



SYLLABUS

Class – B.Com. III Year

Subject – Public Finance

Unit-I	Public finance: Meaning, nature, scope and importance, difference between private and public finance. Principle of maximum social advantage. Role of state in public finance.
Unit-II	Sources of revenue: taxes, loans, grants and aid – meaning and types, canons of taxation, problem of justice in taxes, incidence of taxation, taxable capacity. Impact of taxation & tax evasion characteristics of Indian tax system, defects & steps of reform.
Unit-III	Principle of public expenditure, principle of public debt and its methods of redemption. Effects of public expenditure on production and distribution public debt in India.
Unit-IV	Public finance in India: sources of revenue of central and state govt. concept and types of budget, Fiscal Deficit, Deficit financing and deficit budget, financial relation between central and state.
Unit-V	Constitution and function of finance commission, recommendation of latest finance commission, latest budget of central and MP govt. financial relations between central & state govt., main head of revenue & expenditure of central & state govt.



UNIT-I

Public Finance: Meaning, Nature and importance

Introduction

The State in modern times is called a welfare State. The activities of such a modern welfare State have vastly increased. For a smooth performance of these functions the State needs finance. Thus public finance means the finances of public bodies—national, State or local—for the performance of their functions. The term 'finance' may also refer to financial management and administration. Public finance thus means the administration of the financial operations of the public authorities. It refers to that branch of Economics which deal with the income and expenditure of public bodies and the principles, problems and policies relating to these matters.

Definition

Carl Plehn defines public finance as. "The science which deals with the activity of statesman in obtaining and applying the material means necessary for fulfilling the proper functions of the State."

Scope of Public Finance

1. **Public Revenues** – In this division we study all those sources from which the government derives its revenues. An extensive study of the principles of taxation is an integral part of this branch. Along with this, we also study in this branch the problem of the incidence of taxation-
2. **Public Expenditure** – Public expenditure is the beginning and end of the collection of revenues by the government. As pointed out by Plehn, "Public expenditure is the end and aim of collection of revenues and of other financial activities of the statesman". Under public expenditure we study its classification, the canons or principles which govern it and its effects on production, employment, income distribution, stability and growth. We also study the reasons for increase in public expenditure and changes in the pattern.
3. **Public Debt** – When public revenue falls short of public expenditure, the government borrows from the public to meet the gap. This is public debt. Under public debt; we study the reasons, methods and sources of public debt, its effects on production, consumption, income distribution and economy, the burden of public debt and the methods of debt redemption
4. **Financial Administration** – The aim of financial administration is to control processes and operations of public revenue, public expenditure and public debt. The scope of financial administration includes the collection, custody and disbursement of public money; the coordination of expenditure according to a well-formulated plan; the management of public debt; and the general control of the financial operations of the state. It also includes the preparation of the budget; its execution and above all auditing the finances of the state.

Nature of Public Finance

1. **It is a Social Science** – Public finance is a social science which is concerned with the problems of raising of funds and their allocation for the collective satisfaction of wants. Its methods of study are based both on the study of the principles and theories or laws of public finance and on a descriptive and statistical study of the actual operations of government finances. Its principles are in the nature of generalizations which state the cause and effect relationships of different variables like public revenue, expenditure, debt and financial administration. These also form the subject matter of public finance.
2. **It is an Art** – Public finance is also an art. It is concerned with fiscal policies which influence economic policies and economic structure of the country. All governments aim at bringing social justice through an equitable financial system.

Importance of Public Finance

1. **Increasing the growth rate of Economy** – The role of public expenditure in economic development lies in increasing the growth rate of the economy, providing more employment



opportunities, raising incomes and standard of living, reducing inequalities of income and wealth, encouraging private initiative and enterprise and bringing about regional balance in the economy. All these are achieved by spending on public works, agriculture: industry, transport and communications, power, financial and banking institutions, social services etc. The government is able to increase public expenditure through a budget deficit.

2. **Emergence of Social Services** – The importance of public finance as also increased due to emergence of social services which can be performed more conveniently, efficiently and also at the minimum cost as against individual. Such services are education, health, social security and protection from certain uncertainties. The need for such social services is increasing day by day and with them is increasing the importance of public finance.
3. **Reduction in Economic Inequalities** – Public finance can play a vital role in reducing economic inequalities which is the source of dissatisfaction, class-struggles, poverty etc. The state can levy heavy taxes on richer sections of the society and thereby spend the income so received on providing food, cheap housing, free medical aid etc. for the poorer sections of the society. Similarly, heavy taxes can be imposed on the use of harmful commodities, such as harmful drugs, wine, opium, hashish etc.
4. **Increases Employment** – Public finance can play vital role in increasing employment which is the burning problem of almost all the countries of the world, The Governments these days establish, give grants, subsidies, grant exemption from excise duty, sales tax etc. to employment-oriented cottage and small-scale industries. Unbalanced budget is also an indispensable measure of increasing volume of employment during depression.
5. **Capital Formation** – The economic development, as is well known, depends upon the rate of capital-formation in the country. Public finance can play a vital role in increasing the rate of capital-formation in the economy. It can be managed in such a manner as to step up the rate of saving and investment in the economy. For example, the tax system can be so managed as to discourage the consumption of non-essential goods and thereby release the resources for being invested in more productive industries. Further, the tax system can be employed to increase the rate of private saving which in turn, can be used as the basis for an increase in public investment.
6. **Industrial Development** – The governments these days give subsidies and grants to different industries to enable them to increase the production of essential goods in the country. These subsidies and grants have special place in the government expenditure of underdeveloped and backward countries .

Differences or Dissimilarities between public and private finance

The following are the main points of differences or dissimilarities between public and private finance:

1. **Adjustment between Income and Expenditure** – An individual determines his expenditure on the basis of his income. He prepares his family budget on his expected income during the month. On the other hand, the government first estimates about its expenditure and then finds out means to raise the necessary income. As pointed out by Bastable, 'The individual says, I can spend so much', the Finance Minister says, 'I have to raise so much'
2. **Elasticity of Finance** – Public Finance is more elastic than private finance. There is not much scope for changes in private finance while drastic changes can be made in government finance. For example, a private individual cannot effect any special increase in his income. As against this the government can increase its income by imposing fresh taxes on the people.
3. **Differences in Objectives** – There are a fundamental difference in the objective of private and public finance. The motive of private expenditure is personal benefit whereas the objective of public expenditure is social benefit. An individual always tries to save and a firm to earn profit. But there are no such considerations on the part of the government, except the public welfare. However, there are some public enterprises which are run on profits that are utilised for public welfare.



4. **Nature of Expenditure** – There are differences in the nature of expenditure between the two". An Individual's expenditure is governed by his habits, customs, fashions etc on the other hand. The government expenditure depends on its economic and social policies, like removing unemployment and poverty, reducing income inequalities, providing' infrastructure facilities, etc
5. **Compulsion** – There is compulsion in public finance. People have to pay taxes. If they do not pay, they are punished by fine and imprisonment. BA an individual or firm cannot force anybody to pay him money. He can file a suit in the court. But even then he may not receive his money back. The same is the case with loans. The government can force the people to lend it during war or emergency. But a individual cannot compel any person to lend him money.
6. **Law of Equi-marginal Utility** – The private individual spends his me on various items in such a manner as to secure equal marginal utilities from them. It is only by equalizing the various marginal utilities that he can secure maximum utility out of his expenditure. The government on the contrary, does not give as much importance to this law as a private individual does. Modern governments sometimes incur certain types of expenditure from which they do not derive any advantage, but they o incur this expenditure to satisfy certain sections of the community
7. **Present Vs Future** – An individual is more concerned with his present needs and tries to satisfy them. Life being uncertain and short, he has his immediate gain or profit in view. On the other hand, government is a permanent organisation. Only the ruling party changes it is concerned not only with the welfare of present generation but also I with future generations. It therefore, undertakes and spends on those activities which also benefit future generations
8. **Nature of the Budget** – A surplus budget is always good for a private individual. Bin a surplus budget may not be good for the government. It implies two things: (i) The government is levying more taxes on the people than is necessary, (ii) The government is not spending as much on the welfare of the public as it should. Keynes supported a deficit budget to meet the situation created by depression. Further, the government budget is passed by the parliament. But the budget of an individual or firm is a private affair without any controlling authority.
9. **Nature of Borrowing** – In the case of an individual, there can no internal borrowing". An individual cannot borrow from himself. He can borrow only from an external agency. The State, however, can borrow both from internal as well as external sources. It borrows not only from its own citizens, but also from foreigners.

Budgetary activities of the government results in transfer of purchasing power from some individuals to others. Taxation causes transfer of purchasing power from tax payers to the public authorities, while public expenditure results in transfer back from the public authorities to some individuals, therefore financial operations of the government cause 'Sacrifice or Disutility' on one hand and 'Benefits or Utility' on the other.

This results in changes in pattern of production, consumption & distribution of income and wealth. So it is important to know whether those changes are socially advantageous or not.

If they are socially advantageous, then the financial operations are justified otherwise not.

According to Hugh Dalton, "The best system of public finance is that which secures the maximum social advantages from the operations which it conducts."

Principle Maximum Social Advantage (MSA)

The Principle of Maximum Social Advantage (MSA)' is the fundamental principle of Public Finance.

The Principle of Maximum Social Advantages states that public finance leads to economic welfare when public expenditure & taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.



Hugh Dalton explains the principle of maximum social advantages with reference to –

1. marginal Social Sacrifice
2. Marginal Social Benefits

This principle is however based on the following assumptions –

- All taxes result in sacrifice and all public expenditure lead to benefits.
- Public revenue consists of only taxes and no other sources of income to the government.
- The government has no surplus or deficit budget but only balanced budget.

Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

Marginal Social Sacrifice (MSS)

Marginal Social Sacrifice (MSS) refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax.

Every unit of tax imposed by the government taxes result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing i.e. the total social sacrifice increases at an increasing rate. This is because, when taxes are imposed, the stock of money with the community diminishes. As a result of diminishing stock of money, the marginal utility of money goes on increasing. Eventually every additional unit of taxation creates greater amount of impact and greater amount of sacrifice on the society. That is why the marginal social sacrifice goes on increasing.

Marginal Social Benefit (MSB)

While imposition to tax puts burden on the people, public expenditure confers benefits. The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal social Benefit (MSB).

Limitations of Social Advantage

The principle of Maximum Social Advantage suffers from a number of shortcomings. Importance ones are –

1. There is no effect means of quantifying utility and disutility.
2. Equating of marginal utility and disutility is spoken of for the society as a whole”, not for “individual members” of the society so there is the possibility that for some individuals marginal utility of public expenditure may be higher or lower than the marginal disutility, of taxation. This raises the question of distributional equity. How the marginal utilities and disutilities should be divided among individual members of the society.
3. The basic weakness of this principle is that it gives neither a concrete standard by which the efficiency of various expenditure programmes can be.
4. The utility of public expenditure is a macro issue, while the disutility of taxation is a micro one. To treat the two as the two sides of the same coin is methodologically wrong.
5. In a situation of large scale involuntary unemployment, government spending may need to be increased enormously with or without the sanction of the principle. Here the principle breaks down.

Tests of Social Advantage

Dalton has provided the following tests of social advantage –

1. The first is the need to preserve the community from internal disorder and external attacks. Here it is assumed that the society is worth preserving. It is not a strictly economic test of social advantage, yet it is true that no society can progress without peace.
2. The second test is strictly economic and relates to increasing the economic welfare of the community. Two conditions are necessary for this. They are improvement in production and improvement in the distribution of what is produced.



Lady U.K. Hicks has also developed two criteria for judging whether the operation of public finance would add to net social benefit or not. They are production optimum and utility optimum. An optimum in production is attained when production of one commodity cannot be increased through reallocation of given productive resources without reducing the output of some other commodity. A utility optimum is achieved when a reallocation of national product cannot increase the total satisfaction of the commodity.

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Unit – II

Sources of Revenue: Taxes, Loans, grant & Aids

Meaning and significance Source of Revenue

As public expenditure is necessary for the government to perform its various functions for the welfare of the society, so it requires public revenue. Public revenue holds the same position in study of public finance, which production holds in the study of economics. Just as production is the means of consumption, public revenue is the means for public expenditure.

The income of government through all sources is called public income or public revenue. However, Dalton has defined 'Public income' in a broad and a narrow sense, i.e., in terms of Public receipts and 'Public revenue'. Public revenue includes income from taxes, prices of goods and services supplied by public enterprises, revenue from administrative activities, such as fees, fines, etc., and gifts and grants; while Public receipts include all the incomes of the government which it may have during a given period of time, i.e., $\text{Public receipts} = \text{Public revenue} + \text{Income from all other sources, such as public borrowing from individuals banks and income from public enterprises.}$

Various Classifications of Revenues

1. **Adam Smith's Classification** – Adam Smith classified public revenue into two categories –
 - a. Revenue from the people
 - b. Revenue from the State PropertyRevenue from the people includes tax revenue and revenue from State property includes revenue obtained from public enterprises as well as that revenue which are derived from the property in possession of the state.
2. **Bastable's Classification** – Like Adam Smith, Bastable has also divided public into the following two categories –
 - a. That income which the state receives from its various functions just like a private individual.
 - b. Those income which the State derives in the own capacity as "State".The first category includes all the income which the State derives in the form of fees and prices, while the second category includes taxes and Levis. This classification is also limited and narrow like that of Adam Smith. This classification does not appear to be compressive from one other angle also, that is, fee, gifts, fines and special assessments are difficult to be classified into separate groups.
3. **Prof. Adam's Classification** – Prof Adam has divided the public revenue into three categories–
 - a. **Direct Revenue** – This includes income form (a) public domains, (b) public industries, (c) Gratuities, etc., (d) confiscations and indemnities. These categories includes all the income which the State derives from public land public enterprise like rail, roads, highways, post and telegraph and other incomes which the state derives due to the ownership of productive enterprises.
 - b. **Derivative Revenue** – This includes taxes, fees, assessments, fines and penalties, i.e., the income derives from the people is grouped under this head.
 - c. **Anticipatory Revenue** – This includes income from the sale of bond or other forms of commercial credit. It also includes income from the treasury notes. This group deals mainly with the revenue derived from the public credit.

Administrative Revenue

Administrative revenues refer to the receipts from fees, licences fines, forfeitures and escheats and special assessment, etc. The revenue from these sources is collectively termed as administrative activities of the government. According to Taylor, administrative revenues arise as a by-product of the administration.



Fees – A fee is a compulsory contribution made for a specific series which primarily has a public purpose: A fee has been defined by Prof. Seligman as “a payment to defray the cost of each recurring services undertaken by the government. Primarily in the public interest, but conferring measureable special advantages on the fee payer.”

Commercial Revenue

The characteristics which distinguishes commercial revenue from the categories of revenue is the direct receipt of a commodity or services in return for payment and a rough adjustment of the amount of payment to cost. Commercial revenues may arise from two principal sources. They may either arise from public properties or from public enterprises.

- a. **Revenue from Public properties** – The government everywhere owns some real properties, like lands, buildings, forests, mines, fisheries, etc. The government can obtain revenue either by selling or leasing these properties. Thus, for example, the Government of Orissa gets large revenue by selling timber, tends leaves, bamboos and other forest products. So also the government can obtain huge royalties by leasing out mines or fisheries, etc. Revenue from public enterprises is also known as revenue from public domain.
- b. **Revenue from public enterprises** – In modern times the role of the public sector in the various countries is fast expanding. The State for various reasons takes Up the production and sale of a number of essential commodities and services. The State may also enter the economic arena, in insurance of the policy of planning and socialism.

Thus, the State derives revenues from its public enterprises by selling the produced goods and services. Under revenue, from public enterprises, we include the receipts from the railways, post offices, State transport and from public sector industrial undertakings, etc. The government charges a price for the provision of these goods and services. In India, however, till the recent past, the performance of the public sector enterprises has not been very encouraging. Thus, the railway finance has not been very sound. The contribution of Posts and Telegraphs Department to the total non-tax revenue has been modest. Similarly, till now most of the other public undertakings have been running in the red avoid the payment of a price by avoiding the purchase of a commodity or service produced by the government. Price is a contractual payment. Thirdly, a price paid for the enjoyment of a good or service by an individual. It is paid for individual satisfaction. But a tax is paid for furthering common good.

Gifts and Grants

Gifts are given by private agencies, individuals and institutions. Gifts are purely voluntary in nature. In a country there are many patriotic and public spirited individuals and organizations who make voluntary contributions for some specific purposes. These gifts are usually made for helping some particular causes, like providing aid to the flood-affected people or drought affected or quake hit people. Gifts may be given in the form of contributions to the National Defence Fund, etc. Gifts may also be given by foreign nations or foreign organizations. The Red Cross sands gifts to the people in distress in any country of the world. “Gifts are, however, not a very important source of public revenue.

Public Revenue

The income of government through all sources is called public income or public revenue. Public revenue includes income from taxes, prices of goods and services supplied by public enterprises, revenue from administrative activities, such as fees, fines, etc. and gifts and grants.

Characteristics of Tax

A tax possesses three characteristics. **First, a tax is a compulsory** contribution to the State from the citizens or even from aliens subject to the jurisdiction for reasons of residence or property and this contribution is for general or common use, As it is a compulsory contribution, so no one can refuse to pay a tax on any ground; for instance, as he does not drive any benefit from certain State services or as he has no right of franchise, so he is not liable to pay a tax. Therefore, everyone has to pay a tax upon whom it is levied by the State; it is immaterial whether he is an adult or a minor, or a citizen or an alien.



Moreover, the refusal to pay a tax is subject to punishment. However, there are certain qualifications to it.

The second characteristic is that a tax imposes a personal obligation on the tax payer. It means that it is the duties of the taxpayer to pay the tax if he is liable to pay it and should in no case think to evade it. Suppose a tax is imposed on the incomes of the individuals, the sources of income may be many and the public authority may not be in the know of all those sources. Here it is the duty of the tax payer to show all of his income and take into account his total income while paying the tax.

The third characteristic is that the contribution received from the tax payers, may not be incurred for their benefit alone, but for the general and common benefit. As an individual finds himself helpless to meet all this needs especially those which involve heavy expenditure, i.e., the construction of a hospital, the State renders such services for the benefit of all people. Hence, taxes are imposed upon all those people, who are able to pay them, to share the common burden.

Meaning of Tax

It is, of course, very necessary to define tax before going into further details about taxation. The following are the various definitions of tax given by different economists –
Adams- "A tax is a contribution from citizens for the support of the State.

Objects or Aims of Taxation

What are the aims behind the imposition and collection of taxes? Generally we may say that the imposition of taxes has the following aims –

1. **Raising Public Revenue** – The first and foremost aim of taxes is to raise Public Revenue to meet the ever-increasing public expenditure. This aim has its special significance particularly in the undeveloped economies where the Government has taken over the task of securing at minimum level of living to the public and has assumed the responsibility of active participation in the task of economic growth. This aim also receives even greater importance due to the fact that the public sector has been constantly increasing in these economies.
2. **Reduction in the Inequality of Wealth**- Another important object of taxation is to reduce the inequality of wealth. One of the chief characteristics of under-developed countries is said to be that there is vast gap between the income of persons in the highest income group and of those in the lowest income group. That is why one of the -important aims of the growth programmes in these countries is to bring about a reduction in the inequalities in the distribution of incomes and wealth. One of the aims of the taxation comes to be redistribution of wealth and income in such a way so as to ensure more equitable distribution and by taxing rich people heavily and to confer benefit on the poor.
3. **The Aim of Tax Collection is Public Good**- It is for the benefit of the general public and for the maximum welfare of the whole society that the taxes are imposed and collected. The use of taxes in the welfare of vested individual interests or for the development of a particular section in a way not agreeable to the general public is not permissible. Tax-revenue is spent keeping in view the aggregate welfare of the whole nation and not of a particular section.
4. **Restriction on production and use of harmful goods** - The government not only raises revenue through taxation but it also imposes restriction on the use of certain goods and services in a way desirable and respectable for a healthy State of society. Taxes on intoxicant tobacco etc., raise public revenue on less than other taxes but their main aim is prevent the deterioration of health of general public.
5. **Regulation of Import and Export**- On the other hand there is import and export duties which also raise revenue but their specific aims are some others. Import taxes are levied in order to restrict imports of those goods which may harm the "infant" industries producing those goods in the country. Similarly luxury goods may be taxed heavily while being imported so as to divert the national funds in some other forms of production inside the country. In the same way



export tax may be levied within for the purpose of restricting export of those goods which are required 'within the country, and their export may hamper national production or consumption. Thus an important objective of taxation is to regulate the economy in accordance with the needs of the country.

Introduction

Taxation imposes burden or sacrifice on the tax-payers. Tax moreover, have far-reaching economic effects. The tax system, therefore, should be so organised as to impose the smallest possible sacrifice on the community. For that purpose, the tax system should be based on certain well-defined rules and principles. Otherwise, the very objective of taxation and the aspect of social justice, both may be hampered. For example, a tax which widens the gulf between the rich and the poor may be highly productive, but as it goes against the canon of social justice, it should not be supported. So also, if a tax adversely affects the productive system of a country, it should be avoided.

Thus, to devise a sound and efficient tax system, economists and public men, from time to time, have laid down certain principles to which the tax structure should conform. In this direction, the contribution of Adam Smith is very great. He laid down certain canons or maxims of taxation for the guidance of taxing authority, which are still famous for their clarity, simplicity and reasonableness. Later on, other economists laid down more canons of taxation to supplement the canons of Dr. Smith.

1. **The Canon of Ability of Equity** – The canon of ability is the most important canon of taxation to Adam Smith, "The subjects of every State ought to contribute towards the support of the government as nearly as possible its proportion to their respective abilities, that is in proportion to the revenue which they respectively enjoy under the protection of the State." This principle emphasizes that the tax burden should be imposed according to the respective abilities of the tax-payer so as to achieve equality of sacrifice. Here equality of sacrifice does not mean that all should pay at equal rates. Equality in taxation signifies that the rich should contribute at a higher rate and the poor at a lower rate. Sometimes the canon of ability has been interpreted to mean proportional taxation. But actually this canon stands for progressive taxation and hence this principle is just and equitable.
2. **The canon of Certainty** – The canon of certainty is important from the point of view of the tax-payers as well as the government. The tax-payers must be certain about the rate of tax, method and time of collection, etc. There should be no element of arbitrariness in taxation. Otherwise it will lead to all kinds of malpractices, such as corruption and bribery, etc. The taxpayers will be subjected to unnecessary harassment. Similarly, the government also will fail to prepare accurate budgets unless it is certain about the amount of revenue likely to be raised by taxes and can make an estimate. So Adam Smith had laid down, "the tax which every individual is bound to pay ought to be certain and not arbitrary. The time of payment, the quantity to be paid ought to be clear and plain to the contributor and to every other person." An old tax imposes the least inconvenience and confusion as people are already fully accustomed to and familiar with it. So it is popularly said: "An old tax is no tax."
3. **The Canon of Convenience** – The canon of convenience follows from the canon of certainty. Not only should the time and method of payment be certain, but they should be minted as to cause least inconvenience. Thus, Adam Smith pointed out, "Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."
4. **The Canon of Economy** – Adam Smith laid down the canon of economy in the following way: "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."

Characteristics of a Good Tax System

A Good tax system should have the following characteristics –

1. **Equity** – The burden of a tax in a good taxation system should be the minimum. Along with that, it should be distributed amongst the different sections of the community in a just and equitable manner. The heaviest burden should be borne by the broadest shoulders. There should be a



proper blending of direct and indirect taxes in the taxation system to achieve this objective. From the point of view of equity, the Indian tax system leaves much to be desired. The predominance of indirect taxes in the Indian tax system reflects the inequitable nature of this system.

2. **Productivity** – The term 'productivity' is interpreted in two senses. Firstly, the tax system should be such as to provide adequate name to the government to meet its expenditure. Secondly, the taxation system should be such as to produce no adverse effect on the productive capacity of the country. From the point of view of productivity, the Indian tax system leaves much to be desired. The Indian income-tax system for example, produces adverse reaction on the incentive to work of the citizens.
3. **Elasticity** – The tax system should provide to the government increased income with the increase in the national income of the country. The tax system should also yield more income when the government expenditure goes up at a time of emergency or crisis. It should be possible then to obtain more income with slight increases in the rates or the taxes. Two things are essential to bring about elasticity in the tax system. Firstly, there should be a proper blending of direct and indirect taxes. Secondly, certain sources of income should be exclusively reserved in emergencies, such as, war etc. The Indian tax system satisfies the canon of elasticity in a sufficient measure insofar as the income of the government keeps on increasing in accordance with its requirements.
4. **Convenience** – The government should also keep in mind the convenience of the tax payer while devising the tax system of the country. Since the taxpayers make sacrifices-when they pay the taxes, it is essential for the government to see that they are not put to any avoidable inconvenience. Besides, the tax system should be simple so as to be within the understanding of the ordinary taxpayer. The Indian tax system, no doubt satisfies the canon of convenience, but it does not satisfy at all the canon of simplicity. It is a highly complex and complicated tax system, much beyond the understanding of the average taxpayer.
5. **Absence of Tax Evasion** – The tax system of the country should be so devised as to leave no scope for tax evasion on the part of the taxpayers. To achieve this objective, there should be a proper blending of all sorts of commodity and personal taxes. This will reduce the scope for tax evasion to the minimum. From this point of view, the Indian tax system leaves much to be desired. There is at present a large-scale evasion of the income-tax going on in the country, especially by the business classes.
6. **Maximum Social Advantage** – According to Dalton, that system of taxation is the best which is based on the principle of „maximum social advantage. The objective of every tax system should be to promote the greatest good of the greatest number. It is also essential that the tax system produces no adverse reactions on the productive capacity of the country. It is doubtful if the Indian tax system satisfies this canon of maximum social advantage.
7. **Economical** – A good tax system should be economical to the government in the sense that the cost of collection of taxes should be small in proportion to the revenue from them.
8. **Multiple Taxes** – A good tax system should have multiple taxes rather than a single tax. According to Dalton, It is best to rely on a few substantial taxes for the bulk of the tax revenue.
9. **Income-Elastic** – It should be income-elastic. As national income increases, the share of taxation in national income should rise more than proportionately.

Problem of justice in taxation

1. **The Physiocratic Theory** – This is the earliest theory regarding taxation and this is based on the view that land is capable of producing a net surplus. The Physiocratic School of Economic Thought had its origin in France. And the Physiocrats maintained that agriculture alone could yield a net return and could add to the wealth of the country and hence recommended that revenue of the State should be derived from a single direct tax levied upon land. Henry George of San Francisco also advocated a single tax on the appropriation of unearned increment, by the state.



2. **Financial Theory** – There are various theories with regard to the distribution burden of taxation among the people. One of them is often called financial theory, which is embodied in the principle attributed to Colburn: pluck the goose with as little squealing as possible.
3. **The Principle of Equity** – Horizontal and Vertical Theory: Modern writers have laid a great emphasis on justice and advocated to follow the principle of equity in the distribution of burden of taxation. Equity generally means fairness or justice in the distribution of burden of taxation. Equity involves two aspects: the treatment of people in like and unlike circumstances. The like circumstances imply that those who are equally well off from the economic point of view, should pay equal amount as taxes. It is also called horizontal equity. The unlike circumstances imply that the people in dissimilar circumstances should be subjected to dissimilar treatment i.e., the persons who are 'better off' should pay more as taxes than others: This is called vertical equity.
4. **Cost of Service Theory** – This is one of the oldest principles advocated for the distribution of the tax burden. According to this theory, the basis of taxation should be the cost incurred by government on different services for the benefit of the individual tax-payers. Each tax-payer has to pay the tax equal to the cost of service to him. It means, the higher the cost, the higher should be the tax rate and vice versa. The government acts like a producer of a commodity, who charges the price from his customers equal to the amount of cost of production of the commodity.
5. **Benefit Theory of Taxation** – This theory explains that every citizen should be called upon to taxes in proportion to the benefits derived by him from services provided. Therefore, contribute to the cost value of other facilities in proportion to benefits received by them. The more the benefit a citizen derives, the more taxes he should bear, is the main assumption of the theory. The principle justifies the payment of taxes. It also measures benefits received by the individuals in the case of certain special taxes such as petrol tax, betterment tax etc.

Features of Indian tax system

In India the authorities have been of the view that tax policy is a powerful tool by which the economy can be effectively regulated and by economic incentives and disincentives can be created. As a result our tax system has come to acquire the following salient features –

1. The system has become extremely complicated with rapidly changing provisions and rates. Frequently, these provisions have been contradictory to each other and self-defeating in nature.
2. The system is laced with a excess of exemptions, rebates, concessions, penalties and other provisions. In addition, there are notifications, clarifications, procedural details and the like. All this has made the system a highly complex one, and according to one opinion, counterproductive.
3. The authorities have always recognized the need to simplify the tax system but steps taken to this effect have only added to its complexities.
4. The tax-base of our country is a narrow one. Taxpayers are practicing large-scale tax evasion and avoidance. They are helped in this task by highly complicated tax provisions and procedures, as also by the vast discretionary powers enjoyed by the tax officials.
5. Frequent voluntary disclosure schemes under which tax evaders are provided an opportunity to pay, tax (often on concessional basis) on concealed income and wealth, etc. have also contributed to the phenomenon of tax evasion.
6. Indirect taxes comprise a major portion of our tax revenue. Compared with direct taxes, they feed inflationary forces. They are more burdensome and cause widespread distortions in the allocation of resources. They are known to be highly regressive in their nature. Selective exemption of items from indirect taxes has not been able to reduce their regressive nature because of widespread evasion.
7. The authorities have used, on a systematic and selective basis, tax holidays and other concessions; for promoting certain industries considered essential for the overall balanced growth of the economy; for promoting and helping small-scale industries and self-employment.



activities so as to reduce unemployment and encourage labor-intensive techniques; for encouraging investment in backward areas with the objective of reducing inter-regional economic disparities.

8. Critics claim that the tax provisions relating to depreciation are based upon the cost of acquiring assets and not the cost of their replacement. This, therefore, discourages capital formation.
9. Authorities have tried to encourage exports by levying customs duties on imports; providing income tax and other forms of relief on income from exports.
10. Over the years, the government has made a systematic effort to reform indirect taxes by converting the base of excise duties from specific to value added, and by replacing excise duties with VAT.

Characteristics of a Good Tax System

A Good tax system should-have the following characteristics:

1. **Equity** – The burden of a tax in a good taxation system should be the minimum. Along with that, it should be distributed amongst the different sections of the community in a just and equitable manner. The heaviest burden should be borne by the broadest shoulders. There should be a proper blending of direct and indirect taxes in the taxation system to achieve this objective. From the point of view of equity, the Indian tax system leaves much to be desired. The predominance of indirect taxes in the Indian tax system reflects the inequitable nature of this system.
2. **Productivity** – The term 'productivity' is-interpreted in two senses. Firstly, the tax system should be such as to provide adequate income to the government to meet its expenditure. Secondly, the taxation system should be such as to produce no adverse effect on the productive capacity of the country. From the point of view of productivity, the Indian tax system leaves much to be desired. The Indian income-tax system for example, produces adverse reaction on the incentive to work of the citizens.
3. **Elasticity** –The tax system should provide to the government increased income with the increase in the national income of the country.
4. **Convenience** – The government should also keep in mind the convenience of the tax payer while devising the tax system of the country. Since the taxpayers make sacrifices when they pay the taxes, it is essential for the government to see that they are not put to any avoidable inconvenience.
5. **Absence of Tax Evasion** – The tax system of the country should be so devised as to leave no scope for tax evasion on the part of the taxpayers. To achieve this objective, there should be a proper blending of all sorts of commodity and personal taxes. This will reduce the scope for tax evasion to the minimum.

**Unit – III****Public Expenditure**

Public expenditure is the spending of revenue that a government gets from tax and non-tax sources.

Size of the public expenditure is measured generally in term of the government expenditure/GDP ratio. This ratio has been rising over the years in all countries—developed as well as developing. Public expenditure of the USA, for instance, was only 8 per cent of its national income in 1880. In 1929 it was 10 per cent before the beginning of the Great Depression. In the post-war period, it increased to 28 per cent in 1960 and to 37 per cent in 1985. Over the last twenty years growth in public expenditure has stagnated or slowed down. It was higher in 2002 as compared to 1970, but in the mid-1980s, expenditure had been higher.

Economic Effects of Public Expenditure

Under the traditional approach to the subject of public expenditures topics that were discussed were trend of public expenditure, expenditure control and the important functions which give rise to those expenditures. Such a discussion provides materials which are essential to an understanding of what government does with its money. But it is an incomplete view of the economic aspects of public expenditure. It is important to realize that most government services are basic in nature whose benefits touch all branches of economic life. Government expenditure on protection, highway construction, education, health, communications, etc., are, for instance, necessary to increase the productivity of the economy.

But it is now realized that a major part of public spending makes a basic contribution to the productive efficiency of the economy. Hugh Dalton in his book titled, "Public Finance" (1922), examined the effects public expenditure on production and distribution as also some other effects such as effect on employment. In the analysis of these effects his main concern has been incentives—ability and willingness to work and save and invest. After the Keynesian Revolution, public expenditure became a part of macro-economic analysis. Public finance scientists began to study how changes in public spending can be used as a stabilisation measure. Such a study was assisted by government expenditure multiplier.

Effect on Production

In order to have a correct view of the effects of public expenditure on production, according to Dalton, it is necessary to consider (i) effects upon ability to work and save, (ii) effects on desire to work and save, and (iii) effects on diversions of economic resources as between different uses and localities.

If taxation reduces a man's ability to work through reduction of his efficiency, public expenditure will increase it through increases in his efficiency. Here we should consider socially desirable expenditure which has the capacity to increase efficiency. Expenditures on education, medical services and house accommodation are likely to increase efficiency.

Effect on Distribution

The use of progressive taxes is generally advocated as a means of influencing income distribution; it renders post-tax income distribution less unequal. Hugh Dalton has stated that like the taxes, public spendings too can be made progressive. "But while taxes can, in certain circumstances, improve income distribution by making the rich relatively less rich, they cannot substantially improve the wretched living conditions of the poor. Government expenditures are obviously more Relevant for this purpose." Robert S. McNamara, the then President of the World Bank, stated in 1972 that a "shift in the patterns of public expenditures represents one of the most effective techniques government possesses to improve the condition of the poor."



Effect on Economic Development

There are two principal channels, through which government spending may influence economic growth and development. First, government spending, particularly investment, may provide such goods that enter directly into private sector production. We can take the examples of education and infrastructure. Some government spending is such that they indirectly influence the efficiency of private sector allocation of resources. To the extent that government expenditure corrects market failures, guarantees property rights, enforces contracts and provides essential public goods, effect on growth will be positive. Further, if public capital formation and private capital formation are complementary, public spending on public projects are likely to encourage entrepreneurs to increase private investment and growth. But there is also the possibility that government regulation may impose excessive burden on the private sector, distort private incentives and financing of govt. Spending may did up interest rates crowding out private investment.

Adverse/Bad Effect of Public Expenditure

1. **Unnecessary Assistance to Industries and Business** – If the government gives protection and provides financial assistance to those industries and businesses which have lost their shape and do not occupy any importance in the economic development of the country then it is mere wastage of public resources. It will lead to development of those industries and business which hinder the path of economic development and thereby the country is likely to go to the worse.
2. **Excessive Expenditure on Defence** – If the government incurs excessive expenditure on defence, it will adversely affect the development of the poor and backward community of the country. Pakistan is the burning example of the same. From moral and human points of view also, excessive expenditure incurred on defence is treated as uneconomic and unnecessary. It will also affect the security and peace of the entire region. India's defence expenditure is increasing rapidly which is evident from the table given below, adversely affecting all development programmes, especially of the poor, illiterate, ignorant and backward classes.
3. **Tendency of gaining Political Influence** – Now-a-days the concept of public expenditure is being applied by ministers in particular for gaining political influence and sounding vote bank. Huge amount of public expenditure is being done by both Central and State ministers in their respective areas just to gain political influence at the cost of other backward areas of the country/state. It leads to serve criticism and dissatisfaction amongst the masses. It is also one of the major factors of political instability in the country.
4. **Advantage to a Particular Community** – Sometimes public expenditure is incurred just to give advantage to a particular community or lass over and above the other communities. It will lead to division of the society in two clear-cut classes leading to class conflicts, feelings of superiority and inferiority and more movements, unrest, strike, dharnas etc. AS a matter of fact, the peace of the entire country is badly hurt and disturbed.
5. **Rapid Increase in Taxation** – In order to meet the rising public expenditure, government imposes new taxes every year leading to heavy incidence of taxation on the community. If it is not enough then the government takes the shelter of deficit financing which leads to rapid inflation. The service class and poor classes in particular are adversely affected. In case of India too, deficit financing is increasing every year leading to inflationary tendency along with a general rise in price level every year.
6. **Government expenditure is Misue of Scarce and Limited Resources and also Unproductive** – According o traditional economists, government expenditure is the misuse of scarce and limited resources of the country and also unproductive. They are of the opinion only that public expenditure is productive which leads to physical increase in the production of commodities meant for direct consumption. However, this old concept of public expenditure has been rejection by the modern economists.
7. **Fear of Minority Political Parties** – Political parties led by minority groups are always fearful of the increase of public on the ground that the political party or parties in power use the public



expenditure in fulfilling their own political interests. However, this view is not true in case of India where minority is leading the majority.

8. **Dominance of Public Sector Reduced the Authority of Private Sector** – While citing the dangers of increase in public expenditure capitalists argue that it reduces the authority of private sector which is the backbone of capitalists economy. However, in the modern economy, the above criticism does not stand true as the interference of the government is increasing in all types of economics whether socialist economy, capitalist economy or mixed economy.

Public Debts Meaning –

Public debt or public borrowing is considered to be an important source of income to the government. If revenue collected through taxes & other sources is not adequate to cover government expenditure government may resort to borrowing. Such borrowings become necessary more in times of financial crises & emergencies like war, drought, etc.

Public debt may be raised internally or externally. Internal debt refers to public debt floated within the country; while external debt refers loans floated outside the country.

The instrument of public debt takes the form of government bonds or securities of various kinds. Such securities are drawn as a contract between the government & the lenders. By issuing securities the government raises a public loan & incurs a liability to repay both the principal & interest amount as per contract. In India, government issues treasury bills, post office savings certificates, National Savings Certificates as instrument of public borrowings.

Importance of Public Debts

1. **Abandonment of Laissez-faire policy** – The view of policy makers with regards to public borrowing has changed considerably. The 19th century economists had belief in the policy of laissez fair and advocated that. That government was the best which governed the least and consequently spent the minimum. The change in the perception of the government from police state to welfare state is a remarkable one in the context of public borrowing. The functions of a welfare state are enormous and continuous. Consequently. it resorts to borrow money, both internally and externally to execute five year plans and various development project and various infrastructure development schemes and social sector schemes to enhance the living standard of the people.
2. **Deficit budget** – Sometimes the situation becomes such that the current revenue cannot meet the proposed expenditure unless they are supplemented by additional taxes and borrowing. But tax collection takes longer time. In such a situation, to meet its requirement immediately, the government may resort to borrowing from the public.
3. **Waging wars**- Modern war is so costly that the normal income through taxation falls short of the actual war expenditure. War expenditures are so huge that they cannot be met by taxing people alone. Governments, therefore, have to borrow extensively from individuals and institutions towards war financing.
4. **Facing natural calamities**- Natural calamities such as floods, famines earthquakes, tsunami etc. lend to increase the government expenditure in order to provide relief to the victims. This requires huge public borrowing by the government.
5. **Fighting depression**- Borrowing is anti-cyclical. Public debt creation is considered as a very significant remedy to depression. Depression is the effect of fall in effective demand. The government can create effective demand by pumping that is by injecting money into the income stream. This involves huge amounts of money which the government may mobilise by borrowing the surplus of the country.
6. **To curb inflation**- Public borrowing may be regarded as a means to relieve the pressure of inflationary spiral in the economy, as by raising public loans, the government absorbs the excessive purchasing power in the hands of the people and check prices from rising.



7. **Public enterprises and utilities-** Public borrowing is necessary to promote public enterprises and utilities like railways, post and telegraph, power generation, etc. Promotion of these public corporations requires huge financial resources. The current revenues cannot afford it. The government can meet them only through public borrowing rather than by taxation.
8. **Unpopularity of Taxation-** People generally do not like to pay taxes to the government. Taxation, whether new or old is always unpopular with the public. The people generally oppose the enhancement of existing rates of taxes and the imposition of additional taxes. To get over this public opposition, the modern governments adopt the easy method of resorting to public debt.

PRINCIPLES OF PUBLIC DEBTS

- First principle: the allocation of credit to desired aims
- Second principle: priorities setting before scarcity of resource and time
- Third principle: generational equilibrium
- Fourth principle: debt structure on sustainability criteria
- Fifth principle: sound legal framework
- Sixth principle: best management practices
- Seventh principle: operational transparency
- Eighth principle: thorough process auditing



Unit – IV

Financial relation between central and State

Central Sources of Revenue- Taxes within Union jurisdiction are enumerated in List I, of the Seventh Schedule as under.

1. Taxes on income other than agricultural income (item 82).
2. Duties of customs including export duties (item 83).
3. Duties of excise on tobacco and other goods manufactured or produced in India except
 - a. Alcoholic liquors for human consumption.
 - b. Opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance included in paragraph (b) of inventory (item 84).
4. Corporation Tax (item 85) .
5. Taxes on capital value of assets, exclusive of agricultural land, on individuals and companies, taxes on capital of companies (item 85).
6. Estate duty in respect of property other than agricultural land (item 87).
7. Terminal taxes on goods or passengers, carried by railway, sea or air, taxes on railway fares and freights ((item 88).
8. Taxes other than stamp duties on transactions in stock exchange and future markets (item 90).
9. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills or lending, letter of credit, policies of insurance, transfer of shares, debenture, proxies and receipts (item 91).
10. Taxes on sale or purchase of newspapers and on advertisements published therein (item 97).
11. Taxes on the sale and purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce (item 92A).

Budget

Government has several policies to implement in the overall task of performing its functions to meet the objectives of social & economic growth. For implementing these policies, it has to spend huge amount of funds on defence, administration, and development, welfare projects & various other relief operations. It is therefore necessary to find out all possible sources of getting funds so that sufficient revenue can be generated to meet the mounting expenditure.

Planning process of assessing revenue & expenditure is termed as Budget.

The term budget is derived from the French word "Budgette" which means a "leather bags; or a "wallet". It is a statement of the financial plan of the government. It shows the income & expenditure of the government during a financial year, which runs generally from 1st April to 31st March.

Budget is most important information document of the government. One part of the government's budget is similar to company's annual report. This part presents the overall picture of the financial performance of the government. The second part of the budget presents government's financial plans for the period upto its next budget.

So, every citizen of a nation from the common man to the politi-cian is eager to know about the budget as they would like to get an idea of the: -

- Financial performance of the government over the past one year.
- To know about the financial programmes & policies of the government for the next one year.
- To know how their standard of living will be affected by the financial policies of the government in the next one year.

Definitions of Budget

According to Tayler, "Budget is a financial plan of government r a definite period".



According to Rene, "A budget is a document containing a preliminary approved plan of public revenues and expenditure".

OBJECTIVE OF BUDGET

The important objectives that are sought to be achieved through a budget in an economy are discussed below:

1. **Allocation of resources:** Keeping into view the socio-economic and other objectives which a government wants to achieve, re-sources are allocated through budget. In India, the most important activity is to accelerate the rate of economic development and for that resources are allocated on a large scale.
2. **Redistributive activities:** A developing economy like India is generally the victim of many social and economic problems which need to be solved as early as possible. The important problems are the problem of poverty, unemployment, income inequalities, illiteracy etc. In India, serious efforts are being made to solve these problems. For this the government redistributes income and wealth to reduce inequalities, by incurring expenditures on social security and giving subsidies for public etc.
3. **Economic stability:** Inflation and deflation both are not good from economic point of view; Therefore, whenever a country suffers from inflation or deflation, besides other corrective measures, appropriate budgetary steps are taken to remedy the situation. When a country suffers from the bout of depression, cyclical un-employment is created on a very large scale. Economic activities get depressed. In such a situation government has to adopt various fiscal measures improve the health of the economy.
4. **Management of public enterprises:** To curb monopolies in heavy, basic and key sectors owned and managed by private enterprises, government establishes and operates such units in the public sector, this is necessary to avoid distortion of priorities of the government and society.

Other Objective

5. Help in Economic planning
6. Tool for fiscal policies
7. Basis of public welfare
8. Legislative control on public funds
9. Tool of administrative efficiency.

REVENUE BUDGET

This financial statement includes the revenue receipts of the government i.e. revenue collected by way of taxes & other receipts. It also contains the items of expenditure met from such revenue.

Revenue Receipts

These are the incomes which are received by the government from all sources in its ordinary course of governance. These receipts do not create a liability or lead to a reduction in assets.

Revenue receipts are further classified as tax revenue and non-tax revenue.

1. **Tax Revenue:-** Tax revenue consists of the income received from different taxes and other duties levied by the government. It is a major source of public revenue. Every citizen, by law is bound to pay them and non-payment is punishable.

Taxes are of two types, viz.. Direct Taxes and Indirect Taxes.

Direct taxes are those taxes which have to be paid by the person on whom they are levied. Its burden cannot be shifted to someone else. E.g. Income tax, property tax, corporation tax, estate duty, etc. are



direct taxes. There is no direct benefit to the tax payer. Indirect taxes are those taxes which are levied on commodities and services and affect the income of a person through their consumption expenditure. Here the burden can be shifted to some other person. E.g. Custom duties, sales tax, services tax, excise duties, etc. are indirect taxes.

2. **Tax Revenue:-** Apart from taxes, governments also receive revenue from other non-tax sources. The non-tax sources of public revenue are as follows: -

- **Fees:** The government provides variety of services for which fees have to be paid. E.g. fees paid for registration of property, births, deaths, etc.
- **Fines and penalties:** Fines and penalties are imposed by the government for not following (violating) the rules and regulations.
- **Profits from public sector enterprises:** Many enterprises are owned and managed by the government. The profits received from them is an important source of non-tax revenue. For example in India, the Indian Railways, Oil and Natural Gas Commission, Air India, Indian Airlines, etc. are owned by the Government of India. The profit generated by them is a source of revenue to the government.
- **Gifts and grants:** Gifts and grants are received by the government when there are natural calamities like earthquake, floods, famines, etc. Citizens of the country, foreign governments and international organisations like the UNICEF, UNESCO, etc. donate during times of natural calamities.
- **Special assessment duty:** It is a type of levy imposed by the government on the people for getting some special benefit. • For example, in a particular locality, if roads are improved, property prices will rise. The Property owners in that locality will benefit due to the appreciation in the value of property. Therefore the government imposes a levy on them which is known as special assessment duties.

3. **India's Revenue Receipts:** - The tax revenue provides major share of revenue receipts to the central government of India. In 2006-07 tax revenue (direct + indirect taxes) of central government was Rs. 3,27,205 crores while non-tax revenue was Rs. 76,260 crores.

REVENUE EXPENDITURE

1. Expenses included in Revenue Expenditure –

In general revenue expenditure included following –

- Expenditure by the government on consumption of goods and services.
- Expenditure on agricultural and industrial development, scientific research, education, health and social services.
- Expenditure on defence and civil administration.
- Expenditure on exports and external affairs.
- Grants given to State governments even if some of them may be used for creation of seats.
- Payment of interest on loans taken in the previous year.
- Expenditure on subsidies.

India's Defence Expenditure –

In 2006-07, Defence expenditure of the central government of India was Rs. 51,542 crores.

2. Capital Receipts

This part of the budget included receipts & expenditure on capital account projected for the next financial year. Capital budget consists of capital receipts & capital expenditure.

Items included in Capital Receipts –

The main items of Capital receipts (income are –

- Loans raised by the government from the public through the sale of bonds and securities. They are called market loans.



- Borrowings by Government from RBI and other financial institutions through the sale of Treasury bills.
- Loans and aids received from foreign countries and other international Organizations like International Monetary Fund (IMF), World Bank etc.
- Receipts from small savings schemes like the National saving scheme, President fund, etc.

Introduction

In public the government first outlines its expenditure recording to the needs and objectives of the national policy and then attempts to locate sources of funds to meet this estimated expenditure. The main sources of revenue are tax revenue and non-tax revenue. Non-tax revenue mainly includes surplus from public enterprises. When the total estimated expenditure exceeds the aggregate estimated receipts during a year, the gap between the two is to be filled by what is called "deficit financing

Definition of Deficit Financing

Deficit financing, thus, refers to the financing of the excess expenditure over the total revenue receipts of the government during a year, by various methods.

Deficit Financing = Total Public Expenditure—Total Public Revenue.

Deficit Financing in Developed Countries

In developed countries, the total revenue receipts include tax and 'nontax revenue and excludes all borrowings. That means deficit financing in developed countries refers to the financing of expenditure, through borrowings — whether internal or external and whether from the central bank, commercial banks, non-banking institutions or from individuals and corporations (market loans).

Effects of deficit financing

Today financing is resorted to by the governments of both developed and developing countries. It is, therefore, necessary to examine the reasons for deficit financing for the two types of economies.

Reasons for Deficit Budgets in Advanced Countries

1. **For wars.** Deficit financing was used earlier for financing of wars. The form of this deficit financing was mainly internal borrowings from the market (Vern people and financial institutions) and external borrowings.
2. **Depression (anti-cyclical instrument).** J.M. Keynes on his book, General Theory of Employment Interest and Money. Advocated deficit financing of government expenditure to fight depression pumping more money into the economy to increase effective demand on the country. It is the deficiency of effective demand that increases unemployment in a developed country. This was amply shown by the depression of the thirties in countries like the USA, the UK, and other European countries. Thus, deficit financing is an anti-cyclical instrument in developed countries.
3. **To maintain full employment.** Now, deficit financing, particularly through public borrowings, is used by developed countries to maintain the full employment level. Since unemployment of the level of 2 to 3 per cent of the working force is treated as a normal situation, if it rises beyond this, every advanced country thinks it an obligation on the part of the government to take immediate steps to avoid it. This is done through deficit financing.
4. **To prevent recessionary trends.** No government of an advanced country can wait till the depression sets in. Whenever there are symptoms of recessionary trends in the economy, the government of an advanced country does not hesitate to resort to some kind of deficit financing in the country to prevent recessionary trends.
5. **To fill up budgetary deficit (functional finance).** Since the concept of "balanced budget" has been abandoned long back, budgets now looked upon as a functional instrument to regulate the economy. If the government revenues are not adequate enough to meet the functional



expenditure of the government, then deficit financing is unhesitatingly resorted to, to fill the budgetary deficits.

Deficit Financing in Developing Countries

The problems of developing countries like India, Pakistan, Bangladesh, are different from those in developed countries. Therefore, the rationale behind or justification for deficit financing in countries like India is entirely different. The following are the main reasons for deficit financing in India:

1. **Mobilization of physical resources.** There is a vast amount of physical resources, such as iron ore, different kinds of minerals, water, of land, etc., which are unutilised or underutilised or misutilised by the private sector. Public revenue is inadequate to use them efficiently and rationally. Underdeveloped countries are rich natural resources, such as mines and forests. They have abundance of unemployed labour. Through deficit financing, these idle resources can be activated and gainfully used for national development.
2. **Social overhead expenditure.** In developing countries to, lack of infrastructural facilities (power communication and transport etc.), there is low development of private sector industries. Since huge expenditure is necessary for such facilities and in which there is no large and quick profit, the government of a developing country has to spend a huge amount on social overhead capital for creating infrastructural facilities of power, communication and transport etc. Deficit financing is necessary for this purpose as the government tax and non-tax revenue is insufficient to meet this expenditure.
3. **Monetizing the rural sector.** In these days of money economy, it is necessary to monetise all sectors of a developing economy. A considerable's part of the rural sector is barter economy. Deficit financing is a useful instrument to change the barter sectors of the economy into monetised sectors. New money created can be used to popularise the use of money in such sectors.

Functions of finance commission

Under Article 280, a provision was made for the appointment of a Finance Commission by the President at an interval of five years or earlier to make recommendations pertaining to the sharing of income and excise taxes and grants-in-aid of state revenues. It is a quasi-judicial body whose recommendations, once accepted by the Government become binding on it. Further, the institution of the Finance Commission is a unique feature of our Constitution. It has no parallel in any other federation, old or new. The Australian Grants Commission resembles our Finance Commission to some extent. But there are important differences between the two. The former is a permanent body and deals with grants only on annual basis; the latter is an ad-hoc body which ceases to exist once it makes its recommendations but has wider powers as both tax-sharing and grants-in-aid come under its purview. Its awards remain in operation for five years

TERMS OF REFERENCE

The Finance Commission is required to recommend financial transfers from the Central Government to the states with a view to reducing vertical as well as horizontal fiscal imbalances. The terms of reference of the Finance Commission are fixed in a broad way by the Constitution under Article 280(iii). Though the Central Government is prevented from determining arbitrarily the terms of reference of the Finance Commission, yet there is scope for some flexibility under clause 3(c) of Article 280 which reads: "any other matter referred to the Commission by the President in the interest of sound finance." Under this clause the Government has put certain restrictions on the working of the Finance Commissions leading to controversies on several occasions. And with the advent of planning and development planning gaining importance, the Finance Commission's role was confined, according to the terms of reference, to the examination of non-plan revenue accounts of states budget.

TERMS OF REFERENCE

The Commission was entrusted with the task of making recommendations as to the following matters :



1. The distribution between the union and the states of the net proceeds of taxes which are to be, or may be, divided between them under Chapter 1, Part-XII of the Constitution and the allocation between the states of the respective shares of such proceeds;
2. Principle which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India and the sums to be paid to the states which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes of other than those specified in the provisos to clause (i) of that article; and
3. The measures needed to augment the Consolidated Fund of state to supplement the resources of the Panchayats and Municipalities in the States on the basis of the recommendation made by the Finance Commission of the State

Fourteenth Finance Commission

The fourteen finance commission is instructed on 02 Jan. 2013 under the chairmanship of Dr. Y.V. Reddi (Reserve Bank of India) following are its members:

1. Prof. Abhijeet Sen, Member Planning Commission.
2. Ms. Sushma Nath, Former Union Finance Secretary.
3. Dr. M. Govind Rao
4. Dr. Sudipto Mundle, Former acting chairman, national statistical commission.
5. Ajay Narayan Jha, Secretary

Main points of consideration under 14th commission are as follows:

1. The commission setup under the provision of constitution on sharing of tax proceeds between the union & states: will apply from April, 01, 2015.
2. The commission would look into the need for insulating the pricing of public utility services such as drinking water, irrigation, power & public transport from policy fluctuation, through statutory provisions.
3. On basis of recommendation of state finance commission measures are suggest to increase resources of panchayat & Nagar palika (Municipal Commission) by increasing the capital & savings of state government

Direct Taxes

1. A surcharge of 10 per cent on persons whose taxable income exceeds? 1 crore per year, this will apply to individuals, Hindu Undivided families, firms and entities with similar tax status.
2. Surcharge was also increased from 5 per cent to 10 per cent on domestic companies whose taxable income exceeds? 10 crore per year. In the case of foreign companies who pay the higher rate of corporate tax, the surcharge was increased from 2 per cent to 5 per cent.
3. All other cases, such as dividend distribution tax or tax on distributed income, the then existing surcharge of 5 per cent was increased to 10 per cent. The additional surcharge in all the above cases is to remain in force for only one year, that is, the financial year 2013-14.
4. Some benefit was given to the first-home buyer in the payment of interest on loans taken from financial and banking institution.
5. The rate of the tax on the payment of royalty and fees for technical services to non-residents was raised from 10 per cent to 25 per cent.
6. The following reduction was announced in the rates of securities Transaction Tax (STT):
Equity features: from 0.17 to 0.01 per cent MF/ETF redemptions at fund counts: from 0.25 to 0.001 per cent MF/ETF purchase and sale on exchanges : from 0.1 to 0.001 per cent, only on the seller.
7. Commodities Transaction Tax was introduced in a limited way at 0.01 per cent of the price of trade.
8. The Direct Taxes Code is proposed to be introduced not as an amended version of the Income-tax Act 1961 but as a new code based on the first international practices that will be compatible with the needs of a fast developing country. The recommendations of the Standing Committee on finance have been submitted and the Finance Ministry is examining them.



Indirect Taxes –

1. The first announcement made by the Finance Minister in the case of indirect taxes was no change in the peak rate of basic customs duty of 10 per cent for non-agricultural products, no change in the normal rate of excise duty of 12 per cent and the normal rate of service tax of 12 per cent.
2. In the case of excise duty route for readymade garment industry which is in the throes of crises was –r announced in addition to the GEN VAT route available at present. Similarly, excise duty was exempted in the case of handmade carpets and textile floor covering of jute or coir. Relief was increased by 18 per cent. similar increases were proposed for cigars, chariots and cigarillos. Excise duty on SUVs raised from 22 percent to 30 per cent, on marble from Rs. 30 per square meter to TRs. 60 per square meter, on mobile phone priced at more than Rs. 2,000 by 6 per cent.

GOODS AND SERVICES TAX

The Finance Minister had mentioned the Goods and Services Tax (GST) in the Budget speech for 2007-08 and had hoped that it would be brought into effect from 1.4.2010. This could not happen. The Empowered Committee of State Finance Ministers, led the Union Finance Minister to believe, as he announced in his budget speech of 2013.14, that the overwhelming majority of states are agreed that these are need for a constitutional amendment. He was hopeful that this consensus would be taken forward in the next few months and brings to this Lok Sabha a draft Bill on the Constitutional amendment and draft Bill on GST. He announced the first decisive step by announcing the setting apart in the Central Budget 2013-14 a sum of Rs. 9,000 crore.