effective incidence** deals the tax payers reaction to a change of tax and its consequences. So, it compares two sets of economic situations, namely one with tax and the other without tax. In the words of Mrs. Hicks "In order to discover the full economic consequences of a tax, we have to draw and compare two pictures - one of the economic set up (distribution of consumers wants and incomes and allocation of factors) as it is with the tax in question in operation; the other of a similar economic set up but without the tax".

Another eminent writer on Public Finance, R.A. Musgrave explains the burden of tax in terms of distributional changes in income under three concepts of incidence. They are namely (1) specific or Absolute incidence (2) differential incidence and (3) budget incidence. Under **specific or absolute incidence,** the distributional effects of income are measured due to imposition of tax. Under **differential incidence,** the difference in the distributional results of two tax policies yielding the same tax revenue in real terms has been analysed. **Budget incidence** refers to the distirubtion effects of income on account of the combined influence of tax and public expenditure. In other words, budget incidence takes into account not only the tax burdens but the benefits of public expenditure also, according to the people in an economy.

All this tells us that different writers had viewed the problem of tax burden in different ways.

CHECK YOUR PORGRESS - I

1. Identify the following concepts of the burden :

   (a) Money burden, (b) Real burden, (c) Formal incidence, (d) Effective incidence, (e) Specific or absolute incidence, (f) Differential incidence and (g) Budget incidence

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12.3 NATURE OF TAX BURDEN

According to R.A. Musgrave, there are four possible components of the burden of tax. They are (a) Resource transfer (b) Excess burden (c) Output effects and (d) Employment effects. In analysing tax burdens, it is necessary to understand whether the total burden is equal to the tax revenue collected.

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12.3.1 Resource Transfer

In the first category namely **'resource transfer'** the burden is measured by changes in the resource available at the disposal of the private sector. To the extent resources are transferred from private use to public use due to impostion of a tax, the burden is equal to the tax revenue raised by the government.

12.3.2 Excess Burden

In the second category, namely **'excess burden'** a situation is conceived where due to imposition of tax consumer's choice may have also been affected. For instance, a tax on automobiles would push up their prices by the amount of the tax. If this interferes with consumer's choice, what would happen? (It ofcourse depends upon the elasticity of demand for automobiles), but for convenience sake, let us suppose that consumer's choice is affected. Then some one may forego the purchase of a car because of the tax payable. He does not pay tax but even then his budget choice is less satisfactory than it was before. This may be the case with respect to some consumers but not all consumers. Therefore, although government could get certain amount by way of tax on automobiles, it must have affected the consumers choice for some and to that extent, it results in 'excess burden'. According to Musgrave, excess burden is interpreted in terms of efficiency cost also. For instance, if due to imposition of a tax, let us suppose that private sector's economic decisions are distorted. If it results in loss of welfare it is termed as 'Excess Burden'. In the words of Musgrave "excess burden is the different between the total loss of words of Musgrave "excess burden is the different between the total loss of welfare (or the economic cost) of a tax as it is actually imposed and loss of welfare (or the economic cost) of a tax as it is acutally imposed and the los which would result if the same tax revenue

had been collected without distorting economic decisions in the private sector". In other words, a neutral tax conceptually is the one which does not result in'Excess Burden'. But tax-neutrality is rather difficult to be achieved in actual practice.

12.3.3 Output Effects

In the third category, namely **'output effects'** we may conceive a situation where due to imposition of tax, the work effort must have been adversely affected. This aspect has already been dealt with in the previous lesson (see 'Effects of taxation')

12.3.4 Employment Effects

Similarly, in the fourth category, namely **'Employment Effects'** we may conceive a situation where imposition of tax must have resulted in changes in the level of aggregated demand and unemployment. When a tax is imposed, it may result in reducing the level of employment may likely increase.

All the above four types of tax burden may interact each other and finally, the burden is measured by changes in the distribution of income.

CHECK YOUR PROGRESS - II

2. What are the components of the burden of tax?

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12.4 MEASURING TAX BURDEN

Most of the studies measuring the burden of taxation ignored the benefits of public expenditure. It is because the benefits according to different income classes from out of public expenditure cannot be correctly measured. In the present lesson, we first proceed with measuring tax burden, assuming that there are no changes in the benefits from public expenditure. Tax burden is measured by the distibutional effects that can be studied broadly under two situations namely (i) absolute tax incidence and (ii) differential tax incidence. Tax burden is generally expressed as a percent of personal income of the tax paying unit (household or family etc.) In some studies it is expressed as a persent of consumer expenditure of the tax paying unit.

12.4.1 Absolute Tax Incidence

Suppose a tax has been imposed, while holding public expenditures constant. What will happen to the distribution of income? In determining the distributional changes, we should not overlook the "macro" effects in the economy. Consequently the distributional changes brought out by the imposition of tax are mixed up with those brought out due to macro effects also. An example makes this point clear. Suppose income tax is increased by the government. This results in decline in aggregate demand, which may lead to unemployment, and there by a decline in price level or a reduced rate of inflation. The resultant distribution of income among different classes after the increase in income tax cannot be exclusively attributed to change in the income tax. The effects of tax are mixed up with the macro effects caused due to inflation or deflation also. Ignoring the other macro effects, if we measure the distributional changes due to imposition

of a tax it is called 'Absolute Incidence' Musgrave did not favour this type of incidence as the distributional effects of a tax are mixed up with the macro effects of inflation or deflation. To overcome this difficulty in the measurement of tax burden, Musgrave developed another hypothesis. It is called differential incidence.

12.4.2 Differentital Incidence

In this situation, one might examine the distributional changes in income by substituting one tax for another while holding total revenue and expenditures constant. This may bringout some changes in the distribution of income. Some households may gain and some others may lose their income. In other words redistribution of income can be brought out by differential incidence. It measures the difference in the distributional effects of financing a given public expenditure simply by substituting one tax for another. (Even this measure of distributional effects also cannot strictly be attributed to tax substitution, if one examines an economy with less than full employment situation. But presently we do not deal with those situation).

If the distributional effects or account of both taxation as well as public expenditure are considered, the net effect is named as **'Budget incidence'**.

CHECK YOUR PROGRESS - III

3. Explain the tax burden under absolute tax incidence.

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4. How distributional changes in income is affected by differential tax incidence?

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12.5 DISTRIBUTION OF TAX BURDEN

The distribution of tax burden depends upon certain assumptions made regarding the incidence of various taxes. For instance, it may be assumed that the corporation tax falls on the share holders. Some may assume that it must have been shifted partly under certain conditions. Similarly, it may be assumed that sales tax or excise duties may fall on the consumers in proportion to their consumption. On the basis of incidence assumption, the burden distribution can be calculated. The distribution of tax burden can be done either by various income classes or by various consumer expenditure classes. The burden of indirect taxes like the income tax, wealth tax, corporation tax etc., cannot be distributed on the basis of consumer expenditure. So, if we are interested to know the distribution of tax burden, the appropriate way of doing it would be on the basis of 'income' classes rather than on the basis of 'consumer expenditure' classes. The following tables gives a set of incidence assumptions made in analysing tax burden.

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Incidence Assumption

	Description of Tax	Incidence assumption	Allocation made according to
1.	Personal Income Tax	Stays with the payer	Tax payments
2.	Excise and Sales Taxes.	Shifted to Consumers	Consumption of various commodities.
3.	Corporation Income Tax.	Stays partly with share holders and partly shifted to consumers.	In proportion to ownership of shares and in proportional to consumption.

In the above table, we have given some incidence assumptions to certain important taxes. If personal income tax is assumed to be staying with the person, who pays the tax to the government, the burden distribution is made in proportion to the tax payments made by different households belonging to different income classes. Similarly, if we assume that excise and sales taxes (the most important indirect taxes) are shifted fully to the consumers, the burden distribution is on the basis of consumption of various commodities, as which these taxes have been imposed. Some people held the view that corporation income tax partly stays with share holders and the remaining is shifted to the consumers. So, the burden distribution will be made in proportion to the ownership of shares held by different households and the remaining shifted part in proportion to consumption.

The burden of tax can be expressed as a percent of total household income or as a percent of household consumer expenditure. Of the two, it is better to express it as a percent of household income.

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12.6 PROGRESSIVE, PROPORTIONAL AND REGRESSIVE DISTRIBUTION OF INCIDENCE

Having distributed the tax payments of various income, classes, it is necessary for us to know whether any of the taxes or the tax system as a whole is proportionaly, progressive or regressive. In the previous lesson dealing with proportional, progressive and regressive taxation, we had stated these terms keeping in view only the rate structure. But, here whether a tax is progressive, proportional or regressive is considered with reference to the distribution of tax burden. In a way, this type of interpretation is more meaningful rather than simply looking at the rate structure and classifying the taxes as Progressive, Proportional or Regressive. We present a hypothetical table to make this point clear.

Table 1

Distribution of Tax Burden by Income Class (as a percent of household income)

Description of Tax	0-1000	1001-2000	2001-4000	4001-10,000	10,001-20,000
1. General Sales Tax	2.7	3.0	3.3	3.0	2.2
2. Excise Duties	3.0	3.4	3.6	4.2	5.8
3. Income Tax	-	0.1	0.3	0.2	0.1

In the above table, we find the tax burden is distributed among different income classes. If we examine the general sales tax, the burden distribution is progressive upto the income class of Rs. 2001-4000. But beyond this income class, the more the household income, the lesser is the burden of tax as reflected in the falling percentages. So, we may say that burden distribution is regressive beyond the household income of Rs. 2001-4000. In the case of excise duties, the burden distribution is progressive. If the same percentage is paid forwards taxes by all the households the tax system may be stated to be proportional

12.7 LIMITATIONS

There are many limitations while analysing the tax burden distribution. Firstly, we must have a distribution of income by size before new taxes are imposed or changes in existing taxes are brought out. Such information is not adequately available for many countries.

Secondly, the allocation of tax payments across the various income brackets are done on the basis of incidence hypothesis. So, if the incidence hypothesis is altered, there is every possibility of getting a different picture of the distributional effects of the tax. For instance, if one assumes that corporation income tax is not shifted, then the entire tax has to be distributed among shareholders of various income classes only. Instead, if a portion of it is assumed to have been shifted the distributional impact would be different.

Thirdly, distributional effects would be different if we want to find out under a 'differential incidence' instead of 'absolute incidence' hypothesis.

Finally, there are many difficulties in allocating the expenditure benefits by different income classes. Therefore, most of the studies on tax burden, ignore the effects of public expenditure. This is, strictly speaking, not correct in so far as estimating the distribution of net tax burdens among different income classes is concerned.

12.8 SUMMARY CONCLUSION

Despite these limitations, a study on tax burden distribution clearly tells us whether a particular tax or the tax system as a whole is regressive, proportional or progressive. If the tax system is progressive, most of the objectives like reduction of inequalities of income and wealth etc., could be achieved. As the distribution of income is not only affected by tax and expenditure changes but by other decisions taken by the private sector as well, it is necessary that the tax system should be periodically reviewed of its progressiveness or otherwise.

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– Dr. T. Divakara Rao

12.9 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L Bhatia : *Public Finance*
3. Hugh Dalton : *Principles of Public Finance*
4. R.A. Musgrave : *The Theory of Public Finance*

12.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What do you mean by tax burden? How can be measured?
2. Explain the components of the burden of tax.

II. Answer the following questions in about 15 lines each.

1. Explain the following concepts :
   (a) Money burden & (b) Real burden
2. Explain the following concepts :
   (a) Absolute tax incidence
   (b) Differential tax incidence
3. What are the limitations of distribution of tax burden?

BLOCK III

INDIAN TAX STRUCTURE

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This block deals with tax system followed in Indian economy in post-independence period. It analyses the trends in the growth and composition of tax structure of Central and State Governments in India. Important direct and indirect taxes are dealt with in 2 units. The block also discusses the tax policy of India and examines the recommendations made by different commissions in the spnere of direct and indirect taxation.

This block contains the following four units:

Unit 13. Pattern and Growth of Tax Revenue

Unit 14. Important Direct Taxes

Unit 15. Important Indirect Taxes

Unit 16. Tax Policy Since Independence Recommendations of Various Commissions

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UNIT-13 : PATTERN AND GROWTH OF TAX REVENUE

Contents

13.0 Aims and Objectives
13.1 Introduction
13.2 Meaning and significance of Tax Structure
13.3 Capital Budget and Revenue Budget
13.4 Tax Revenue and Non-Tax Revenue
13.5 Trends in Tax components
13.6 Elasticity and Buoyancy
13.7 Tax Revenues of Union and State Governments
13.8 Summary and Conclusions
13.9 Suggested Books
13.10 Model Examination Questions

13.0 AIMS AND OBJECTIVES

The purpose of this unit is to analyse the trends in Tax Components of Central and State Governments in India.

After reaidng this unit, you will be able to understand

- the meaning and significance of tax structure,
- the distinction between capital budget and revenue budget,
- the distinction between tax revenue and non-tax revenue,
- trends in tax components,
- the concepts of tax elasticity an buoyancy, and
- tax revenues of Central and State Governments.

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13.1 INTRODUCTION

Taxes form a major source of revenue for Central as well as State Governments in India. For instance, tax revenue consistutes 70-80% of the total revenue receipts of the central and state governments in India. Tax revenue as a percentage of the GNP increased from 6.8 in 1950-51 to 16.3 in 1984-85. In absolute terms, tax revenue increased 55 times between 1950-51 and 1984- 85. In 1983-84, every Indian paid on the average Rs.1.24 per day. The contribution of indirect taxes has been more than that of direct taxes and the importance of indirect taxes has been increasing. For instance the share of indirect tax in total tax revenue has risen from 63% in 1950-51 to 86% in 1984-85. Firstly, the revenue from different taxes may rise at different rates. Secondly, tax rates may be changing over a period of time. Hence a study of tax structure in India is of paramount importance.

13.2 MEANING AND SIGNIFICANCE OF TAX STRUCTURE

The term 'Tax Structure' refers to the composition of taxes imposed by a government. It also indicates the relative importance of individual taxes. Tax structure, therefore, refers to the combination of taxes lived by the government indicating the relative importance of the

constituents. The central governments as well as the state governments levy a number of taxes. union excise duties and customs duties among the indirect taxes have a dominant place in the tax revenue structure of the central government on the other hand. The important taxes imposed by the state governments are sales tax, state excise duties, stamps and registration, motor vehicle tax, land revenue and entertainment tax.

According to R.A. Musgrave and P.B.Musgrave, as per capita income rises, the importance of income tax increases in relation to that of custom duties and taxes on domestic sales and production. Payroll taxes also rise relatively in importance with an increase in percapita income. But this dictum may not be valid for all countries. For instance, India's tax system does not conform to the above pattern. The tax structure does not remain static but changes over time in any dynamic society. Changes in it occur partly because of economic, political and social changes. The tax structure of developed countries differs from that of developing countries. Similarly, the tax structure of capitalist countries differs from that of socialist countries. The literacy levels of citizens, their civil consciousness, administrative ability of tax collectors, political phylosophy of citizens and several other factors influence the tax structure of a country.

13.3 CAPITAL BUDGET AND REVENUE BUDGET

The tax revenues received by the government, loans raised but it and receipts from recovery of loans granted by the government form the consolidated fund. All expenditure of the government is incurred from this consolidated fund. The details on revenue and expenditure are given in government budget. The government budget comprises (1) Revenue budget and (2) Capital budget. The capital budget represents, that part of the Government revenue and expenditure relating to the formation of the capital assets. For instance, the expenditure incurred for the construction of roads, buildings, dams etc., constitutes the capital expenditure. It also includes the repayments of loans taken by the government. As for as the revenue from capital assets is concerned it is normally much less. The returns from the capital assets owned by the government constitute a part of the revenue side of the capital budget. The other part comes from the surplus of revenue budget as well as loans raised by the government from different sources. Let us consider the revenue budget. It consists of the revenue receipts of the government (tax and non-tax revenues) and the expenditure met from these revenues. Tax revenue comprises of the proceeds of taxes and other duties levied by the government. Other receipts of government mainly consists of interest on loans advanced, and dividends on investiments made by the government. In the case of State Governments, Grants -in-aid from the Union Government is the another constituent of the revenue budget.

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13.4 TAX REVENUE AND NON-TAX REVENUE

Broadly speaking, tax revenue and non-tax revenue are the two components of the revenue budget. In the union budget for 1983- 84, tax revenue constituted 75.5% of the total revenue on the revenue account. For the year 1970-71 the corresponding figure was 73.3%. In 1950-51 tax revenue constituted 79.7% of the combined revenue receipts of Central and State Governments and of Union territories. So, tax revenue which constitutes 70 to 80% of the revenue receipts of the government deserves to be studied. In 1981-82 the total tax revenue in the country amounting Rs.24,142 crores constituted 18.3% of the G.N.P of the country. During that year every citizen on an average paid a sum of Rs.352 by way of taxes, i.e., nearly one rupee a day. By 1983-84, this increased to Rs.1.24 per day per man on an average. The per capita N.N.P during 1983-84 was Rs.2,201.4. It means that 20.6% of the per capita N.N.P was paid as taxes in 1983-84 Table 1 shows the growth of tax revenue in the country.

It may be seen from the table that there has been a tremendous rise in the tax revenue during the past 35 years. The rise has been nearly 55 times during the 35 years period. The annual compound growth rate has been 12 percent. The rise was slightly higher in the Central

taxes than in the state taxes. Tax revenue as a percentage of G.N.P increased from nearly 7 to 18. Tax GNP ratio in india may appear to be less than that of developed countries like the Netherlands. Sweden, France, and the UK, where it is more than 35% of GNP. Since ratio depends upon several factors we cannot conclude that India is an under taxed nation

CHECK YOUR PROGRESS - I

1. What is meant by consolidated fund?

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2. What is Capital Budget?

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3. What is Revenue Budget?

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13.5 TRENDS IN TAX COMPONENTS

The Revenue from indirect taxes increased at a higher rate than that from the direct taxes. The increase in the revenue from indirect taxes was about 75 times during the period 1950- 51 to 1984-85, where as it was only about 20 times in the case of direct taxes. However, when we consider the relative important of the two constitutents, it is obvious, that the relative importance of direct taxes in 1981-82 decreased to less than half of what it was in 1950-51. The relative share of indirect taxes rose from 63% in 1950-51 to nearly 86% of the total tax revenue in 1984-85. Dependence on indirect taxes, therefore, is a feature of India's present tax structure. In the budget for 1985- 86(BE), the total amount of tax revenue to be collected by the Centre (including the states sphere) is estimated at Rs.25,992 crores. Of this, 81% is expected from indirect taxes and 19% from direct taxes. Reliance on indirect taxes has been one of the characteristic features of most of the developing countries and India is no exception. Taxation is by far the most important source of development finance. As such resources necessay for ecnomic development have to be mobilised through taxation. Though direct taxes may be desirable from the eagalitarian point of view, because of the limited scope for direct taxes in developing countries, indirect taxes have assumed more importance. Moreover, with the increasing possibility of achieving tax progressivity

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in the sphere of indirect taxation through taxes on luxury consumption, the traditional contrast between regressive indirect taxes and progressive direct taxes tends to diminish.

13.6 ELASTICITY AND BUOYANCY

As national income grows, tax revenue also grows. It is important to study the response of tax revenue for changes in national income. This responsiveness is measured by elasticity of tax revenue. It measures percentage change in tax revenue for 1 percent change in national income. If one percent increase in national income leads to more than 1 per cent increase in tax revenue, we say that tax revenue is elastic. On the other hand, if 1 percent increase in national income leads to less than 1 percent increase in tax revenue, we say that tax revenue is inelastic. We can show this by a simple formula. Representing elasticity by e, national income by Y and tax revenue by T, we can write the formula for elasticity as follows.

$$e = \frac{\Delta T}{T} \div \frac{\Delta Y}{Y}$$

$$= \frac{\Delta T}{T} \cdot \frac{Y}{\Delta Y}$$

In the above formula ΔT and ΔY should be understand as increase in tax revenue and increase in national income between the base year and year of reckoning. In India elasticity is greater than unity for not only total tax revenue but also for direct tax revenue and indirect tax revenue. However, indirect tax revenue has a higher value of elasticity than direct tax revenue. Thus indirect taxes are more responsive to national income than direct taxes. While computing the elasticity we have to see that there is no change in the tax rates and tax base. If tax rates and tax base also change during the period, we call it tax buoyancy. Thus tax buoyancy is an all inclusive measure and compares the growth in tax revenue including changes in Tax base and tax rates with rise in national income.

13.7 TAX REVENUES OF UNION AND STATE GOVERNMENTS

Let us now consider the type of taxes and combination of taxes imposed by the Union Government and State Governments. Tables 2 and 3 respectively indicate the tax structures of the Central and State Governments in India. Table 4 shows the important components of the tax structure of Andhra Pradesh.

13.7.1 Tax Revenues of Union Government

The taxes imposed by the Union/Central Government are classified into three categories. (i) taxes on income and expenditure (ii) taxes on property and capital transactions and (iii) taxes on commodities and services. From the point of revenue taxes on commodities and services occupy the most important place followed by taxes on income and expenditure. Taxes on property and capital transactions occupy the least important place.

The relative importance of the taxes changed over a period of time. In 1950-51 customs duties occupied the most important place, in the tax structure of the Union Government, accounting for about 38 percent of the total revenue. Taxes on incomes occupied the second place. The union excise duties occupied the third place accounting for 16.8 percent of the total tax revenue followed by corporation taxes which occupy the fourth place. These four were the important taxes of the Union Government and they accounted for 90 percent of its total tax revenue.

By the year 1960-61, the relative importance of these taxes in the tax structure of the Union Government has changed. Union excise duties occupied the first place accounting for 46 percent of total tax revenue followed by customs duties, income tax and corporation tax. Though the relative position of these taxes did not change during the decade ending by the year 1970-71, the share of excise duties rose to 55 percent of the total tax revenue. By the year 1983-84 the position of the first two taxes remained the same, where as income tax and corporation tax inter-

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changed their places. Corporation occupied the third rank pushing down the income tax to the fourth place. Even now these four taxes play a dominant role in the Central Government tax structure. More than three fourths of the gross total tax revenue of Central Government was contributed by two indirect taxes namely, Union Excise duties and Customs duties.

13.7.2 Tax Revenues of State Government

About half a dozen taxes are important in the tax structure of a state. They are (1) Sales Tax, (2) State Excise Duties, (3) Land Revenue, (4) Stamps and registration, (5) Motor Vehicle tax, and (6) entertainment tax.

In 1950-51 Sales Tax occupied the First Plan followed by land revenue and state excise duties. Stamp and registration fee and motor vehicle tax occupied fourth and fifth places. The two direct taxes, land revenue and stamps and registration fee provided about 34% of the states tax revenue.

Even by 1960-61 the relative importance of the above taxes did not change. But sales tax and motor vehicle tax improved their shares substantially and state excise duties and stamps and registration faced reduction in their shares.

During the subsequent period, sales tax improved its share whereas the share of state excise remained the same. The shares of the remaining three taxes declined continuously. As a result, of these changes by the year 1986-87, the share of sales tax rose to 58.2% whole the share of state excise duties remained at 14.4%. The shares of motor vehicle tax and stamps and registration are same around 5.5%. Land revenue became insignificant with share of only 2.0%. Thus the share of direct taxes revenue and stamp and registration fee declined from 34% in 1950-51 to 7.5% in 1986-87.

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13.7.3 TAX REVENUE OF ANDHRA PRADESH

The tax structure of Andhra Pradesh is also more or less similar to the overall tax structure of the states. Indirect taxes occupy the dominent role and direct taxes provide only a small share. For instances is 1983-84 budget of Andhra Pradesh Government, indirect taxes account for 93.6% of the state's own tax revenue. However, as compared to the overall state's tax structure, Andhra Pradesh has a lower share in sales tax, but higher share in state excise duties and motor vehicle tax.

CHECK YOUR PROGRESS - II

1. What is meant by elasticity of a tax?

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2. What is meant by buoyance of a tax?

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3. List the four important taxes of the Central Government and give their shares in the total tax revenue of the Central Government?

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4. List the six important taxes of State Governments and give their shares in the total own tax revenue of Andhra Pradesh?

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13.8 SUMMARY AND CONCLUSION

Taxes form a major source of revenue for the Central Governments accounting for 70 to 80% of the total revenue receipts union excise duties and customs duties are important indirect taxes for the Central Government accounting more than 75% revenue of the tax. Sales tax, state excise duties, stamps and registration, motor vehicle tax, land revenue and entertainment tax are important taxes of the state governments. The first two contribute more than 70% of the own tax revenue of the state governments.

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The budget which gives revenue and expenditure of the government comprises of two components - capital budget and revenue budget. The expenditure side of the capital budget consists expenditure on assets and repayments of loans. The revenue side consists returns from capital assets, surplus of revenue budget and loans raised by the government. The revenue budget consists of tax and non-tax revenues and expenditure met from there revenues. In the case of state governments, grants in-aid from the central government is another constituent of revenue budget.

The share of indirect taxes increasing and in recent times it has crossed 80%. In the tax structure of the Central Government, the position of income tax is pushed below the corporation tax. In the case of state governments the share of sales tax increased steeply and land revenue became insignificant.

– Dr. T. Divakara Rao

13.9 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Dalton : *Public Finance*
4. U. Hicks : *Public Finance*

13.10 MODEL EXAMINATION QUESTIONS

I. Answer each of the following questions in about 30 lines

1. Examine the tax structure of Government of India.
2. Explain the tax structure of state governments in India.

II. Answer each of the following questions in about 15 lines

1. What are the major trends in the composition of taxes of Government of India?
2. What are the major trends in the composition of taxes of the state governments in india.?
3. Explain the meaning and distinction between elasticity and buoyancy of tax revenue.

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UNIT-14 : IMPORTANT DIRECT TAXES

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14.5 Summary and Conclusions
14.6 Suggested Books
14.7 Model Examination Questions

14.0 AIMS AND OBJECTIVES

The unit examines the nature, base structure and rate structure of three important direct taxes namely, Income tax, Corporation Tax and Wealth tax of the Government of India.

After reading this unit, you will be able to know

* history, objectives, tax base, exemptions and structure of income tax,
* rationality, history, features, incidence and structure of corporation tax and

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* rationality, history, exemptions anmd rate structure of Wealth tax.

14.1 INTRODUCTION

Personal income tax, corporation.tax and wealth tax are important direct taxes in India. while the first two taxes contribute more than 90% of the revenue from direct taxes, the third one contributes only about 2%. Income tax was introduced in 1860 and has a long history. It is considered as the most important tax from the point of view of both equity and effeciency in the allocation of resources. The revenue from income tax is shared with states. Corporation tax is exclusively central tax. Corporations pay the tax at a flat rate on the assessable profits and also deduct income tax at the prescribed rates out of the dividends payable to the share holders. Wealth tax introduced in 1957 is imposed on the net wealth belonging to individuals and Hindu undivided families.

14.2 INCOME TAX

14.2.1 History

Income tax was first introduced in 1860 as a temporary measure by Sir James Wilson to meet the financial difficuilties caused by the suppression of the Indian Mutiny of 1857. It was imposed on both agricultural income and non-agricultural income. The tax was discontinue in 1865.

However, when income tax was reintroduced in 1886 on a permanent basis, agricultural income was excluded from the ambit of income tax because a cess was levied on agricultural incomes. The cess was later removed and agricultural incomes continued to be exempted from the levy of the central income tax. As a result of the Government of India Act of 1919, the Income tax became a central subject and later the Income Tax Act of 1922 was passed which remained in force for nearly 40 years. The Income Tax Act of 1961 (which is now currently in force) was passed largely on the basis of the recommendation of the Law Commission of 1958 and the Direct Taxes Administration Enquiry Committee (Mahvir Tyagi Committee). The Act came into effect on 1.4.1962. However, this is not simple and there are various problems and litigation. So, the Government of India has decided to revise the direct tax laws including income tax.

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14.2.2 Agricultural and Non-agricultural Income Taxes

Under the Indian Constitutionm (1950) only State Governments are empowered to tax agricultural incomes. But most of the State Governments in India do not impose agricultural income tax. As consequence, a major source of income as executed from the tax base. However, following the recommendations of the committee on Taxation of Agricultural Wealth and Income (called K.N.Raj Committee), the Finance Act of 1973 provided that with effect from the year 1974-75, the agricultural income of an assessee would be taken into account in determinining the rate of tax on his non-agricultural income. That is, in the case of an assessee whose non-agricultural income execeeds the minimum exeption limit, both agricultural income and non-agricultural income would be totalled up to arrive at the approprioate rate of tax payable on the non-agricultural portion of the income. Because of this partial integration of agricultural and non-agricultural incomes, an assessee with income from both the sources is made to pay higher rate of tax than was the case before 1973. But even this does not ensure equity between the two categories of tax payers-one who has income only from no-agricultural sources and the other who has income from both agricultural and non-agricultral sources. The former pays higher tax than the latter even though the total income of both is the same. However, the Union Government does not have any intention of taxing agricultural incomes It was made clear by the Union Finance Minister, when he announced the long term fiscal policy for India on the 9th

of December, 1985. Elborating the Union Government's stand, the Finance Minister declared :"It is often stated that exclusion of agricultural income is a major short-comming of personal income tax base in India and constitutes an important explanation for the weak revenue raising capacity of the personal income tax. Taxing agricultural income presents many conceptual and administrtive problems. Land revenue and taxation of agricultural income are States' subjects under the Constitution. The Centre has no intension of seeking any change in this position".

14.2.3 Tax Base

The Indian Income tax does not give definition of the word, 'income' but enumerates sources of income and prescribes the method of computing the income. Income includes salaries, interest on securities, income from house property profits and gains of business and professions, capital gains, the value of benefits or perquisites, if any, winnings from lotteries, etc. Under the Indian Income Tax Act, tax is levied on the total income of the tax payer, i.e., on all the income from whatever source derived, unless it is exempted.

14.2.4 Who is to be Taxed ?

A resident person is taxable in both his Indian income as well as his foreign income. Indian income means the income which accrued or arose or was received in India. Foreign income means the income which accrued or arose outside India. A person who is not a resident is not taxable on his foreign income except in certain circumstances. A non-resident is taxable only on his Indian income. The net income of all individuals, Joint-Hindu families, unregistered firms and other associations of persons is taxable under the Act and this is commonly called the personal income tax. Income of cetrtain institutions like the co-operative societies and religious and charitable trusts are exampted from taxation.

14.2.5 Exemptions and the Rate of the Tax

Income tax is considered to be the most important tax from the point of view of both equity and efficiency in the allocation of resources. The principle of equity requires that all persons should be treated equally. Those who have greater economic ability must be made to pay more taxes than those who have less economic ability. Persons with the same economic status must be asked to pay taxes equally. Persons in different economic strata should be taxed differently. Income tax is one of the few taxes which len themselves to this type of equal treatment of all. Accordingly, income below a certain level are exepted from the payment of tax. Allowances and tax abatements are also allowed under certain conditions. Progressivity in the rate of tax is another widely accepted norm among modern taxes and income tax incorporates this principle. Moreover, a progressive income tax is also expected to reduce inequalities in incomes.

Exemption limits and the rates of tax of are not incorporated in the the Indian Income Tax Act as such, but they are announced every year in the budget session and become part of the Finance Act. The rates of tax and the exemption limits vary depending upon the the status of the assessee. Normally, the minimum subsitence needs of an average family are taken into account while deciding upon the exemption limit. This is called the 'tax free slab'. Since 1939 income tax has been levied in India under 'a slab system'. The earlier system was called 'the step system'. Under the slab system all assessees irrespective of the size of their total income they pay the tax equally under each slab. Successive slabs of income attracts higher rates of tax. The tax rate applicablle to different slabs may be referred to as marginal rates of tax relevant to the slab. The tax rate payable by the richest persons and other is the same for the initial slab and other slabs. Richer persons get themselves pushed to higher slabs. As a consequence, the average rate of tax T/Y (total tax paid divided by total income) is different for different individuals for rich it is high, for those not so rich the average rate is also not so high. Table 3 of this lesson makes

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14.2.6 Super Tax

Between 1917 and 1965, the government of India used to leavy two taxes on income (1) income tax and (2) super tax. In 1965 inorder to simplify tax calculations, super tax was merged with the income tax. Super tax was an additional tax on the same amount of income which was assessed for income tax. This tax was first imposed in 1917 to meet the wartime needs of the government. It was levied on assesses other than companies. From the very begining, super tax was imposed on the basis of a slab system.

The income of Joint companies also was subject to two taxes: the income tax and the corporation tax which was known as super tax on companies upto 1965. In 1965 the super tax on companies was also integrated with the income tax on them and a composite rate of tax on companies was prescribed. At present tax imposed on the incomes of the companies or corporate bodies is in effect of combination of the pre - 1965 income tax and the super tax on companies.

14.2.7 Changes after 1965

Between 1965 and 1985 several changes in the Income Tax structures have been made both with regard to the exemption limit (no-tax slab) and the rates of tax. During 1966-67 to 1969-70 the non-tax slab for individuals (married with more than one child) remained at Rs.4,000 per annum. In 1970-71 it was raised to Rs.5,000. The exemption limit was further raised to

Rs.6,000	in	1974-75
Rs.8,000	in	1975-76

The minimum exemption limit was raised to Rs.10,000 in 1977-78 and to Rs.12,000 in 1980-81, though the nil-rate slab remained at Rs.8,000 upto 1981-82. Exemption limit was raised to

Rs.15,000	in	1981-82
Rs.18,000	in	1985-86

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Erosion in the value of money because of inflation made the Government raise the rates of exemption. With effect from the assessment year 1972-73 the marginal rate of tax on incomes exceeding Rs.2,00,000 was fixed at 85%. In addition, there was a surcharge of 15% on the income tax payable. As a result the highest marginal rate of taxation worked out to be 97.75% (85% + 15% of 85%).

The Direct Taxes Enquiry Committee popularly known as the Wanchoo Committee recommended a ceiling of 75% as the maximum marginal rate. The Committee was observed that when the marginal rate of tax is as high as 97.75%. It would be difficult for a person to resist the temptation to evade the tax. Ludwig Erhard and Professor Colin Clark, the authros of 'German Miracle' are of the opinion that the maximum rate of personal taxation should not exceed 50%. Prof. Kaldor advocated a maximum rate of 45%. The Study Team in its report on some aspects of the **Black Economy in India** (March 1985) also remarked that the combined effect of current rates of income tax and wealth tax (for 1984- 85) is strong enough to generate a powerful incentive for tax evasion. The Study Team recommended that the tax on company profits, the personal income tax, the wealth tax, Stamp Duties and the Estate Duty be all reduced substantially by the Central Government.

Perhaps realising the force of the argument that high/ confiscatory rates of taxation whould act like a premium on dishonesty, the Government of India reduced the marginal rate of taxation to 77% in the budget for 1974-75, (70% + 10% of 70%). In the budget for 1976-77, the maximum marginal rate of tax was further reduced to 66% for incomes above Rs.1 lakh. The rates of personal income tax were further lowered in the budget for 1985-86 as part of the long term strategy for securing better compliance and for improving the built-in revenue raising capacity

of the income tax. The Union Finance Minister in his policy statement of 19-12-85 observed that frequent changes in tax structure would be a source of uncertainty which would discourage tax complliance, create difficulties for effective tax administration and take its toll of economic growth. He declared that in order to provide the necessary stability, the Government of India intended to keep the present rate schedule of taxes on personal income and wealth unchanged for a minimum period of five years. Further the Surcharge on income tax levied at the rate of 12.5% in the case of all categories of non-corporate tax payers was abolished in the budget for 1985-86.

The rate schedule applicable to different categories of tax payers has been restructured and the revised rates are lower than the earlier ones. The following table indicates the income tax rate schedule applicable to individuals, Hindu undivided families, unregistered firms, etc., with effect from 1989-90.

Upto Rs.22,000	NIL
Rs.22,001 to Rs.30,000	20 per cent
Rs.30,001 to Rs.50,000	30 per cent
Rs.50,001 to Rs.1,00,000	40 per cent
Over Rs.1,00,000	50 per cent

In addition to these rates at present a surcharge of 12 per cent is being levied on total income exeeding Rs.70,000

In it's long term fiscal policy the governent also made it clear that adjustments in tax brackets after taking into account the impact of inflation, the overall budgetary position and other relevant factors.

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14.2.8 Revenue Yield

The yields from income tax and all direct taxes are shown in Table 1. It is clear from the table that the growth rate of income tax has been slower than that of corporation tax. Further, the share of income tax in the total yeild of direct taxes declined from nearly 75% in 1950-51 to 50% in 1980-81 and further to 38% in the budget estimates of 1985-86.

14.2.9 Elasticity and Buoyancy of Income

For the period 1960-61 to 1978-79 elasticity of income tax revenue is only 0.88 which shows that revenue from income tax is inelastic. But buoyancy co-efficient for the same period is 1.14. Among the Central taxes corporation tax has the highest elasticity coefficient.

14.2.10 Progressivity

In spite of high rates of income taxation that prevailed upto 1985-86, it is observed that the progressivity in the case of income tax has not been significant and that its capacity to reduce the inequality of income distribution among the direct tax assessees has not been adequate. Opportunity for avoidance of tax, evasion of tax and ineffective tax collections resulting in accumulation of arrears are largely responsible for the ineffectiveness of income tax in reducing inequalities.

14.2.11 Evasion of Income Tax

A Study Team of the National Institute of Public Finance and Policy examined some of the aspects of the black money economy in India and presented its report in March 1985. The Committee felt that higher effective rates of taxation had been a major contributory factor for tax evasion. The aggregate of incomes which are taxable but are not reported to the tax

authorities has been defined as black income. For the sake of the brevity it may be called 'tax evaded income'. The estimates of black income generated in India ranged from Rs.9,950 crores to Rs.11,870 crores in 1975-76 and from Rs.20,632 crores to Rs.23,678 crores in 1980-81. In terms of per cent of GDP these estimates range from 15% to 18% in 1975-76 and 18 to 21% in 1980-81. Black income generation in 1983-84 at Rs.37,000 crores was not less than 18% of GDP. Tax-evaded-income as a ratio to income assessed was estimated to range from 57% to 87% in 1975-76. The comparable range for 1980-81 was between 68 and 139 per cent. It is a telling commentary on the state of income tax and its collection machinery. It is also an indication of the revenue potential of income tax, if the generation of black money can be reduced and collections stepped up. Given the political will to stand firm against tax evaders, it should not be difficult to make income tax a more productive and elastic source of revenue than it has so far been. In recent years the problem of income tax arrears has assumed importance and therefore the machinery for tax collection must become more effective.

14.2.12 Expenditure Tax

Expenditure tax is often suggested as an alternative to income tax. Nicholas Kaldor, a British Tax Expert, recommended the introduction of expenditure tax in India as a supplementary tax along with moderate of income tax. It is claimed that expenditure is a better index of taxable capacity and that it can be more easily defined than income. It does not discourage savings. Expenditure tax was introduced in India with effect from 1-4- 1958 and applied only to individuals and Hindu undivided families. However, the tax was not popular and productive in India. So it was abolished in 1962. Though it was reintroduced in 1964, it was finally abolished in 1966. The unsuccessful experiment with expenditure tax in India emphasises the need to make income tax a truly progressive and productive tax.

Though income tax is imposed and collected by the Centre, the net proceeds of the tax have to be shared with the States. Currently 85% of the proceeds are distributed to the States and the remaining portion is retained by the centre.

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CHECK YOUR PROGRESS - I

1. When was income tax first introduced and why?

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2. What is the base for income tax?

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3. Distinguish between averge tax rate and marginal tax rate?

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4. When is super tax first introduced? What is its present stage?

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5. What is black money? What is it's magnitude in India?

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14.3 CORPORATION TAX

Corporation tax is primarily a central tax without any share of it to the assigned State in India. Tax imposed on the income of the corporation is called the corporation income tax as ditinguished from personal income tax which has been examined in the earlier section. A corporation has a separate legal entity. It can do business in its own name. The base for this tax is the profits of the corporation. The income that is earned by the company may or may not be distributed to the share holders. But this tax is levied on the income of the company as such. Corporations are treated as entities distinct from (separate from) the share holders of that company. The corporation has a life independent of the lives of its share holders. The share-holders may change but the corporation remains unchanged. So, a company paying income tax on its profits does not pay as on agent of its share holders but only as a regular tax payer.

14.3.1 Rationale

The economic justification for a separate corporation income tax is based on the following principles/reasons:-

1. **Benefit theory or privilege theory** : The Government renders many services to the joint stock companies which benefit their business operations by reducing costs, broadening markets, and facilitating financial transactions. So the corporations should be charged for benefits received from public services.

2. **Regulatory measure** : The Corporation tax is necessary to regulate and control the behaviour of the companies. The tax may be used to provide incentives or disincentives to invest in general or in specified sectors.

3. **Ability to pay principle:** Separate taxation of corporate income is necessary to prevent inequalities between different classes of income earners who have the necessary ability to

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pay.

4. **Social Control:** Corporation tax is necessary not only for improving the allocation of social costs but also for effective social control of the companies

5. **Old Tax:** Separate taxation of companies' income has been in vogue in several countries for a long time. Having entered the tax structure of India, it has remained there.

Taxation of corporate income in India is as old as the income tax. However, there have been modifications in respect of its scope from time to time. The Income Tax Act and the Annual Fiance Acts govern the operation of the corporation tax.

Only profit making corporations are liable to pay this tax. A small corporation may choose to be taxed as a partnership in which case it need not pay corporation tax. But the full income of the corporation will be taxed under personal income tax as income of the partners/stock holders.

14.3.2 History

In India companies were required to pay only income tax till 1917. Super tax on a slab basis was imposed on companies with effect from 1-4-1917 on the profits of the company. The Finance Act of 1965 merged the super tax with the income tax. The combined rate of corporation tax was kept at 80% and out of this different rates of rebate were allowed to diffemt types of incomes and companies. Under the Finance Act of 1966, tax rates on different types of companies were prescribed at different rates varying from 45% to 70%. Since then, the rates have been changed several times. The lastest rate schedule is shown in 14.3.5.

14.3.3 Features

The main features of the corporation tax are:

(1) The company pays the tax at a flat rate on the assessable profits. The tax is paid only on behalf of the company and not as an agent of the share holders. (2) The company is also under an obligation to deduct income tax at the prescribed rates out of the dividends payable to the share holders. The tax so deducted at the source is adjusted against the income tax payable by the individual share holder. In case the liability of the individual share holder is less than the amount deducted at source, the excess amount is refunded. (3) Corporation tax does not involve double taxation, First, the company pays the tax on its income as a company on its own behalf. When the profits are distributed the individual share holder pays income tax on his aggregate income including the dividend income.

14.3.4 Incidence

It is difficult to answer the question. "Who bears the incidence of the tax?" Broadly speaking, three categories of persons are affected by this tax: (a) shareholders/stock holders (b) consumers of the product and (c) suppliers of labour and material to the corporation. How the burden is distributed among different categories depends upon the structure of the markets and several other factors.

It is well known that investment generates income and employment. To increase investments to promote modernisation of plant and machinery several concessions, rebates and allowances are given to business and industry on the following lines: (i) New undertakings are exempted from income and corporation taxes for the first five years of their existence. This is called 'Tax Holiday'. (ii) Development rebate is granted for all investments in plant and machinery. Business houses are allowed to carry forward this rebate in case there are insufficient profits in the year of investment.(iii) Additional depreciation allowance equal to normal ones was allowed in respect of investments in plant and machinery installed between 1-4-80 to 31-3-1985. While this is being

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discontinued in the budget for 1985-86, the general rate of depreciation allowance is increased from 10% to 15% with effect from the assessment year 1985-86.

14.3.5 1985-86 Budget and Long Term Fiscal Policy of December 1985

While presenting the budget for 1985-86, the Union Finance Minister made the following observations: The statutory rate of Corporate tax in India is high, but because of various exemptions the effective rate is significantly lower and the several well meaning exemptions not only led to an erosion of the tax base but the endless litigation. The Finance Minister proposed to rationalise the rate structure and introduce a directional change. Accordingly, the basic rate of income tax applicable to companies was reduced by 5 percentage points: For example,

I. In the case of a domestic company

i)	in which the pubic are substantially interested	50% of the total income
ii)	in which public are substantially not interested	
	(a) in the case of trading or investment company	60% of the total income
	(b) in any other case	55% of the total income

II. In the case of non-domestic companies 50% to 65% of the total income

Surcharge : 50% of income tax calculated in accordance with the provisions of the preceeding paragraph.

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The Finance Minister in his statement on the long term fiscal policy also announced on 19-12-85 that the rates of corporation tax would not be reduced or increased further. However, the surcharge and sur tax will be abolished with effect from the assessment year commencing on 1-4-1987. Simultaneously with the abolitin of the investment allowance from 1987-88, a new scheme will be introduced which will allow corporate enterprises to deduct upto 20% of their profits from their taxable income in case the amounts are deposited witht the Industrial Development Bank of India or any other institution to be notified by the Government.

The Finance Minister proposes to raise more resources through strict enforcement of tax laws and the buoyancy arising out of lower tax rates. Table shows that corporation tax is the most important of the direct taxes and that its revenue significance is going up. For the period 1960-61 to 1978-79, the corporation tax had the highest elasticity coefficient (0.94 of course, less than one) among the Central taxes. The buoyancy coefficient for the same period was 1.04, i.e., more than one.

As the Union Finance Minister rightly emphasised, what matters is not the tax rates on paper either in the case of personal income taxation or company income taxation but their actual collection and incidence. Where taxes are evaded by the better- off sections of society, the equity goal of the tax system is eroded. An important element of the long term fiscal policy is to ensure that taxes levied are fully collected and strong action taken to curb evasion. Another important objective of long term fiscal policy is to reverse the decline in the share of direct taxes.

14.4 WEALTH TAX

14.4.1 Rationale

Enquiry Commission (1953-54) emphasised the need for an annual tax on wealth on economic, social and equity grounds. Nicholas Kaldor in his report on tax reform (1956) recommended the imposition of this tax. Normally, taxation of wealth may take several forms: (a) taxation of net wealth as such (b) taxation of property in the form of buildings, etc., (c) estate duty on the transfer of wealth from one person to another, because of death; (d) gift tax, etc. In this section, we are primarily interested in the taxation of net wealth as such.

The use of direct taxation for the purpose of reducing inequalities of income and wealth is too well known to require repetition. To promote socio-economic equality, taxation of wealth is regarded as an important instrument. Wealth tax as a supplement to income tax not only promotes greater economic equality but also reduces the scope for evasion of the income tax. It also makes the owners of wealth, use their wealth for productive purpose, for income yeilding purposes. For example, owners of jewellery do not pay any income tax because they do not get any income from jewellery. But a welath tax on jewellery may make them invest their assets in a fruitful and productive way. Further, in a developing economy, wealth tax is a source of development finance.

14.4.2 History

Wealth tax was initially introduced in India with effect from 1- 4-1957. The wealth Tax Act of 1957 provided for an annual levy on net wealth belonging to individuals, Hindu undivided families and companies. But wealth tax on companies was discontinued with effect from 1960-61. The entire wealth of an assessee is not subjected to wealth tax. Only the net wealth of an assessee possessed by him on the relevant valuation date is subjected to the levy of wealth tax. Net wealth refers to the aggregate value of the assets of an assessee in excess of the debts as on the valuation date. Valuation date refers to the last day of the previous year as adopted for income tax purposes or the 31st of March of an year.

Assets for wealth tax pruposes include property of every description movable or immovable, like cash, bank balances, shares, jewellery, business assets, etc. But the following have been specifically excluded and, therefore, are not liable to be taxed: (a) animals, (b) agricultural land and growing crops, (c) building owned or occupied by a cultivator, (d) rights to annuities.

14.4.3 Exemptions.

The exempted assets can be broadly divided into 2 categories; Some of the assets are totally exempted whereas the others enjoy only a partial exemption. In the case of partial exemption a limit is prescribed and have value of the assets in excess of the prescribed limit is included in the net wealth of the assessee for wealth tax purposes.

(a) Any one house or part of a house belonging to the assessee worth upto Rs.One lakh

(b) New residential houses or flats constructed after 1- 4-76 with a plinth area of 80 Sq.ms.or less, fully exempted.

(c) Furniture and household utensils

(d) Tools and instruments for carrying on professions upto Rs.20,000 in value.

(e) Works of art, books, drawings, paintings, photographs, etc.

The exemption limits of wealth tax and the rate structure have been frequently changed. When wealth tax was initially introduced in India in 1957-58, an exemption limit of Rs. 2 lakhs was prescribed for individuals and Rs. 4 lakhs for Hindu undivided families. The tax was levied on a graduated basis. It may be noted that hit, here to after the blanket exemption was crossed the tax was assessed on the entire net wealth. According to calculations, the overall effective

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progressivity of wealth tax is not significant and that it cannot bring about reduction in inequality to any significant degree.

14.4.4 Rate Structure

The structure of wealth tax was examined by a number of high power bodies including the Estimates Committee and the Public Accounts committee. A number of suggestions were made to make the system of wealth tax more conducive to the promotion of savings and investment in the economy. In the budget for 1985-86 therefore, the basic exemption limit was raised to Rs.2,50,000 whereas the prevailing rate schedule did not provide for a nil slab. The revised rate schedule is as follows

SLAB	RATE
Rs.2,50,001 to Rs.10,00,000	Half per cent
Rs.10,00,001 to Rs.20,00,000	One per cent
Over Rs.20,00,000	Two per cent

The maximum marginal rate was reduced from 5% to 2%. Besides, on specific assets exemption is given upto a consolidated limit of Rs.5 lakhs.

While the wealth tax laws apply to the wealth of a person when he is alive, the estate duty laws apply to the wealth of a person after death. The Union Finance Minister asserted that the Estate Duty did not achieve the two objectives with which it was introduced, namely, to reduce unequal distribution of wealth and assist the State in financing economic development. So, the levy was abolished in respect of estates passing on death after the 15th of March, 1985.

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14.4.5 Revenue Significance

The revenue significance of the wealth tax is indicated in Table appended to this lesson. From the table it is clear that wealth tax contributes only about 2% of the total tax revenue to the centre from direct taxes. The most important direct taxes of the centre are corporation tax and income tax which together contribute about 92% of the direct tax revenue of the Central Government.

CHECK YOUR PROGRESS - II

1. What are the features of corporation tax?

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2. What is Wealth tax? When was it introduced?

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3. What are the exemptions for wealth tax?

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4. What is the revenue significance?

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14.5 SUMMARY AND CONCLUSIONS

Personal income tax, Corporation tax and Wealth tax are important direct taxes in India. Income tax was first introduced in 1986 as a temporary measure to meet financial difficulties caused by the Indian Mutiny of 1857 and was discontinued in 1865. It was again introduced in 1886 on a permanent basis. The share of income tax in the total yield of direct taxes declined from 75% in 1950-51 to 50% in 1980-81 an 38% in 1985-86. Further, revenue from income tax is inelastic. However, buoyancy coefficient is greater than unity. Evation of income tax is very high in India. Black income accounted for 18% of gross domestic product in India. Expenditure tax was introduced in 1958 as a supplement to income tax and abolished in 1966.

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Corporation tax is a central tax and is imposed on profits of corporations. Several concessions, rebates and allowances are given to promote modernisation of plant and mechinery. This tax has the highest elasticity coefficient of 0.94 among central taxes. The buoyancy coefficient is 1.04

Wealth tax was introduced in India in 1957 on the basis of recommendations of Kaldor. The progressivity of Wealth tax is not sufficient and it cannot bring about reduction in inequalities to any significant degree. It accounts for only 2% of the direct tax revenue of the centre.

– Dr. T. Divakara Rao

14.6 SUGGESTED BOOKS

1. B.P.Thyagi : Public Finance
2. H.L.Bhatia : Public Finance
3. Hugh Dalton : Public Finance

14.7 MODEL EXAMINATION QUESTIONS

I. Answer each of the following questions in about 30 lines

1. Trace the history of income tax in India bringout the changes made till it achieved it's present form.
2. Examine the rationale underlying the corporation tax and it's main features.
3. Explain the rationale, history and rates structure of wealth tax in India.

II. Answer each of the following questions in about 15 lines

1. What is super tax? What are the changes made in it?
2. Explain the features of income tax in terms of revenue yeild, elasticity and buoyancy and progressivity.
3. Examine the problem of evasion of income tax?

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UNIT-15 : IMPORTANT INDIRECT TAXES

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15.2 Meaning and Importance of Indirect Taxes
15.3 Union Excise Duties
- 15.3.1 Meaning
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- 15.3.4 Forms of Excise
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- 15.3.7 Revenue Yield
- 15.3.8 Incidence of Indirect Taxation in India

15.4 Customs Duties
- 15.4.1 Meaning
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- 15.5.3 Sales Tax in Andhra Pradesh
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15.6 Summary and Conclusions
15.7 Suggested Books
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15.0 AIMS AND OBJECTIVES

The unit discusses the nature, rationale, rate structure, broad trends and revenue significance of important indirect taxes of union and state governments.

After reading the unit, you will be able to know.

- the importance of indirect taxes,

* history, rate structure, revenue yield, and incidence of union excise duties and customs duties, and

* meaning and development of sales tax in Andhra Pradesh.

15.1 INTRODUCTION

Indirect taxes occupy a prominant place in the tax structure of the central government and the state governments. The share of indirect taxes in the total tax revenue of central and state governments has been steadily raising from 63% in 1950-51 to 86% in 1984-85. The most important indirect taxes of central government are union excise duties and customs duties. The share of these two taxes is more than 75% of the gross tax revenue of the central government. Sales tax is the most important tax of the state governments. It's contribution is about 58% of the states, tax revenue in 1985-86.

15.2 MEANING AND IMPORTANCE OF INDIRECT TAXES

An indirect tax is one which is collected from one group with the general understanding that it will be paid indirectly by another group. Indirect taxation is an important instrument of resource mobilisation of economic development. As a result of the growth of industrial, production and expansion of trade, the importance of indirect taxes increased reducing the share of direct taxes in total revenue. Indirect taxes have displayed better growth and buoyancy in recent years. As between the excise duties and customs duties, the later have increased faster, though the contribution of excise duties is still the largest. We now examine the importanace of the excise duties in India.

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15.3 UNION EXCISE DUTIES

15.3.1 Meaning

Union Excise Duties are inland taxes levied on the domestic production of commodities for consumption or sale within the country. They are levied at the manufacturing stage and imposed only on commodities and not on services. In India, excise duties cover a wide range of commodities including intermediate and capital goods. Under the Indian Constitution when a duty is called excise, which is generally imposed only at the manufacturing stage, it can be levied only by the Union Government except in the case of the duties on alcohol and narcotic drugs. State Governments can impose excise duties only on alcohol and narcotics.

15.3.2 History

Excise as a levy has been collected in India since ancient times. Even in the Mauryan period, an excise duty on liquor and salt was levied to augment the revenues from traditional sources. The Moghuls, the Marathas and the British levied various forms of taxes on salt, treating it as a monopoly article. However in 1894 a begining was made towards the modern excise system when a duty at the rate of 5% ad valorem was imposed on cotton yarn of more than 200 counts. A levy on motor spirit was introduced in 1917. The next item to be placed under excise was kerosene. No new commodities were taxed thereafter for a number of years. The year 1934 marked the first step in the rationalism of excise levies and the extension of their coverage. Sugar, matches and steel in gots were brought under the tax net. Exigencies of Second World

War necessitated further extention of excises besides the increase in ration on the existing items. Till 1943 three different commodities were subject to excise levies under different enactments. By 1944, nearly 16 enactments regulated the levy and collection of excise duties. So in 1944 the various laws were consolidated into the Centtral Excises and Salt Act and common provisions were made applicable to all goods. The original Act has been amended several times resulting in complexities in the matter of administration. The Central Excise Reorganisation Committee of 1963 (Chanda Committee) recommended a comprehensive review of the Act and Rules. Though a new Central Excise Bill was introduced in 1970, the bill lapsed. Between 1971 and 1975, the base of excise duties was widended to cover the entire range of manufactured products. The Indirect Taxation Enquiry Committee known as the L.K.Jha Committee in 1979 made recommendations for the restructuring of the indirect tax system and rationalisation of individual taxes. The Union Finance Minister in his statement on long term fiscal policy (19-12-85) said that the Goverment proposed to reform the structure of customs and excise duties in order to realize equity, simplicity and built-in revenue raising capacity.

15.3.3 Objectives

Excise duties in India have been imposed for realizing the following objectives. (a) raise revenue; (b) reduce domestic consumption in general or that of specific goods; (c) raise revenue from those who cannot be reached by direct taxation; (d) encourage exports; (e) restrain inflation; (f) redistribute income; (g) allocate resources properly; (h) tax those industries on whose products increased incomes are to be spent; (i) tax industries with large profits; (j) assist the small scale and cottage industry; and (k)promote economic growth and equity.

15.3.4 Forms of Excises

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Excise duties have been levied by the Centre in various forms (a) Basic excise (b) Special excise and (c) additional excises in lieu of sales tax on some commodities (textiles, sugar, and tobacco) since 1957. Besides the above mentioned duties, additional excises on textiles and textile products for financing the controlled cloth scheme and cesses earmarked for special purposes are also levied. Basic and special duties of excise are shared between the Centre and the States. The proceeds of additional excise in lieu of sales tax are passed on to the states after deducting the share of the Union Territories and the costs of collection. The multiplicity of forms in which excise duties are lived complicates the structure and makes it difficult to assess the final burden. Therefore, the Government proposed to simplify the structure by merging the varrious excise duties into a single basic rate (except additional excise duties in lieu of sales tax). In 1985-86, a beginning was made in this direction. The Government also proposes to reduce the number of cesses. Merger of additional excise in lieu of sales tax with basic excise duties, though desirable, is not feasible as it would require evolving a suitable formula for allocating a part of the excise duties on textiles, sugar and tobacco, for distribution among the states.

Commodity taxes may take the form of either ad valorem duties or specific duties. Taxes levied as a percentage of the price of a product or input are called ad valorem duties. The higher the price the greater is the amount of tax. Though in the past specific duties, the tax is levied as a specified amount per unit. Though in the past specific duties predominated in the excise tariff, in recent years there has been a growing emphasis on ad valorem levies. Problems of evasion and related adminstrative problems led to the replacement of some ad valorem duties by specific duties. An important handicap of specific rates is that their revenue yeilds do not keep pace with inflation. However, the Government proposes to make arragement for periodical upward

revision of tax rates whenever there is an increase in prices. In this context, it may be noted that sales taxes are levied on ad valorem basis though excise duties are levied at specific rates.

15.3.5 Exemptions

At present central excise tariff is characterised by along range of nominal rates coupled with numerous exemptions. The Government of India proposes to systematically review the exemptions and rates of duty of Central excises.

Another area which requires special consolidation is the taxation of inputs. Taxation of inputs-raw materials, components, and other intermediates-generally distorts the production structure, which may result in reduction of the tax revenue. A major element in the reforms of indirect taxes will be to progressively relieve inputs of excise duties. To avoid the problem of taxation of inputs, the best means is to adopt a system of value added taxation. However, because of the difficulties in introducing a system of full fledged system of value added taxation (VAT), a modified system of VAT or MODVAT is proposed. MODVAT is not intended to give substantial relief in excise duty. The loss of duty on inputs will be recoupled through higher excise taxation of final products. MODVAT system is proposed in 1986-87 Budget.

15.3.6 Rate of Structure

The structure of excise rates on various commodities is the result of attempts made from year to year in successive. Budgets to mobolise additional resources and to achieve various socio-economic objectives through fiscal means. Revenue considerations often led to increase in the rates of excises. Commenting on the rate structure, the Indirect Taxation Enquiry Committee observed that the most striking feature about the rates was the wide amplitude ranging from 2 per cent to as high as 370 per cent. [illegible]ation of tobacco and petroleum products was left out the range was from 2% to 100%. In [illegible] the commodities subjected to excise duties were grouped into 133 tariff items.

15.3.7 Revenue Yield

In 1920-21 an amount of Rs.2.85 crores was collected from excise duties on 2 items (excluding salt). In 1950-51 the number of items was 13 and the yield was Rs.68 crores. By 1970-7 the number of items increased to 88 and the revenue yeild was Rs.1,759 crores. In 1976-77 the number of items increased to 124 while in 1985 the number of items stood at 133. The table appended to unit 13 shows the growth of revenue from indirect taxes and the contribution of excises to it. The contribution of excise duties to total tax revenue of the centre increased from 16.7% in 1950-51 to 52.0% in 1976-77. Subsequently, the contribution declined to 47.2% in 1985-86.

The growth in excise revenue has been due to various factors such as increased coverage, changes in tax rates, and increased consumption. Increase in tax rates, however, was the biggest factor in the growth of revenue according to the Jha Committee Report. The elasticity coefficient of excise revenue (in relation to National Income) was 0.79 for the period 1960-61 to 1978-79, i.e., less than one. The Indirect Taxation Enquiry Committee suggested that the indirect tax system should have the following objectives; (a) built-in elasticity with reference to national income; (b) progressivity in its over-all incidence; (c) non-neutrality of the tax system in relation to the objectives of efficient use of economic resources, growth of production, employment and investment; and (d) simplicity in administration.

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The Union Finance Minister in his statementt on the long term fiscal policy stated (19-12-85) that the basic thrust of the reform of the Central Excise Duties would be to simplify the multitude of rates and exemptions to provide relief in the taxation of inputs and to rationalise the special schemes aimed at helping the small scale industry. Representatives of trade and industry have stated that because of the disappearance of shortages in most areas, it is necessary to discard the earlier policy of realising additional revenue through stiff levies. It is said that a rise in the production and sale of goods will augment the revenues.

15.3.8 Incidence of Indirect Taxation in India

Studies by the National Institute of Public Finance and Policy and of the Ministry of Finance revealed a progressive distribution of indirect taxes with reference to consumer expenditure. Indirect tax burden as a proportion of expenditure increased progressively as the quantum of expenditure increased. However, the Jha Committee recommended that indirect taxes should be made more progressive. The need to promote the built - in revenue raising capacity of indirect taxes also was emphasised by the Union Finance Minister in his policy statement.

CHECK YOUR PROGRESS - I

1. What are the objectives of excise duties?

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2. Distinguish between ad valorem and specific duties?

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3. What is the defect of specific duty and how can it be rectified?

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4. What is meant by modified value added tax? (MODVAT)

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15.4 CUSTOMS DUTIES

15.4.1 Meaning

Customs duties may be defined as taxes imposed on goods entering a Customs area (import duties) or leaving a Customs are (Export duties). Under the Indian Constitution customs duties consisting of both import and export duties are exclusively Central taxes-imposed, collected and appropriated by the Centre and not shared with the states.

15.4.2 Need for Customs Duties

Customs duties may be levied for purposes of revenue or protection. When the objectives is to raise revenue, they are called 'revenue duties' and when the objectives is the protection of home industries they are called 'protective duties'. However, in several cases customs duties may be both protective and productive.

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Customs duties offer several advantages to a developing country. But it's very nature a customs duty is imposed when a commodity is imported but not if it is produced domestically. This may be consistant with the development plans of the country. Customs duties are particularily effective devices for accomplishing one of the objectives of development strategy, viz., restriction of imports of consumer goods, particularly those of luxury nature, and of capital goods not significant for economic development. Customs duties help in the reduction of demand for foreign exchange. They also help in influencing the allocation of resources. Further, it is easy to collect customs duties because they are collected at a few Customs houses. However, the importance of customs duties in a country depends upon the significance of foreign trade in that country.

15.4.3 Import Duties

The major component of India's Customs duties continues to be import duties. A duty on imports is among the oldest forms of taxation.. Even in the 4th century B.C.Kautilya in his Arthasastra laid down principles for the collection of tolls on merchandise which was imported or exported. The rationale for this approach was to keep the countries self-sufficient in respect of their basic needs. Only commodities of luxury nature were largely allowed to be imported. However, as countries developed, the character of international trade began to change. Not only silks and spices but even foodgrains and cotton began to move across the sea. By the time Adam Smith wrote his book in 1776, he was able to make out a convincing case for free trade. However, a number of factors leter on made the policy makers depart from the principle

of free trade. The desire to foster domestic industries was one of the reasons. Feeding and protecting the infant industries and the young industries became an important objective. The need to achieve balance in the country's external payments was another objective. Developing countries have been relying on import control as an additonal instrument for the purpose.

Prior to 1923 the policy pursued by the Government of India was based on the philosophy of free trade and the changes effected in the import duties were largely based on considerations of revenue. Following the recommendations of the Indian Fiscal Commission of 1921-22, the Government of India accepted the policy of discriminating protection. In the early years after Independence, while revenue considerations were not ignored, there was greater emphasis on making the import tariff help the country's industrial development. In the Fifties India's Sterling Balances began to decline and this led to a major tightening up of restrictions on imports. Around the middle of 1965 India's foreign exchange reserves came down to a critical level of less than 100 crores. It is against this background that a wide ranging rationalisation of import tariff was undertaken in August 1965. As a result, broadly 3 rates came into effect, namely, 40%, 60% and 100% ad valorem. Though there were only 3 standard ad voleram rates the effective rates were as many as seven 15%, 27.5%, 35%, 40%, 50% 60% and 100%

Another important attempt to rationalise the import tariff was made in 1971 when the above mentioned seven ad valerom rate of duty were replaced by four rates of import duty, viz., 30%, 40%, 60% and 100%. These form the structure of what are known as basic import duties. Under the Finance Act of 1963, the Government also assumed powers to impose a regulatory duty of customs on all imports.

In addition to the basic and auxiliary duties, there is an additional duty known as a countervailing duty levied under the Customs Tariff Act of 1975. The principle underlaying a countervailing duty is that when an indigenous product is subjected to an excise levy an equivalent addition should be made to the import duty to ensure that the protection provided by the import duty to domestic industry is not eroded.

Although 100 commodities are covered under import duty, the import items are mechinary and equipment, iron and steel, chemicals, motor vehicle parts, kerosine etc.

According to the long term fiscal policy of the Government of India, the basic thrust of customs tariff will be primarily to regulate imports and progressively reduce the role of quantitative import restrictions. At the present stage of industrial development a uniform system of nominal tariff rates for capital goods, raw materials and components may not be feasible. There will be a two-tier structure of customs for raw- material and components. Thus if the basic duty on raw materials will be some what lower than that on the components.

That import duties constitute the most important segment of revenue from Customs is obvious from the fact that while the estimated revenue from Customs for 1985-86 (BE) is Rs.7,881 crores, the expected yeild of import duties is Rs.7,696 crores i.e., 97.7% of the total. The estimated yeild from export duties is Rs.96 crores, i.e., 1.2% of customs. For the period 1060-61 to 1978-79 the elasticity coefficient of import duties at 0.59 was the lowest among the Central taxes. The indirect Taxation Enquiry Committee, however, was of the opinion that import duties would be fairly responsive to growth in income and prices.

15.4.4 Export Duties

Export duties have been levied on different commodities from time to time. These were

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an integral part of the early tariff policy. During the early part of the British rule export duties were levied at small ad valorem rates on many articles of export. The Indian Fiscal Commission (1921-22) suggested that export duties should be levied only on articles for which India had a monopoly or semi-monopoly. The Indian Taxation Enquiry Committee (1924-25) also endorsed this view. In the Post- Independence era, in order to promote Indian exports it became necessary to scale down export duties on a number of commodities like jute products, tea, textiles, mineral ores, etc. By the end of the Third Five Year Plan (1965-66) these duties virtually disappered. It is worth pointing out that Government have powers to impose and enhance export duties without prior approval of the parliament on the assumption that the duties are not born by the Indian consumer. Export duties are at present levied on some 19 items such as coffee, tobacco, raw cotton and iron ore. The levy of export duties becomes legitimate for commodities with inelastic home supply. The export duty leviable for commodities with inelastic home supply. The export duty leviable on each item takes into account inter alia factors like domestic production and likely exportable surpluses, demand for products in the foreign markets and the prices prevailing in the international market, changes in exchange rates, etc.

15.5 SALES TAX

15.5.1 Meaning

Sales tax is one of the few taxes levied vitually by almost all countries in the world. It is one of the elastic source of revenue. Sales tax is a tax imposed on sales or elements incidental to the sales, such as receipts from them of all or on a wide range of commodities.

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15.5.2 Development

Sales taxation was not unfamilier to ancient India. In modern India, however, no state had a sales tax before 1938. Today there is no state in India without sales tax. Under the Indian Constitution the states have the power to levy taxes on the sale or purchase of goods other than newspapers. Sales taxes are of 3 types: general sales taxes, sales ax on inter-state trade and sales tax on motor spirit. Taxation of inter-state sales is a Central levy and is administered under a separate Act.

Sales taxes are levied in 3 ways the single point, the double point and the multi-point, the last having the character of a general turnover tax. A majority of states impose only a single point tax. In some states there is a mixture of all the 3 types of taxes mentioned above. Andhra Pradesh is one such state. Therefore, a brief account of the levy of the Sales tax in Andhra Pradesh is helpful in understanding the complexity of the problem.

15.5.3 Sales Tax in Andhra Pradesh

Under the Andhra Pradesh General Sales Tax Act of 1957, a multipoint tax of five paise in the rupee has come to be imposed on the sale of some goods. But goods mentioned in the first schedule of the Act are liable to a single point sales tax at the point of (first) sale in the state. Goods mentioned in the second schedule also are liable to a single point purchase tax. Goods mentioned in the third schedule are 'declared goods' and are liable to a single point tax. Goods mentioned in schedule four are exempted from the tax. There is no minimum turnover limit for goods included in the scheduleds, whereas in the case of general goods the turnover

commodity. Luxury goods are taxed at rates varying from 10% to 15%. Sales tax is levied not only on consumer goods but also on raw materials, components and other inputs that go into the production of consumer goods as well as capital goods.

15.5.4 Revenue Significance

The bulk of State revenue is now accounted for by indirect taxes. Their share rose from 63%, in 1950-51 to 87% of the total tax revenue in 1976-77 and to 92% in 1982-83. Of these, the Sales tax was the most important and accounted for 57% of the States' tax revenue in 1976-77 as against 26% in 1950-51. In 1982-83 (Accounts) and 1984-85 (BE) also Sales tax contributed about 58%of the state's tax revenue. Further, the Indirect Taxation Enquiry Committee found that the yield from sales tax satisfied the criterion of built-in elasticity. For the period 1960-61 to 1978-79 the income elasticity coefficient of sales taxation was 1.38. Thus the elasticity of sales tax is greater than one. In developing countries where direct taxation cannot reach a large majority of population sales tax plays a major role as a source of development finance. As the Jha Committee remarked, sales become the one source of revenue which State governments developed to meet the increasing need for resources.

15.5.5 Reform of Sales Tax

However, it is said that as between the Central and the State indirect taxes, the former are more progressive. Therefore, there is need for making sales tax progressive in its incidence. The Jha Committee also recommended that some measure of uniformity in sales tax was necessary as rate differentials encouraged uneconomic diversion of trade in a manner which would result in a loss of revenue to the State with a higher rate of taxation. However, the States are unwilling to surrender to the centre their freedom to impose sales tax in the name of uniformity. There is also a suggestion that the present sales tax system should be replaced by Value Added Tax (VAT). But even the Jha Committee thought that it would not be prudent to think in terms of VAT even at the whole - sale stage (not to speak of the retail stage) in the near future. We shall discuss this in the next lesson.

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CHECK YOUR PROGRESS - II

1. What is the difference between revenue duties and protective duties?

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2. What are the aims of Customs duties?

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3. What is meant by countervailing duty?

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4. Discuss the importance of import and export duties in terms of revenue yield.

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15.6 SUMMARY AND CONCLUSIONS

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Excise duties, Customs duties and Sales tax are important indirect taxes. A begining was made towards the modern excise system in 1894. Between 1971 and 1975, the base of excise duties was widened to cover the entire range of manufactured products. In recent years, there is a shift from specific duties to ad valorem duties in excise tariff. The range of rates of excise duties is very wide from 2% to 37%. There is substantial increase in the constitution of excise duties, to total tax revenue of the centre. It's share increased from 16.7% in 1950- 51 to 47.2% in 1985-86.

Customs duties are levied either for revenue purpose or for protection. They help in reducing dem and for foreign exchange. Of the two components of customs duties namely, import duties and export duties, the former plays a dominant role yielding 97.2% of the revenue from customs duties. Wherever an excise duty is levied on an indigeneous product an equivalent adition will be made to import duty on the commodity in order to ensure protection for the product. This is called countervailing duty.

– Prof. M.L. Kanta Rao

15.7 SUGGESTED BOOKS

1. B.P.Thyagi : Public Finance
2. H.L.Bhatia : Public Finance
3. Hugh Datton : Public Finance

15.8 MODEL EXAMINATION QUESTIONS

I.Answer each of the following questions in about 30 lines

1. Explain the objectives and forms of Union Excise duties.
2. Examine the need for customs duties and the relative importance of the two components in it.

II.Answer each of the following questions in about 15 lines

1. Explain the development of sales tax and it's role in the tax structure of state governments.
2. Explain the rate structure and revenue yield of Union excise du `es.

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UNIT-16 : TAX POLICY SINCE INDEPENDENCE - RECOMMENDATIONS OF VARIOUS COMMISSIONS

Contents

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- 16.4.6 Committees on Indirect Taxation
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16.5 Summary and Conclusions

16.6 Suggested Books

16.7 Model Examination Questions

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16.0 AIMS AND OBJECTIVES

The unit explains the tax policy of India and the recomendations made by different Commissions in the sphere of direct and indirect taxation.

After reading this unit, you will be able to

* identify the importance of fiscal policy and taxation,
* distingunish between tax design and tax reform,
* analyse the tax structure of India,
* identify the suggestions made by various commissions on taxation, and
* identify the major elements in the long term fiscal policy of the Government of India of 1985

16.1 INTRODUCTION

Tax policy is a part of fiscal policy and it has a very important role to play in achieving economic growth and stability. In addition to resource mobilisation, tax policy in India has a number of objectives like equity, economic development, productive employment, etc.

The purpose of tax reform is to introduce the necessary correction mechanisam into tax structure when it is inadequate to fulfil the desired objectives. Various committees have been appointed to recommend suitable measures to make the tax structure development oriented.

A study team of the National Institute of Public Finance and Policy believed that high effective rate of taxation encouraged evasion of taxes. The Union Minister for Finance not only reduced the rates of direct taxation in the budget for 1985-86 but abolished the estate duty.

Recognising the importance of stability, in the sphere of taxation the Union Finance Minister announced a long term Fiscal Policy for India in December 1985.

16.2 IMPORTANCE OF FISCAL POLICY AND OF TAXATION

Fiscal policy has a very important role to play in securing economic growth and stability in less developed countries. The instruments of Fiscal Policy are taxation and spending, borrowing and lending, and buying and selling. Among these instruments taxation is a very potent instrument. Taxation can be used not only to discourageundesirablethings but also to keep alive or promote desirable things. Securing an adequate level of capital formation, is one of the fundamental needs of developing countries. It is also necessary to encourage enterprise, induce technological improvement and pave the way for efficient allocation of resources. Public sector saving put together may determine the capital formation which is required to bring about planned rate of growth. Any deficiency in the private sector saving must be filled inby a Public Sector saving. Tax policy must therefore help in securing an adequate level of saving. However verysteep rates of income and corporate taxation may affect savings. On the other hand some of the commodity taxes like sales taxation, excise taxation and customs duties may aggravate inequalities. A conflict may thus arise between the goals of growth and equity. Tax Policy therefore is concerned with the problem of adequately tapping the taxable capacity of the community through appropriate taxes. As such, tax policy has to concern itself with the level of taxation (tax-GNP rato) the composition of tax structure and the design of individual taxes which will subserve the interests of the community.

16.3 TAX DESIGN AND TAX REFORM

In this context it is necessary to distinguish between tax design and tax reform. Tax design is concerned with designing a tax or tax structure de nova where as tax reform is concerned with adjusting an already existing tax or a tax structure to changed circumstances. Tax design includes (a) imposition of an all together new tax (b) replacing an already existing tax by a new tax (c) abolishing an already existing tax to give a new appearance to the tax structure and (d) introducing new tax base and or new rate structure to the existing tax. Tax reform includes introducing changes in the existing tax base, tax rates, exemptions, concessions and the administrative procedure. Tax design refers to tax engineering aspect and tax reform refers to periodical repairs to the structure after it is designed and installed. Tax design is the science and art of creating the structure of tax and /or the tax structure as a whole. If in the course of operation, a tax/tax structure is not found to be fulfilling the objectives originally planned, then introducing the required corrections into the tax design become necessary. This is the core of Tax Reform.

During the second half of the 20th century the field of tax reform has been the subject not only of an increasing number of studies but also on continuous attempts to change fiscal system. The model for tax reform generally accepted in the sphere of direct taxation is that of broadening of the personal and corporate income taxation and of improving the taxation of Wealth. In the sphere of indirect taxation the reform is attempted through the use of value added tax (VAT). In the 'fiscal reform market', quite a few models are available and the relevant model appropriate for the conditions in the economy, and the model which can achieve the objectives laid down, has to be selected.

We shall therefore try to understand the (a) objectives of tax policy pursued in India (b) how far these objectives have been achieved and (c) the possible lines of reform necessary to enable the taxes to achieve the objectives set forth. Several committees have gone into the working of the Indian tax structure either in full or in parts and made hundreds of recommendations. However it should be remembered that tax policy cannot do miracles. Taxation is only one element in a complex net work of institutions practices and relationships that characterise a society.

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CHECK YOUR PROGRESS - I

1. What are the instruments of fiscal policy?

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2. What are the goals of tax policy?

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3. Explain the terms tax design and tax reform.

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16.4 THE TAX POLICY OF INDIA

The tax structure in India was not designed by any master archiect with definite objectives in mind. It has grown up haphazardly, influenced by historical factors and the thinking of foreign rulers till 1947. In the post independence era, the role of taxation for raising resources needed for economic development was recongnised. It was also thought that taxation could be used to reduce inequalities and to promote public investment. So the fundamental principle underlying the tax structure of India was the principle of mobilisation of economic surplus. Taxation must moblise the increase in the surplus that arises as a result of development efforts. While mobilising resources for economic development taxation should also promote equity.

Tax policy, like other governmental policies, derives it's meaning and direction from the aspirations and goals of the society within which it operates and of the people whom it serves. In a planned economy the goals of tax policy can not be different from the objectives of planning. Th tax policy of India since April, 1951, has to be viewed in this context. Firstly, taxation has been considered as a powerful instrument in the hands of the Government to transfer purchasing power from individuals to Government. Secondly, taxation is expected to reduce inequlities in income and wealth because social, economic and political stability is not possible in the absence of welfare of weaker sections of society. The major question is whether the first and second objectives can be achieved simultaneously. Thirdly, taxation has to provide incentives for capital formation in the credit sector. Fourthly, taxation has to check inflation through discouraging consumption.

16.4.1 Tax Reform in India

Motivated by the desire to improve the efficiency of tax system as a whole or of individual taxes, the Government of India appointed several committees and commissions. In the preindependance era the Indian Taxation Enquiry Committee of 1925 made a study of the Indian tax scene. Nearly thirty years after that the Government of India appointed the Taxation Enquiry Commission in April, 1953, with Dr. John Matthai as the Chairman. The Commission was asked to examine the tax system of the Central, State and local Governments, in relation to the objectives of economic development and equity. The Commission was also asked to suggest modifications in the tax system wherever necessary. The report of the commission was submitted in three volumes. Volume I dealt with the tax system as a whole of all the 3 tiers of the Government. Volume II was devoted to a detailed examination of the Central taxes particularly income tax, corporation tax, customs and excises. Volume III was devoted to a detailed examination of the state taxes. The problems of local finances also were considered in the third volume. The Commission held that Indian taxation on the basis of then existing rate structure and base structure did not fully tap the taxable resources of the country. In the sphere of state taxation the commission held that sales tax must tax continue to be a state tax. However inter-state sales would be the concern of the Centre. The Centre should control the taxation of raw material also. On the whole the commission attempted systematic reorientation of the traditionally conservative and regressive Indian tax structure to fullfil the requirements of development planning (like Tax holiday, Development rebate etc.,).

16.4.2 Nicholas Kaldor's Report

In January 1956, Nicholas Kaldor of Cambridge University was asked by the Finance Ministry to investigate and suggest changes in the Indian tax structure in view of the revenue requirements during the second plan period. Kaldor concentrated mainly on direct taxation and suggested a number of significant changes. He suggested a number of taxes in what was called an integrated direct tax system. Five taxes, income tax, capital gains tax, annual wealth tax, personal expenditure tax and the general gift tax-should all be assessed simultaneously on the basis of a single comprehensive return. He asserted that an effective system of progressive taxation is vital to the survival of democratic institutions in India. The maximum rate of income tax however was not to be more than 45%. Kaldor considered expenditure as a better index of ability than income. A progressive tax on expenditure at rates ranging from 25% to 300% was recommended. Capital gains are to be included in taxable income. An annual tax on wealth and a gift tax to prevent avoidance of estate duty were recommended by Kaldor.

He thought that the introduction of a personal expenditure tax and an annual tax on wealth would serve the purpose of mitigating the severe disincentive effects on work, saving and enterprise of a highly progressive tax levied on income. According to him companies are to be taxed at a nonrefundable flat rate of 7 annas a rupee (about 44%) on all profits distributed and undistributed and all other business taxes are to be abolished. With regard to the control of evasion of business income he recommended that there should be a compulsory auditing of accounts of income in excess of Rs.50,000 in the case of business income and Rs.1,00,000 in the case of other personal income. Control of tax evasion would bring in additional revenue for the second plan. He thought that a comprehensive return of income and a self checking system of taxation would help economy in raising the necessary resource.

In December 1958 Kaldor submitted his proposals for Tax reform. In the last few years India made a fair start towards creating an effective system of progressive taxation with the introduction of new taxes on capital gains, on wealth, on personal expenditure and on gifts. It has thus laid the basis for a system which may serve as a model to other democracies. But it is no use blinking the fact that the reforms so far introduced are at best a begining that the legislation of some of the new taxes is seriously defective, while the measures for their effective

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administration have not been provided and that other and equally important reforms in the field of business and company taxation have not been tackled at all. He even warned that unless some of the legislation introduced at that time was amended and was supplemented by legislation in important respects and by reforms in the administrative field there was a serious risk that the noble attempt at creating an egalitarian democracy would end in failure. Though Kaldor recommended a maximum Income tax rate of 45%, it has not been done so far. Even company taxation has not been reduced to the level of 7 annas in the rupee. Expenditure tax introduced on the basis of his recommendation also was not continued and was abolished in 1966.

16.4.3 Recommendations of Wanchoo Committee

In the field of direct taxation, two other committees were appointed. *The Direct Taxes Enquiry Committee headed by justice K.N.Wanchoo* was appointed in March 1970. The committee submitted its report in January 1972. The committee recommened reduction of the maximum marginal rate of income tax from 97.75% to 75%. It also recommended relief in taxation to middle and lower income groups. It recommended that every income tax payee should be allocated a permanent number. The committee did not favour the merging of the income of husband and wife for tax purposes. Though the committee had limited terms of reference, it made very useful suggestions. The committee made it clear that the foremost reason for tax evasion was the prevalence of high tax rates.

16.4.4 Recommendations of Choksi Committee

The Direct Tax Laws Committee known as the Choksi Committee was appointed in June 1977 and presented its report in Sept.1978. The committee made wide ranging recommendations for procedural and administrative improvements in the laws of four direct taxes viz. income tax, wealth tax, gift tax and surtax. The committee suggested a consolidated tax law for all the four taxes levied and collected by the Union Government. A maximum marginal rate of 60% was recommended on incomes exceeding Rs. 2 lakhs. The committee recommended abolition of surcharge on income tax.

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16.4.5 Recommendations of K.N.Raj Committee

The Committee on Taxation of Agricultural Wealth and Income known as K.N.Raj Committee was appointed in February 1972 and submitted its report in Oct. 1972 The committee recommended that the existing system of land revenue should be replaced by an Agricultural Holdings Tax (AHT). The committee also recommended the integration of agricultural income and non agricultural income for determining the rate of income tax on non-agricultural income.

16.4.6 Committees on Indirect Taxation

In the sphere of Indirect taxation different aspects of tne problem have been studied by the Chanda Committee in 1963, the one man committee of Sri Bhoothalingam, in 1965, the customs study team headed by Sri D.N.Tiwari in 1967 and another committee headed by Sri Venkatappaiah L.K.Jha Committee :

Considering the importance of indirect taxation on the fast changing economic scene, a committee headed by Sri L.K.Jha, known as the Indirect Taxation Enquiry Committee was appointed which submitted its final report in 1978.

The Committee observed that the prime purpose of a tax system is to mobilise real resources needed for promoting economic and social progress. From the economic view point the tax system should encourage the kind of economic activity to sustain for which resources are being mobilised. At the same time it should not reduce the efficiency of resource use. For the tax

UNIT-18 : PATTERN AND GROWTH OF PUBLIC EXPENDITURE IN INDIA

Contents

18.0 Aims and Objectives
18.1 Introduction
18.2 Classification of Public Expenditure
18.3 Classification of Public Expenditure in India
18.4 Pattern and Growth of Public Expenditure in India
18.5 Conclusion/Summary
18.6 Suggested Books
18.7 Model Examination Questions

18.0 AIMS AND OBJECTIVES

The purpose of this unit is to examine different methods of classification of Public Expenditure, to discuss the classificatory scheme adopted in India and to study the patterns and growth of Public Expenditure in India.

After reading the unit, you will be able to

* classify the Public Expenditure into various categories,
* identify the functional classification in India and
* examine the pattern and growth of public expenditure in India.

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18.1 INTRODUCTION

In order to understand the pattern and growth of Public Expenditure, it is necessary to understand the classificatory scheme adopted for the purpose. Classification means a systematic arguement of the items of expenditure on some scientific basis. Each expenditures may assist growth while others may be useful for reducing economic inequalities. Some expenditures may be necessary for the short-term point of view while others may be necessary for the short term point view. A proper classification of Public Expenditure helps us to understand broadly the effects of the expenditure incurred.

18.2 CLASSIFICATION OF PUBLIC EXPENDITURE

The classification of public expenditure should satisfy two conditions, first, the classes should be mutually exclusive. In other words, if any item of expenditure should belong to only one class. If the classification is not proper, it would be difficult to say whether an item belongs to one class or another. Only when the classes are mutually exclusive, it would be possible to consider a particular expenditure under one particular category. Secondly, the basis of classification should be an imprtant characteristic of public expenditure. For instance, if the public expenditure is mainly intended for providing benefits to different sections of the society. It has to be classified on the basis of the benefits conferred on different groups. If these two principles are followed, the classification becomes scientific. The following are some of classifications suggested in the past.

18.2.1 Basis of Benefit

Since the objective of public expenditure is to create benefits to the people, it can be

classified on the basis of the extent of benefits conferred on different sections of people. On this basis, Cohn and Plehn classified public expenditure into four classes. The *first class* is the expenditure which confers common benefits on all. Expenditure on education, health, transport, general administration etc., belong to this category. The *second category* is the expenditure which confers a special benefit on some groups. Expenditure on police, justice, etc., belongs to this category. Even though these services benefit the entire community particular sections who need protection derive a special benefit. *The third category* is the expenditure which directly confers a special benefit on certain groups and indirectly on the entire society. Expenditure on social security, unemployment relief, old age pension, etc, are examples for this category, The *fourth category* is the expenditure do not confer any benefit on the enitre community or on any group. Subsidy given to a particular type of industry may be taken as an example for this category.

18.2.2 Basis of Functions or Functional Classification

This classification takes functions of the government as the basis and classifies expenditure according to these functions. This classification was first adopted by Adam Smith and it was supported by Basatable. On this basis, the public expenditure may be classied into : (i) protective expenditure which includes purchase of arms and ammunitions, maitenance of army, police, administration of justice and jails, etc., and (ii) commercial expenditure which includes rail, roads, highways, etc., and (iii) development expenditure which includes expenditure on education, health, Public utilities etc.,

This classification had the advantage of distinguishing one type of expenditure from another on the basis of its effect on the welfare of the people. But the major difficulty with this classification is that it is not possible to say that a particular expenditure is protective but not developmental on commercial but not developmental. For instance, public expenditure on transportation is not only commercial but also development.

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18.2.3 Basis of Revenue

This classification based on the income received by the government was developed by Nicholson. According to this classification, public expenditure will be divided into four categories.

The *first category* is the expenditure which does not result in any direct return. Expenditure on poverty relief may be cited as an instance. The *second category* is the expenditure which provides indirect return, Expenditure on primary education may not generate income directly but it facilitates increase in productivity in the future. The *third category* is the expenditure which results in a direct return of a part of the expenditure incurred. Providing higher education by collecting some fees may be taken as an example because the fees collected may not cover the entire cost. The fourth or the *final category* is the expenditure which results in full return or even profit. Expenditure incurred by Postal and Railway Departments are examples of this category.

This classification is also not fully satisfactory. Some expenditure may not have any direct return but they may have indirect returns. For instance, expenditure on defence and poor relief may have indirect effects on national income. Further, this classification is based on income returns. But the major goal of government expenditure is not the earning of income. Hence classification of public expenditure on the basis of revenue is not appropriate.

18.2.4 Basis of Importance

This classification was adopted by Shirras who divided expenditure into (a) primary expenditure; and (b) secondary expenditure. **Primary expenditure** includes all expenditure which every government must undertake viz.expenditure on defence maintenance of law and order and repayment of public debts. All other expenditures are treated as secondary. But in modern times, some expenditures such as those on education and health are also equally important and

18.2.5 Dalton's Classification

Dalton classified public expenditure into grants and purchase prices. When the government incurs and expenditure receiving no service or commodity in return, it is called a **grant**. Unemployment relief, pensions, etc, are grants. When the government spends money and gets some service in return it is a purchase price salary paid to government employee is a **purchase price.**

This classification of public expenditure into grants and purchase prices is similar to the division of public revenue into taxes and selling prices. In the case of taxes, there is no direct return from the government to the tax payer. In the same manner, the person receiving the grant does not provide any service to the government in return. On the other hand, in the case of the purchase prices, the government recieves some commodity or servie in return. Purchase price in public expenditure is similar to selling price in the case of public revenue. However, this classification of public expenditure into grants and purchase price has the limitation that the two categories are not mutually exclusive. Certain expenditures of the government will appear from one angle and purhcase price from another angle . Interest on public debt and pensions are examples of this category. If we take the present only into account, they can be classified as grants becuase no commodity or service is received by the government in return for the payment. But these payments are made because of the services or commodities provided by the receipients in the past. From this part of view, these expenditures should be treated as purchase prices.

18.2.6 Pigou's Classification

According to Prof. Pigou public expenditure can be classified as transfer expenditure and non-transfer expenditure. **Transfer expenditure** refers to that expenditure which is incurred by gvernment for the benefit of citizens such as old age pensions, unemployment allowances, free medical aid etc., On the contrary **non-transfer expenditure** refers to that expenditure which is incurred by the government for its own benefit. For example, the expenditure incurred on administration is known as non-transfer expenditure. However, the main limitation with this classification is that there is no clear line of demarcation between the transfer and non-transfer expenditure.

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CHECK YOUR PROGRESS - I

1. How do you classify the public expenditure on the basis of benefit.?

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2. What are the categories of public expenditure on the basis of functions?

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3. Explain Pigou's classification of public expenditure.

18.3 CLASSIFICATION OF PUBLIC EXPENDITURE IN INDIA

India has been adopting economic-cum-functional classification of public expenditure since 1957-58. In the economic classification a distinction will be made between revenue and capital accounts. The expenditure on various departments and services necessary for the normal functioning of the government is called revenue or current expenditure. This expenditure does not build any assets necessary for the economic development of the country. Examples of revenue expenditure are payment of salaries and other allowances to the government employees, contribution to internation organisations, expenditure on health and education etc. This expenditure may not have a direct impact in the economic growth but some expenditures on this account are necessary for economic growth in the long run. For instance, expenditure on education and health may not assist economic growth in he immediate future but they certainly help to achieve a higher growth in the long run. Capital expenditure is meant for the acquisition of capital assets like land, buildings, machinery and equipment etc. This expenditure is generally financed out of receipts from market borrowings, borrowings from the Reserve Bank of India, foreign government and international institutions.

Though it is said in a broad sense, that revenue expenditure is non- developmental and capital expenditure developmental, it is not true in the real sense. Certain capital expenditures may be non-developmental and certain revenue expenditures may be developmental. Hence it is to classify capital expenditure as developmental and non-developmental. Similarly, revenue expenditure is also classified as developmental and non-developmental.

Since India has been adopting Five-Year Plan, public expenditure is classified as Plan and Non-Plan expenditure. This distinction can be clarified through an example. Suppose a new school is proposed during the Seventh Five Year Plan. The expenditure incurred on this will be treated as plan expenditure. Obviously some part of it will be revenue expenditure and some part will be capital expenditure. But both of them taken together consitute plan expenditure during the sevnth plan period. But during the next plan period, the expenditure on this school for payment of salaries or for repairs buildings well become non-plan expenditure. It sould be noted that the following plan period this expenditure will be merely a continuation of the past economic activity. To cite another example, if a post is created, it becomes plan expenditure till the end of that plan period during which it is created. But during the subsequent period, it becomes non-pan exepnditure. This distinction between plan and non-plan expenditure is necessary because new activities undertaken in each plan period should be distinguished.

The functional classification of the expenditure in India takes into account the followig categories.

a) General services

b) Economic services

c) Social and Community services

d) Defence services

e) Loans and advances to State and Union Territory Governments

The classification given above is applicable to both and capital expenditure. For instance.

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general services in the capital account refer to construction of office buildings for the organs of the state such as parliament and its wings administration of justice, elections, etc. The contributions of the government to international organisations like the UNO,IMF,IBRD, etc., are also included in this account. In the category of defence services, expenditure on salaries, pensions and other retirment benefits comes under revenue expenditure whereas expenditure on construction of buildings and purchases of machinery, tools, etc, for the army, navy and air force comes under capital expenditure. The components of social and community services are education, health, family welfare, labour and employment, etc. These expenditure are meant for human capital formation. These expenditures are meant for human capital formation. The expenditures are also classified as capital and revenue expenditure. For the rapid economic development of the country, certain services include agriculture and allied services, industries, export promotion, irrigation, power, transport, communications, etc. The last category namely, gransts-in-aid to State and Union Territory Governments includes loans and advances given to them and also to the public enterprises.

18.4 PATTERN GROWTH OF PUBLIC EXPENDITURE IN INDIA

Since the inception of planning India, there has been a phenomenal increase in public Expenditure. This increase is observed in both developmental and non-developmental expenditures. The growth in Public expenditure since 1950-51 can be observed from the data provided in Table 1.

TABLE 1

Growth of Public Expenditure in India (Centre, State, Union Territories)

(Rs. in Crores)

Year	Public Expenditure	Gross National Product	% of Public Expenditure in Gross National Product
1950-51	899.8	9,136	9.8
1955-56	1,437.2	9,710	14.8
1960-61	2,673.4	13,999	19.1
1965-66	5,464.5	21,866	25.0
1975-76	17,305.0	66,227	26.1
1980-81	35,258.0	1,14,319	30.8
1981-82	39,977.0	1,48,671	26.9
1982-83	46,098.0	1,64,399	28.0
1983-84 (R.E.)	54,678.0	1,92,000	28.5
1984-85 (B.E.)	60,280.0	2,17,500	27.7

Source : **Basic Statistics Relating to Indian Economy,**
C.S.O., Government of India.

The total public expenditure increased from Rs.899.8 crores in 1950-51 to Rs. 35,258.0 crores in 1980-81. Thus, it increased by about 40 times. A better way of understanding the growth of public expenditure is to take its proportion in the gross National Product. Even in this respect we find that it increased continously from 9.8 percent in 1950-51 to 30.8 per cent in 1980-81. Thus, we find a continuous increase in the public expenditure during the past three decades.

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TABLE 2
Growth of Developmental and Non-Developmental Expenditures (Central, State and Union Territories)

(Rs. in Crores)

Year	Developmental expenditure	Non-Delopmental expenditure	Others	Percentge in Total Public Expenditure Developmental expenditure	Non-Developmental expenditure
1950-51	326.3	545.0	28.5	36.2	60.6
1955-56	667.3	654.1	115.8	46.4	45.5
1960-61	1,260.7	1,033.6	379.1	47.1	38.7
1965-66	2,387.3	2,140.3	936.9	43.7	39.2
1975-76	8,181.5	7,142.6	1,980.9	47.3	41.3
1980-81	17,715.5	13,293.2	4,249.3	50.2	37.7
1981-82	20,794.0	14,992.0	4,191.0	52.0	37.5
1982-83	23,794.0	17,897.0	4,407.0	51.6	38.8
1983-84 (R.E.)	27,905.0	21,940.0	4,833.0	51.0	40.1
1984-85 (B.E.)	30,840.0	23,418.0	6,022.0	51.2	38.8

Source : **Basic Statistics Relating to Indian Economy,**
C.S.O., Government of India.

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The effect of public expenditure on the economy depends on the nature of the expenditure, i.e., whether it is developmental or non-developmental. It is not possible to understand the effects of public expenditure by merely examining its size. A very important classification to understand the effects of public expenditure on the ecoomy is to classify it as developmental and non-developmental expenditure . Public expenditure in India according to this classification is shown in Table-2. It can be observed that developmental expenditure increased from Rs.326 crores in 1950-51 to 17,715 crores in 1980-81 whereas non-developmental expenditure increased from Rs. 545 crores to Rs.13,293 crores during the same period. In other words, while developmental expenditure increased by about 55 times, the non-developmental expenditure increased by only 24 times. Thus, we find that developmental expenditure grew at a faster rate than the non-developmental expenditure, its share in total expenditure also increased substantially. In 195051, developmental expenditure accounted for 36.0 per cent of total expenditure while non-developmental expenditure accounted for 60.6 per cent. But by 1980-81 these proportions changed substantially and developmental expenditure rose to 50.2 per cent and non-developmental expenditure came down to 37.7 per cent. Thus, we find a drastic shift in the pattern of expenditure during the three decades under consideration.

In order to examine the public expenditure incurred under different functions, data are provided for the expenditure of the Government of India. In other words, expenditures of the State Governments and Union Territories are not included here. Table 3 provides this formation.

In 1980-81, social and community services accounted for Rs.1007.8 crores and economic services accounted for Rs.5405.5 crores. Their shares in total expenditure are 5.44 per cent and 29.17 per cent respectively. There is a slight increase in the share of social and community services, i.e., during the period 1965-66 to 1980-81. A major portion of this expenditure is accounted for by education and health.

TABLE 3

Expenditure of the Central Government

(Rs. in Crores)

	1965-66 Amount	Percent	1970-71 Amount	Percent	1975-76 Amount	Percent	1980-81 Amount	1984-85 Percent	1986-87 (B.E.) Amount	Percent	Amount	Percent
Development Expenditure	1081.9	(39.77)	1477.5	(35.86)	3945.4	(41.80)	8549.7	(46.14)	18504.8	(51.80)	23559.4	(49.13)
Social Community Services	131.5	(4.83)	227.4	(5.52)	601.0	(6.37)	1007.8	(5.44)	2146.0	(6.01)	3293.4	(6.87)
1. Education	87.2	(3.21)	159.2	(3.86)	355.9	(3.77)	542.3	(2.93)	1257.0	(3.51)	1712.5	(3,57)
2. Medical, Public Health & Water Supply	15.2	(0.56)	28.7	(0.70)	59.7	(4.63)	116.4	(0.63)	211.9	(0.60)	-387.8	(0.81)
3. Others	29.1	(1.07)	39.5	(0.9[illegible])	185.4	(1.96)	349.1	(1.88)	677.1	(1.90)	1193.1	(2.49)
I. Economic Services	714.4	(26.26)	863.7	(2[illegible].96)	[illegible]703.4	(28.64)	5405.5	(29.17)	12029.6	(33.67)	14250.2	(29.72)
1. Agriculture & Allied Services	21.1	(0.78)	77.6	(1.88)	7[illegible]7.4	(7.71)	1127.88	(6.90)	2570.2	(7.19)	2900.9	(6.05)
2. Industry	183.6	(6.75)	296.7	(7.20)	1001.5	(10.61)	1641.2	(8.86)	5200.6	(14.56)	5561.8	(11.60)
3. Others	509.7	(18.74)	489.4	(11.88)	[illegible]6.0	(8.54)	2485.5	(13.41)	4258.8	(11.92)	5787.5	(12.07)
II. Grants-in-aid to States & Union Territories		236.0	(8.68)	386.4	(9.38)	[illegible]41.[illegible]	(6.79)	2133.8	(11.52)	4329.2	(12.12)	6015.8 (12.54)
Non-Developmental Expenditure including defence		1638.5	(60.23)	2643.0	(64.14)	5493.5	(58.20)	9979.2	(53.86)	17219.2	(48.20	24396.4 (50.87)
tal Expenditure		2720.4	100.00	4120.5	100.00	9438.9	100.00	18528.9	100.00	35.724.0	100.00	47955.8 100.00

Economic services account for Rs.5405.2 crores or 29.17 per cent of the total expenditure. This item is also getting an increasing share during the period under consideration . Agriculture and industry are the major items belonging to this category of which industry is accounting for a higher share. However, there is a phenomenal increase in the expenditure on agriculture. It increased from Rs.21.1 crores in 1965-66(0.78 percent) to Rs.1278.8 crores (6.90 percent) Thus, we find that agriculture received emphasis only after the mid 60s.

Another important category is the non-developmental expenditure which includes Defence. This expenditre, though it has increased in absolute terms, has not received any increasing share. Its share in the total expenditure declined from 60.23 in 1965-66 to 53.86 per cen in 19809-81.

18.5 CONCLUSION/SUMMARY

In order to understand the pattern and growth of public expenditure in India, it necessary to understand the classification of public expenditure. Any classificatory scheme would be scientific if the classes are mutually exclusive. The basis of classification is an important characteristic of public expenditure. For instance, the classification based on revenue is not suitable because the major goal of public expenditure is not the earning income. Most of the systems of the classification do not satisfy the condition that the classes shown to be mutally exclusive. If benefit is used as the basis of classification, it is difficult to say whether a particular expenditure benefits a particular group of people or the entire community. The functional classification has the disadvantage that it is not possible to say whether a particular expenditure is protective but not developmental or commercial but not development. The basis of revenue does not take indirect returns into account and the basis is not an appropriate one.

In India, economic-cum functional classification has been adopted. The economic classification distinguishes between revenue and capital accounts on the other. The functional classification distinguishes the general services, economic services, social and community services, defence services etc., from one another

There has been continous increase in public expenditure in India. The proportion of the public expenditure in the Gross National Product increased from 9.8 percent in 1950-51 to 30.8 percent in 1980-81. This increase is mainly due to the growth of developmental expenditure. While developmental expenditure increased by about 55 times, non-developmental increased by only 24 times. As a result of this, there is a shift in the pattern. In 1950-51, these proportions changed substantially and the developmental expenditure rose to 50.2 percent and non- developmental expenditure came down to 37.7 percnet. The expenditure pattern of Government of India reveals that there has been a substantial increase in the expenditure on agriculture after mid 60s.

– Prof. S. Subramanyam

18.6 SUGGESTED BOOKS

1. H.Dalton : *Public Finance*
2. B.P.Thyagi : *Public Finance*
3. H.L.Bhatia : *Public Finance*

18.7 MODEL EXAMINATION QUESTIONS

I. Answer th follwing in about 30 lines each.

1. Explain different classification of Public expenditure.
2. How is public expenditure in India classified.

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II. Answer the following in about 15 lines each.

1. Explain the classification of public expenditure on the basis of benefit and functions.
2. Explain Nicholson's and Dalton's classification on public expenditure.
3. Breifly analyse the pattern and growth of public expenditure in India.

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UNIT-19 : EFFECTS OF PUBLIC EXPENDITURE

Contents

19.0	Aims and Objectives
19.1	Introduction
19.2	Effects of Public Expenditure on Production
19.3	Effects of Public Expenditure on Distribution
19.4	Other Effects
19.5	Summary and Conclusion

19.0 AIMS AND OBJECTIVES

This unit examines the effects of public expenditure on production, distribution and diversion of resources across areas and uses.

After reading the unit, you will be able to

* examine the effects of public expenditure on production,
* analyse the influence of public expenditure on income distribution, and
* discuss the effects of public expenditure in achieving economic stability and economic growth.

19.1 INTRODUCTION

It has been pointed out in the previous lesson that economic development leads to an increase in public expenditure. In India public expenditure accounts for 33 percent of the gross national product. This huge amount of public expenditure should not be viewed as a mere financial mechanism. It effects the level and composition of production as well as the pattern of distribution of income Thus, it is an instrument for achieving the desirable objectives of growth with social justice.

Public expediture can influence the pattern of utilisation of economic resources in two ways; First, resources which are unutilised previously may be utilised with the help of public expenditure. Private individuals may not be willing to invest in these sectors either becuase they need huge investments beyond the capacity of private individuals or because investment in these sectors may not be profitable. For instance, the generation of electricity needs a huge investment and it may not result in appreciable profits. Public expenditure on these will incresase production. Secondly, public expenditure may influence the direction of the utilisation of services. This, in turn, affects the composition of the output which is very essential for achieving the objective of social justice. If production activity is allowed to be regulated by the market mechanism, only those goods which have greater demand will be produced and the resources will be used for the production of only these commodities. Due to lack of purchasing power, commodities needed by the poor known as 'wage goods' will not be in great demand and hence their production will neglected. In such a situation, public expenditure may help directly or indirectly in diverting the resources for the production of wage goods. The effects of public expenditure may be seen more clearly, if considered in relation to production and distribution seperately.

19.2 EFFECTS ON PRODUCTION

The effecs of public expenditure on production can be either direct or indirect. For instance, expenditure on irrigation is directly productive. On the other hand, expenditure

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on socio-economic infrstructure like roads, communications and human capital formation like education and health are indirectly productive.

Dalton analyses the effect of public expenditure on production by considering the following factors:

(a) effects on the ability to work, save and invest;
(b) effects on the willingness to work, save and invest; and
(c) effects on the division of economic resources between different localities and uses.

19.2.1 Effects on Ability to Work, Save and Invest

If public expenditure can influence the capabilities of an individual, his ability to work increasess. Public expenditure on health, education, housing facilties, etc, will increase the worker's efficiecy. But some of these expenditure should be provided only in kind because grants in money may be used for a different purpose thereby defeating the major objective of this expenditure. For instance, expenditure on education and health will be more effective if they are provided in kind. Some of the expenditure may not have a direct impact on the efficiency of the recipients but may effect the future efficiency of the recipients but may affect the future efficiency of the children of the recipients. Expenditure on widow pensions is an example of this.

Public expenditure can increase a person's ability to save if it gives him an additional margin for saving. Public expenditure on health and education can increase the ability to save because private individuals need not spend on these services. But the amount needed for this expenditure has to be collected from the individuals by way of taxes. Thus, the ability to save of the persons from whom taxes are collected will be reduced. It is difficult to decide the net effect of these two forces. Public expenditure will increase the ability to invest if it places funds in the hands of those who undertake capital investment.

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19.2.2 Willingness to Work, Save and Invest

The effect of public expenditure on the desire to work, save and invest is not so clear. Whether public expenditure increases or decreases the desire to work, save and invest depends more on the expectations of the individuals regarding future receipts rather than on the present receipts. The expectation of fixed, periodical and unconditional receipts will not increase the desire the work or save. War pensions and interest on war loans adversely effect the desire to work and save, since these incomes are assured to the individuals.

On the other hand, certain grants are provided under special circumstances only. Sickness and maternity leave benefits belong to this category. Public expenditure on these items will no destroy the desire to work and save. They may even increase the desire to work. For instance, if these grants increase proportionately with income, the desire to work increase. But it is difficult to operationalise this method. If grants decrease with work, the desire to work and save will be adversely affected. Another situation in which grants affect the desire to work and save is when they are given on the basis of the economic position of the individual. For instance, if unemployment benefits are linked to the income of the household, the desire to work and save may be adversely affected. Public expenditure on maintaining law and order will create confidence in the minds of the people and encourages investment in production actitivies.

19.2.3 Diversion of Economic Resources

Public expenditure is an effective tool for achieving diversion of resources. This diversion can take place in a variety of ways. First, resources can be diverted from one locality to another through public expenditure. This diversion may some times increasse the production power. Special grants to poorer areas for developing their socio-economic infrastructure may improve

the economic efficiency of the people in those areas. Similarly, th establishment of industries in the backward areas may solve the problem of unemployment. But there are many difficulties in establishing industries in the backward areas. Only public expenditure is capable of solving some of these problems. A second type of diversion is temporal diversion. Public expenditure can divert resources from the present use to their future use. Under capitalism where public expenditure is minimal, too little provision will be made for the future. This is so because individuals tend to discount the future. In other words, people prefer to spend Rs.100 this year rather than have Rs. 105 to spend in the next. This tendency becomes all the more clear if we consider a distant future. A person may prefer to spend Rs.100 now rather than Rs. 1,000 after 30 years. Further even if they make provision for the future, it will be in the form of material capital rather than human capital. Thus, public expenditure to increase economic provision for the future will create a better balance between the present and thefuture and makes for continous increasse in the productive power. Finally, another type of diversion that can be achieved through public expenditure is diversion of resources for different uses. Expenditure on defence, police, civil administration, etc., diverts resources from the private sector to public sector. Such an expenditure expenditure is sometimes looked upon as economic waste. In the case of expenditure of this type, the advantage of achieving greater security must be balanced against the disadvantage of doing without those commodities which would have been produced in the absence of the expenditure on security. However, some forms of public expenditure may increase the productive power if the funds are left in the private hand. Expenditures on transport development, irrigation afforestation, research, education, public health and social security belong to this category.

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CHECK YOUR PROGRESS - I

1. How does public expenditure affect ability to work, save and invest?

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2. How is public expenditure useful in diverting economic resources for improving the efficiency.

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19.3. EFFECTS ON DISTRIBUTION

Public expenditure influence the distribution of income. It should be accepted that the pattern of public expenditure which reduces inequalities in the distribution of income as desirable. Of all types of public expenditure, grants and subsidies will have a more definite impact on the distribution of income than the others. But whether they narrow down or widen economic inequalities depends on the nature of the grant or subsidy provided. Grants can be classified into three categories - proportional, progressive, and regressive. A grant is said to be proportional if

It is regrssive if the proportion increases with income. For instance a fixed and equal old age pension would be progressive in respect of individuals because the proportion of the grants in total income declines. On the other hand, interest on public debt is regressive, because the higher income groups who contribute to it more than propotionately recieve relatively larger amounts of interest.

Regarding the effect of grants on income distribution, it is obvious that a progressive grant system tends to reduce inequality. But a sharply regressive grant system tends to widen inequality. Distributional considerations require the adoption of a progressive grant system. The most progressive grant system is the one which brings all incomes below a certain level upto that level and adds nothing to any income above that level. The second requirement is not attainable as long as public debt exist, with interest payments regressively distributed.

Regarding subsides wa can observe that a subsidy on bread milk lowers its price and that it acts like a progressive grant. But a subsidy on private savings would be regressive. It is not always true that food subsidies are progressive. They are progressive only if the subsidised food items form a larger proportion of the expenditure of the poor than that of the rich. But subsidies can be given in two ways. If subsidy is given on an item without regard to its possible consumer it is called a general subsidy. On the other hand, if subsidies are given on food cosumed by certain groups such as school children or expectant mothers they are called special subsidies. The case for special subsidies is always strong from the distributional point of view. Another important point to be remembered while granting a food subsidy is that if the purposse of a subsidy is to increase consumption, food items marked by a high elasticity of demand are more suitable than those marked by an inelastic demand.

Grants may also have some indirect effects. A grant may sometimes act as a disincentive for work by providing additional income to the recipeint. In this case, the indirect effect is acting adversely on income distribution. However, it is also possible that the indirect effect may help to increase his income in which case there will be improvement in the distribution of income.

Certain grants may improve the distribution of income not by diminishing the inequality of incomes but by adjusting individual income more closely to individual needs during different periods of time. The social security measures such as old age pensions, sickness benefit unemployment benefit, industrial injury benefit, widow's pensions, etc., are aimed at fulfilling this objective.

19.4 OTHER EFFECTS

Public expenditure can be used as a policy tool to bring about many desired changes. It can be used for achieving economic stability economic growth and for other purposes.

19.4.1 Achieving Economic Stability

Economic instability is a characteristic feature of capitalistic economies. These economies are sometimes subjected to booms and depressions which are called business cycles. The havoc created by the Great Depression of 1930s brought about a revolutionary change in the thinking of economists. Public expenditure has been treated as an important mechanism for controlling business cycles.

According to Keynes, the basic factor responsible for booms and depressions is effective demand. If the effective demand is deficient, there will be a depression. On other hand, an excessive aggregate demand results in a boom. The Keynesian solution for arresting these cycles is the regulation of public expenditure to keep the effective demand at the desire level. For instance, during a period of depression, marginal efficiency of capital will be very low leading ... In this situation if additional purchasing power injected

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through public expenditure, it would increasse the aggregate demand and thereby control the depression. In a situation of boom also, public expenditure can be used as a policy tool for correcting the situation. In this case, there will be excessive private demand leading to inflation. Curtailment of public expenditure leads to decline in the aggregate demand.

Keyne's policy suggestion for achieving economic stability through the adjustment of public expenditure can be developed as a scheme of compensatory spending. Public expenditure will be used to compensate for the deficiency or curtail the excess of aggregate private demand. During depression, increase in public expenditure can be brought about through deficit financing, i.e., keeping the total government expenditure at higher level than the total government revenue On the other hand, during a boom the public expenditure has to be curtailed maintaining the same level of taxation and borrowing.

However, it should be noted that the policy of compensatory finance may not be effective under certain conditions. For instance, when deficit financing is adopted to encourage private demand, there would be an increase in economic activity only if there are no bottlenecks on the supply side, i.e., supply of raw materials, skills, etc.,

19.4.2 Achieving Economic Growth

Another major effect of public expenditure is the achievement of economic growth. According to John Adler, a rising proportion of additional output should be devoted to capital formation. For this purpose two-fold changes in the government budget are necessary. First, the govenrment budget should be raised so that a rising proportion of additional output would be available for development purposes. Secondly, a rising proportion of government revenues should be used to finance development Thus, public expenditure has a significant role to play in the proces of development.

19.4.3 Stimulating or Reducing Private Iniative

Public expenditure can be used either to stimulate and supplement private initiative or to eliminate in private sector altogether. Stimulation of the private sector can be achieved directly or indirectly. Loans, subsidies, tax concessions and exemptions provide a direct stimulus to the private sector. Indirect stimulations may be achieved directly or indirectly. Loans, subsidies, tax concessions and exemptions may be achieved through the provision of social and economic overheads. Expenditure on education and health come under the category of social overheads. Provision of power, transportation, communication etc., come under the head of economic overheads. Social and economic overheads are essential prerequisites for economic growth. However, there are certain enterprises which the private sector may be unwilling to undertake either because of low profit margin or because of long gestation period. This group includes the key and basic industries, such as those concerned with the development of irrigation and power. These investments should be made by the govvernment.

19.4.4 Other Goals

Public expenditure can also be used to achieve some other goals. For instance, it can be used for generating employment in backward areas. It can also be used to contain the growth of big cities by adopting suitable policies like development of satellite towns.

CHECK YOUR PROGRESS - II

3. How can economic stability be achieved by using the instrument of public expenditure?

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4. Can public expenditure play a significant role in the process of economic growth?

5. Do you agree with the view that public expenditure influences the income distribution?

19.5 CONCLUSION/SUMMARY

Public expenditure should be viewed as a mere financial mechanism. It can be used as an instrument to achieve the desirable level and pattern of production and distribution. It can also be used to mobilise. the hitherto unutilised resources and to divert the resources into desirable channels. Public expenditure influences production through its being able to influence the people's ability and desire to work, save and invest and the diversion of economic resources for different locations as well as uses. Further, various grants and subsidies provided by public expenditure produce some other effects also. For instance, economic instability, economic growth unemployment and undesirable growth of big cities can be tackled through a carefully designed scheme of public expenditure.

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19.6 SUGGESTED BOOKS

1. B.P.Thyagi : Public Finance
2. H.L.Bhatia : Public Finance
3. Hugh Dalton : Public Finance

19.7 MODEL EXAMINATION QUESTION

I. Answer the follwing in about 30 lines each.

1. Examine the effects of public expenditure on production.
2. How is public expenditure useful for brining about desirable changes in income distribution and economic stablisation?

II. **Answer the following in about 15 lines each.**

1. What are the effects of public expenditure on ability to work, save and invest?
2. How can economic resources be directed through public expenditure?
3. What is the role of public expenditure in stabilising the economy growth?

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the private economy. A high level of public debt has come to stay as permanent feature of mdern western economy. the noble-laureate economist James Tobin, during his recent (1985) visit to India observed: "...... the present parameters of the U.S. Federal budget imply that the federal debt will grow faster than the economy indefinitely. "As discussed in the beignning itself, public debt instruments (securities, bonds, etc) are essential elements of the financial infrastructure of modern economies.

If one were to compare the current economic thinking with the classical economisis' views on public debt, the change would seem to be revolutionary. Classical economists, in arguing against public debt, generally assumed full employment, unproductiveness of public expenditure, and undesirability of spending for purpose other than defence, justice, etc. Therefore, they objected to government borrowing. In their view the government, by borrowing and by taxing to defray interest payments, depreived the economy of cash and capital and the government's use of resources was less productive than that by private enterprises. As a policy management of public debt was discussed only in the context of needs to repay the war debts, without causing too many economic disturbances.

As a result of the shift in the objective of economic policy from minimum interference and avoidance of deficits to the objective of maintaining economic stability, economists took a more realistic attitude about the role of public fianance. The new approach is epitomized by the term **"Functional Fianance"** advocated by A.P. Lerner, Arthur smithies, A.H. Hanson and others Under this approach government uses its expenditue and revenue programmes, deficits and borrowing to produce desirable effects and avoid undesirable effects on the national income, production and employment. In this view, the growth of public debt need cause no alarm so long as it is brought about in response to the requirements of the situation. The fears of national bankruptcy and increasing burden on the community are largely illusory. Public debt could be allowed to grow so long as full employment was being maintained and the national income was growing and the increased interest payments could come out of increased taxation on the increments of the national income.

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Such a view of public debt is based on three important premises; (i) the creation of public debt does not involve any transfer of the primary real burden to future generation; (ii) the analogy between individual or private debt and public debt is fallacious in all essential respects; and (iii) there is a fundamental distinction between an internal or domestic and external debt.

20.7 THE BURDEN OF PUBLIC DEBT

The term 'primary burden of public debt' , or simply "burden of debt" is defined in terms of the transfer of real resources from the private economy to public economy or sector. This social burden is incurred at the time of public borrowing, when such resources (say, copper and steel) are used up for government spending, not in the future. As hinted earlier, in the case of external borrowing only it is feasible to enhance the current flow of goods available to the community and pay for this increasse out of the future output. But a closed economy (one without external borrowing and external trade) cannot dispose of more goods and services than it is currently producing. It certainly cannot increase this flow by paying out of future output, for there is no way that we can dispose of tomorrow's output today. Hence,the goods and services acquired by the government through domestic loans must always be 'paid for' by those belonging to the present generation, that is, those living at the time of loan-finance government spending. Tax-payments in future, on account of interest and repayment of the debt are balanced by the interest receipts and capital transfers. Because both the tax-payers and the bond-holders belong to the same future generation, no net burden is involved. These payments are merely transfers of income between future members of the community. A.P. Lerner's, the leading exponent of Functional Finance view aptly sums up this: "A nation owing money to other nations (or to the citizens of other nations) is improverished or burdened in the same kind of way as a man

who owes money to the other man. But this does not hold for national debt which is owed by the nation to the citizens of the same nation. There is no external creditor".. In so far as the internal debt is concerned "we owe it to ourserlves". and if we assume that the Government use of resources thus transferred is an efficient as their alternative use by the private economy, it is obvious that domestic public debt involves 'no burden'.

The 'no burden' view of public debt, as discussed above, has several critiques. Among such critiques J.M. Buchanan's is the foremost. In his famous book, **Public Principles Debt, (1958),** Buchanan seeks to disprove all the three premises of Functional Finance. He defines the term 'burden' in the sense of a reduction in consumption by the future members of the community who are forced to pay taxes for servicing and repayment of the debt. By 'future generation' is meant "any set of individuals living in any period following that in which the debt is created The present generation (or the bond-purchasers) do not make any sacrifice since the transacion is voluntary. No one else in the present generation is affected as taxes are not raised. the other economists who have made significant contributions to the 'debt burden debate are Bowen-Davis-Kopf (they have written jointly and are known as "BDK"), R. Musgrave, Modigliani, Carl C. Shoup, Neisser and Vickrey, BDK have argued lies with the future generation (every generation is assumed to have a life-span of 44 years) when debt repayment is made. The other economists have argued that the debt burden is shifted to the future by the investment channel, in the sense that the creation of public debt primarily reduces or adversely affects the private investment and consequently the flow of real income to the future generation would be curtailed, thus reducing the future private consumption. The entire debate about the burden of public debt has generated more heat than light. There is still no general agreement among economists on the precise nature of public debt and as to who ultimately bears the burden.

Some of the protagonists of modern theory of public debt such as D. Mc Cord- Wright, B.U. Ratchford and J.E. Meade, while holding the 'no shifting view', emphasise that there are significant problems on account of an internal debt. The existence of public debt may involve frictional and incentive-induced effects (or 'burden') which might disturb the optimal allocation of resources in the economy. For instance, argues Meade, an ever-rising volume of public debt would lead to a very high level of taxation. The ratio of such taxation to national income plus transfers would, ultimately exceed the ratio of Government expenditure, to national income, giving rise to friction tax losses. These tax losses could have been avoided through a balanced budget or restricted deficit resulting in a 'manageable, size of public debt.

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Let us point out some of the economic problems arising from the creation of large public debt :

(i) An ever-increasing need to raise taxes in order to meet the debt- servicing and sinking fund obligations may pressurize the government to resort to regressive taxation (that is, a system in which the burden of taxes is heavier upon low income receivers than upon those with high incomes). The consequences would be far more adverse if the tax system happened to be already regressive.

(ii) If the debt is purchased by the banks out of newly created reserves while the economy is operating near a level of full employment, price inflation will follow. As we have noted earlier, borrowing from the Central Bank is directly inflationary. Evidently if borrowing is inflationary, the heavier the borrowing (the greater the increase in outstanding debt) the greater would be the inflationary potential.

(iii) The debt-financed government spending, if it is less productive than the private sector use of these funds, may lead to waste of productive efficiency for the economy as a whole or undersirable economic burden on particular classes.

The above list ('i' to 'iii') is certainly not an exhaustive one and should be taken only as suggestive of ways in which public debt may cause undesirable economic consequences or 'burdensome' economic costs. It should, neverthless, be clearly noted that each of the examples given indicates a conditional burden only, becoming real when accompanied by unwise policy which could be avoided.

20.8 REPAYMENT OF PUBLIC DEBT

The record of post-war years in almost all countries, including India, has shown that despite a tremendous growth of public debt, the economies have continued to prosper. The much-feared adverse economic consequences of public borrowing (especially, those advocated by the classical economists) didnot act like "a mill-stone around the neck". What really has happended is that the modern economies have learnt to live with a large-size public debt. Moreover, it is indeed difficult to envisage the functioning of a modern and complex economic system without a substantial supply of government debt instruments. In simple terms, for instance, it would be extremely difficult for modern banking to operate effectively if there are no risk-free investment possibilities in the form of various government securites the secondary reserves for the banks. How cumbersome would it be for the banks to maintain all their reserves in the form of currency notes alone? And again, what a waste would such cash reserves entail in terms of loss of their potential use? As a matter of fact, a wide-spread ownership and maturity pattern of public debt have become crucial for a successful monetary policy and management. Finally, even if the government desired a reduction (or net repayment) of debt on a large scale, it may involve serious consequences for the economy, such as : reduction of useful government expenditure, undersirable impact on tax system, net destruction of a part of the circulating medium when the debt is held by the banks, etc.

The most important consideration in viewing the repayment of debt (or the burden of the debt) is to look at the debt and national income relationship. A high national income will by sheer weight of proportion reduce the burden of debt. E.D.Domar in his seminal article says "Whatever effects the existence and growth of the debt may have, what matter is its relation to other economic variable, such as national income, resources of the banking systems, volume of private securities and so on; the particular relation studied depending on the character of the problem at hand".

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Redemption or repayment of debt is necessary for several reasons. It improves government's image and credit in money market. It also serves as a brake on government's carelessness in spending. Timely repayment saves the government from going bankrupt. It saves future generations from bearing the burden. There are various methods of redemption of public debt.

20.8.1 Refunding

Refunding means issuing of new bonds or securities by the government in order to pay-off the matured loans. This method involved no liquidation of money burden. Money burden gets accumalated to some future date.

20.8.2 Use of Budget Surplus

The surplus in government budget will be used to pay-off it's debt to the people. This results an automatic liquidation of its debt liability.

20.8.3 Terminal Annuity

The government pays-off it's debt in equal annual instalments. This method leads to a fall in the burden every year.

20.8.4 Sinking Fund

The government establishes a separate fund known as sinking fund for the repayment of public debt. A fixed sum of money will be credited to this fund every year. The sinking fund is of two types - certain and uncertain. A certain sinking fund is one to which government credits a fixed annual sum. If the government credits to this fund only when it secures a surplus in the budget it is called uncertain sinking fund.

20.8.5 Debt Conversion

Some times the ruling rates of interests in the market may be high when the government contracts debt. If the rate of interest in the market falls the government converts it's old high interest debt in to a low interest debt. This method reduces the burden of interest on the community.

20.8.6 New Taxation

New taxes may be levied to secure the necessary revenue to pay-off the old loans. This method results in transfer of resources from tax payers to creditors.

20.8.7 Capital Levy

Some economists suggest that war time debt should be paid off by imposing capital levy on people. It is a one time tax on capital assets. There will be an exemption limit and beyond this limit, the rates will be increasingly progressive. There are many arguments in support of capital levy. Firstly the richer sections who pay capital levy reap huge profits during war time through rise in prices and hence they should bear the burden of repayment of war time debt. Secondly this levy satisfies the canon of equity because only those people who are in a position will be taxed. Thirdly, if the leavy is not imposed the debt increases rapidly with the passage of time. Fourthly, the levy controles inflationary measures in the economy by neutralising the excessive purchasing power of the richer sections. However there are arguments against capital levy. It discourages savings and produces unfavourable effects on industry. Secondly, capital may get transferred to foreign countries effecting economic development of the country. Thirdly, it discourages inflow of foreign capital and hence retards economic development of the country. Lastly, there are some administrative difficuities in the imposition of capital levy. If a person has high income but no property in his name he will escape the capital levy. This is contrary to the cannon of taxation.

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20.8.8 Surplus Balance of Payments

The debtor country will expand it's exports and curb it's imports to accumulate foreign exchange reserves. Foreign debt will be paid out of the surplus balance of payments. However, an external debt can also be repaid by contracting fresh loans from foreign countries.

20.8.9 Repudiation

A government may disclaim any responsibility of a loan contracted by preceeding governments. This was done by the Soviet Government the period following the revolution. Normally no government resorts to this method as it adversely affects it's credit worthlyness. This is especially true of external debts.

CHECK YOUR PROGRESS - II

1. What is tthe argument of classicals regarding public debt?

2. Explain the modern view about public debt?

3. What are the merits of Capital levy?

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4. What are the demerits of Capital levy?

5. Explain the method of sinking fund?

6. What is meant by debt conversion?

20.9 SUMMARY/CONCLUSION

Public debt differs from taxation became the government has to repay the borrowed funds which no such obligations is involved if the revenue is raised through taxation. Public debt may be raised through deficit financing. In this case, debt transactions is not voluntary. It is known as forced saving. Though public debt can be classified as marketable and non-marketable, there may be very few buyers of securities other than government controlled institutions. Transfer of real resources is involved in external borrowing but not in internal debt. India's debt form 73% of national income and external debt accounts for 13% of India's total debt. Of the domestic debt, about 64% belong to the marketable category.

Classical economists argued against public debt. They assued full employment, unproductiveness of public expenditure and undesirability of spending for purposes other than defence, justice etc. The modern approach known as functional finance view argues that the growth of debt need came us alarm so long as is brought about in response to the requirements of the situation. India's development plans are largely financed by public borrowing and a large part of this had led to inflationary price rise in the economy.

– Prof. S. Subrahmanyam

20.10 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L.Bhatia : *Public Finance*
3. Hugh Dalton : *Public Finance*

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20.11 MODEL EXAMINATION QUESTIONS

I. Answer each of the following questions in about 30 lines.

1. Define public debt and explains it's nature.
2. Is it correct to say that the burden of public debt is born by the future generations. Give reasons.

II. Answer each of the following questions in about 15 lines.

1. Discuss the growth of public debt in India since 1951.
2. Explain the economic significance of various categories of public debt.
3. How is the domestic debt different from external debt?
4. Explain various methods of repayment of public debt.

UNIT-21 : PUBLIC DEBT, TAXATION AND DEFICIT FINANCING

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21.3 Public Borrowing and Deficit Financing

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21.6 Model Examination Questions

21.0 AIMS AND OBJECTIVES

The unit explains the differences between various sources of Government finance namely, public debt, taxation and deficit financing. It also examines the economic consequences of public debt taxation and deficit financing.

After reading the unit, you will be able to

* identify the differences between public debt and taxation, debt
* identify the differences between public debt and deficit financing, and
* analyse the economic consequences of public debt, taxation and deficit financing.

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21.1 INTRODUCTION

Taxation, public debt and deficit financing are the major sources for financing Public expenditure. The total expenditure of Central and State Governments in India is Rs. 36,845 crores in 1980-81 – If this total expenditure; 54 per cent is contributed by taxation, 35 per cent by public borrowing and 11 per cent by deficit financing. The question that now arises is : why should the government resource to different methods for raising resources? Why can't the government just tax every citizen equally and collect the desired finances? Such a method, however, would be feasible only in a simple economy involving a small number of people among whom inequalities of income and wealth are not significant and the sole objective of government expenditure is to provide certain public goods and services. In a modern economy, raising revenues to finance its expenditure for provision of goods and services to the society, though important, is not the exclusive purpose of government finance. Equitable distribution of income and wealth, full employment, economic stability and economic growth are other important goals of government expenditure. Obviously, one goal may be efficient in achieving a certain goal but not in achieving another. Again, there may be a conflict between two or more objectives. Moreover, economies differ a great deal from one another. Some are developed while others are developing. Some adopt socialist pattern while others subscribe to capitalist path. Hence the analysis of determining the economic impact of different methods of government finance is highly complex.

21.2 PUBLIC BORROWING AND TAXATION

In a modern economy, every citizen consumers public goods and services in one form or

other - collective security, legal protection, roads and public transportation, public health and educational facilities, etc. There is generally no direct payment by the citizens for these services. When you watch a T.V. programme or listen to a radio-broadcast, you do not make a direct payment for the service enjoyed. But individuals acting through their elected representatives subject themselves to reduction in real income of one kind (private goods and services, which they could have alternatively used) in order to be able to secure real income of another kind (public goods and services). The government gets control over private incomes or resources through compulsory levies called taxation in order to finance its public expenditure or provision for public goods. Taxes thus in effect are the "prices" that individuals pay in exchange for the use of public goods. The traditional definition of taxes as compulsory levies or payments, at times, misses the under - lying process of exchange. The implication of such an exchange is that the reduction in private income occurs at the time of tax payment, and that since the enhanced supply of public goods is made available simultaneously, there may not be any net loss in terms of social welfare or collective gain.

Let us now compare taxation with public borrowing, which is essentially an alternative method of raising revenues to cover public expenditure. Public borrowing is a means through which government may finance public services without reducing the real wealth of individuals during the period when the funds are acquired. 'However, this may not really be true at the macro - level, if the government simultaneously uses real resources for providing public goods. But we shall disregard this aspect for the time being. The essence of borrowing process, as opposed to taxation, is that the government secures the revenues on a voluntary exchange basis. Government securities or bonds are bought in exchange for a government promise or obligation to provide them with future income. Thus, government borrowing and taxation are contrasting methods of financing public goods. In brief, in the case of taxation, individual private real wealth (and income) is currently reduced in "exchange" for collective or public goods directly provided by the Government, while in the case of public borrowing, individuals give up no real resources to secure the current benefit of public services.

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The discussion above, however, represents an over-simplified view. The two alternative methods of government finance may lead to different consequences for the economy and its functioning. It is in this sense that the economists have long argued (and they have't still stopped either) about the relative merits of these two sources of government finance. In general, the classical and neo-classical economists, wedded to the concept of a self-adjusting economy, stressed that loan-finance was an inferior or wasteful method of government finance as against taxation. Their arguments, in brief, have been as here under :

a) Loan-finance being less painful than current taxes encourages irresponsible governmental spending;

b) Government borrowing withdraws productive private resources or capital, according to Mill, out of "wage funds" meant for labourers, while others argued that such a withdrawal will be from private investment;

c) Loan-finance leads to reduction in future capital stock : (i) by affecting "inheritance", and (ii) through taxes imposed in order to service and amortize the debt. Classical economists, by and large, held that the debt burden was shifted to the future generations;

d) Public borrowing denotes unbalanced budgets, which may lead to currency deterioration (through inflation); and

e) The neo-classical economists such as Pigou feared that the transfer of incomes from taxpayers to bondholders might lead to a more unequal distribution of income.

It is generally accepted now that the views given above on the role of finance are grossly unjust. In fact, "a world of small government, small government debt and fairly simple pattern of

economic organisation and behaviour" has definitely been replaced by "a world of big government, big government debt, and a vastly more complex economic organisation and behaviour" (Ervin Miller). However, the fact is that taxation and loan - finance" says Musgrave, "remains important because it determines the way in which the resource withdrawal from the private sector will be divided between consumption and capital formation", Under loan-finance, the distribution of resources withdrawal between consumption and savings (or capital formation) would largely depend on the relative interest elasticity of saving and investment schedule (assuming that saving is a function of disposable income as well as of the rate of interest). When government undertakes borrowing it increases the demand for loanable funds causing an increase in the rate of interest. If both saving and investment schedules are interest-elastic, there will be some fall in investment and some rise in saving. Thus, the resource-withdrawal due to public borrowing will take place from both the consumption and private capital formation. The less elastic the investment schedule is, the more elastic is the saving schedule and the more will be drawn from private consumption and vice-versa. Thus, it is not true, that public borrowing affects only the private capital formation; it may also, working through the interest rate, influence consumption activity. However, if one were to compare it in this respect and an equivalent amount of tax finance for increasing government's real expenditure, it will be seen that the share of resource withdrawal from consumption will be far greater in the latter case than the former one under similar conditions of elasticity of saving and investment. Thus different effects follow from the use of tax and loan-finance.

We have noted that tax finance is more likely to reduce consumption than the loan finance. Now we have to answer one question. Is tax finance more likely to accelerate economic growth than loan finance? The increase in taxation to finance even the whole of public investment would be very large and would, in the first instance, be politically impossible to achieve. Besides, the disincentive effects of taxation would become serious after a certain level of taxation is crossed. Furthermore, it may not be really feasible or socially acceptable to reduce the already low levels of consumption any further. Finally, there is no reason why public investment in self-liquidating projects (such as steel and power plants) should not be financed through public borrowing. For all these reasons, it would be proper to hold that public borrowing should supplement taxation as a method of financing public sector investment in a developing economy.

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As compared to this role of loan-finance in a developing economy, public borrowing would play a different role in a developed economy. Macro-economic policies in the developed industrial economies, under the influence of Keynesian compensatory finance, usually focus on demand management. For achieving economic stability and full employment, loan-finance, as stated earlier, will increase aggregate demand, the extent of increase depending on the interest-elasticity of saving and investment. Post-Keynesian analysis of the wealth effect (which emphasizes that consumption expenditure is not the function of income alone, but also of the volume of wealth held) of an increase in government debt reinforces the expansionary effects of loan-finance. It is quite likely that the issuance of debt or bonds will increase the net worth of the private economy which in turn might induce an upward shift in the consumption function. However, if full employment or near full employment exists, loan-finance cannot be used even for creating a durable public good becuse inflation is likely to result. Under an inflationary or potentially inflationary situation, taxation and restricitve credit policies (to curb private investment activity) are called for.

It may be reasonable to conclude that the choice between tax and loan finance cannot be made on any *a priori* considerations. Such a choice will have to be made on the basis of the macro-economic requirements.

CHECK YOUR PROGRESS - I

1. Gove some examples of public goods consumed by every citizen.

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2. What is the major difference between taxation and public borrowing?

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3. Why is loan finance treated as wasteful method by classical and neo-classical economists.

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4. Why is tax finance an inadequate source?

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21.3 PUBLIC BORROWING AND DEFICIT FINANCING

We have so far analysed the act of public borrowing as an alternative means to taxation for financing public expenditure. In a full-employment economy, these two methods exhaust the possibilities, since the direct creation of currency (inflationary finance) would produce results that are equivalent to a form of taxation, as explained later. This statement, however, assumes that all public borrowing is real. Real borrowing takes place only if some individuals or groups in the economy deliberately exchange current purchasing power for a government obligation to provide an income return in future periods. However, in actual fiscal practice, the basic meaning of real public debt is rarely adhered to. Whenever a national government deficit is created, that

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is, when the rate of public spending exceeds the rate of tax collections, it is financed by what is called debt issue. The nominal size of public debt is always increased with the occurrence of a budget deficit. No serious attempt is generally made to distinguish between what we have referred to as "real debt" and "fake debt", "disguised money creation" or "monetization of the debt". Failure to make this distinciton, quite often, creates much confusion. Looking at the volume of public borrowing carried out by a national government in any year, it is difficult to say how much of it real and how much of it represents disguised currency creation or fake debt. The distinciton between the two methods of borrowing is important, since they lead to very different economic consequences.

We term the non-real debt or monetization of debt as "deficit financing". It needs to be emphasized that the monetization process is not confined to currency creation (by the Central bank) alone, it also incorporates other forms of debt-induced credit creation or liquidity expansion such as enhancement of commercial bank deposits. Let us briefly discuss the mechanics of currency and credit creation through public borrowing or the sale of public debt.

In the first instance, and net purchases of government debt, in the form of either securities, bonds or Treasury bills, by the Central bank of a country (Reserve Bank of India, in our case) results in direct expansion of monetary base, that is, acquisition of new currency. Since the Reserve Bank of India (R.B.I.) does not possess independent cash funds, issuance of new currency is the only method available to finance its purchases of government debt. Again, the R.B.I., being the banker to the government, is obliged to buy any amount of securities and bills which the government may offer. In India, there is no ceiling fixed on the volume of government borrowing from the R.B.I. Generally speaking, about one-third of out-standing domestic public debt in India represents borrowing from the R.B.I. The common form by which the Government of India, obtains immediate credit from the R.B.I. is through the issue of non-marketable short-term securities known as "Ad hoc Treasury bills", which have a nominal maturity period of 91 days. But such Treasury bills are usually converted, later on, into medium and long-term government securities, this procedure is known as "funding of the debt". In addition to this, the R.B.I buys all government securities issued but not absorbed by the public. Accordingly, the definition of deficit financing in India generally includes : (a) withdrawal of cash balances by the government, and (b) net purchase or absorption of all types of government securities and bills by the Central bank. As stated in the beginning, such deficit finance accounted for about 11 per cent of Government finance in 1980-81. It should be noted that this definition still stops short of the meaning that we have earlier ascribed to deficit financing. For a clear understanding of this wider dimension of deficit financing, let us discuss the role of commercial banks in debt-financing.

The mechanics of monetization of debt involving commercial banks (and other similar credit institutions) is more complex than the debt-based currency creation by the Central Bank. We shall illustrate it by taking a hypothetical example. Let us assume; (i) that the government issues exclusive loans (or securities) to the banks to finance its spending of, say, Rs. 100 crore; (ii) that the banks are required to maintain 20 per cent of their deposits as 'minimum' cash reserve ratio; and (iii) that the entire transaction is instantaneous, that is, no time-lags are involved. In this situation, the banks' cash reserves would be reduced by Rs. 100 crores, while their investment in government securities would increase by an equivalent amount, the net worth remaining unchanged. At the same time, the government spends Rs. 100 crores thus acquired. Let us imagine that the cash-bank deposit ratio for individuals (who receive incomes or payments from the government directly or indirectly) is 10 percent. This would mean that the banks would receive Rs. 90 crores from the original funds lent to the government. The banks on the basis of 20 percent minimum cash ratio would acquire excess reserves of Rs. 72 crore, which can be the basis for further credit either to the government or to the private sector. This process, if the government continues to borrow, can be repeated several times. However, as excess reserves decrease every time the process is repeated, the process could continue only upto a limit. The

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entire process or the total credit expansion as a result of this transaction can be explained by using the familiar Keynesian multiplier as hereunder:

$$M = \frac{1}{1-r(1-y)}$$

Where 'M' denotes the credit multiplier, 'r' the marginal deposit/cash ratio of the public and 'y' is minimum reserve ratio. In the numerical example given above, this credit multiplier works out to be 3 57.

The process given above would not change much when the purchase of government securities is made from the private sector, except that in this case, spending would be done by the private sector. We should, however, mention that the bank financing of government loans is different from similar financing by other financial intermediaries. Banks can expand their holdings of government securities by several times the rise in their free cash reserves; but if they have no excess reserves and if they have to obtain cash for investing in government securities by curtailing loans and advances to the private sector, there is no net expansion effect.

There is yet another method by which debt monetization may occur. If the average maturity schedule of the debt is significantly shortened, the liquidity schedule of the economy will shift upwards. In other words, as a government security nears the time of maturity by, its 'moneyness' content [illegible] being a debt with zero maturity.

Let us [illegible] the actual magnitude of monetization of India's public debt through the first two sources [illegible] R.B.I. and the commercial banks, respectively), during the recent years. Table 1 summarises [illegible] data on net bank credit to the government as a source of increase in money supply (technically called "money stock") for the selected years over the period 1970/71 to 1983/84. It will be seen [illegible] the bank credit to government has played a dominant role in money stock expansion accounting for as high as 64.3 per cent in 1980/81. In this regard, the R.B.I.'s contribution, as may be expected, is generally much greater than that of all the commercial banks put together. At the end of March 1984, the volume of money stock was provisionally estimated at Rs. 85,567 crore against which the outstanding bank credit to government amounted to Rs. 40,566 crore or 47.4 per cent (R.B.I. alone being responsible for 31.1 per cent).

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TABLE - 1

Net Bank Credit to Government as Source of Money Stock

(M_3)* Variation 1970/71 - 1983/84

(Amount in Rs. Crore)

Source of Variation	1970/71 Amount	%	1975/76 Amount	%	1980/81 Amount	%	1983/84** Amount	%
A. Net Bank Credit to Government	+ 512	38.8	+ 579	20.5	+ 5501	64.3	+ 5818	45.8
i) R.B.I's net credit to Govt.	+ 311	23.6	+127	4.5	+ 3698	43.2	+ 4311	33.9
ii) Other Banks' credit to Govt.	+ 201	15.2	+452	16.0	+ 1803	21.1	+ 1507	11.9
B. Total Change in M_3	+ 1319		+ 2829		- 8558		+ 12699	

* M_3 = Currency with public + Demand deposits with Banks and other deposits with R.B.I + P.O. Savings Bank Deposits + Time deposits with Banks.

** Provisional

Source : Reserve Bank of India, **Report on Currency and Finance, 1983-84** Vol. II, p. 39.

The difference between direct deficit - financing, that is creation of new currency by the Central bank, and the indirect deficit-financing, viz., additions to liquid assets by bank-financing of government debt and also by shortening the maturity schedule of the debt, makes the task of measuring the actual budget deficit for a given period extremely difficult. Again, the issues of liquidity management (involving both its volume and structure) are not strictly confined to the realm of fiscal policy or budgetary operations. Such issues, by and lange, extend to the areas of monetary and debt management policies. What we need to emphasise is that any increase in money supply (broadly defined as "money stock" and other similar liquid assets) not balanced by an equivalent increase in the supply of real goods and services would lead to an increase in overall price-level, as per the well-known Quantity Theory of money. In brief, the balance between money supply and the demand formoney (which is, in the first place, a function of real output or the volume of transactions in the economy) is crucial to the maintaining of price stability. An increase in price level, resulting from an imbalance between the supply of and demand for money, in turn, would mean a decline in the real purchasing power of money. This amounts to a general taxation whereby a part of the real purchasing power of money with the public is eroded by deficit financing or deficit budgeting. Such indiscriminate taxation or erosion of purchasing power would differently affect the various sections of the population. In particular, the poorer segments would be obviously worst-hit since their already low incomes would be further cut down by currency deception or conceit. There is yet another "indirect mechanism" through which deficit financing may affect the economy. An increase in the demand for money, as reflected by deficit borrowing by the gvovernment, would push up the rate of interest, rendering new investment activity more expensive. Naturally, this would adversely affect the creation of additional employment.

But the analysis given above should not make one conclude that deficit financing has no positive role to play. In case much of the economy is not monetized (as is the case of many of the developing countries), the deficit-financed expenditure may lead to increase in real output in the short-period if there are unused resources (that is, the economy is functioning at less than full-employment level). Lastly, a moderate and steady increase in price-level is quite often found to be essential for inducing new investment activity. Some of these and similar conditions always prevail, especially in developing countries. For this reason, apart from the political convenience, governments in modern times have continued to resort to deficit financing. Nevertheless, it remains vitally important to keep the size of deficit financing within reasonable limits through efficient fiscal and monetary management.

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CHECK YOUR PROGRESS - II

1. Explain the meaning of ad hoc treasury bills.

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2. What is meant by funding of debt?

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3. Assume that Rs. 100 crores is invested in government securities by commercial banks. Also assume that cash-bank deposit ratio is 15% and 25% is the minimum cash ratio. What is the total expansion of credit?

   If cash - bank deposit ratio falls to 5% and minimum cash ratio falls to 15%; What is the total expansion of credit?

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4. What is the difference between direct deficit finance and indirect deficit finance?

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21.4 SUMMING UP/CONCLUSION

Taxation and public borrowing are alternative means of financing government expenditure. Deficit financing or deficit borrowing amounts to hidden and indiscriminate taxation of general nature. The economic consequences that follow the employment of these different methods of government finance vary according to the nature of economic transactions involved. The use of any particular method or methods of government finance would much depend on the overall goals and targets of fiscal policy in a given economy. In general, deficit financing in order to play a positive role, requires the designing of efficient fiscal-monetary and debt management policies in terms of an overall-mix.

– **Prof. S. Sarupriya**

21.5 SUGGESTED BOOKS

1. B.P. Thyagi : *Public Finance*
2. H.L. Bhatia : *Public Finance*
3. Hugh Datton : *Public Finance*

21.6 MODEL EXAMINATION QUESTIONS

I. Answer each of the following questions in about 30 lines.

1. Explain the nature of taxation and public debt as alternative forms of government finance.
2. What do you understand by deficit financing? Why is deficit financing regarded as "hidden taxation"?
3. Discuss the mechanics of deficit financing.

II. Answer each of the following questions in about 15 lines.

1. What are the economic consequences of deficit financing.
2. Why were the classical and neo-classical economists argued against public borrowing.
3. What are the conditions under which a government can resort to deficit financing.

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BLOCK VI

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FUNCTIONAL AND DEVELOPMENT FINANCE

This Block starts with the explanation of the meaning and role fiscal policy and continues to trace the evoluation of fiscal theory and to explain the Long Term Fiscal Policy pertaining to Indian fiscal policy. A unit is devoted to discuss the various aspects relating to budget and to describe the method adopted in India in the preparation of budget. The last unit of this block concentracts on the various sources of development finance in India in addition to explaining the concepts of functional and development finance.

The Block contains the following three units.

Unit - 22 : Role of Fiscal Policy in India

Unit - 23 : Budget Formulation

Unit - 24 : Financing in India and Development Finance.

UNIT-22 : ROLE OF FISCAL POLICY IN INDIA

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22.0 Aims and Objectives
22.1 Introduction
22.2 Meaning of Fiscal Policy
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22.4 Fiscal Policy for Growth and Development
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22.6 Fiscal Instruments and Their Tasks in a Developing Economy
22.7 Policy Performance and Fiscal Structure In India
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22.10 The Long Term Fiscal Policy
22.11 Summary and Conclusions
22.12 Suggested Books
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"Nothing shows so clearly the character of society and of a civilization as does the Fiscal Policy......"

Joseph A. Schumpeter

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22.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the meaning and the role of fiscal policy in advanced capitalist economies and in a developing economy like ours, based on macro-economic analysis; to trace the evolution of fiscal theory; to explain the Indian fiscal policy in terms of its performance, key problem areas and tasks ahead; and finally to discuss the Long Term Fiscal Policy.

After reading the unit, you will be able to

* discuss the evolution of fiscal policy,
* identify the major objectives and instruments of fiscal policy,
* explain the salient features of Indian fiscal structure and policy performance in India.
* identify the problems of Indian fiscal policy, and
* analyse the long term fiscal policy.

22.1 INTRODUCTION

In the last three blocks, we have analysed the tax structure, public expenditure pattern and burden of public debt in India. In this Unit, let us try to learn about the fiscal policy in India.

The role of fiscal policy has lot of significance in the sense that every country is anxious to gear its public finances in pursuit of the twin aims of stability and growth.

22.2 MEANING OF FISCAL POLICY

Fiscal Policy is essentially concerned with the "Overall" effects of government's fiscal operations, namely, its total expenditure and taxation on macro economic aggregates of national income, output, price stability, etc. What distinguishes fiscal policy from other aspects of public finance is its central concern, as stated above with the aggregate variables. An individual tax or an item of government expenditure has, generally speaking, a specific and narrow objective such as raising government revenue or reduction or increase in consumption. One may argue that the aggregate taxation or government expenditure is arrived at by the addition of individual items. To certain extent this is true, but they need to be separated for analytical purposes as well as for policy making. The boundary between fiscal policy and other aspects of public finance, no doubt is rather thin and, in ultimate analysis, remains arbitrary. In fact, decisions about the "over-all" variables are made up of decisions about particulars. Any decision that has over-all effects will also exercise particular effects on particular individuals, enterprises or sectors of the economy.

It is also useful to make a distinction between fiscal policy and monetary policy, the two policies which are inter-connected in several ways. Monetary policy is generally defined as a policy with respect to quantity of money, while fiscal policy is a policy with respect to all government sources and uses of funds and their composition. Arthur Smithies defines fiscal policy as "a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment".

In other words, fiscal policy denotes the use of budgetary instruments (taxation, public borrowing and credit creation and public spending) for advancement of the socio-economic goals of a country. Thus seen, Dirk J. Wolfson aptly describes fiscal policy as comprising "all measures to increase the general welfare through the public control of resources by means of public spending, resouce mobilization, and rate setting in public and semipublic enterprises". As we would discuss later, Wolfson's definition is especially relevant for a developing country situation such as India's.

22.3 EVOLUTION OF FISCAL POLICY

Classicals' view

The modern-day concept of fiscal policy, as an active instrument to promote over-all economic objectives, is only a little over half-a-century old. Prior to 1930s, the (classical) economists emphatically believed that the scope of fiscal activities of the government was very restricted. Except to the extent that certain collective wants, such as maintenance of law and order, national defence and provision for some essential services, have to be satisfied through public spending, such economists argues, government ought not to interfere with the functioning of economy. Neither fiscal theory nor fiscal practice before the 1930s was concerned, in any essential way, with maintaining high level of employment and stabilizing the rate of growth of total national output: it was believed that in the long run the economy would tend to produce at a rate determined by "real" factors—the supply of labour and capital and the state of technology. Prices and wage rates, under this system, would adjust to changes in total money expenditure for goods and services and thus would leave real output unchanged. Thus, if any adjustment were needed, they could be effectively carried out through monetary policy, following the famous quantity theory of money.

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However, it will be misleading to conclude that for the classical economists (or even earlier, in the tradition of scholastic economic thought), there was no concern for fiscal policy. So long there has been governments, there has been a fiscal policy. The need to provide for collective want satisfaction, through what came to be known as "public goods", was well recognised. For instance, Adam Smith, apart from emphasizing external and internal security as "primary" tasks for any government, advocated certain economic and social ends : "erecting and maintaining those public institutions ... and works, which though they may be in the highest degree advantageous to a great society, could never repay the expense to any individual". In modern idioms, this statement could be regarded as an advocacy for social capital formation by the state. However, it remains true that the earlier economists' justification for resource allocation to satisfy certain collective wants and the burden distribution of its financing (namely, taxation) was primarily based on moral and humanitarian grounds, and not on economic ground. If we were to sum-up the basic principles of classical (and to a large extent, neoclassical also) fiscal policy, the following would emerge as its key-stones :

Basic Principles of Classical Fiscal Policy

(i) Government expenditure beyond what is required to maintain essential services, including public works, should be avoided.

(ii) Government should not in any case, undertake spending beyond the revenues that can be raised through taxation. 'Balanced budget' must guide the Fiscal Policy as a "fundamental article of financial faith". Any budgetary deficit would lead only to inflationary price increase, under the classical assumption of full employment.

(iii) As a corollory to (ii) above, public borrowing should be avoided as it will withdraw resources from productive employment.

(iv) Taxes should be kept as low as possible. The distribution of tax burden should be 'fair' and 'just'. Hence, "public expenditure was required only to secure the collective consumption of certain goods and service and that taxation was a contribution to defray the costs incurred for this purposes". It was premised that the government should pay its way just like an individual or firm.

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Keynesian View

The above thinking about the nature and role of fiscal policy underwent a redical and fundamental change with the advent of Keynesian economic analysis in the 1930s. John Maynard Keynes effectively argued that the government finances could be manipulated to influence the level of effective demand. For achieving full employment, it is crucial that available resources (which may be considered as fixed in short-run) ought to be matched with probable demand or aggregate (money) expenditure. Arranged in terms of integrated national income accounts, one can estimate : (A) total resources available, and (B) probable demand (consumption and investment spending of both the public and the private sectors). If A>B, there is a 'gap' which must be filled-in by fiscal/public policy measures. Such a gap may also arise if A<B, which should also be adjusted by fiscal measures. This is infact, the well-known Keynesian equation : Y = C+I+G. The question of filling-in this gap through the use of fiscal instruments (government spending, taxation, and deficit financing) has been conceptualized under the term **"contemporary finance"**. (associated with the contribution of A.H. Hansen).

A.P. Lerner's Functional Finance

However, Keynesian fiscal theory was further refined and fuller culmination in A.P. Lerner's

"Functional finance". as enunciated in his famous book, *Economics of Control*. This approach to Fiscal Policy, as assumed up by Jesse Burkhead, "views government revenue and expenditure and government debt solely as instruments for the control of aggregate community expenditure. These are the tools, and the goal is maintenance of stable employment at constant prices". Under this scheme, taxes for instance should not be viewed as sources of raising revenue, but essentially as instruments for affecting privateconsumption and investment expenditure. These views are obviously in complete contrast to the views of classical or pre-Keynesian economists, as discussed earlier.

The major implications of the Functional Finance approach are :

i) Government finances should be dealt on a 'functional' basis; and revenue and expenditure should not be considered solely by the requirements of securing collective consumption.

ii) The budget need not always be balanced. It is, in fact, less desirable (to balance the budget) under conditions of economic recession.

iii) Similarly, public expenditure (or for that matter, taxation) should not be considered for its direct benefits, but for the sake of indirect impact it produces in the form of raising effective demand.

With some knowledge of macroeconomic analysis, it is not difficult to comprehend as to how such a fiscal policy functions. Returning to the equation : Y = C+I+G, or allowing for nation's exports and imports : Y = C+I+G+X−M, the public spending can be directly controlled by the government, while other variable can be indirectly affected through taxation and other fiscal measures. The Keynesian analysis, thus brings the fiscal policy into the mainstream of economic analysis.

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Check Your Progress - I

1. What are the basic principles of classical fiscal policy?

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2. What is the Keynesian's view on fiscal policy?

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3. **What is 'functional finance'?**

22.4 FISCAL POLICY FOR GROWTH AND DEVELOPMENT

Ms. U.K. Hicks rightly observes :

"Now that fiscal policy has been developed as an established economic function of the government, every country is anxious to gear its public finances in pursuit of the twin aims of stability and growth; but their relative importance is very differently regarded from one country to another. A poor and backward country will strive to put most of the emphasis on growth, especially if... its population is expanding rapidly". In the context of this statement, one can examine the role of fiscal policy in a developing country like ours.

In spite of its revolutionary impact on economic theory, 'compensatory' fiscal policy has little relevance for the present-day developing countries. Compensatory finance was evolved in the context of cyclical fluctuations and is primarily suited to the conditions of advanced capitalist economies. In a developing country, the actual constraint to a steady growth of income and output is certainly not the lack of effective demand, but the structural bottlenecks (on supply side) - reflected in the form of paucity of resources (social overhead capital, in particular) and the low levels of productivity of available resources. Resource development or growth, in this sense, is dependent on (a) the size of capital formation or savings, and (b) productivity of capital including the human capital (The lagic of this statement is based on Harrod-Domar growth model). Therefore, the primary task of fiscal policy for a developing country like ours is additional resource mobilisation. However, any consideration of such resource mobilisation without sufficient reference to the strategy of development adopted by the country would be meaningless. The pattern of resource mobilisation, its use and effectiveness (all basic questions of fiscal policy) are directly linked to the development strategy. India, as we know, has adopted the strategy of planned development wherein public sector has been assigned a key role. As much as 60 per cent of our investments (although the exact proportion varies from plant-to-plan) has been allocated to the public sector. Other development outlays of the plan also significantly contribute to the national development. In order to finance this large volume of public sector outlays as well as to promote private sector investment, especially in a democratic society, there is no alternative to fiscal policy. Fiscal policy, says R.J. Chelliah, "is the most powerful and the least undesirable weapon of control which the state can employ to promote economic development.

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Fiscal policy for a developing economy, in the light of the above, should aim at raising the ***"incremental saving ratio"***. It means that an increasingly higher proportion of additional income should be saved and not allowed to be used for consumption. Furthermore, extreme inequalities of income and wealth are, in several ways, detrimental to the cause of development. Inequalities of this nature germinate serious socio-economic crises. For instance, while there are surplus stocks of foodgrains, there is little of purchasing power or incomes with the vast multitude of the poor to buy them. Again, on welfare grounds, government's spending the poor to buy them. Again, on welfare grounds, government's spending programmes will be required to meet the

special needs of backward regions. And depressed social sections of the population. Lastly, a reasonable degree of price stability is essential for economic growth and development. A continuously rising price-level may jeoparadize our development efforts. However, the question of fiscal measures for price stability is indeed a tricky one, since a certain degree of price increase is not only inevitable but has been found desirable for expanding economic activity.

22.5 MAJOR OBJECTIVES OF FISCAL POLICY

On the basis of the above, **the major objectives of fiscal policy in India** can be briefly stated as follows.

A) Resource mobilization for development, which involves (i) increasing savings, especially collective (or public sector) savings; (ii) curbing unnecessary consumption; and (iii) transfer of savings/resources from the private sector to the public sector.

B) Acceleration of economic growth and development which entails (i) increasing public investment, especially in social and economic infrastructure; (ii) optimising sectoral distribution of investment; and (iii) improving efficiency in production and distribution systems by promoting modernization, induction and diffusion of new technology, greater domestic efforts for Research and Development (R & D), etc.

C) Specific anti-poverty programmes and reduction in inequalities, which involves (i) curbing concentration of economic power; (ii) emphasis on anti-poverty and rural development programmes; and (iii) special measures like mass education and public wealth etc.

D) Price stability.

22.6 FISCAL INSTRUMENTS AND THEIR TASKS IN A DEVELOPING COUNTRY

How various fiscal instruments and fiscal choices can be used to achive objectives? In this regard, Table 1 specifies the major fiscal instruments or areas of activity and their tasks.

TABLE-1

Fiscal Instruments and Their Tasks in a Developing Economy

Policy Instruments	*Tasks/Activity*
1. Public Expenditure	a) Direct spending on public sector capital formation, especially on social overheads. b) Indirect expenditure on promoting private investment, including R & D. c) Priority to anti-poverty programmes and desirable welfare expenditure (for instance, family welare, literacy and public wealth).
2. Taxes and Subsidies	a) Heavy taxes on undesirable consumption. b) Special tax concession/subsidies for (i) promoting savings, (ii) affecting changes in sectoral/regional distribution of investment. c) Progressive taxation to curb concentration of income and welath.

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3. Choice of Revenue adjustment	Source of government finance varying consequential effects on price stability and other objectives. For instance, an increase in general or overall prices would differ in terms of its magnitude, social implications and time-path of change while the same amount of revenue is raised by indirect taxes, deficit finance, or upward price-revision of public sector produced input goods (energy, steel, etc.). Hence a 'least cost' solution has to be strived for in terms of resource mobilization through the alternative revenue sources.
4. Loan Finance and Debt Management	a) Public borrowing, primarily, a technique for transferring savings from private to the public sector. b) Minimum use of borrowing from the central banks and commercial banks. c) Debt management related to the needs of developing the financial infrastructure and the regulation of overall liquidity conditions.
5. Fiscal Coordination	a) Economic Planning and fiscal policy coordination. b) Need for coordination budgetary policies of the Central and State governments. c) Coordination among the various aspects of fiscal policy.

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22.7 POLICY PERFORMANCE AND FISCAL STRUCTURE IN INDIA

In our efforts towards planned economic development, initiated in 1951, fiscal policy has played a key role, especially in terms of resource mobilisation. As much as 75-80 per cent of plan spending (public sector) has been financed by internal resources, raised through fiscal instruments, mainly taxation and public borrowing. Some indications of public sector growth in India's national economy can be seen in Table 2.

TABLE-2

Public Sector in India's National Economy

Aggregates	Public Sector share in percent	
	1970-71	1981-81
a) Gross Domestic Product	14.9	22.0
b) Gross Domestic Saving	18.5	20.9
c) Gross Domestic Capital Formation	37.8	46.4
d) Final Consumption Expenditure	11.3	12.9

Source : C.S.O. : *Basic Statistics relating to the Indian Economy, 1950-51 – 1981-82, p. 25.*

Over the period 1950-51 to 1981-82 tax revenues and current expenditure of the Central and State Government increased over three-fold, while the capital expenditure registered a seven-fold

increase. In 1981-82, the total public expenditure in India amounted to Rs. 43,738 crore or 33.2 percent of GNP. Of this expenditure, 65.5 per cent was on 'development outlay' (i.e., economic and social service), while 34.5 percent was accounted by non-development expenditure on general administration, defence, interest payments and subsidies etc. As against this volume of public expenditure, the total tax revenue amounted to Rs. 24,142 crore. The tax income ratio has expanded from less than 7 percent in 1950-51 to about 16 percent in 1980. All thesse data suggest a remarkable expansion of State's fiscal activity. Table 3 summarises India's fiscal structure for the year 1981-82, which is intended to given an over-view of major fiscal aggregates.

TABLE-3

Fiscal Structure : India*, 1981-82

(In Rs. crores)

I. Public Expenditure/Outlay		43,738
1. Devolopment Outlay	28,653 (65.5)	
of which : Plan Outlay	18,373 (42.0)	
2. Non. Development Outlay	15,085 (34.4)	
II. Current Revenue		30,425
1. Tax Revenue	24,142	
a) Income & Corporation Tax	3,445 (14.3)	
b) Customs	4,300 (17.8)	
c) Union Excise Duties	7,421 (30.7)	
d) Sales Tax	5,063 (21.0)	
e) Other Taxes	3,913 (16.2)	
2. Non-tax Revenue	6,283	
of which : Surplus from Public Enterprises (for the plan)	2,235	
III. Capital Receipts (net)		10,794
1. Internal Public Borrowing	6,567	
2. Misc. Receipts	2,946	
3. External Loans and Grants	1,301	
III. Overall Budgetary Deficit		2,519

* Central and State Governments.

Note : Figures in brackets indicate percentages.

Source : Government of India, *Economic Survey 1983-84.* PP. 112-3.

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22.8 SALIENT FEATURES OF INDIAN FISCAL STRUCTURE

On the basis of the above data, let us briefly note the salient features of the Indian fiscal structure:

(i) A major part of our public expenditure, over 65 per cent is spent on development activities.

(ii) The expenditure on Plan projects and schemes claims a substantial share, 42 per cent, of the total government expenditure.

(iii) Over a half of public outlay is financed by various taxes.

(iv) In the tax structure itself, the direct taxes are relatively of much less significance, contributing less than one-fifth (assuming that a part of the 'other taxes' are in the nature of direct taxes, As high as 80 per cent of tax revenue is derived from the various commodity or indirect taxes. Union Excise Duties and Sales tax, together, account for as much as 52 per cent of resources raised through taxation.

(v) External resources (foreign loans and grants) play an insignificant role as a source of government finance, accounting for hardly 3 per cent of total outlay and 12 per cent of capital receipts.

(vi) Domestic or internal market borrowings are the leading source, contributing over 60 per cent, for capital finance of the government. The share of this source in total outlay works out to 15 per cent.

(vii) Finally, direct deficit finance, as such, finances only about 6 per cent. However, the figure of actual deficit finance is much higher, since a significant part of internal public borrowing, represented by subscriptions from the Reserve Bank of India and the commercial banks, is in the nature of deficit financing.

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22.9 PROBLEMS OF INDIAN FISCAL POLICY

Let us now discuss some of the areas of Indian fiscal policy, of late, especially since the mid-70s, the government fiscal operations have shown strains and new pressures. Below is a brief summary of such issues.

22.9.1 Disequilibrium Between Revenue and Expenditure

There has been a tendency towards persistent dis-equilibrium between the government revenues and current expenditure. The combined revenue budgets of the Central and State Governments revealed an average anual deficit of Rs. 861 crores during 1980-85, as against an average surplus of Rs. 1,400 crore during the preceding 5-year period, 1975-80. A major factor responsible for this situation, has been the relative decline in tax-income ratio as compared to the share of revenue expenditure in GDP. These tendencies, notes the Seventh Five Year Plan "have gradually eroded the capacity of Government sector to generate the necessary surplus to expand essential investment". The data, as cited above, obviously suggest that a part of the capital receipts has been used to finance the current expenditure.

22.9.2 Not So Buoyant and Responsive

The tendency of non-plan current outlay to expand much faster than the tax revenues suggest that "expenditures are more responsive to inflation than tax revenues". This means that the Indian tax structure has not been sufficiently buoyant and responsive to growth in income.

22.9.3 Black or Unaccounted Money

The conclusion under (b) above is also demonstrated by the fact that the share of direct taxes (on income and wealth) in the total tax revenue, as well as percentage of GNP, has declined in the recent years, despite economic expansion. This obviously means a serious failure of the tax structure in terms of both tapping additional income as well as to reduce concentration of income and wealth. Perhaps a major part of the problem arises on account of the existence and growth of black or unaccounted money incomes which escape the tax net. The amount of such black money in the economy has recently been estimated at Rs. 32,000 - 35,000 crore. It is further claimed that the governmental stringent measures against tax evasion, initiated in the recent years, has been able to touch no more than 10 per cent of black money. The tax evasion remains the major menace to India's fiscal policy.

22.9.4 Low Returns on Public Investment

Added to the problem of lack of buoyancy of the tax system, there is the question of low returns on public investment. Our public enterprises represent an investment as high as Rs. 50,000 crore. But it is well known that a vast majority of these enterprises have incurred huge losses and the overall return on public investment has been quite low. This means that no surplus funds could be available from the public sector for further expansion and growth. The argument that public enterprises have been established for certain 'social' objective and not for profits, has an obvious limit too.

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22.9.5 Deficit Financing

As a natural corollary to the above developments, government had to resort to deficit financing on an increasing scale leading to serious inflationary price increase along with concommitant socio-economic repurcussions. This constitutes a serious fiscal hazard to economic stability. Furthermore, governmental fiscal management of budgetary deficits (overall) has been hardly efficient. Over the recent years, the Central and State Government have preferred to resort to hikes in administered price (of input goods produced or controlled by the public sector) as against additional taxation and direct deficit financing. The choice has not been made in terms of any strict economic rationality (such as least inflationary inpact) but largely as a matter of political convenience. This further aggravated the inflationary situation, resulting in a variety of distortions in resource use.

22.9.6 Lack of Effective Public Expenditure Policy

Yet another area of critical importance to fiscal policy relates to a lack of effective public expenditure policy. The existing procedures for scrutiny of public expenditure, especially of non-development nature, lack any meaningful orientation in terms of cost-effective analysis.

22.9.7 Lack of Fiscal Discipline

There is an overall lack of fiscal discipline in the country, whether it be a question of tax procedures, deficit financing or expenditure control.

The above is certainly not a fully exhaustive list of fiscal problems facing our country, but it provides a gainful insight into various dimensions relating to economic growth, stability and social justice. The need for drastic fiscal reforms has been recently well recognised by the Government when it announced its 'Long Term Fiscal Policy' (LTFP) in December, 1985. We now turn to a brief discussion to LTFP.

Check Your Progress - II

4. What are the major objectives of fiscal policy?

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5. List the major fiscal instruments.

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6. Identify some issues of Indian fiscal policy.

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22.10 THE LONG TERM FISCAL POLICY

The Seventh Plan exphasizes the need to evolve a "long term strategy" in order to restore bugetary revenues and expenditures so as to enable the public sector to finance development outlay without inflation and at the same time to pursue a sound fiscal policy in relation to the private sector. The plan document further specifies *four components of such a long a long-term strategy:* (i) to reform and strengthen the tax structure, so as to make it buoyant and responsive to growth in income, (ii) the formulation of an adequate expenditure policy: (iii) the maintenance of fiscal discipline especially to meet the requirements of a non-inflationary fiscal policy; and (iv) to formulate policies for the public sector enterprises to improve their performances and generate surpluses. In pursuance of plan directive, the Government of India announced a Long Term Fiscal Policy in December, 1985. The term 'Long Term' refers to a five year period co-terminous

wth the plan. With the formulation of LTFP a much greater cooordination has been introduced between the strategy of planned development and the fiscal policy.

The LTFP in essence, is a fiscal response to the basic plan objective of "growth" modernization self-reliance and social justice". Its *specific aims are:* (a) to import a definite direction and coherence to the sequence of annual budgets; (b) to introduce a greater role for rule based fiscal and financial policies, (c) to assist in promoting a much more integrated approach to economic policy and its management; and finally, (d) to serve as an effective vehicle for strengthening the operational linkages between the Seventh Plan and the annual budgeting exercises "by providings an indicative yearwise financial framework for fiscal policy".

The LTFP does not provide details of all the envisaged fiscal reforms. It gives certain broad guidelines in areas such as public expenditure policy, performance of public sector enterprises, etc. However, major reforms have been suggested in the field of taxation, both direct and indirect. Below is a brief summary of the taxation measure laid down by the LTFP

22.10.1 Direct Taxes

(i) In order to provide the necessary stability, the present schedule of taxes on personal income wealth would be kept unchanged for a minimum period of five years.

(ii) The direct tax laws, which have been found to be quite cumbersome, should be re-written with the objectives of "(a) rationalising and simplifying in order to make the provisions easier to administer; (b) improving the effectiveness of the provisions for curbing tax evasion; (c) building effective deterrent penal provisions; (d) bringing about uniformity of procedures; (e) reducing the categories of taxable entities".

(iii) In order to strengthen the saving incentives, a new scheme called as the "National Deposit Scheme (New Series)" would be launched.

(iv) The existing corporate tax rates would be maintained but the corporate sector would be allowed to deduct a specified fraction of their profit from taxable income if deposited with notified institutions such as the Industrial Development Bank of India (IDBI) to the maximum of 20 per cent of the profits.

(v) The surcharge and surtax on corporate tax would be abolished from April 1, 1987.

(vi) It is proposed to simplify the provisions relating to depreciation under the corporate tax.

(vii) The Capital Gains tax would be retionalised by advancing the date for revaluation of assets to April 1, 1974, introducing a two-tier system of tax rates (50 per cent for real estates and 60 per cent for other assests), and by exempting certain financial investments from the tax.

22.10.2 Indirect Taxes

(i) It is proposed to merge the various (in fact, too many) excise duties into a single basic rate.

(ii) A new "Harmonized System of Classification" for the custom tariff would be introduced.

(iii) In principle, the LTFP advocate the adoption of Value Added Tax (VAT) as a replacement for the present system of indirect taxes. Since such an overhauling of the indirect taxation may not be feasible right now, a Modified Value Added Tax

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(MODVAT) is to be introduced immediately, which would considerably relieve taxation on inputs and help in avoiding the cascading effects of indirect taxes.

(iv) Special tax concessions would be available for small scale industrial sector.

(v) The basic thrust of customs tariff reform will be to place increasing reliance on tariffs to regulate imports and progressively reduce the role of quantitative restriction in this regard.

In addition to the above tax reforms, the LTFP spells out several measures to check economic evils of tax evasion and smuggling. Basically such measures relates to stringent enforcement, plugging legal loopholes, simplification of tax laws, etc.

Several of the recommendations of the LTFP have already been implemented in the last Union Budgets for 1985-86 and 1986-87. The LTFP indeed serves very useful purpose. It not only spells out by the basic thrust of India's fiscal policy, but also sets norms and parameters for evaluating public finances of the country.

22.11 CONCLUSION

Fiscal policy, says India's Seventh Five Year Plan, "involves more than raising resources for the Government sector. It comprises powerful instrument for influencing macro variables such as savings, investment, the price level and costs as well as allocation of resources. And these must be employed to the best advantage".

This approach to fiscal policy took quite a long time to emerge. The Classical economists believed in least governmental interference with the economy. This called only for a passive role for fiscal policy, essentially devoted to satisfaction of limited collective wants and distributive justice. With the acendency of Keynesian economic analysis, an active fiscal policy has become the pass-word in modern times. The strongest expression of Keynesian fiscal policy is found in the concept of 'Functional Finance'. However, not much of Keynesian and post Keynesian analysis and policy recommendations is relevant for the developing countries, which are required to give top priority to growth and development rather than restrict themselves to a "gapfilling" role for economic stability.

India's fiscal policy since 1951 has been oriented towards promotion of growth, self-reliance and social justice. However, while the fiscal policy performed well in terms of quantitative expansion of fiscal aggregates, it has been found inadequate in several respects. On the whole, fiscal efficiency has been quite low. The Seventh Plan and the LTFP herald a new and re-vitalizing thrust for India's fiscal policy.

At the end, we may again quote Joseph A. Schumpeter: ".... fiscal measures effect the economic organisation right to its cells and that the method of raising a given amount of revenue may make all difference between paralysis and prosperity."

– Prof. S. Sarupria

22.12 SUGGESTED BOOKS

1. B.P. Thyagi : Public Finance
2. H.L. Bhatia : Public Finance
3. R.J. Chellaiah : Fiscal Policy in Under developed countries

22.13 MODEL EXAMINATION QUESTIONS

I Answer the following in about 30 lines each

1. What do you mean by fiscal policy? Briefly trace the evolution of fiscal policy.
2. Explain the classical views on fiscal policy
3. Explain the terms 'Compensatory Finance' and 'Functional Finance'.
4. What are the objectives of fiscal policy in an advanced capitalist economy? Demonstrate the working of fiscal policy in such a country.
5. Critically examine the performance of fiscal policy in India.
6. Discuss the major fiscal problems in India.
7. Give your views on the significance and role of fiscal policy in India.
8. Write a note on the 'Long Term Fiscal Policy'.
9. Discuss the existing 'fiscal structure' in India.
10. Explain how various fiscal instruments can be used for economic policy objectives in India.

II Answer the following the about 15 lines each

1. What are the objectives of fiscal policy.
2. Why a developing country needs a different type of fiscal policy than a developing country? Specify.
3. What do you mean by 'resource mobilization' in the context of Indian Economy.
4. Why should every country be "anxious to pursue the twin aims of stability and growth"?
5. What do you mean by deficit fianancing'? Is it really so bad that we should never resort to it?
6. What are the various instruments of fiscal policy? Discuss their relative importance.
7. Why is the success of our Five Year Plans linked to the performance of Fiscal Policy?
8. Briefly discuss the "taxation in India".
9. Attempt a critique of India's fiscal policy.

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UNIT-23 : BUDGET FORMATION

Contents

23.0 Aims and Objectives

23.1 Introduction

23.2 Origin of the Term Budget

23.3 Uses of Budget

23.4 Balanced and Unbalanced Budget

23.5 Case for Balanced Budget

23.6 Case for Unbalanced Budget

23.7 Budgeting in India

23.8 Economic Classification of Budgetary Transactions

23.9 Conclusion

23.10 Suggested Books

23.11 Model Examination Questions

23.0 AIMS AND OBJECTIVES

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This unit discusses the various asperts relating to budget and describes the method adopted in India in the preparation of budget.

After reading the unit, you will be able to

* understand the uses of budget,
* distinguish between balanced and unbalanced budget,
* analyse the case for balanced and unbalanced budget, and
* understand, the economic classification of budgetary transactions in India.

23.1 INTRODUCTION

Due to their faith in the doctrine of laiseez faire and Say's Law by Markets, the classical economists advocated a balanced budget as the principle of sound finance. But the Keynesian economies has shown that in the interests of full employment, a deficit budget may become necessary. In course of time, the balanced budget doctrine was overthrown, and unbalanced budgets are considered to be very useful for an economy. In India, we have a railway budget, and general budget at the union government level. We have a simple budget at the state government level.

23.2 ORIGIN OF THE TERM "BUDGET"

The term "budget" is derived from a French word, "bougette" which means a leather bag or wallet, and came into being in 1733. The Chancellor of Exchequer used to have a leather wallet to carry his financial paper to the House of Common. When he set off to place his financial plan before the House of Commons, he is used to open his "budget", that is, the bag.

23.3 USES OF BUDGET

Budgeting is an annual fiscal exercise by the Finance Minister of a country and involves effective allocation of scare resources among a multitude of competing public service for attaining certain predetermined goals. Budget determines the scope and range of taxation and specifies the objects to which the public revenue shall be applied. It is also the handmaid of policy–making, both short-term and long-term, and one of the means by which such policy is implemented. It brings the various activities of the government into focus, helps the legislature to take a forward look and enables it to keep policy under review, and provides a means of avoiding lopsided development of public services. Moreover, the budget helps to secure economical and efficient administration by providing suitable yardsticks. Besides, it reflects the true picture of the economy. The existing levels of taxable capacity of the people, the growth in national income, the rates of savings and investment, the volume of employment, the direction in which the economy is proceeding, are all reflected in the national budget. The priorities assigned by the government for various services, the total volume of public expenditure and its allocation among different governmental activities would not only reflect the existing state of economy but also the objectives sought to be achieved by the government through its fiscal operations.

In recent years, budget is an invaluable instrument in the promotion of rapid and orderly economic progress and social change comprehending within its fold direct efforts of the government as well as indirect measures, curbs and constraints designed to influence the private sector activities towards the desired goals.

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23.4 BALANCED AND UNBALANCED BUDGET

A budget may be either balanced or unbalanced. A budget is said to be balanced if current government income i.e., tax receipts equals current expenditure. If the difference between current income and current expenditure is substantial, the budget said to be unbalanced. An unbalanced budget is again of two types – surplus budget and deficit budget. An unbalanced budget in which current income is in excess of current expenditure is known as surplus budget. On the other hand, a deficit budget is one in which current income falls shortly current expenditure. From the above definitions, it follows that a balanced budget does not allow borrowings.

23.5 CASE FOR BALANCED BUDGET

The classical economists believed in a neutral fiscal policy accoridng to which the size of the public sector should be small and the functions of the government should be reduced to the minimum possible extent so that the market mechanism might operate without institutional constraints. Due to their faith in the doctrine of *laiscez faire* and Say's Law of Markets, they considered that a small sized public budget is the best. This is because when full employment, optimal allocation of resources, and equitable distribution can be achieved through the market mechanism, fiscal operations of the government have to be of a non-regulatory and non-interfer nature.

A balanced budget was favoured by the classical economists for the following reasons:

(a) An unbalanced budget, particularly a deficit budget necessitates government borrowing from the private sector which causes a reduction in the loanable funds available to productive private investment.

(b) All government expenditure in the economic field is wasteful and unproductive. Therefore a deficit budget may lead to inflation on account of large and unproductive government expenditure.

(c) Public debt is undesirable for two reasons. Firstly, when public debt matures, government will have to impose additional taxation for its repayment. This additional taxation tends to have an adverse effect on private incentive to work, save and invest. Secondly, public debt increases the demand for loanable funds which causes the rate of interest in the money market to rise. A rise in the rate of interest adversely affects sector investment.

In short, according to the Classical principles of sound finance, a budget must be balanced annually, and the gap if any, between the revenue and expenditrue should be kept at the minimum. In other words, a government should tax the least and that it should not resort to borrowing as far as possible.

The Classical principles of fiscal policy are less relevent to the developing economies where the market mechanism does not work effectively to bring about the high rate of investment due to the existence of economic rigidities, structural disequilibrium, factor immobility,etc. Even in the developed countries the tools of public finance are consciously used to influence the flow of resources into desirable forms of investment and as instruments of economic stabilisation and promotion of economic growth. Moreover, the classical theory which regarded balanced budget as neutral in its effects assumed a static model of the economy which is not relevant to the developing economies. It is also wrong to think that a balanced budget has no multiplier effect. An unbalanced budget will also be a positive and dynamic tool of economic development for raising the volume of savings and investment.

A part from the classical arguments, the balanced budget is also favoured on the basis of the following arguements.

(a) The traditional view of the "soundness"of private budgets also applies to public budgets. Although this argument had its origin in the tendency of the governments resorting to wasteful and unnecessary expenditure, balancing the budget would act as an effective check upon any extravagance of the government.

(b) a balanced budget imparts a sense of fiscal discipline to the government in raising and spending funds.

(c) Since deficit budgets create inflationary pressures, the government would find its expenditure mounting up. This phenomenon itself will add to the temptation to have deficit budgets in future also. The government finds it easier to expand its expenditure if it is to be financed through deficit financing which will have adverse effects on the economy.

(d) for curing depression, a deficit budget was advocated. But the theory of Balanced Budget Multiplier shows that, with appropriate qualifying conditions, even a balanced budget can raise the level of economic activity and income, provide the size of the budget is increased. In other words, to cure a depression (or inflationary pressures) just an appropriate change in the size of the budget without imbalancing it, will do.

23.6 CASE FOR UNBALANCED BUDGET

The arguements in favour of an unbalanced budget are as follows:

(a) since the goal of any government is achieved of full employment, a budget should be used to achieve this goal even by unbalancing the budget wherever necessary.

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(b) a budget needs to be unbalanced in order to avoid the problems of inflation and deflation.

(c) government budgets do not stand on the same footing as private budgets and hence should not be compared.

(d) the government is a part of the economy and therfore its budget cannot be neutral in its impact. It is now well recognised that market mechanism is not capable of bringing about the optimum results in the economy. In order to remove the evil effects of cyclical fluctuations, and to reduce inequalities in the distribution of incomes and wealth, unbalancing the budget gives good results.

(e) a balanced budget itself does not necessarily imply absence of wasteful expenditure.

(f) any predetermined rule that a budget should be always balanced would only restrict the freedom of the government in using fiscal policy as an instrument for achieving socio-economic development.

Check Your Progress - I

1. What is the origin of the term budget?

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2. Give three most important uses of a budget.

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3. Define the term balanced budget.

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4. Distinguish between a surplus budget and a deficit budget.

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23.7 BUDGETING IN INDIA

In India, the budget is called the "Annual Financial Statement". Unlike France and the UK, India does not have a single budget for the entire country. In India, there are budgets at the Union government level as well as the State government level. Again Union government has two budgets, namely, the Railway Budget and the General Budget.

Railway Budget deals with the financial estimates of Railway Ministry while the General Budget deals with the financial estimates of all other Central agencies. The Railway Budget is prepared by the Railway Ministry and is submitted to Parliament by the Railways Minister usually a week before the presentation of the General Budget which is prepared by the Finance Ministry and presented to Parliament by the Finance Minister. However, the totals of the receipts and expenditure of the railways are incorporated in the Budget Statement of the Union Government.

The seperation of railway finances from the general finances was first made in 1924 to safeguard the stability of the general budget as railway estimates were subject to violent fluctuations by their very nature. Under the Seperation Convention, railway revenues have to pay an annual contribution to the general revenues at a prescribed rate on the capital invested on the building of railways as computed annually. The railway estimates provide for the cost of replacements and renewals of railway assets, expenditure on passenger amenities, labour welfare, and railway projects which are necessary but are not always remunerative.

In India, government accounts of the Union governemnt as well as the state governments are kept in three parts, namely, (a) Consolidated Fund; (b) Cotingency Fund, and (c) Public Account.

Consolidated Fund is a fund into which all revenues and all receipts of the government, including loan receipts, are credited. Similarly all goverment expenditure is incurred from out of this Fund. No amount can be spent from the Consolidated Fund without the sanction of the Parliament or State legislature. However, such sanction is not necessary in the case of a few items of expenditure specified in the Consolidated Fund. These charged items of expenditure included salaries of the Judges of the Supreme Court or High Court and Comptroller and Auditor General of India. These items are included in the Budget but not put to vote in parliament or State Legislature. The Contingency Fund is put under the direct control of the unforseen expenditure pending authorisation of the Parliament or State Legislature. At present, the corpus of the Contingency Fund of the Government of India as authorised by the Parliament stands at Rs.30 crores.

Funds in the Public Account are those which do not belong to the Government, This fund includes funds collected on account of provident funds, small savings, etc. Legislative sanction is not required for making payments from out of this Public Account.

23.8 ECONOMIC CLASSIFICATION OF BUDGETARY TRANSACTIONS

In India, economic classification of budgetary transactions was first introduced in the Union Budget for 1957-58. The receipts and expenditure of both the Union and State Governments are divided into Revenue Account and Capital Account.

Revenue Receipts are the receipts of a routine and recurrent nature such as tax and non-tax revenues, while Capital Receipts include market loans, income from public enterprises, receipts

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from Capital assets, external aid, etc.

Revenue expenditure is that expenditure which does not result in the creation or acquisition of capital assets. It is recurrent in nature and is usually met from out of the revenue receipts. In India, revenue expenditure of the Union government includes all current expenditure of the government on civil administration, defence, interest payments, grants-in-aid of the States and Union Territories.

Revenue expenditure is again classifed into developmental and non-developmental expenditure. Developmental expenditure comprises expenditure on: (i) social and community services such as education, medical and public health; (ii) economic service such as agriculture and allied services (including food subsidies), industries and minerals, transport and communications, foreign trade and export promotion, water and power developments; and (iii) grants- in-aid of States and Union Territories for developmental purposes. Non- developmental expenditure consists of expenditure on collection of taxes and duties, administration services, debt services, defence, grants-in-aid of States and Union Territories for non-developmental purposes.

Capital expenditure refers to expenditure on capital projects and durable investment goods. It also includes investments, and loans and advances grants by the Union goverment for capital outlay to the State and Union Territories, public enterprises and others. This expenditure is usually met from out of capital receipts. Sometimes, a surplus on revenue account is carried over to the capital account. The details of union budget for 1991-92 are shown in Table 1.

Capital expenditure is also classfied into developmental outlay, non-developmental capital outlay, loans and advances, and discharge of debt. Developmental outlay includes expenditure on; (i) social and community services such as research, medical and public health, water supply, housing, etc., and (ii) economic services such as agriculture and allied, services, industry and minerals, water and power development, transport and communications, railways, posts and telegraphs, etc. The non-developmental capital outlay consists of expenditure mostly on defence projects, loans and advances from the Union goverment to the States and Union Territories, public enterprises and others; and payments for the discharge of both internal and external public debt are shown in the capital budget separately.

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Moreover, in India the Union budget also includes a plan budget which is a document showing the budgetary proivision for important projects, programmes and schemes included in the Central Plan. It gives the details of the budgetary support for the Central Plan by the sectors of development, including the Central assistance to the State and Union Territories.

Check Your Progress - II

1. Why is railway budget separated from to general budget?

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2. What is meant by consolidated fund?

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3. What is contingency fund? How is it operated?

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4. What is meant by revenue account?

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5. What is meant by capital account?

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23.9 CONCLUSION

The Classical economists believed in a neutral fiscal policy according to which the size of the public sector should be small and that the government functions should be minimum. In their view, the fiscal operations of the government should be non-regulatory and non-interfering in nautre. They believed in the virtues of a balanced budget on the ground that it does not disturb the pattern of income distribution and flow of productive resources. However, the classical principles of fiscal policy are less relevant to developing economies where the market mechanism does not work effectively for various reasons. Although several arguements are put forth in favour of both balanced and unbalanced budgets, the latter has gained importance at present. Unlike the classical view, the modern theory established that even a balanced budget has multiplier effects on income under certain conditions. The present day budgeting is a stupendous task. In India, at the Union government level, there are two budgets, namely, the railway buget and the general budget. The govenment accounts are kept in three parts, namely Consolidated Fund, Contingency Fund and Public Account. Economic classification of budgetary transactions was introduced in India which is still being followed.

– Dr. K. Siva Subrahmanyam

23.10 SUGGESTED BOOKS

1. B.P.Thyagi : Public Finance
2. H.L.Bhatia : Public Finance

23.11 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each

1. Critically examine the classicals' view on balanced budget.
2. Explain the budget formulation in India.

II. Answer the following questions in about 15 lines each

1. List the arguments in favour of balanced budget.
2. Explain the arguments in favour of unbalanced budget

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Table 1 : Budget 1991-92

REVENUE (*000 crores*)

	1989-90	1990-91	1991-92
Revenue Account :	52.3	57.4	67.5
Tax Revenue :	38.3	44.3	52.5
Non-Tax Revenue :	13.9	13.1	15.0
Capital Account :	30.0	38.6	38.2
Loan Recovery :	5.0	6.0	5.7
Other Incomes :	–	–	2.5
Borrowings :	25.0	32.6	30.0
Total Revenue (1+2) :	82.3	95.9	105.7
Deficits			
Revenue deficit :	11.9	17.6	13.9
Expenditure on Revenue Account :	64.2	75.0	81.4
Income on Revenue Account :	52.3	57.4	67.5
Budget deficit (Net RBI Loans)	10.6	10.8	7.7
Total Expenditure (Plan Exp. + Non-plan Exp.) :	92.9	106.7	113.4
Total Revenue (Revenue Account + Capital Account) :	82.3	95.9	107.7
Financial Deficit :	35.6	43.4	37.7
Borrowings :	25.0	32.6	30.0
Budget deficit (Net RBI Loans) :	25.0	32.6	30.0

EXPENDITURE (*000 crores*)

	1989-90	1990-91	1991-92
1. Plan Expenditure :	28.4	29.9	33.3
Revenue Account :	12.1	14.0	17.1
Capital Account :	16.3	15.9	16.6
1. Non-Plan Expenditure :	64.5	76.8	79.7
Revenue Account :	52.1	61.0	64.3
Capital Account :	12.4	15.8	15.4
3. Total Expenditure (1+2) :	92.9	106.7	113.4
Revenue Account :	64.2	75.0	81.4
Capital Account :	28.7	31.7	32.0

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UNIT-24 : FINANCING IN INDIA AND DEVELOPMENT FINANCE

Contents

24.0 Aims and Objectives

24.1 Introduction

24.2 What is Functional Finance

24.3 What is Developmental Finance

24.4 Classification of Sources of Development Finance
(A) Domestic Resources (B) External or Foreign resources

24.5 Conclusion

24.6 Suggested Books

24.7 Model Examination Questions

24.0 AIMS AND OBJECTIVES

This unit discusses the concepts of development finance and various sources of development finance in India.

After reading this unit, you will be able to

* understand the concepts of functional finance and development finance,
* classify development finance broadly into domestic and foreign resources, and
* analyse the importance of each source under the two categories.

24.1 INTRODUCTION

Some economists led by Abba P.Lerner insist that public finance must be "functional finance" whose sole objective is maintenance of full employment and price stability. Ignoring revenue considerations, they argue that all fiscal weapons such as taxation, public borrowing and public expenditure should be oriented towards achievement of this objective. However, the "functional finance" approach is not applicable to developing economies where fiscal operations are to be conducted not only for achieving reasonable price stability but also for revenue mobilisation, capital formation, and growth with redistributive justice. This calls for a development finance approach in the developing economies. Various sources of finance such as taxation, public borrowing, surplus from public enterprises, deficit financing and foreign assistance are to be judiciously combined in order to achieve the goals of development finance.

24.2 WHAT IS FUNCTIONAL FINANCE?

Functional finance approach is a complete antithesis to the annually balanced budget approach. The budget approach stress the importance of "control" and "regulation" over the fiscal activities of the state, whereas the functional finance approach advocates that the government budget should be used to promote macroeconomic goals without any reference to budget balance. Functional finance approach, unlike the annually balanced budget, is less

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concerned with allocative and redistributive considerations and more concerned with aggregate economic performance and economic growth objectives.

The concept of functional finance was developed rather early in the Keynesian era and is built upon Keynesian economic theory. According to this theory, the primary function of public finance is to help the economy to operate at full employment and with price stability. The most famous proponent of the functional finance principle is Abba P.Lerner. He argues that all fiscal operations of the government such as government spending, taxing, borrowing, repayment of loans, the issue of new money, and withdrawal of money from circulation should be undertaken keeping their effects on the national economy in mind. Thus, according to Lerner, functional finance refers to " the principle of judging fiscal measures by the way they work or function in the economy."

24.3 WHAT IS DEVELOPMENT FINANCE?

Development finance, unlike functional finance, refers to the finance of the development strategy adopted by a developing economy for achieving rapid economic development with social justice through fiscal measures. It is not an anti-cyclical fiscal policy. Under the development finance approach, all fiscal measures are judged by the way they work in achieving the goals of economic development such as capital formation, redistributive justice, price stability, etc.

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24.4 CLASSIFICATION OF SOURCES OF DEVELOPMENT FINANCE

The various sources of development finance can be classified into two broad categories: domestic resources, and external or foreign resources.

A. DOMESTIC RESOURCES

The resources which the government would be able to mobilise from within the country are referred to as domestic resources. These can again be divided into a few important categories,namely, taxation, public borrowing, surplus from public enterprises, and deficit financing.

(a) Taxation

Taxation is by far the most important means of resource mobilisation. In fact several countries such as Japan and USSR, have already relied upon this is source in the initial stages of their development. In the context of development finance, taxation should seek to accomplish two broad objectives, namely: (i) restraining or curtailing comsumption and thus transfering resources from consumption to investment; and (ii) modifying the pattern of investment.

(i) Restraining or curtailing consumption

Both direct and indirect taxes reduce the level of consumption. Direct taxes reduce consumption by reducing the level of disposable income of the people, and indirect taxes by making consumption goods costly. Economic development brings about an increase in the incomes of the people. Since the marginal propensity of a majority of people in the developing economies is very high or near unity, increases in income resulting from increased productivity will tend to be consumed. At this juncture, increased commodity taxation could be used to restrict the rise in consumption and thereby making resources available for public investment. However,

taxation is to be used not to reduce the output of necessaries but to raise the incremental saving ratio. For this purpose, indirect taxation has to be used in two different ways. Firstly, it has to be used for restraining a rapid expansion in the output of many non-necessaries and luxuries. Secondly, it has to be used for the transfer of a part of the increased output of wage goods to the investment good sector. Thus by transferring the control of resouces from private consumption to public investment, taxation can be used as an instrument of development finance for increasing savings and investment rates.

(ii) Modifying the Pattern of Investment

Taxation diverts resources from private sector to the public sector, from consumption goods industries to investment goods industries within the private sector, and demand from imports to domestic goods.

Taxation inevitably transfers resources, from the private secotr to the public sector. Besides, taxation of luxuries and exemption of capital goods would cause some diversion of resouces from consumption goods industries to investment goods industries in the private sector. Division of demand from imports to domestic goods would be achieved through import duties in which cause the investment in the be achieved through import duties in which case the investment in the domestic goods industries would increase. Thus taxation can be used as a means of development finance for modifying the pattern of investment.

Moreover, the pattern of investment can also be modified by following a well- conceived discrimenatory tax policy. For example, (a) profits distributed can be taxed at higher rates than profits reinvested for the development of industries which are considered socially useful; (b) allowances for depreciation or for new investments for the socially-important industries can be raised by the government. Similarly, such allowances can be cut down or withdrawn for industries which are considered to be no longer socially useful; (c) through a policy of differential import duties, the government can control both the volume and the direction over fields of investment where imported equipment or material is required. Thus, in the context of development finance, the government through a discriminatory tax policy would be able to fulfill the twin conditions of control in one direction, and incentives on the other, without destroying the freedom of private enterprise.

However, in the developing countries, the scope of taxation is rather limited. As a proportion of national income, taxation consitutes a small percentage. Direct taxation accounts for note more than 25 per cent of the total tax revenue of the government mainly due to low levels of income of the people, existence of a large non-monetised secotor, inefficient tax machinery, large scale evasion, etc. Even indirect taxation has several limits in these countries because a high proportion of consumption in these countries is consumption of subsistence production which inevitably escapes taxation. Moreover, greater use of indirect taxation tends to raise costs of manufacture and thereby tend to increase prices in these countries. Furthermore, as the incidence of indirect taxes is mostly on the poor, they became regressive in nature. Considerations of social justice do not therefore support any substantial increase in indirect taxation for resource mobilisation.

(b) Public Borrowings

As the government cannot raise adequate resources for development finance through taxation

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borrowing programme depends on: (a) the volume of available savings and (b) the institutional framework for tapping these savings.

The volume of available savings in the developing economies is small due to low capacity of the people to save and their marginal propensity to consume. During the initial stages of development, it may be difficult to borrow funds from the people as the increased incomes of the people are likely to be consumed by them. Even if there are savings, people tend to invest their savings not in government securities or in the manufacturing sector but in passive capital such as real estate, speculation, redistributive trades, jewellery, and money-lending.

In the developing economies, the institutional set up for mobilising savings for development finance is rather weak. Organised money and capital markets and banking institutions are not well developed. This again limits the scope for public borrowings.

Therefore, in order to promote savings and investment, the government of a developing economy has to: (i) provide an adequate network of banking and savings institutions; (ii) develop money and capital markets; (iii) encourage corporate savings through tax incentives; (iv) introduce compulsory savings schemes, if necessary; and (v) inculcate savings habits among the people.

(c) Surplus from Public Enterprises

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Although public enterprises in socialist countries such as the USSR make a substantial contribution to the exchequer, in developing economies the role of the public enterprises is rather limited. Some argue that public enterprises should be run on a no-profit no-loss basis, while other argue that there enterprises, like the private enterprises, should be run on commerical principles and aim at generating surpluses for development finance. The goal of surplus form public enterprises would enable the government to siphon off a part of the purchasing power of the people in times of inflation through a rise in the prices of goods and services supplied through public enterprises. Besides, many public enterprises such as steel, power and major irrigation projects involve huge capital expenditure in the initial stages and start earning profits only after a considerable time lag. Hence the prices of the goods and services charged by the public enterprises must be higher than the costs to offset the initial losses.

However, the scope for earning substantial profits from public enterprises in the developing economies is rather limited for two important reasons: firstly, many public enterprises in these countries are still at an early stage of development and therefore cannot earn profits for several years; and secondly; man public enterprises tend to be concentrated in the field of public utilities and the provision of overhead facilities where the scope for profit is very much limited.

(d) Deficit Financing

When the government is unable to raise necessary resources through taxation, public borrowings, and public enterprises, it will be forced to resort to deficit financing or creation of additional money. In the developed capitalist countries, deficit financing is usually resorted to during the periods of depression and war. But deficit financing as a means of development fiannce is of recent origin. Some economists suggest the use of deficit financing for the deliberate generation of inflation in a developing country where there is need for increasing the rate of investment. A mild degree of inflation can accelerate the pace of economic growth in a developing economy by promoting capital formation. The resulting fall in real wages due to inflation increases

stimulating effect upon the incentive to invest; and secondly, the share of profits increases relative to that of wages. This implies, in effect, a redistribution of income in favour of the class whose marginal propensity to save is higher than that of the wage earning class, which increases savings for investment.

However, it may be pointed out here that the success of the weapon of deficit financing depends upon the smooth operation of the multiplier mechanism. The multiplier is based upon two fundamental assumptions, namely, (i) there is enough of excess capacity in the capital equipment; and (ii) there is involuntary unemployment which implies scope for a cut in wages.

In many developing economies, the excess capacity in capital is limited, if not non-existent. This means that when the supply of money is increased through deficit financing, output cannot immediately be increased on account of the lack of excess capacity in capital equipments. The increased demand thus outstrips supply and generates inflationary pressures. Moreover, the type of unemployment characteristic of the developing economies is not one of involuntary unemployment but is disguised unemployment. Since workers in the developing economies live close to subsistence level, wage cut is also not possible. Furthermore, due to structural bottlenecks there will be a greater time lag between production and injection of additional money into the economy. The greater the time lag the greater would be the inflationary potential. Similarly, the greater the maladjustment between the demand for and supply of specific commodities, the greater would be the rise in prices. For the above reasons, deficit financing in developing economies is likely to lead to inflationary pressures.

Although deficit financing cannot be said to be always bad, deficit financing should be the medicine but not the daily bread in development finance. For this, several measures have to be taken by the government to check the inflationary pressures resulting from deficit financing. These measures include: (a) increasing the supply of essential consumption goods such as goodgrains and cloth; (b) increasing the outlay on developmental projects promising a quick yield; (c) imposing economic controls, including physical controls; (d) obtaining foreign assistance for augementing the supply of imported consumer goods; (e) preventing under rise in the wages of industrial labour; (f) mopping up the excess purchasing power of the people through taxation, public borrowing, insurance and schemes of provident fund, etc; (g) imposing monetary controls of selective nature to curb speculative activities; (h) appealing to the public sentiment of the people to hold their earnings in the form of savings rather than spending them on current consumption; and (i) strengthening the administrative machinery to prevent all wasteful expenditure, leakages, and corrupt practices.

B. EXTERNAL OR FOREIGN RESOURCES

When domestic resources are not sufficient for development finance, a developing economy will be forced to seek external or foreign assistance.

Foreign assitance comprises financial or technical assitance received from foreign individuals, foreign private corporate bodies, foreign governments, and international financial institutions.

Foreign private capital may not adequately enter the developing economies due to threat of nationalisation, difficulty of repatriation of capital and remittance of profits, lack of necessary infrastructural facilities, narrow domestic markets, etc. In several cases, foreign private capital in the developing countries went mostly into extractive industries working mainly for export but

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However, in recent years the developing economies are receiving increased foreign assistance through inter-governmental aid, and from international financial institutions such as the world Bank.

In the initial stages of development, foreign assitance becomes very necessary for the developing countries. Therefore, efforts should be made to attract foreign capital. For this purpose, investment treaties, government guarantees to foreign investors against risks, tax concessions, promotional techniques, and joint ventures will go a long way to attract the inflow of foreign capital.

Check Your Progress - I

1. What is meant by the principle of functional finance?

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2. What do you mean by the term "development finance"?

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3. Explain the scope of public borrowings in development finance?

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4. How does deficit financing accelerate the pace of economic development?

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5. Why should public enterprises generate surpluses for development finance?

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6. What are the important reasons for the inadequate inflow of foreign private capital into the developing economies.

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24.5 CONCLUSION

Although functional finance approach repudiates the classical view of balanced budget, it neglects the long term growth of an economy. It also avoids several other considerations such as revenue mobilisation, stepping up the rates of savings and investment, redistributive justice, capital formation, etc., which are very important goals of fiscal policy in developing economies. Under the development finance approach, all fiscal measurers are judged by the way they work in achieving the goals of economic development. The various sources of development finance have their own limitations in the developing economies. Nevertheless, efforts for mobilising adequate domestic and external resources should be made in the interest of development finance.

– Dr. K. Siva Subrahmanyam

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24.6 SUGGESTED BOOKS

1. B.P.Thyagi : Public finance
2. H.L.Bhatia : Public finance

24.7 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines

1) Discuss Various sources of development finance.

II. Answer the following questions in about 15 lines each

1. Discuss the objectives of taxation in the context of development finance.
2. Write a note on the concept of deficit financing in development finance.

BLOCK VII

FEDERAL FINANCE

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This last block deals with the principles governing the allocation of financial resources to the federal as well as State Governments, with special reference to India. It also discuss the Centre-State financial relations in India, the present status of the finance commission, and the recommendations of the Eighth and Nineth Finance Commissions.

The Block consists of 2 Units.

Unit - 25 : Principles of Federal Finance

Unit - 26 : Centre - State Financial Relations in India

UNIT-25 : PRINCIPLES OF FEDERAL FINANCE

Contents

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25.2 Meaning of Federal Finance

25.3 Fiscal Imbalances in Federal Finance

25.4 Principles of Federal Finance

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- 25.4.2 Principles of Adequacy and Elasticity
- 25.4.3 Principle of Suitability

25.5 Applicability of the Principles in India

25.6 Summary/ Conclusion

25.7 Suggested Books

25.8 Model Examination Questions

25.0 AIMS AND OBJECTIVES

The purpose of this unit is to understand the principles governing the allocation of financial resources to the federal as well as State Government with special reference to India.

After reading the unit, you will be able to

* explain the term, 'federal finance',
* indentify the fiscal imbalances in federal finance,
* analyse the principles of federal finance, and
* apply these principles to India.

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25.1 INTRODUCTIONS

A federation involves two levels of governments viz., the federal government and the state or regional governments. A federal form of government, therefore, requires division of public functions and financial resources between these two levels of government. The operational efficiency of a particular level of government in relation to a particular public function depends on the allocation of public functions to these two levels of government. For performing effectively the public functions allocated to a level of government the financial resources of the government have to be divided between those two levels of government. There are certain principles concerning the allocation of financial resources between the federal government and the federating units, namely, the states. The present lesson is devoted to an examination of these principles and their relevance to India.

25.2 MEANING OF FEDERAL FINANCE

"Federal finance" refers to the finances of the federal as well as the state governments and the fiscal relationship between these two levels of governments. In a federation, both the federal and state governments derive their powers directly from the Constitution of the country. The Constitutions assigns to each level of government specific functions and powers over which the

other level of government does not usually have any control.

25.3 FISCAL IMBALANCES IN FEDERAL FINANCE

Imbalance in the allocation of functional responsibilities and financial resources between the federal and state governments characterize all federations. In a federations, two types of fiscal imbalances are present. The first is the **"vertical fiscal imbalance"** which occurs when there is an imbalance between tax revenues and expenditure needs among different levels of government (federal-state or state-local).

The second is the **"horizontal fiscal imbalance"** which occurs when there is an imbalance between tax revenues and expenditure needs among different states. Differences in the distribution of income and wealth, resources endowments, and the consequent differences in their income earnings abilities result in horizontal fiscal imbalance among different states in a federation.

In India we find both vertical and horizontal fiscal imbalances. These fiscal imbalances are aggravated by developments in both taxation and public expenditure. On the one hand, with the progressive integration of economy, the more productive and elastic tax sources have increasingly became suitable for exploitation at the national level from the view point of resource allocation as well as that of efficiency in administration. On the other hand, the gradual evolution from a state marked by *laissez faire* into a welfare State has forced the Union and State governments, particularly the State governments, to undertake a wide range of costly public services such as education and public health. Thus the government unit most suited to the provision of a particular public service may not necessarily be the best for raising the necessary financial resources. Moreover, the problem has become complicated by marked disparities in inter-state distribution of income and wealth. Hence, the need for redressing the fiscal imbalances in India is great.

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Check Your Progress - I

1. What is federal finance?

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2. What is vertical fiscal imbalance?

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3. What is horizontal fiscal imbalance

25.4 PRINCIPLES OF FEDERAL FINANCE

There are differences of opinion by many economists on the various principles of federal finance which some times clash with each other. Therefore, an understanding of the important principles of federal finance put forward by different economists is necessary.

25.4.1 Principles of Independence and Responsiblity

This principle states that each level of government in a federation should be vested with independent financial powers. In other words, each level of government should have seperate sources of revenue, full powers to levy taxes, to incur expenditure, to borrow and lend funds in order to effectively carry out the public functions entrusted to it. Moreover, according to this principle, each level of government should be held responsible for raising the revenue necessary for performing the functions entrusted to it.

However, it must be observed that this principle may well be impracticable and undesirable, even if feasible for the following reasons:

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(a) This principle implies that there should be a system of "complete" separation of revenue which has been already proved to be impracticable by the developments in federal finance.

(b) Even if all states in a federation are given the same sources of revenue, potential of various sources will differ from state to state owing to horizontal fiscal imbalance. As a result, this priciple conflicts with the principle of adequacy.

(c) In view of the growing integration of the economy, rapid development of trade, and the adoption of national planning, it may not be possible to give full freedom to the state governments to do what they like in the financial field. In fact, the allocation of resources between the federal and state governments should be such as can best be administrated by each of them without weakening the efficiency of the national fiscal policy. It ensures growth with stability, protection of the balance of payments and alleviation of distributional inequalities in personal incomes.

25.4.2 Principle of Adequacy and Elasticity

According to the principle of adequacy, the resources, allocated to each level of government should be adequate for the present discharge of duties entrusted to it. Such adequacy should relate to not only the existing needs but also the future requirements. It frequently happens in a federation that the state governments are entrusted with functions which entail increasing expenditure from year to year. Even if the states are able to finance such expenditure at present, they may in due course find their expenditure growing at a faster rate than their revenues which are mostly elastic in nature. On the other hand, the federal government has functions which entail more or less unchanging expenditure in ordinary times but which may shoot up during war or any national financial crisis. Thus in normal times the growth of federal revenues is faster than its peace time expenditure. In view of the changing industrial and economic conditions, it

distribution of financial resources between the federal and the state governments has disrupted the centre-state relations.

25.4.3 Principle of Operational Efficiency and Administrative Economy (orPrinciple of Suitability

According to this principle, each level of government is able to exploit certain taxes efficiently and economically. The taxes allocated to a particular level of government must be such that they can be collected by it more efficiently than by the other level of government, with economies in administrative and collection costs. This principle, if followed, would naturally cause a vertical fiscal imbalance in a federation. However, in order to reduce such an imbalance, a well-conceived system of revenue trnasfers from the higher level government to the lower level government such as devolution of federal tax revenue and grants in-aid, could be employed.

In practice, it is difficult to observe all the above mentioned principles in the actual scheme of financial allocation between the federal and state governments because they, conflict with one another. For example, if principle of independence and responsibility is observed it may not be possible to observe the principle of adequacy and elasticity. Similarly, if the principle of suitability is followed, it may be difficult to observe the other two principles. Therefore, in view of the conflicting nature of these principles, the actual scheme of allocation in various federations is based on a judicious combination of these principles.

25.5 APPLICABILITY OF THE PRINCIPLES TO INDIA

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In India the principle of independence and responsibility is partly followed because the Indian Constitution provides for only a partial separation of revenue between the Union and State Governments. The Union and State Governments have been clearly allocated certain taxes by the Indian Constitution. They have exclusive powers to levy taxes and incur expenditure within their respective spheres. But with regard to borrowings, the powers of the States are seriously curtailed because the Union governments enjoys a virtual monopoly in this respect.

The principle of adequacy and elasticity is observed to a lesser extent than the others in the Indian federal financial system. Owing to the increasing integration of the economy and the developments in transport, commerce and trade, the centralisation of productive resources and decentralisation of functional responsibilities have become inevitable. The States are not able to mobolise adequate resources from their own taxes and consequently they have to depend upon the Union Government for assistance. The responsibilities of the State have also increased after the adoption of economic planning in the country which has the effect of increasing their dependence on the Union government for assistance.

In India, the scheme of allocation of financial resources is largely based on the principle of operational efficiency and administrative economy (or principle of suitability). Since the Union government is best suited to exploit many productive and elastic taxes, the states are left with only a few taxes which are comparatiely less elastic and less productive in nature. The states are burdened with several expensive and expansive responsibilities, especially social services. In view of this, a considerable volume of revenue transfers from the Union government to the States has become increasingly necessary. Realising this, the framers of the Indian Commission have included a few compensation privisions to full in the States' revenue gap.

Besides allocating specific taxes to both the Union and the State Governments, the Indian Constitution provides for other kind of tax revenue transfers from the Union government to the state governments. They are setforth here under:

(a) Duties or taxes levied and collected by the Union government but the net proceeds are or may be shared between the Union and State governments, e.g., personal Income Tax and Union Excise duties.

(b) Taxes levied and collected by the Union government but the entire net proceeds of which are assigned to the States; e.g., Estate duty.

(c) Duties levied by the Union government which are collected and retained by the State governments e.g., Central Sales Tax.

The Indian Constitution has provided for the appointment of the Finance Commission in view of the possible emergence of vertical as well as horizontal fiscal imbalances in the Indian federal financial system.

Check Your Progress - II

1. What are the principles of federal finance

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25.6 CONCLUSION

Fiscal imbalance in the allocation of functional responsibilities and financial resources is a characteristic feature of all federations. In order to ensure vertical and horizontal fiscal equity, allocation of resources to the federal and state governments should be made in such a way that there is correspondence between functional responsibilities and financial resources at each level of government. However among the principles laid down by economists for allocation of financial resources between the federal and state governments, the principle of operational efficiency and administrative economy (or the principle of suitability) alone is considered practicable in many federations including India.

– Dr.K. Siva Subrahmanyam

25.7 SUGGESTED BOOKS

1 B.P. Thyagi : Public Finance
2 H.L. Bhatia : Public Finance
3 U.K. Hicks & Others : Federalism and Economic Growth
4 B.P. Adarkar : The Principles and Problems of Federal Finance
5 Wilfered David (ed.) : Public Finance, Planning and Economic Development (Essays in Honour of U.K. Hicks)

25.8 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each:

1. Discuss the fiscal imbalances in federal finance.
2. Explain the principles of federal finance and their relevance to India.

II. Answer the following questions in about 15 lines each:

1. State the problem of federal finance
2. Examine the principle of 'Independence and Responsibility'
3. Explain the 'Principle of Suitability'.

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UNIT-26 : CENTRE - STATE FINANCIAL RELATIONS IN INDIA

Contents

26.0 Aims and Objectives

26.1 Introduction

26.2 Centre - State Financial Relations in India

26.3 Finance Commission

26.4 Finance Commission Vs Planning Commission

26.5 Recommendations of the Eighth Finance Commission

26.6 Recommendations of the Nineth Finance Commission

26.7 Summary/Conclusion

26.8 Suggested Books

26.9 Model Examination Questions

26.0 AIMS AND OBJECTIVES

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The purpose of this unit is to discuss the Centre - State financial relations in India, the present status of the Finance Commission, and the recommendations of the Eighth and Ninth Finance Commissions.

After reading the unit, you will be able to

* explain the Centre-State financial relations in India,
* analyse the structure and functions of the finance commission,
* explain the functions of Planning and Finance Commissions, and
* discuss the recommendations of Eighth and Ninth Finance Commissions.

26.1 INTRODUCTION

The framers of the Indian Constitution were aware that no distribution of financial resources, no matter how carefully made, could be satisfactory at all times and all circumstances. They acknowledged the possibility of revenue deficits occuring in respect of the States and therefore provided for the devolution of revenues through shared taxes and grants from the Union to the State governments. However, the adoption of the national economic planning and the inadequate resource base of the States have gradually in recent years. The State governments also complain of the gradual encroachment on their fiscal autonomy by the Union government. The Finance Commission which is a Constitutional body is not able to protect the State from such fiscal encroachment, although it has been trying to devolve a larger quantum of resources on them.

26.2 CENTRE - STATE FINANCIAL RELATIONS IN INDIA

26.2.1 Divisions of Powers under Indian Constitution

The financial relations between the Centre and the State governments in India as enumerated in the Indian Constitution are largely based on the provisions of the Government of India Act, 1935. The Indian Constitution provides for a Union List, a State List and a Concurrent List. In the 'Union List' the powers and functions of the Union governments are enumerated clearly in the 'State List'. The "Concurrent List" contains items over which the Union and the State governments have concurrent jurisdiction. According to the Indian Constitution, the residury powers are vested in the Union government. An examination of the three lists shows that while the Union government is alloted the more elastic tax sources such as customs duties, excise duties, corporation tax, and income tax, the States have the less elastic tax sources such as land revenue, sales tax, motor vehicle tax and excise duties on alcoholic liquors, opium, Indian hemp and other narcotic drugs and narcotics. The concurrent list does not confers any tax power.

26.2.2 Grants-in-Aid

Although tax resources are distributed between the Union and the State governments, the Indian Constitution provides for transfer of revenue of certain tax heads from the Union to the State governments on the basis of the recommendations of the Finance Commission. These tax heads include personal income tax, union excise duties, estate duty, etc. Besides, the Constitution provides for transfer of revenue through grants-in-aid from the Union to the State governments. These grants can broadly be divided into three important categories, namely, (a) grants paid to the States as per the recommendations of the Finance Commission which are variously called 'non-plan grants' or 'statutoy grants' (b) grants paid to the States in consultation with the planning commission for execution of plan schemes which are refferred as 'plan grants' and (c) grants paid at the discretion of the Union government to the States for helping them to meet the contingencies of natural calamities, etc. As the Union government has the power to raise internal as well as external loans on the security of its Consolidated Fund. But State governments are permitted to raise external loans. They can borrow from the Union Governments or from within India only on the security of their Consolidated Fund. However, if any state is indebted to the Union government, it cannot raise any fresh loan without the consent of the Union government. Thus serious restrictions are placed by the Indian Constitution on the borrowing powers of the States. The Union government has provided to the States a large variety of loans for both plan and non-plan purposes. Practically a large number of States in India are increasingly indebted to the Union government. Hence these State governments are required to obtain the consent of the Union government before resorting to new borrowings.

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26.2.3 Dependence of State Governments on Centre

In India, the Centre-State financial relations as evolved during the post- Independence period coincides with the national economic planning. Ever since the adoption of national economic planning, the State government have been come to depend on the Union government for increasing financial assistance. Moreover, there is a gradual encroachment on the fiscal autonomy of the States due to the centralisation of several productive revenue sources.

26.2.4 Encroachment of States' Fiscal Autonomy

The State governments which are entrusted with several expensive public functions complain of inadequate resources and encroachment on their fiscal autonomy for which they hold the Union government responsible. They do so on the following grounds:

(a) The introduction of the corporation tax which has formerly been a component of the income tax has deprived the States of a substantial revenue, since the revenue from the corporation tax is not being shared between the Union and the State governments.

(b) Although the surcharge on income tax which is being levied by the Union government (abolished with effect from 1985-86) is virtually an addition to the income tax, its revenue is not shared between the Union and the State governments as in the case of income tax.

(c) In 1956 the State governments surrendered their right to levy sales tax on textiles, sugar and tobacco to the Union government which agreed to levy additional excise duties on these commodities and transfer the revenue to the States. But the Union government has not increased the tax rates of these duties and, therefore, the revenue mobilised from this source has not increased significantly unlike that of the basic excise duties. In the absence of these additional excise duties, the States would have mobilised more revenue from sales tax on these commodities. The States are, therefore, not adequately componsated for the boss of their sales tax revenue in respect of these three commodities. Owing to this reason the State governments are not prepared to surrender their right to levy sales tax on other commodities which the Union government wants to bring under the purview of the additional excise duties.

(d) The Union government has not been consulting the States before reducing or abolishing taxes in the revenue of which the States have a stake.

(e) The Union government has the right to meet any deficit in its budget by having recourse to the printing press. Such deficits during certain years constituted as much as 10 to 15 per cent of the aggregate outlay of the Union government. The States, on the other hand, have no such mechanism to fall back upon. They can only seek temporary overdrafts from the Reserve Bank of India. The overall limit set for such overdrafts does not, however, exceed two and a half per cent of the total annual expenditure for most of the States. The Reserve Bank is supposed to cut off the standard banking facilities offered to the State governments if they exceed the limit for more than seven consecutive days.

(f) Under the Indian Constitution, the Union government may, simply by passing an Act in Parliament, declare a commodity to be of "special importance". Once a commodity is so declared, no State government is able to impose sales tax on it at a rate higher than four per cent. As more and more goods such as cotton, coal, iron and steel, are "declared" in this manner, the dependence of the States on the Union government increases.

(g) Of the total transfer of resources from the Union to the States, not more than one-fourth constitutes the resources transferred in terms of the Finance Commission's recommedations. The other three-fourths, including plan grants, is completely left to the discretion of the Union government. Political and party considerations are, therefore, likely to affect the transfer of a large part of the total resources.

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26.3 FINANCE COMMISSION

The Indian Constitution is unique in the sense that it provides for the appointment of an independent expert body, viz., the Finance Commission, to deal with the problem of Union-State fiscal relations. Such a provision for the setting up of an independent Constitutional body with wide powers is not found in the Constitutions of several other federations.

The Indian Constitution lays down that the President should appoint a Finance Commission within two years of the commencement of the Constitution and thereafter at the end of every fifth year or earlier. The Finance Commission consists of the Chairman and four other members. The Chairman must be a person who has had experience of Public affairs, while the members should be persons who (i) are, or have been, or are qualified to be, appointed judges of a High Court or (ii) have special knowledge of the Finance and Accounts of the Government; or (iii) have had wide experience of financial matters in administration; or (iv) have special knowledge of economics.

26.3.1 Function of the Commission

The Function of the Finance Commission is to make recommendations to the President of India concerning (a) the distribution of those taxes which are to be or may be divided between the Union and the States; (b) the distribution of the States' share among the State *inter se;* (c) the principles which should govern the grants-in-aid of the States from out of the Consolidated Fund of India; and (d) any other matter referred to the Finance commission by the President in the interests of sound finance.

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The Finance Commission has the status of a Civil Court and determines its own procedure. It is an advisory body. As a matter of fact the President is not bound to accept all the recommendations of the Commission. However, by convention, most, if not all, of the recommendations of the Finance Commission are accepted by the Union government. The financial assistance which the states receive on the basis of the recommendations of the Finance Commission is of a statutory nature and does not involve Central control over its utilisation. Therefore, the fiscal autonomy of the States is not affected by the Finance Commission. On the other hand, grants made to the States by the Union government under Article 282 of the Indian Constitution are discretionary in nature and are given to the States as conditional grants in consulation with the Planning Commission. Nine Finance Commissions have so for been appointed by the President of India.

26.4 FINANCE COMMISSION VERSUS PLANNING COMMISSION

With the adoption of economic planning, the role for the Finance Commission has undergone a radical change. The national economic planning in India has resulted in considerable centralisation of the resources. The Planning Commission which was established in 1950 by an Executive Order has gradually emerged as an important agency for Central transfers (mainly for developmental purposes). For the purpose of formulating the Plan, the Planning Commission estimates the resources which may be available for financing State Plans (as well as the Central Plans). Such an exercise, by its very nature, encompasses the entire area of the State's financial transactions. Therefore, demarcation of an area of devolution under the exclusive jurisdiction of the Finance Commission is not possible.

There is an overlapping of the functions of the Planning Commission and the Finance Commission. Both carry out independent resource exercises for estimating each State's position on non-plan account. However, as the federal financial system has evolved in India, the recommendations of the finance Commission relating to shared taxes and grants-in-aid under Article 275 of the Indian Constitution are generally accepted by the Union Government.

The Planning Commission independently estimates the balance from current revenues (i.e., the excess/shortfall of revenue receipts at pre-plan levels of taxation over current non-plan expenditure), the magnitude of which (excluding central tansfers) differs from the Finance Commission's estimate of the non-plan revenue position (excluding transfers from the Centre). In its own estimate the Planning Commission does not alter the recommendations of the Finance Commission. But in the resource exercise which forms the basis for the determination of the plan size, its thc estimate of the Planning Commission that presumably finally prevails.

Therefore, the importance of the Finance Commission consists not so much in the magnitude of gaps assessed by it, but in (i) its approach to the problem of federal finance; (ii) the methodology adopted by it for estimating non-plan revenue gap; and (iii) the criteria applied by it for inter-state distribution of resources.

Although the Finance Commission strengthens the finances of the States without subjecting them to Central control, it can offer the States only partial protection against Central encroachment on their fiscal autonomy. This is due to the fact that a large part of the Central assistance in relation to plans comes to the States in the form of loans and grants under Article 282 of Indian Constitution. These "plan grants" which the States cannot refuse unless they are prepared to forgo the benefits of development make the States vulnerable to Central Control.

Moreover, in evolving a rational and objective criteria for its devolutions, the Finance Commission *vi-a-vis* the Planning Commission is rather in a disadvantageous position on two counts. First, the scope of the Planning Commission is much wider than that of the Finance Commission (e.g., non-plan revenue account in the case of the 4th, 5th and 7th Finance Commissions). Secondly, in devising its scheme of resource transfer and of allocation in general, the Planning Commission has the benefit of agreed plan priorities which, in turn, are presumably determined in accordance with the overall objectives of planning. Thus a rational and well-defined basis already exists for the Planning Commission's devolutions. As for the Finance Commission, the terms of reference are so broad as to render the formulation of operational criteria rather difficult.

Thus, soon after the adoption of the Indian Constitution, the gradual rise in importance of the Planning Commission with wide powers over resource allocations has resulted in a progressive downgrading of the role of the Finance Commission in India.

The issue of duplication and overlapping of functions of the Finance Commission and the Planning Commission in India has attracted the attention of not only the Public Finance experts but also of several Finance Commissions. However, there is no unanimity of views on this subject. In short, solutions suggested in this regard are of three types, namely, (i) abolition of the Planning Commission and the transfer of its functions to a permanent Finance Commission; (ii) abolition of the Finance Commission and the transfer of its functions of the Planning Commission; and (iii) Coordination of functions to the Planning Commission and the Finance Commission in an appropriate and workable manner.

Legally, there is nothing in the Indian Constitution to prevent the Finance Commission from taking into account the requirements of the Plan also. Similarly, there is no bar to making

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the Commission a permanent body. A Permanent Commission ensures a high degree of stability and continuity in its work. In fact, as Asok Chanda observes, "the provision of a Finance Commission is intended to assure the States that the scheme of distribution will not be made by the Union arbitrarily but will assess the changing needs of the States in making them". A permanent Finance Commission will be in harmony with the spirit and even with the express provision of the Commission. Such an arrangement also makes recommendations of the Finance Commission all the more realistic as they would take into account the interdependence of capital revenue expenditure in a planned programme.

Check Your Progress - I

1. What is the function of Finance Commission?

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2. List the division of Centre-State powers under Indian Constitution?

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3. Do you find any difference between Finance Commission and Planning Commission?

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26.5 RECOMMENDATIONS OF EIGHTH FINANCE COMMISSION

The Eighth Finance Commission was constituted by the President of India in June 1982 with the late Y.B. Chavan as its Chairman. The Commission submitted its interim report covering the period 1984-85 in November 1983, and its final report on April 30, 1984 covering the period from 1984-85 to 1988-89.

The following are the important recommendations of the Eighth Finance Commission.

26.5.1 Income Tax

The Commission did not alter the existing shares of the States and the Union in the divisible pool of income tax. In other words, it recommended the retention of the States' share at the existing level of 85 per cent. Regarding the *inter-se* distribution of income tax proceeds, the

Commission felt that the criteria for allocation should be more progressive that the existing system which give weight only to two factors, *viz.*, population and contribution. It was also of the opinion that "there is nothing in the Constitution which bars the allocation of income tax on the same criteria as that of excise duties." Accordingly, in order to give weightage to factors like collection, population as well as the levels of development, the Commission recommended that (a) 10 per cent of the States' share of income tax might continue to be allocated on the basis of contribution as measured by assessment, and (b) the balance of 90 per cent should be allocated between the States on the same principle as applicable for allocating a predominant part of the States' share of union excise duties, *i.e.*, by giving a weightage of 25 per cent to population; 25 per cent to the inverse per capita income multiplied by population; and 50 per cent to the distance of per capita income of States from the highest per capita income of any State multiplied by population.

26.5.2 Union Excise Duties

The Commission recommended an increase of the States' share from 40 per cent to 45 per cent of net proceeds of all excise duties excluding those collected under the provisions of Additional Excise Duties (Textiles and Textile Articles) Act, 1978 and the cesses earmarked by law for special purposes. It also suggested that earmarking of certain levies of excise should be kept to the minimum. Regarding excise duty on electricity, the Commission endorsed the recommendations of the earlier Commissions and suggest that the entire excise duty on electricity should be distributed among the States in an amount equal to the collections in or attributable to that States. However, the Finance Minister in his Budget Speech for 1984-85 announced the abolition of this duty from October 1, 1984 and left it to the State governments to tap this source in the way they liked.

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Regarding the criteria for the allocation of excise duty among the States, the Commission was guided by three overriding considerations of progressivity, simplicity, and availability of firm and reliable data. After reviewing the three composite criteria of distribution other than population adopted by the Seventh Commission, the Eighth Commission opted for a less complicated one, that of the distance of per capita income of any State (Distance method) which would take care of factors like striking imbalances between States in their revenue resources, capacity to raise resources, and relative backwardness. In the view of the Commission this criterion suffered the least from data deficiency, and would generally be acceptable to most States. It also observed that special arrangements were necessary to help the States having deficits on their revenue account.

On the basis of the above mentioned considerations, the Eighth Finance Commission recommended that; (a) 40 per cent of the net proceeds of shareable excise duties excluding that on electricity, should be distributed among the States in a manner similar to the distribution of 90 per cent of shareable income tax; (b) in helping the states which have deficits on revenue account, the Commission set apart 5 per cent of the net proceeds of excise duty to be distributed on the basis of the proportion of deficits of each State to the total deficit of all States.

26.5.3 Surcharge on Income tax

The Commission observed that a surcharge continued indefinitely could well be called an 'additional income tax' shareable with the rest of the proceeds of income tax. Accordingly, the Commission suggested that the surcharge on income tax should be withdrawn from the commencement of 1985-86 and that suitable adjustments be made in respect of the basic rates of income tax.

26.5.4 Corporation Tax

The Commission strongly felt that a further review of the Corporation tax was overdue for removing a major irritant in Union-State fiscal relations.

26.5.5 Additional Excise Duties

The Commission felt that the only proper principle for the allocation of the net proceeds of additional excise duties on textiles, sugar and tobacco would be the "consumption" of the relevant commodities in each State. However, in the absence of reliable estimates of state-wise consumption of these commodities, the Commission used the State Domestic Product (SDP) on the assumption that the consumption of sugar, textiles and tobacco would tend to increase with the rise in the State income. Significant weightage was also given that equal weight should be given to SDP and population for determining the shares of the States in the additional excise duties for all the three commodities. It also held that there was no necessity for setting apart any guaranteed amount as well as the States would be getting a larger amount than the guaranteed one under any kind of distribution principle.

26.5.6 Estate Duty

Agreeing with the Seventh Commission, the Eighth Commission recommended that the net proceeds of the state duty in respect of property other than agricultural property should be distributed among the States in proportion to the gross value of the property (both moveable and immoveable) located in each State and brought into assessment, with the property located abroad deemed to be located in the State where it was brought to assessment.

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26.5.7 Grant-in-lieu of Tax on Railway Passenger Fares

The Commission recommended that the quantum of the grant in lieu of a tax on railway passenger fares should be raised to Rs. 95 crores per annum. It also recommended that the shares of the States from this grant should be allocated in the same proportion as the average of the non-suburban passenger earnings in each State in the years from 1978-79 to 1981-82 one to the average of the aggregate non-suburban passenger earning of all States in those years.

26.5.8 Financing Relief Expenditure

The Eighth Finance Commission recommended that the scheme of financing the relief expenditure as recommended by the Seventh Commission should continue. Besides, the Commission revised the margin moneys for the different States upwards and fixed the margin money for each State at a higher level than before. It also recommended equal sharing of the margin money between the Union and the States.

26.5.9 Non-Plan Capital Gap of the States

For the purpose of debt relief, the Commission computed non-plan capital gap of the States after excluding repayments of overdraft loans and small saving loans. It recommended an amount of Rs. 2285.39 crores to the States in the five year period commencing from 1984-85, including,

26.5.10 Grants-in-Aid

Commission recommended a total amount of Rs. 2200.22 crores to eleven States over th[illegible]ar period of 1984-85 to 1988-89 towards grants to cover the deficits on their revenue account. It also recommended another sum of Rs. 967.33 crores to the States towards grants for covering the up grading of standards of administration as well as for the Commission also recommended that a sum of Rs, 120.375 crores should be paid to the States each year to meet their margin money requirements. Finally, the Commission recommended grants to deficit States to cover net additional interest liability on accousnt of fresh borrowings and lendings as well as to cover the additional burden on account of committed expenditure in respect of plan schemes.

The Eighth Finance Commission substantially increased the quantum of assistance to be received by the States through devolutions and grants. The State governments would be provided a total amount of Rs. 7806.87 crores for the year 1985-86 on the basis of the recommendations of the Commission.

26.6 RECOMMENDATIONS OF THE NINETH FINANCE COMMISSION

The Ninth Finance Commission was constituted by the President of India in June 1987 with N.P.K. Salve as its chairman. The commission submitted its second report in December 1989 covering the period 1989-90 to 1994-95. Let us discuss the important recommendations of the Ninth Finance Commission.

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26.6.1 Income Tax

Following the broad approach of the Eighth Finance Commission, it also recommended that the shareable proceeds of income tax are to be distributed among the states in the following manner.

(i) 10 per cent on the basis of 'contribution' as measured by the assessment of income tax for the years 1985-86 to 1987-88;

(ii) 22.5 per cent on the basis of population in 1971;

(iii) 45 per cent on the basis of distance of the per capita income of a state from that of the highest per capita income of the most developed state multiplied by the 1971 population of the State concerned;

(iv) 11.25 per cent on the basis of composite index of backwardness complied by the Nineth Finance Commission.

26.6.2 Union Excise Duties

The Commission has recommended that the divisible pool of union excise duties should include the proceeds of all excise duties including special excise but excluding duties collected under the Additional Duties of Excise Act, 1978. The State's share in the net proceeds of shareable union excise duties shall be 45 per cent.

26.6.3 Estate Duty

Since the Central government abolished the estate duty with effect from April 1985, the Nineth Finance Commission was not required to make any recommendation with request to distribution of revenue proceeds from it among the states.

26.6.4 Grants-in-Aid

The Ninth Finance Commission decided not to apply the principle of budgetary needs and other principles enunciated by the First Finance Commission for determining grants-in-aid to the States. Accordingly it recommended not to fill the budgetary gaps of the States, but to meet their fiscal needs. Fiscal needs is represented by the difference between normatively determined revenue receipts and non-plan expenditure. The commission recognised 14 States for receiving Rs.6,016.35 crores as revenue gap grants. It also recommended that grants-in-aid amounting to Rs. 9,000.83 crores should be paid to 12 States for meeting the deficit in the revenue components of the plans of the State governments.

26.7 SUMMARY/CONCLUSION

In India, the problem of Centre-State financial relations has assumed great importance in the last two decades. The States complain that the gradual centralisation of resources has been eroding their fiscal autonomy. Owing to the imperatives of national economic planning, the States have come to depend upon the Union government for greater financial assistance. The Planning Commission which was created in 1950 has become a very important institution and in the process, the share of assitance being receieved by the States as per the recommendations of the Finance Commission in the total quantum of financial assistance given by the Union government has not only become small but has also been declining gradually. At present there is an overlaping of functions performed by the Finance Commission and the Planning Commission, which can, be prevented, perhaps, by abolishing the Planning Commission and entrusting its functions to a permanent Finance Commission.

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– Dr.K. SIVA SUBRAHMANYAM

26.8 SUGGESTED BOOKS

1	D.T. Lakdawala	Union-State Financial Relations
2	K.V.S. Sastri	Federal-State Fiscal Relations in India
3	G. Thimmaiah	Federal Fiscal Systems of Australia and India: A Study in Comparative Relevance
4	B.N. Gupta	Indian Federal Finance and Budgetary Policy
5		Report of the Eighth Finance Commission, 1984
6		Report of the Nineth Finance Commission, [illegible]

26.9 MODEL EXAMINATION QUESTIONS

I Answer the following questions in about 30 lines each:

1. Explain the role of the Finance Commission in the Indian federal finance
2. What are the important recommendations of the nineth Finance Commission?

3. Discuss the problem of overlapping of the functions of the Finance Commission and Planning Commission.
4. What are the complaints of the State governments?

II Answer the following questions in about 15 lines each:

1. Write a note on the Finance Commission in India.
2. What are the recommendations of the Eighth and Nineth Finance Commissions relating to the income tax?
3. What was the criteria suggested by the Eighth Finance Commission for the distribution of the revenue from Union Excise Duties?

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FACULTY OF SOCIAL SCIENCES

B.A. III YEAR (3 Year Degree Course) Examination

ECONOMICS

PAPER III : Public Finance
Model Question Paper

Time 3 Hours

Max.Marks 100
Min.Marks 35

SECTION A - (MARKS 4× 15 = 60)

Answer any FOUR of the following EIGHT Questions.
Each Question carries 15 marks.
Answer the following in about 30 lines each

1. Explain the concept of maximum social advantage. How do you measure it?
2. What is meant by progressive taxation? Discuss its effects on production and distribution.
3. Distinguish between incidence and impact of a tax. Illustrate your answer considering sales tax.
4. Distinguish between tax design and tax reform. Examine the need for tax reform in India.
5. Examine the reasons for the growth of public expenditure in India.
6. Critically examine the view of classical economists on balanced budget
7. Examine the various theories relating to the pricing of public enterprises.
8. Explain the the various methods of measuring national income.

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SECTION - B (Marks 5× 8 = 40)

Answer any FIVE of the following TEN questions.
Each question carries 8 marks.
Answer the following in about 15 lines each.

9. Briefly explain the structure of an input-output table.
10. Examine the indicators for taxable capacity.
11. Explain the various methods of repayment of public debt.
12. What are the differences between public finance and private finance.
13. Explain the theory of functional finance.
14. What are the effects of public expenditure on income distribution.
15. What are the canons of public expenditure.
16. What are the objectives of fiscal policy in India.
17. Explain the classification of public revenue.
18. Examine briefly the recommendations of Kaldor on direct taxation in India.

Dr. B.R. AMBEDKAR OPEN UNIVERSITY

UNDERGRADUATES COURSES : III YEAR

SUBJECT : ECONOMICS

COURSE III : PUBLIC FINANCE

ASSIGNMENT No. 1

N.B.

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours' time.

I. Answer the following questions in about 30 lines each

1. Explain the nature and scope of Public Finance.
2. Critically examine the canons of taxation.
3. Briefly discuss the theories of incidence of taxation.

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II. Answer each of the following questions in about 15 lines

1. Discuss the characteristics of a tax.
2. Distinguish between direct and indirect taxes.
3. Discuss the cost of service principle of taxation.

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UNDERGRADUATES COURSES : III YEAR

SUBJECT : ECONOMICS

COURSE III : PUBLIC FINANCE

ASSIGNMENT No. 2

N.B.

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours' time.

I. Answer the following questions in about 30 lines each

1. Explain the recommendations of various committees on direct taxes in India.
2. Examine the Wagner's hypothesis for the growth in public expenditure
3. Define the concept of taxable capacity. Discuss the factors which determine the taxable capacity of a country.

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II. Answer each of the following questions in about 15 lines

1. Explain the following concepts
   (a) Absolute tax incidence
   (b) Differential tax incidence
2. Explain the meaning and distinction between elasticity and buoyancy of tax revenue.
3. Explain Nicholson's and Dalton's classification of public expenditure.

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UNDERGRADUATES COURSES : III YEAR

SUBJECT : ECONOMICS

COURSE III : PUBLIC FINANCE

ASSIGNMENT No. 3

N.B.

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours' time.

I. Answer the following questions in about 30 lines each

1. What is deficit financing? Why is it regarded as "hidden taxation"?
2. Examine the role of fiscal policy in economic development?
3. What is the major function of Finance Commission? What are the recommendations of the ninth Finance Commission?

II. Answer each of the following questions in about 15 lines

1. Explain the various methods of repayment of public debt.
2. Distinguish between balanced and unbalanced budget.
3. Discuss the principles of federal finance.

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