PUBLIC ECONOMICS

COURSE CODE: B21EC06DE

Discipline Specific Elective Course

Undergraduate Programme in Economics

Self Learning Material

SREENARAYANAGURU OPEN UNIVERSITY

The State University for Education, Training and Research in Blended Format, Kerala

SREENARAYANAGURU OPEN UNIVERSITY

Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

Public Economics

Course Code: B21EC06DE

Semester - V

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(With Model Question Paper Sets)

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SREENARAYANAGURU
OPEN UNIVERSITY

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MESSAGE FROM VICE CHANCELLOR

Dear learner,

I extend my heartfelt greetings and profound enthusiasm as I warmly welcome you to Sreenarayanaguru Open University. Established in September 2020 as a state-led endeavour to promote higher education through open and distance learning modes, our institution was shaped by the guiding principle that access and quality are the cornerstones of equity. We have firmly resolved to uphold the highest standards of education, setting the benchmark and charting the course.

The courses offered by the Sreenarayanaguru Open University aim to strike a quality balance, ensuring students are equipped for both personal growth and professional excellence. The University embraces the widely acclaimed "blended format," a practical framework that harmoniously integrates Self-Learning Materials, Classroom Counseling, and Virtual modes, fostering a dynamic and enriching experience for both learners and instructors.

The university aims to offer you an engaging and thought-provoking educational journey. The undergraduate programme in Economics is designed to be on par with the high-quality academic programmes offered at state universities throughout the country. The curriculum incorporates the latest methodologies for presenting economic ideas and concepts. It stimulates students' interest in developing a deeper comprehension of the discipline. The curriculum encompasses both theoretical concepts and historical evidence. Suitable emphasis is placed on India's experiences with economic transformation. This would aid learners in preparing for competitive examinations, should they choose to take them. Upon successfully completing the programme, we anticipate that students will be well-equipped to handle key areas within the economics discipline. The Self-Learning Material has been meticulously crafted, incorporating relevant examples to facilitate better comprehension.

Rest assured, the university's student support services will be at your disposal throughout your academic journey, readily available to address any concerns or grievances you may encounter. We encourage you to reach out to us freely regarding any matter about your academic programme. It is our sincere wish that you achieve the utmost success.

Regards,
Dr. Jagathy Raj V. P. 01-08-2025

Contents

BLOCK 1

The Role of Public Sector

UNIT 1

Nature and Functions of Public Finance

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the meaning of public finance
- analyse the importance of public finance
- explain the key fiscal functions of the government
- describe the changing functions of the modern state

Prerequisites

Have you ever wondered how the government manages to build roads, run schools, provide free vaccines, support farmers, or maintain law and order across the country? Have you thought about where the money comes from for all these activities and how decisions are made on what to spend and where? These questions lead us into the fascinating subject of public finance. It deals with how the government raises money mostly through taxes and borrowing, and how it spends that money to meet the needs of society. But public finance is not just about money- it reflects the changing role of the government in people's lives. In earlier times, the state had limited duties like maintaining law and order. But in modern times, governments are expected to do much more to reduce poverty, create jobs, provide healthcare and education, and ensure economic stability. In this unit, we will examine how public finance helps governments to perform these vital functions and why understanding this subject is important for every citizen.

Keywords

Public Finance, Allocation, Distribution, Stabilisation, Canons of Taxation, Income, Expenditure

Discussion

1.1.1 Meaning and Subject Matter of Public Finance

The term Public Finance is composed of two words, 'public' and 'finance'. In Public Finance, the term public does not refer to all people or just a small group; it is used in a specific sense, referring to the government. So, Public Finance mainly deals with the financial matters of the government, that is, the Central, State, and Local governments. Even though schools, hospitals, and temples are public institutions, their finances are not the focus of Public Finance. That is why some experts believe it would be more accurate to call it Government Finance or State Finance.

The word finance is always related to money. For most people, money means currency - like notes and coins. But in Public Finance, finance is understood in its broadest sense. It includes not just money but also anything that can act like money. For example, if someone offers their service or goods instead of money, that also counts as finance. Similarly, the government may collect taxes in kind (like grain or services) instead of cash, especially during special situations like wars or scarcity. So, Public Finance is the study of how the government raises resources and how it spends them to perform various activities that fulfil public wants. These activities are decided by the people or the government and are known as the objectives of the state. The government needs funds to carry out its functions like building roads, providing education, ensuring security, and more. These funds are limited, so the government must use them in the most economical way.

According to Prof. Dalton, Public Finance is a "Subject which is concerned with the income and expenditure of public authorities and with the adjustment of the one to the other." Prof. Findlay Shirras defined "Public Finance is the study of the principles underlying the spending and raising of funds by public authorities." In Public Finance, we study how much money or resources the government should raise and how it should spend them to achieve its goals efficiently. It also involves making decisions about how to balance the use of funds between different activities, in order to ensure that no money is wasted and that all spending helps to reach the goals in the best possible way.

The scope of Public Finance is both limited and broad. It is limited because it studies only the financial activities of governments-Central, State, and Local. But it is broad because it covers all such activities from a financial viewpoint. Other aspects of these activities, such as their political or social impacts, are studied in other subjects like Political Science or Sociology. Public Finance also has two sides viz, positive and normative. It is positive when it studies what the government actually does, like the current tax and expenditure system. It is normative when it talks about what the government should do, based on social goals and values. For example, if the goal is to reduce inequality, public finance suggests ways to collect and spend money that help achieve that aim.

In a democratic system, the welfare of the people is the main objective. However, in reality, sometimes governments may favour some groups over others due to political interests or personal gains, which leads to what is known as government failure. Even though this can happen, while studying theories in public finance, we assume that the government is genuinely trying to maximise public welfare. Thus, public finance is the study of government activities from a financial perspective. It deals with how the government raises and spends money or resources to achieve its goals in the most economical and fair way.

1.1.2 Fiscal Functions

Professor Richard A. Musgrave identified three major fiscal functions that form the foundation of public finance policy. They are the Allocation function, Distribution function and Stabilisation function. Although taxes and government spending can affect the economy in various ways, these three functions describe the key policy objectives of the government. Peggy B. Musgrave later expanded this model by including the foreign sector to reflect the growing global interdependence in modern economies. Let us examine each function in detail.

a. Allocation Function

The allocation function in public finance refers to the role of the government in guiding how resources such as land, labour, and capital are distributed for the production of various goods and services. In an ideal market economy, this allocation is efficiently managed through the forces of demand and supply under conditions like perfect competition, complete information, and the exclusion principle. However, these conditions are often not met in reality, especially in the case of public goods.

Market failure arises when the private market is unable to allocate resources efficiently, particularly due to the unique characteristics of public goods. Public goods are non-excludable and non-rivalrous. The benefits of public goods are shared by everyone, regardless of who pays. Examples include public parks, street lighting, and national defence. Because individuals may not voluntarily pay for these goods, despite benefitting from them, the private sector has little incentive to provide them. This results in under-provision or non-provision of essential services.

To address this gap, the government intervenes to ensure an adequate supply of public goods. However, the challenge lies in determining;

- What type of social goods should be provided?
- How much of these goods is needed?
- How to measure the value of benefits received by individuals?

Another important dimension of the allocation function is its spatial aspect. Some social goods, such as national defence, provide benefits that are nationwide, while others, like street lighting, are localised. This distinction plays a crucial role in fiscal federalism, which concerns the assignment of responsibilities among different levels of government, i.e., central, state, or local, for the provision of various public goods. Thus, the allocation function addresses the efficient provision of goods and services, especially where the market fails, by ensuring that public needs are met fairly and effectively through government action.

b. Distribution Function

The distribution function in fiscal policy refers to how income and wealth are shared among individuals within an economy. The notion of a fair distribution goes beyond economic efficiency and involves subjective value judgments. While an efficient outcome is one where at least one individual is made better off without making anyone else worse off, many redistribution policies, such as taxation and welfare programmes, do involve trade-offs benefiting some individuals at the cost of others. Despite this, governments aim to reduce inequality through various fiscal tools.

Key instruments used to achieve redistribution include tax-transfer schemes, where individuals with higher incomes are taxed more (progressive taxation) and the revenue is used to support lower-income groups through direct transfers or subsidies. Progressive taxation is also employed to fund public services such as education, healthcare, and housing, which disproportionately benefit the poorer sections of society. In addition, governments may use indirect taxes and subsidies to influence consumption by imposing higher taxes on luxury goods consumed mainly by the rich and subsidising essential goods consumed by the poor. Although measuring individual welfare and achieving a perfectly equitable distribution is inherently complex, promoting a more just allocation of resources remains a fundamental objective of fiscal policy.

c. Stabilisation Function

The stabilisation function of fiscal policy focuses on maintaining economic stability by promoting high employment, price stability, external balance, and sustainable growth. In the absence of government intervention, market economies can be prone to fluctuations that result in unemployment, inflation, or even both simultaneously, a situation known as stagflation, such as what occurred in the United States during the 1970s. Furthermore, due to the interconnected nature of global economies, instability in one country can quickly spread to others, making economic management even more challenging.

Economic stability depends on the relationship between aggregate demand and the economy's potential output. Various factors, including income levels, consumer expectations, and credit conditions, affect people's spending behaviour. When aggregate demand falls short of potential output, it can lead to unemployment, while excess demand can push up prices and cause inflation. Since there is no automatic mechanism that quickly restores equilibrium, government intervention becomes essential to correct these imbalances. To stabilise the economy, governments primarily rely on two types of macroeconomic policies: monetary policy and fiscal policy. Monetary policy, administered by the central bank, regulates the money supply through instruments such as reserve requirements, the discount rate, and open market operations. For instance, expanding the money supply can lower interest rates, thereby encouraging borrowing and spending.

Fiscal policy, on the other hand, involves changes in government spending and taxation. By increasing public expenditure or reducing taxes, fiscal policy can stimulate demand during a downturn. However, the impact of a budget deficit on economic stability depends on how it is financed. If paired with an expansionary monetary policy, it tends to boost demand more effectively. Conversely, if the deficit is financed under tight monetary conditions, it could raise interest rates, crowd out private investment, and affect international capital flows. These shifts may also influence exchange rates and the balance of payments. Thus, the stabilisation function plays a crucial role in counteracting economic fluctuations and supporting a balanced and resilient economy.

The three fiscal functions - allocation, distribution, and stabilisation functions are fundamental to sound public finance. They help the government to efficiently manage resources, promote equity, and maintain economic stability. Although these functions may sometimes conflict, well-crafted fiscal policies can balance them effectively. In today's globalised economy, where international trade and finance play a significant role, these functions are more interconnected than ever.

1.1.3 Functions of the Modern State

According to Adam Smith, the government should only perform three basic duties within a system of natural liberty. They are:

- **Defence:** Protect society from foreign invasions and ensure national security.
- **Law and Order:** Ensure justice and maintain peace within the country.
- **Public Works and Institutions:** Provide basic infrastructure like roads, bridges, canals, and educational institutions to help commerce and society function smoothly.

To perform important functions like defence, maintaining law and order, and building public infrastructure, the government needs money. This money mainly comes from taxes. But for a tax system to be fair and useful, it must follow certain basic principles. These were explained by Adam Smith as the four Canons of Taxation.

Canons of Taxation

The canons of taxation are basic principles that guide how a good tax system should work. These ideas were first clearly explained by economist Adam Smith. He said that taxes should be fair, certain, convenient to pay, and economical to collect. These rules help governments to create tax policies that are just and efficient, in order to make sure that people are treated equally and the government gets enough money to meet public needs.

1. **Canon of Equity (or Fairness)**

Canon of Equity means that people should pay taxes based on how much they earn or own. In other words, those who have more income or wealth should pay more taxes, and those with less should pay less. This makes the tax system fair and just for everyone. It follows the idea that the tax burden should be shared according to a person's ability to pay. Example: A rich businessman will pay more tax than a small shopkeeper because he earns more.

2. **Canon of Certainty**

Canon of Certainty that there should be no confusion or doubt about taxes. Every person should clearly know about:

- How much tax do they have to pay?
- When do they need to pay it?
- How should they pay it?

When the tax rules are clear and fixed, people are more likely to follow them, and the government also finds it easier to collect taxes without disputes or complaints.

3. **Canon of Economy**

Canon of Economy focuses on the cost of collecting taxes. The government should not spend too much money or resources to collect taxes. The process should be efficient and simple, so that more of the tax money goes to public use, not into paying for collection expenses. Example: If it costs ₹5 to collect ₹10 in taxes, then it is not a good system. A better system would collect ₹10 at a much lower cost.

4. **Canon of Convenience**

Taxes should be collected in a way that is convenient for the taxpayers. The timing and method of tax collection should suit the people. For example, taxes can be collected at the time when people have money in hand, like when they get their salaries or during harvest season for farmers. Example: Income tax is often deducted from salaries before people receive them, so they do not have to worry about paying it separately.

However, classical economists thought that government spending should be very limited. They believed that taxes were like hail, harming private initiative and reducing funds for the private sector. J.B. Say supported this view and said the best finance plan was to 'spend little' and collect the least amount of tax. J.S. Mill also supported the idea of laissez-faire, i.e., the government should interfere as little as possible in the economy. They believed that individuals working in their self-interest, through the invisible hand of the market, would create benefits for the whole society. According to this view, when each person tries to maximise their income, the total income of the economy also increases.

Over time, the role of the State started to change. Professor R.N. Bhargava noted that the government first came into existence to protect people. The early State was like a 'Police State', focusing only on law, order, and defence. However, as societies evolved, people began expecting more from the State. They wanted protection not just from enemies but also from poverty, disease, ill-health, and ignorance. This gave rise to the idea of the Welfare State, where the government takes steps to maximise the welfare of all people, especially the poor and vulnerable.

A major turning point came in the 1930s during the Great Depression. The economist J.M. Keynes published his famous book *The General Theory of Employment, Interest and Money* in 1936. He argued that the government must take an active role in managing the economy. He introduced the concept of Compensatory Finance, where government spending (G) helps to maintain economic stability and full employment when private sector investment (I) and consumption (C) are low.

Keynes explained income with two simple equations.

Income side: $Y = C + S$ (Income is either consumed or saved)

Expenditure side: $Y = C + I$ (Income is either used for consumption or investment)

If savings (S) are more than investment (I), total spending in the economy drops, which can lead to a slowdown. To avoid this, the government must increase spending (G), making the equation $Y = C + I + G$. This shows the need for public finance to support demand and prevent economic downturns.

Later, economists moved from compensatory finance to a more advanced idea called Functional Finance, developed by A.P. Lerner. Functional finance means the government should use tools like taxation, public spending, borrowing, and managing public debt not just to balance the budget but to achieve important goals like full employment, price stability, and economic growth. Here, the government is active, not passive, in economic management.

While compensatory and functional finance were ideas developed for industrialised countries, developing countries also needed new financial policies. This led to the rise of Development Finance, which focuses on using government resources to promote faster economic development, reduce poverty, and build infrastructure. In today's world, both developed and developing countries see the government playing a major role in the economy. The modern State is not limited to just defence and law and order. It is involved in:

- Building infrastructure (roads, ports, electricity)
- Providing education and health care
- Creating jobs and reducing poverty
- Regulating markets to prevent exploitation
- Ensuring environmental protection
- Promoting social justice and equality

To carry out these expanded functions, the government must use a large part of the

Gross National Product (GNP). The functions of the modern State have evolved from being a simple protector of peace to a key player in ensuring economic development and social welfare. This transformation reflects the growing responsibilities of governments in improving the lives of their citizens and managing the economy for the greater good.

Recap

- Public finance is the study of how governments (central, state, and local) raise and spend resources to meet public needs
- Three major fiscal functions identified by Richard Musgrave are allocation, distribution and stabilisation
- The allocation function ensures the efficient supply of public goods like roads and defence, especially where markets fail
- The distribution function aims to reduce inequality through progressive taxation and welfare programmes
- The stabilisation function maintains economic stability by managing inflation, unemployment, and economic growth
- Public goods are non-excludable and non-rivalrous-everyone benefits regardless of payment
- Fiscal and monetary policies are used to control demand and supply imbalances in the economy
- Classical economists supported minimal government interference, believing markets could self-regulate
- The modern state goes beyond law and order, actively engaging in welfare, development, and economic regulation

Objective Questions

1. Define the term ‘Public Finance’.
2. Identify the economist who described Public Finance as the study of the income and expenditure of public authorities.

3. State the two major aspects or sides of Public Finance.
4. List the three core fiscal functions introduced by Richard Musgrave.
5. Name the type of fiscal function that addresses fairness in income and wealth distribution.
6. Mention the principle of taxation that ensures tax payment is aligned with one's income or ability.
7. Point out the key contributor to the theory of Compensatory Finance during the Great Depression.
8. Highlight the role of A.P. Lerner in the evolution of fiscal theory.
9. State the major change in the role of the State from the classical to the modern era.
10. Mention one example of a public good provided by the government.

Answers

1. Study of how the government raises and spends resources to fulfil public objectives
2. Prof. Hugh Dalton
3. Positive and normative
4. Allocation, Distribution, and Stabilisation
5. Distribution function
6. Canon of Equity
7. J. M. Keynes
8. He developed the concept of Functional Finance
9. Shift from a minimal 'Police State' to an active 'Welfare State'
10. National defence

Assignments

1. Explain the scope and subject matter of Public Finance.
2. Discuss the three fiscal functions proposed by Musgrave and their real-world applications.
3. How does Public Finance ensure fair distribution of income through taxation and subsidies?
4. Describe the transition of the State's role from classical thinkers to modern welfare economists.
5. Analyse the importance of Keynes's theory of compensatory finance during economic downturns.

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UNIT 2

Public Goods and the Free-Rider Problem

Learning Outcomes

After completing this unit, the learner will be able to:

- define public goods and explain their basic characteristics
- differentiate between pure and impure public goods
- identify the features of quasi-public goods and how they differ from pure public goods
- comprehend the concept of the free-rider problem

Prerequisites

Before we begin examining the public goods, let us think about some everyday experiences. In case of walking in a beautifully maintained public park, enjoying streetlights during a night walk, or feeling protected because of national defence without directly paying for them. These services are available to everyone, no matter who you are or whether you contribute financially. Now think about this: if no one can be excluded from using these services, and no one can be forced to pay for them, then who pays for them, and why would anyone pay at all? On the other hand, when we go to the cinema or use a toll road, we must pay a price. This brings up important economic questions like what makes some goods free for all while others are not? Why does the private market not provide certain goods and services, even if they are important for society?

To answer these questions, we need to understand the concepts of public goods, impure and quasi-public goods, and the free-rider problem-a situation where individuals benefit without contributing, leading to under-provision or non-provision of essential services. These topics not only help us see the differences between types of goods but also show why government involvement becomes necessary in some cases.

Keywords

Public Goods, Pure and Impure Public Goods, Quasi Public Goods, Free-Rider Problem

Discussion

1.2.1 Public Goods

To understand public goods, it is helpful to first think about what private goods are. Private goods are the things we usually buy and sell in shops or markets, like food, clothes, or mobile phones. When someone buys a private good, they become its owner, and no one else can use it without permission. These goods are said to be excludable, which means others can be kept from using them. They are also rivals, i.e., if one person uses them, there is less of the good left for others. For example, if you eat a slice of cake, no one else can eat that same slice, so the cake is both excludable and rival.

On the other hand, public goods are very different. These are goods that the market will usually not provide on its own, because it is hard to charge people for using them. This happens because public goods have two special characteristics. They are non-excludability and non-rivalry.

Non-excludable means that once the good is made available, it is impossible to stop people from using it even if they did not pay for it. People can enjoy the benefit without contributing money. This is known as the free rider problem. A free rider is someone who uses a good without paying for it.

Non-rival means that when one person uses the good, it does not reduce the amount available for someone else. Everyone can enjoy it at the same time without taking anything away from each other.

Let us take the example of a street light. If the government or a company installs street lights, everyone walking or driving on that road can benefit from the light. You cannot stop people from walking under it (non-excludable), and one person using the light does not make it dimmer for the next person (non-rival). So, street lights are a classic example of a public good.

Other examples include:

National defence : Everyone in the country is protected, whether or not they pay taxes.

Clean air : Everyone breathes the air around them. One person breathing does not take away the air for others.

Lighthouses : Ships use the lighthouses for navigation, but you cannot charge each ship separately for using it.

Since private companies cannot easily charge people for public goods, they usually do not supply them in a free market. That is why governments often step in to provide public goods, using money collected from taxes.

However, with technological changes, some goods that were once public can become excludable. For example, television broadcasts used to be public goods, but now, with digital encryption, companies can make people pay for specific channels. This shows that the status of some goods can change over time.

1.2.2 Pure and Impure Public Goods

Public goods are things that are made available to everyone and are not easily sold in the market. But not all public goods are exactly the same. Some are called pure public goods, while others are known as impure public goods. Understanding the difference between them is important in learning how governments decide what to provide for the public.

Pure Public Goods

A pure public good has three important features.

1. **Non-Rival Consumption:** This means one person's use of the good does not reduce how much is left for others. For example, when one person watches a TV broadcast or benefits from national defence, it does not take away that benefit from someone else.

2. **Non-Excludability:** Once the good is provided, it is impossible to stop others from using it - even if they have not paid for it. This is what leads to the free rider problem. People benefit without paying, which makes it hard for private companies to provide these goods.

3. **Impossibility of Rejection:** If the good is provided to one person, everyone must receive it - even if they do not want it. Such people are called forced riders. For example, if a country provides national defence, everyone is protected-no one can opt out.

A classic example of a pure public good is national defence. When the army protects a country from external threats, the entire population benefits equally from that protection. Another example is clean air in a natural environment, everyone breathes it, and no one can be kept from doing so.

Because public goods are non-excludable and non-rival, private companies usually do not want to produce them-they cannot easily make a profit. If left to individuals, most people would wait for others to pay and then try to enjoy the benefits for free. This is called the free rider dilemma. As a result, governments often step in to provide public goods using tax revenue, so that everyone can benefit equally.

Governments also try to prevent public bad things like pollution, noise, or unsafe financial practices which tend to be overproduced if there is no collective action.

Impure Public Goods (Quasi-Public Goods)

In reality, it is hard to find goods that are purely public or purely private. Most goods lie somewhere in between. These are called impure public goods, or sometimes quasi-public goods. These goods have some characteristics of public goods and some of private goods.

For example, a public park is mostly non-excludable and non-rival, i.e., anyone can walk in and enjoy it without stopping others. But if it gets too crowded, it becomes a rival because people cannot enjoy it as easily. Similarly, a toll road is non-rival when traffic is low, but it is excludable because people have to pay to use it.

The degree to which a good is public or private can change over time, especially with technology. For instance, TV signals were once public, but now cable and digital subscriptions can make them excludable.

Thus, pure public goods are those that are non-rival, non-excludable and cannot be rejected by individuals-like national defence or fresh air. In contrast, impure public goods have mixed characteristics, as they can be partly excludable or rival, such as public parks or toll roads. Since private firms often cannot profitably supply public goods due to the free rider problem, it becomes the government's role to provide them using public finance. This ensures essential services are accessible to all and reflects the importance of government action in the economy.

1.2.3 Quasi Public Goods

In the classification of goods in economics, public goods are defined as those that are indivisible in consumption and non-excludable. Once such goods are made available, they are equally accessible to all members of society. No individual can be excluded from enjoying their benefits, regardless of whether they have paid for them. Examples include national defence, public parks, and street lighting. Due to their unique nature, public goods are not efficiently allocated through the market mechanism, and their provision is typically undertaken by the government.

However, not all goods fall neatly into the category of pure public or pure private goods. Some goods exhibit characteristics that are intermediate between the two. These are referred to as quasi-public goods or partial public goods. Unlike pure public goods, quasi-public goods are separable and divisible, and they can be provided to individual users under conditions where the exclusion principle is applicable. That is, it is possible to exclude non-payers from using them. Nonetheless, their production or consumption often generates externalities, benefits, or costs that affect individuals other than the direct consumers or producers of the good.

Externalities are the spill-over effects arising from the actions of consumers or producers that impact third parties not directly involved in the economic transaction. These effects may be positive (external economies) or negative (external diseconomies). Positive externalities confer benefits on others without compensation, whereas negative externalities impose unintended costs.

For instance, investment in education by an individual yields broader societal benefits, such as a more informed and productive citizen. This is a positive externality. Conversely, industrial pollution that contaminates local water bodies affects nearby residents and ecosystems, constituting a negative externality. These externalities arise due to the interdependence of people, resources, and economic activities. In a hypothetical situation where such interdependence could be eliminated, externalities would not occur. However, in reality, such complete independence is neither practical nor desirable in a functioning economy.

1.2.3.1 Characteristics of Quasi-Public Goods

Quasi-public goods, also known as partial public goods, have features that lie between those of pure public goods and private goods.

1. **Excludability:**

Unlike pure public goods (like street lighting or national defence), quasi-public goods can be provided to specific individuals, and people can be excluded from using them if they do not pay. This means that sellers can charge a price, and only those who pay are allowed to use the good or service. A toll road is a quasi-public good. You can only use it if you pay the toll. If you do not pay, you are excluded from its use.

2. **Externalities:**

Even though quasi-public goods are sold to individuals, their use or production often creates spill-over effects called externalities. These effects can be positive (benefits to others) or negative (costs to others), and they affect people who are not directly involved in the transaction. Education is a quasi-public good. When someone becomes educated, it benefits not just that person but also society, by making the population more skilled and informed (positive externality). On the other hand, a privately owned car used on a congested road adds to traffic and air pollution, affecting others around (negative externality).

3. **The private cost borne by the purchaser may not reflect the total social cost or benefit**

For quasi-public goods, the private cost or benefit (what the buyer pays or gains) may not reflect the full cost or benefit to society. This means that the price paid by an individual may be too low or too high compared to the actual value of the good when considering its wider impact. Sometimes, individuals do not pay for the full social cost of using the good, as in pollution. At other times, the full benefits of the good are not captured by the individual, leading to under-consumption as in education or vaccination.

Because of this gap between private and social valuation, markets alone cannot allocate these goods efficiently. Government intervention through subsidies, taxes, or regulation is often necessary to correct this imbalance. These goods occupy a grey area where market transactions are possible, yet they do not result in socially optimal outcomes due to the presence of externalities. Thus, market allocation alone cannot ensure economic efficiency in their provision and consumption.

Government's Role in Correcting Externalities

To address the divergence between private and social valuations, government intervention becomes necessary. Through the application of fiscal tools, such as taxes and subsidies, the government can adjust incentives so that the true social costs and benefits are internalised by the economic agents involved. In the case of negative externalities, such as pollution, the government may impose corrective taxes, also known as Pigouvian taxes, on producers or consumers, thereby discouraging overconsumption or harmful production. For positive externalities, such as education or immunisation, the government may offer subsidies or directly provide the good to encourage higher consumption levels that align with the social optimum. Such measures are vital in a mixed economy, where both public and private sectors contribute to the provision of goods and services. In such an economy, the government may not need to supply all quasi-public goods directly; instead, it can rely on regulatory mechanisms and economic incentives to bring private behaviour in conformity with public interest.

Let us consider some common examples that illustrate the nature of quasi-public goods and the externalities associated with them. Education serves as a prominent example, where a student gains private benefits, such as improved employment opportunities, while society benefits from a more skilled and productive workforce constitutes a positive externality. However, without government support in the form of subsidies or public provision, the market may fail to supply education at socially optimal levels. Similarly, vaccination programmes provide individual protection against diseases (a private benefit) while also contributing to public health by reducing the spread of infectious diseases, thus generating positive spill-over effects. To encourage widespread immunisation, governments often intervene by subsidising or directly supplying vaccines. In contrast, pollution control highlights a case of negative externality. When a factory emits pollutants, it may only account for its production costs, while the adverse health and environmental effects are borne by the public. To address this imbalance, governments use tools such as taxation and regulation to ensure that producers internalise these external costs, promoting outcomes that better reflect social welfare.

Thus, Quasi-public goods represent an important category in economic analysis where market outcomes are inefficient due to the presence of externalities. Although these goods are divisible and excludable to some extent, their provision and consumption have broader implications for social welfare. Effective government intervention through taxation, subsidies, or regulation is essential to ensure that the allocation of these goods reflects the true social costs and benefits, thereby achieving a more equitable and efficient economic outcome.

1.2.4 Free-Rider Problem

The free rider problem is a common issue related to the nature of public goods. As you learned, Public goods have two key characteristics- they are non-rival and non-exclusive. Non-rival means that one person's use of the good does not reduce its availability for others. Non-exclusive means it is difficult or impossible to stop people from using the good, even if they have not paid for it. Because of these features, people often try to benefit from public goods without paying for them. This behaviour is known as free riding. An example of the free rider problem is national defence. Once a country provides military protection, it safeguards all its citizens equally, regardless of who pays taxes. Every individual benefits from the security and peace provided by national defence. However, because it is non-rival and non-exclusive, some people might prefer not to pay taxes, assuming others will pay and they will still be protected. This is classic free rider behaviour- enjoying the benefit without contributing to the cost. The problem becomes worse when individuals understate their marginal benefits, i.e., they pretend that they value the public good less than they actually do. They do this to reduce their share of the cost, knowing that they can still enjoy the good once it is provided. This kind of behaviour can lead to a serious market failure, where the pursuit of individual self-interest does not result in efficient outcomes for society.

Public goods often lead to positive externalities. Since private producers cannot collect money from everyone who benefits, they have insufficient incentive to produce such goods. For instance, if someone invents a new idea or software and shares it online, it may benefit millions, but few would willingly pay if they can access it freely. This discourages further innovation and production of such information goods. This situation explains why many public goods, like national defence, public parks, and clean air, are usually provided by the government. The state can collect taxes from everyone and ensure that such goods are made available, even if individuals would not pay voluntarily. If left to the market, the free rider problem would mean such goods are systematically under-provided.

Interestingly, the free rider problem is not always harmful. In some cases, it can prevent undesirable outcomes. For example, if businesses try to form collusive agreements to reduce output and increase prices like a secret pact to exploit consumers, the presence of free riders among them may disrupt such cooperation, which actually benefits the public.

In short, a free rider is someone who benefits from a good or service without paying for it. The free rider problem highlights the challenge of providing public goods in a market economy. While it may seem like a clever individual strategy, if too many people act this way, the overall supply of public goods may suffer, thereby reducing the benefits for everyone. Therefore, government intervention is often necessary to correct this market failure and ensure that essential public goods are provided fairly and efficiently.

Recap

- Public goods are non-rival and non-excludable, unlike private goods, which are rival and excludable
- Non-excludability leads to the free rider problem, where people benefit without paying
- Non-rivalry means one person's use does not reduce availability for others
- Examples of public goods include national defence, street lighting, clean air, and lighthouses
- Pure public goods are fully non-rival, non-excludable, and cannot be rejected (e.g., national defence)
- Impure (quasi) public goods have mixed characteristics-partly rival or excludable (e.g., public parks, toll roads)
- Quasi-public goods generate externalities-positive or negative effects on third parties
- Positive externalities include education and vaccination; negative ones include pollution and traffic
- The private cost of quasi-public goods may not reflect total social cost or benefit
- Government intervention (subsidies, taxes, regulation) is needed to correct market failures
- The free rider problem discourages private production of public goods, leading to under-provision
- The government ensures fair provision of public goods using tax revenue in a mixed economy

Objective Questions

1. Identify the two main characteristics of a public good.
2. Name a classic example of a pure public good.
3. Explain what a free rider is in the context of public goods.
4. State one major reason why private markets fail to provide public goods.
5. Mention one example of a quasi-public good.
6. Describe what makes a good, 'non-rival'.
7. Point out the role of government in correcting market failures in public goods.
8. List one feature that distinguishes quasi-public goods from pure public goods.
9. Indicate a public good that has become excludable due to technological advancements.
10. Recognise the term used for spill-over effects on third parties.

Answers

1. Non-excludability and non-rivalry
2. National defence
3. A person who enjoys the benefits of a good without contributing to its cost
4. Inability to exclude non-payers from consumption
5. Toll road
6. One person's consumption does not reduce availability for others
7. Providing goods through tax funding and correcting externalities
8. Quasi-public goods are excludable to some extent
9. Television broadcasts (e.g., encrypted or pay channels)
10. Externalities

Assignments

1. Explain with examples the differences between pure public goods and impure public goods.
2. Why is the free-rider problem considered a major challenge in the provision of public goods?
3. Analyse the role of government in providing public and quasi-public goods with suitable illustrations.
4. Discuss how technological developments have influenced the classification of public goods.
5. Define quasi-public goods and explain their economic significance in mixed economies.

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3

UNIT

Market Failure

Learning Outcomes

After completing this unit, the learner will be able to:

- discuss the concept of market failure
- differentiate between positive and negative externalities
- identify the role of government in correcting market failures
- comprehend the concept of Pigouvian tax

Prerequisites

Markets are generally seen as efficient systems for allocating resources, where supply and demand determine what is produced and at what price. However, in the real world, markets do not always work perfectly. For instance, a factory may produce goods that people want but also release pollution into the air, affecting the health of nearby residents who are not part of the transaction. These unintended side effects are called externalities, and they represent a key form of market failure. Market failures can also occur with goods that everyone uses but no one wants to pay for, like clean air or public parks. In such cases, government intervention becomes necessary to correct the failure and restore efficiency. One popular solution to negative externalities is the Pigouvian Tax, a concept introduced by economist Arthur Pigou, which suggests taxing activities that cause harm to others, like pollution, so that the social costs are reflected in the market price. This helps to reduce harmful behaviour and encourages more responsible economic decisions.

Keywords

Market Failure, Government Intervention, Externalities, Pigouvian Tax

Discussion

1.3.1 Market Failure and Government Intervention

In most cases, markets are a good way to organise economic activities. They allow buyers and sellers to make decisions freely, and this usually leads to efficient outcomes through what economists call the invisible hand. It is a concept that explains how individuals acting in their self-interest can unintentionally benefit society as a whole. However, markets are not perfect. There are certain situations when markets fail to allocate resources efficiently, and this is known as market failure. There are two major reasons why the government may need to intervene in the economy. They are to promote efficiency and promote equity. Promoting efficiency means using society's resources in the best possible way to maximise total economic output, similar to producing the highest possible yield from a farm using limited land and water. Promoting equity, on the other hand, is about ensuring a fair distribution of that output, so that the harvest is shared more equally among all members of society, helping to reduce social and economic inequalities.

Causes of Market Failure

1. **Externalities**

One common cause of market failure is externality. An externality is the impact of one person's actions on the well-being of others who are not directly involved in the activity. Externalities can be negative or positive. A classic example of a negative externality is pollution. For instance, if a chemical factory releases harmful smoke into the air but does not bear the full cost of that damage, it may pollute more than is socially acceptable. In such cases, government intervention, such as environmental laws or taxes on pollution, can help reduce the harm and improve social welfare.

A positive externality, on the other hand, occurs when someone's actions benefit others. A good example is the planting of trees in urban areas. When a person or community plants trees, they not only enjoy the shade and beauty, but others also benefit from cleaner air, cooler surroundings, and reduced noise pollution. These benefits extend to everyone in the area, not just those who planted the trees. However, because the planter does not receive payment for these wider advantages, the government may step in by supporting tree-planting programmes or offering incentives to promote more green spaces in cities.

2. Market Power

Another reason for market failure is market power. This happens when a single seller or a small group of sellers can control prices because they do not face enough competition. For example, suppose there is only a single electricity company that is the only provider of power in a city. Since residents have no alternative source for electricity, the company can set high prices or offer poor service without fear of losing customers. This market power allows the firm to influence prices unfairly, leading to market failure. In such cases, the government may intervene by regulating prices or even providing electricity through a public utility to ensure fair access and better efficiency. This is an example of a monopoly. In such cases, the government can step in and regulate prices to prevent unfair profits and improve efficiency.

3. Information Failure

Another cause of market failure is information failure, which happens when either the buyer or the seller lacks complete or accurate information. In a properly functioning market, decisions are made based on full knowledge of prices, quality, and other relevant factors. However, if one side has more or better information than the other, known as asymmetric information, then poor decisions may be made. For example, a person may pay too much for a second-hand car because they do not know its true condition. This kind of imbalance disrupts the market equilibrium.

4. Public Goods

Public goods are another important example of market failure. These are goods that are non-excludable and non-rival. A streetlight is a classic example - once it is installed, everyone benefits from it, whether they paid for it or not. Because private companies cannot limit usage or charge everyone who benefits, they often have little incentive to produce such goods. This results in underproduction, and the government usually steps in to provide or subsidise public goods to correct the market failure.

5. Inequity in Income and Wealth Distribution

While markets are generally good at encouraging productive activities and rewarding skills and talents, they are not always fair. For example, a famous cricket player might earn millions while a top chess player earns far less. This is not because one works harder, but because more people are willing to pay to watch cricket than chess. The market does not ensure that everyone gets enough food, clothing, or healthcare. That is why governments use tools like income tax and welfare programmes to reduce inequality and promote equity.

It is important to note that just because the government can improve market outcomes does not mean it always does. Public policy is made through a political process that may be influenced by powerful groups or by leaders who do not have all the necessary information. A key goal in economics is to help us understand when government intervention is truly needed to promote efficiency and fairness, and when it might cause more harm than good.

1.3.2 Externalities

Externalities are unintended side effects of economic activities that affect people who are not directly involved in the transaction. These effects can either be harmful (negative externalities) or beneficial (positive externalities). In both cases, the market outcome, where supply equals demand, fails to account for the well-being of these uninvolved individuals, called bystanders. As a result, the market equilibrium does not represent the most efficient allocation of resources, and government intervention may be needed to correct these market failures.

Negative externalities arise when an economic activity imposes costs on others. A common example is dioxin pollution released during paper production, which increases health risks for the surrounding population. Another example is automobile exhaust, which contributes to air pollution and affects the respiratory health of people who are not part of the transaction between car buyers and sellers. Since drivers do not bear the full cost of the pollution they cause, they tend to drive more than is socially desirable. Governments respond by setting emission standards and levying taxes on gasoline to discourage excessive pollution. Similarly, barking dogs can be a source of noise pollution, disturbing neighbours and reducing their quality of life. Here too, dog owners do not face the full social cost of their pet's behaviour. Local governments often address this issue through laws against disturbing the peace, which aim to reduce the unwanted side effects of pet ownership.

On the other hand, positive externalities occur when an activity provides benefits to others without compensation to the person responsible for it. For instance, when someone restores a historic building, the public gains from the aesthetic and cultural value of the site, even though the owner does not receive payment from every passerby who enjoys it. In response, local authorities may offer tax incentives or enforce heritage protection laws to encourage such socially beneficial behaviour. Another important example of a positive externality is scientific research and innovation. When a firm invests in research and development, the new knowledge generated often benefits other firms and individuals. However, because the inventor cannot fully capture these widespread benefits, they might invest less in research than what is optimal for society. The government addresses this issue by implementing the patent system, granting exclusive rights to inventors for a limited period. A further example is vaccination programmes. When an individual gets vaccinated, not only do they protect themselves from disease, but they also reduce the risk of spreading infections to others. This creates a positive externality for public health.

In each of these cases, whether the externality is positive or negative, private decision-makers fail to account for the external effects of their actions. This leads to an inefficient outcome that does not maximise social welfare. Therefore, government policies such as taxes, subsidies, regulations, and legal rights play a crucial role in influencing behaviour and improving economic outcomes.

1.3.2.1 Negative Externalities

A negative externality happens when the action of a person or a business harms other people, even though those others are not part of the decision. This harm is not paid for by the one who caused it. In other words, a negative externality is an unwanted side effect that creates a cost to society. One common example is pollution. Let us take the example of a plastic bottle factory. Every time the factory makes plastic bottles, it also releases smoke and chemical waste into the air and water. This pollution can cause health problems for people living nearby. But the factory does not pay these people for the damage. This is a negative externality. The factory's actions affect bystanders (people not directly involved) in a harmful way.

Normally, in a market, supply and demand decide the equilibrium price and quantity of a product. At the market equilibrium, the amount buyers want to buy equals the amount sellers want to sell. This is usually considered efficient because it maximises the total benefit to society.But when there is a negative externality like pollution, this market result is not efficient. Because the private cost (cost to the factory) does not include the external cost (cost to society). The factory only considers its costs, like materials and wages. It ignores the cost of pollution to others. As a result, the factory produces more plastic bottles than is good for society.

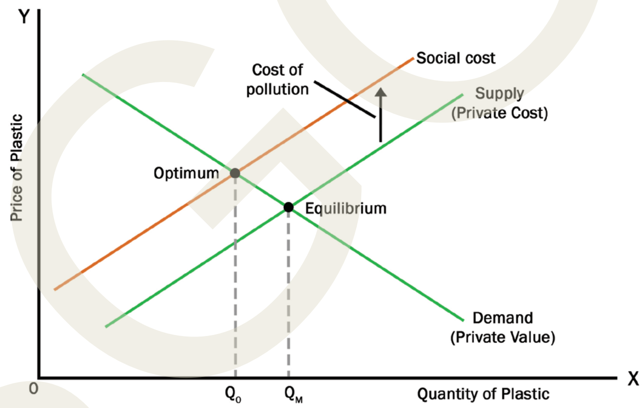

Fig 1.3.1 Social Cost of Producing Plastic Bottles

The figure 1.3.1 illustrates the concept of a negative externality in production using the example of plastic bottle manufacturing. In the graph, the X-axis represents the quantity of plastic bottles produced, while the Y-axis represents the price of plastic bottles. The demand curve slopes downward and reflects the private value or the benefit that consumers receive from each additional plastic bottle. The supply curve slopes upward and reflects the private cost of production, such as labour, materials, and energy costs incurred by plastic bottle manufacturers. However, this supply curve does not include the external environmental costs caused by pollution during production.

To fully capture the impact of plastic bottle production on society, we consider the social cost curve, which lies above the supply curve. This curve includes both the private cost and the external cost-such as pollution, health hazards, and environmental degradation. The vertical distance between the supply curve and the social cost curve shows the cost of pollution per unit of plastic bottles produced. Since the supply curve ignores this additional cost, the market ends up producing more than the socially desirable quantity.

The market equilibrium occurs at the point where the demand curve intersects the supply curve. At this point, the quantity of plastic bottles produced is Q_M. This is the amount the market would supply when only private costs and benefits are considered. However, from society's perspective, this level is excessive because it causes more harm than benefit at the margin. The socially optimal quantity, labelled Q_0, is found where the demand curve intersects the social cost curve. This is the quantity that would be produced if both private and external costs were taken into account.

At Q_M, the marginal social cost of producing one more plastic bottle is higher than the marginal benefit to consumers. This leads to overproduction, deadweight loss, and a misallocation of resources. A benevolent social planner, whose goal is to maximise total social welfare (consumer surplus plus producer surplus minus external costs), would want to reduce production to Q_0, where the value to society from the last bottle produced equals its total cost.

To move the market toward this socially efficient outcome, the government can introduce a pigovian tax, a tax equal to the cost of pollution caused by each bottle produced. This tax raises the cost to producers, effectively shifting the supply curve upward so that it coincides with the social cost curve. When this happens, the new market equilibrium occurs at Q_0, and the externality is said to be internalised, i.e., the producers now consider the full social costs of their actions in their production decisions.

1.3.2.2 Positive Externalities

While many markets suffer from negative externalities, where production imposes additional costs on society, there are also markets characterised by positive externalities. A positive externality arises when the production or consumption of a good benefits people who are not directly involved in the economic transaction. A good example of this is the production of solar panels. When a company manufactures and installs solar panels, it not only benefits by earning profits and meeting demand but also contributes to cleaner energy, environmental protection, and the development of green technology. Additionally, the knowledge gained through innovation and improved production processes in solar panel technology spills over to other firms and industries. This added benefit to society is called a technology spillover.

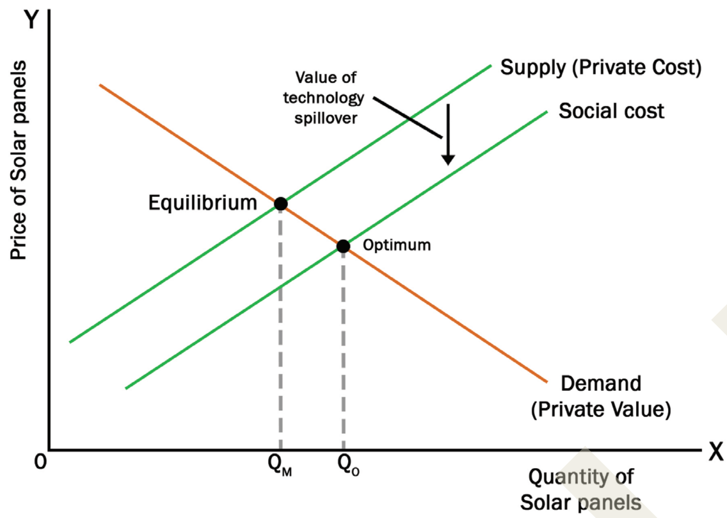

Fig 1.3.2 Positive Externality and Market for Solar Panels

The figure 1.3.2 illustrates how this positive externality affects the market for solar panels. On the X-axis, we measure the quantity of solar panels produced, and on the Y-axis, we measure the price of solar panels. The demand curve slopes downward, reflecting the private value consumers place on solar panels. The supply curve slopes upward and represents the private cost of producing solar panels-this includes the labour, raw materials, and energy costs faced by producers.

However, due to the positive externality from technology spillovers, the true social cost of producing solar panels is actually less than the private cost. This is because society gains extra value from the shared knowledge and environmental benefits of solar energy, even though the producing firm does not directly earn from these benefits. In the graph, this is shown by a social cost curve that lies below the supply curve. The vertical gap between these two curves represents the value of the technology spillover.

In a free market without any intervention, the equilibrium quantity of solar panels produced is QM, where the supply curve (private cost) intersects the demand curve. But from the perspective of a benevolent social planner, this quantity is too low. The planner considers the external benefits and seeks to maximise total surplus, which includes the gains from both private transactions and spillover effects. The optimal quantity from society's viewpoint is Q_o, where the demand curve intersects the social cost curve. At this point, the marginal benefit to consumers is equal to the marginal social cost of production, leading to the most efficient use of resources.

To move the market from QM to the socially optimal level Q_o, the government can internalise the externality. This can be done by offering a subsidy to producers for each unit of solar panels they manufacture. The subsidy lowers the producers' costs and shifts the supply curve downward to align with the social cost curve. If the subsidy exactly equals the value of the technology spillover, then the new market equilibrium will occur at Q_o, achieving the social optimum.

1.3.3 Pigouvian Tax

A Pigouvian tax is a form of corrective tax designed to address the problem of negative externalities, which arise when private market activities impose additional costs on society that are not reflected in market prices. Named after British economist Arthur Cecil Pigou, this type of tax aims to bring private costs in line with social costs by forcing producers to internalise the external damage they cause, particularly in the context of pollution.

To understand how a Pigouvian tax leads to a more efficient outcome, consider the example of chemical-producing factories discharging waste into a river. These firms, when making production decisions based solely on their marginal private costs (MC), tend to overproduce, ignoring the marginal external cost their pollution imposes on society, such as environmental degradation or health hazards. The result is a market failure; i.e., too much of the good is produced, and the social welfare is diminished.

To correct this, the government imposes a pollution tax equal to the marginal external cost per unit of chemical produced. This tax effectively raises the producers' cost, shifting the supply curve upward to reflect the full marginal social cost (MSC), which is the sum of marginal private cost and the tax. In other words, the new supply curve becomes S = MC + tax = MSC. By incorporating the external cost into the producer's decision-making, the Pigouvian tax ensures that producers now consider the broader social implications of their actions. This adjustment is illustrated clearly in the graph given below.

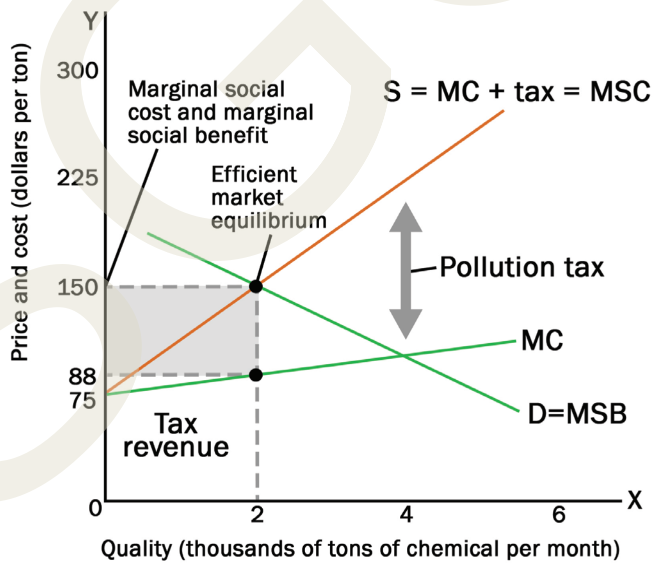

Fig 1.3.3 A Pollution Tax to Achieve an Efficient Outcome

On the X-axis, we measure the quantity of chemicals produced, in thousands of tons per month. On the Y-axis, we measure the price and cost per ton, in dollars. Initially, without any tax, the chemical industry produces at a quantity of 4,000 tons per month, where the demand curve (D = MSB), representing the marginal social benefit, intersects the marginal private cost (MC) curve. At this point, the price is \$88 per ton, and the marginal private cost is also \$88, but this does not account for the external costs imposed on society.

Once a Pigouvian tax is introduced, set at \$62 per ton, the exact value of the marginal external cost- the supply curve shifts upward from MC to S = MC + tax, which is also the marginal social cost (MSC) curve. The new market equilibrium occurs at a lower quantity of 2,000 tons and a higher price of \$150 per ton. At this point, marginal social cost equals marginal social benefit, achieving an efficient market outcome. This efficiency is visually represented by the point where the MSC curve intersects the demand curve.

The vertical distance between the original MC curve and the MSC curve represents the pollution tax, which is \$62. The rectangular area shaded in purple under the new equilibrium price and above the original MC curve represents the government's tax revenue, amounting to \$124,000 per month (calculated as \$62 tax × 2,000 tons).

This policy ensures that producers are discouraged from excessive pollution while still allowing for economically beneficial production. The firms now pay the full cost of their activities-both private and external, and society benefits from a cleaner environment and a more efficient allocation of resources. Thus, the Pigouvian tax is an effective tool for correcting market outcomes in the presence of negative externalities.

Recap

- Market failure occurs when the free market fails to allocate resources efficiently
- Externalities are costs or benefits affecting third parties not involved in a transaction
- Negative externalities (e.g., pollution) impose social costs not reflected in market prices, causing overproduction
- Positive externalities (e.g., vaccinations, R&D) create external benefits, leading to underproduction
- Government interventions like taxes, subsidies, and regulations help to internalise externalities and improve social welfare
- Pigouvian tax is a corrective tax equal to the external cost imposed, used to correct negative externalities
- Information failure, asymmetric information, leads to poor decision-making in markets, e.g., buying a faulty used car

- Market power, such as monopolies, allows firms to set unfair prices due to a lack of competition
- Public goods (e.g., streetlights) are underprovided by markets due to their non-rival and non-excludable nature
- A socially optimal quantity occurs when marginal social cost equals marginal benefit
- Technology spillovers from innovation benefit others, justifying government subsidies for R&D

Objective Questions

1. What is market failure?
2. Which term refers to unintended side effects on third parties?
3. What type of externality is pollution?
4. Which good is both non-excludable and non-rival?
5. What tax helps internalise negative externalities?
6. Why does the government provide R&D subsidies?
7. Which curve lies above the supply curve in the case of a negative externality?
8. Which externality leads to underproduction in the market?
9. What type of market power occurs with only one seller?
10. What is the goal of a Pigouvian tax?

Answers

1. Inefficient resource allocation
2. Externality
3. Negative externality

4. Public good
5. Pigouvian tax
6. Positive externality
7. Social cost curve
8. Positive externality
9. Monopoly
10. Efficiency

Assignments

1. Explain the concept of market failure with examples.
2. Discuss the effects of negative externalities using a suitable diagram.
3. Illustrate the impact of positive externalities on social welfare.
4. Describe the role of the government in correcting market failure.
5. Outline the purpose and working of a Pigouvian tax.

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BLOCK 2

Pubic Resource Mobilisation

1

UNIT

Public Revenue

Learning Outcomes

After completing this unit, the learner will be able to:

- identify the main sources of public revenue
- explain the canons (principles) of taxation
- classify taxes into direct and indirect taxes
- describe the importance of taxation in government finance

Prerequisites

Every government needs money to run the country. It spends money on building roads, schools, and hospitals, paying salaries to government workers, giving pensions, and providing welfare schemes to support the poor and needy. But where does the government get all this money from? It gets money from what we call public revenue.

Public revenue is the income that the government receives from various sources. One of the most important ways the government collects money is through taxes. Everyone, in some way or another, pays taxes, either directly or indirectly. Besides taxes, the government also earns money from things like fees, fines, profits from government-owned companies, and loans.

To make sure the tax system is fair and works properly, economists have laid down certain principles, known as the canons of taxation. These canons help in designing a good tax system-one that is fair, easy to understand, and not too costly to collect. There are also different kinds of taxes. Some are taken directly from a person's income or wealth, while others are collected when people buy goods or services. This is known as the classification of taxes.

Understanding these ideas is very important for economics learners because public revenue and taxation play a big role in shaping a country's economy.

Keywords

Taxation, Canons of Taxation, Direct Taxes, Indirect Taxes, Government Income, Revenue

Discussion

2.1.1 Sources of Public Revenue

The main sources of public revenue are as follows:

I. Taxes

II. Commercial Revenues

III. Administrative Revenues

IV. Gifts and Grants

I. Taxes

Taxes are the most important source of revenue for modern governments. In every country, the greatest part of the public revenue is raised through taxation. According to Dr. Dalton, "A tax is a compulsory contribution imposed by the public authority, irrespective of the exact amount of service to the tax payer in return and not imposed as a penalty for any legal offence." In the words of P.E. Taylor, "Taxes are compulsory payments to governments without expectation of direct return or benefit to the tax-payer." As a matter of fact, tax is a payment for an indirect service to be made by the government to the community as a whole.

II. Commercial Revenues

The revenues, which we call commercial, are received in the form of prices paid for government, produced goods and services, i.e., revenues which are derived by the government from public enterprises by selling their goods and services are called commercial revenues. They include payment for postage, tolls, interest on funds borrowed from the government credit corporations, prices paid for liquor in government stores, electricity and water distributed by the government, income from railway, transport, other public enterprises, etc.

III. Administrative Revenues

The receipts or incomes accrued on account of performing administrative functions by the government are called administrative revenues. Administrative revenues include receipts or incomes in the form of fees, fines and penalties, special assessments, forfeitures, escheat, etc., which may be summarised as follows.

a. **Fees:** Sometimes the government provide certain special services to the public, and in payment for these, it charges fees. Thus, fee revenue is that which is paid to the government for the special services rendered by it, e.g., court fee, licence fee (driving licence fee, etc.), passport fee, etc.

b. **Fines and Penalties:** Fines and penalties are levied and collected from the offenders of the law as punishment. They are the payments made for the contravention of the law. The aim of these sources of revenue is not merely the collection of funds, but the enforcement of justice and the maintenance of law and order in the country.

c. **Special Assessment:** Prof. Seligman has defined special assessment as "a compulsory contribution levied in proportion to the special benefit derived to defray the cost of a special improvement to property undertaken in the public interest." When the government undertakes certain activities of public interest such as the construction of roads, provision of drainage, street-lighting, etc., it may confer the common benefits on the community as a whole and special benefits on those possessing properties nearby. As a result, the values or rents of these properties may rise. The government, therefore, may impose a special levy to recover a part of the expenses so incurred. Such special assessment is levied, generally, in proportion to the increase in the value of the property situated nearby.

d. **Forfeitures:** Forfeiture of basic surety bonds refers to the penalties imposed by courts when individuals fail to appear before the courts to fulfill contractual obligations. However, this source of revenue is of very little significance.

e. **Escheat:** It refers to the claim of the government to the property of a person who dies without having any legal heirs or without leaving a will. It includes bank balances, properties, etc. However, this source of revenue is also of very little importance.

IV. Gifts and Grants

Gifts are voluntary contributions from private individuals or non-government donors to the government fund established for some special purpose, such as, relief fund or a defence fund, during a war or an emergency or floods, droughts, etc. Such contributions are made by patriotic, charitable, public-spirited, or conscientious persons during wars, floods, droughts, or other emergencies.

Grants are the receipts of one country from another country. Many advanced and developed countries of the world, such as the United States, Britain, Germany, Canada, France etc., give grants to poor countries for their economic development. Such grants are very useful for the underdeveloped countries.

2.1.2 Canons of Taxation

Canons of taxation may be studied under the following two major heads:

I. Adam Smith's Canons of Taxation

II. Other Canons of Taxation

I. Adam Smith's Canons of Taxation

Adam Smith was the first writer who gave four canons of taxation in his famous book *Wealth of Nations* in 1776, which should be incorporated in any sound system of taxation. They are as follows.

1. **Canon of Equality or Equity:** The canon of equality implies that the burden of taxation must be distributed equally or equitably in relation to the ability of taxpayers. Equality does not mean that every person or group of persons should pay the taxes in equal amounts irrespective of the wealth or income they possess. The richer a person, the more his ability to pay towards the running of the government. The ability to pay must be judged on the basis of income or wealth.

2. **Canon of Certainty:** The second canon of Adam Smith is that of certainty. It implies that the amount, the time and method of payment of tax should all be clear and certain for the taxpayer to adjust his income and expenditure accordingly. There should not be any sort of embarrassment to the taxpayer. The state should also know how much revenue by way of tax it could expect and when it would get it. The canon of certainty was meant to prevent exploitation of the taxpayer by the tax collector or the state.

3. **Canon of Convenience:** The third canon of Adam Smith is that of convenience. In the words of Adam Smith, "Every tax ought to be levied at the time or in the manner in which it is mostly likely to be convenient for the contributor to pay it." It implies that taxes should be imposed in such a manner and at a time which is most convenient for the taxpayer.

4. **Canon of Economy:** The fourth canon of Adam Smith was that of economy. It implies that the cost of the collection of a tax should be minimal, the revenue from a tax should be much more than the cost of its collection. The difference between the money which comes out of the pockets of the people and that which is deposited in the public treasury should be as small as possible.

II. Other Canons of Taxation or Canons given by Other Economists

In addition to the above four canons of taxation given by Adam Smith, some other writers like Bastable, Shirras, Mrs. Hicks, etc., have added a few more canons of taxation, which are as follows:

1. **Canon of Simplicity:** It implies that the tax system should be simple and easily understandable. It should not be complicated.

2. **Canon of Productivity:** The canon of productivity, as given by Bastable, may mean two things. Firstly, the tax should yield a considerable amount of revenue for the expenditure of the government. Secondly, the tax should not obstruct and discourage production in the short run as well as in the long run.

3. **Canon of Elasticity:** The canon of elasticity implies that the taxes should be so levied that the amount of revenue to be procured through them can be increased or decreased with the least inconvenience in accordance with the needs of the state.

4. **Canon of Diversity:** The canon of diversity implies that diversity should exist in the tax system of a country. In the tax system, there should be all types of taxes so that everybody may be called upon to contribute something towards the state revenue.

5. **Canon of Uniformity:** The canon of uniformity implies that there should be uniformity in the tax system. The method of imposing all taxes should be one and the same, and the determination of rates should be done keeping in view the general objectives.

6. **Canon of Flexibility and Sufficiency:** This canon of flexibility and sufficiency implies that the nature of taxes should be such that the tax can be realised without any resistance from the people, and in case of imposition of new taxes, the same is not opposed. As far as sufficiency is concerned, it should provide sufficient income to the authority.

7. **Canon of Coordination:** It implies that there must be coordination between the different taxes that are imposed by the various taxation authorities.

8. **Canon of Buoyancy:** According to this canon, the tax revenue should have an inherent tendency to increase along with an increase in national income, even if the rates and coverage of taxes are not revised.

2.1.3 Classification of Taxes

Different economists have classified taxes in different ways. This does not mean that one classification contradicts the other. The classification have been made on different bases. Different bases which have been adopted by different economists to classify taxes are the forms, nature, aims and methods of taxation. The following classifications are commonly found in the modern tax system.

I. Direct and Indirect Taxes

II. Proportional, Progressive, Regressive and Degressive Taxes

III. Specific and Ad Valorem Duties/Taxes

IV. Single and Multiple Taxes

2.1.3.1 Direct and Indirect Taxes

Classification of direct and indirect taxes is a controversial issue from time immemorial; there is a dispute as to which tax is direct and which one is indirect. In this connection, different authors have expressed different opinions. Accordingly, direct taxes are those taxes which are paid entirely by the persons on whom they are levied or imposed. In other words, direct taxes are those which cannot be shifted; on the contrary, indirect taxes are those taxes which can be shifted to others.

I.Direct Taxes

A direct tax is one whose burden is borne by the person on whom it is levied. He cannot transfer the burden of the tax to some other person. For example, the income tax is a direct tax, and its burden falls on the person who pays it to the government.

According to Dalton, a direct tax is one which is actually borne and paid by the very person on whom it is legally imposed. Similarly, J. S. Mill defines a direct tax as that which is demanded from the very persons who are intended or desired to pay it. From these definitions, it becomes clear that a direct tax cannot be shifted to others; the liability to pay and the burden of payment fall on the same individual. In this sense, direct taxes are considered permanent in nature, as they establish a clear and unavoidable obligation on the taxpayer. From this, we can conclude that Direct tax is one which is paid by the person on whom it is legally imposed. It is of a permanent nature.

Advantages of Direct Taxes

The main advantages of direct taxes are:-

1. **Economy:** The administrative cost of the collection of direct taxes is quite low. A direct tax like income tax is collected at source in the case of salaried employees. Hence, it is quite economical.

2. **Equity:** Direct taxes are considered to be just and equitable, because they are charged according to the ability of the tax-payer. The richer a person, the greater is the burden of direct taxes on him. In this, people whose incomes are below the exemption limit do not pay any income tax at all.

3. **Certainty:** Direct taxes satisfy the canon of certainty. The taxpayer is certain as to how much, when, whom and at what rate he is expected to pay, and similarly, the state is also certain as to how much, when, from whom and at what rate it has to receive as income from direct taxes.

4. **Elasticity:** Direct taxes are elastic in the sense that the income from them can be increased by raising the rates of taxation.

5. **Civic Consciousness:** It is said that direct taxes create civic consciousness among the taxpayers. As soon as a direct tax (such as income tax) is levied on a person, he immediately becomes conscious of his rights and, therefore, tries to find out whether the money collected by the state is being spent properly or not. It is not wasted on useless projects.

6. **Reduce Inequalities:** Direct taxes are progressive in nature and therefore, rich people are subject to high rates of taxation, while poor people are exempted from direct tax obligations.

7. **Productivity:** Direct taxes are productive in the sense that direct taxes increase along with an increase in income and wealth in the state.

8. **Absence of Leakage:** There is no scope for any leakage in case of direct taxes because they are paid directly by the taxpayers to the government. The whole amount of direct taxes, such as income tax, property tax, wealth tax, etc., reaches the treasury directly.

9. **Direct Relationship:** As a direct tax is paid directly by the taxpayer to the Government hence it establishes a direct relationship between the taxpayer and the government.

10. **Adverse Effects of Direct taxes can be avoided:** One of the merits of direct taxes is that their rates can be modified in time to avoid their adverse effects on willingness and ability to work, save and invest. Exemptions and concessions are given to avoid their adverse effects on production.

Disadvantages of Direct Taxes

The disadvantages of direct taxes are:-

1. **Unpopular:** Direct taxes are unpopular in nature because the taxpayer has the knowledge that he is paying the money, which cannot be shifted. It involves some psychic pain for him. Hence, such taxes are unpopular in nature and are generally opposed by the taxpayers.

2. **Inconvenient:** Direct taxes are inconvenient in the sense that the taxpayer has to prepare and submit income returns showing all the sources of his income to the tax authorities. Accounting procedures are so numerous, complicated and difficult to comply with that, in most cases, even individual taxpayers have to seek the help of professional income tax practitioners to prepare and file their returns.

3. **Arbitrary:** Direct taxes are invariably levied in an arbitrary manner by the government. No definite principles are kept in view while fixing the rates of these taxes. For example, the rate of income tax will depend on the political complexion of the government. This is contrary to the spirit of social justice in society.

4. **Possibility of Evasion:** There is always a possibility of tax evasion in the case of direct taxes. It can easily be evaded through fraudulent practices, i.e., by submitting false returns. That is why it is said that a direct tax is a tax on honesty; it is not evaded only when the taxpayer is honest.

5. **Narrowness of Scope:** Direct taxes are levied only on certain groups of persons and, therefore, due to the narrowness of their scope, they do not raise civic sense in all the groups. Low-income groups are normally exempted from payment of direct taxes on the basis of ability to pay or equity.

6. **Bad effects on Production:** Direct taxes reduce taxpayers' income, discouraging saving and investment, which ultimately has an adverse effect on production

7. **Expensive to Collect:** Direct taxes are often regarded as expensive to collect, as each and every individual taxpayer is to be contacted separately, irrespective of the amount of tax payable by him.

8. **Mental Tension:** Direct taxes cause mental tension in the mind of the taxpayer as he thinks it to be a wastage-cum-burdensome without any return.

9. **Adverse effects on the Will to work and Save:** Another demerit of direct taxes is that they adversely affect the taxpayer's willingness to work and save. This tendency is harmful to the economy of the country, as it leads to an overall slowdown of economic growth. Furthermore, if the authorities impose taxes on property, inheritance, and similar assets, it may further discourage saving.

II. Indirect Taxes

An indirect tax is one that is paid by one individual but the burden of which is borne by another individual. A person who pays the tax in the first instance transfers its burden to the shoulders of another person.

According to Dr. Dalton, an indirect tax is one that is legally imposed on one person but the burden of payment is partly or wholly shifted to another, usually through a change in the terms of a contract or bargain. J. S. Mill also explains that indirect taxes are those which are demanded from one individual with the clear expectation that he will recover the amount by passing on the burden to someone else, often the consumer. Similarly, Prof. Findlay Shirras points out that indirect taxes influence the income and property of individuals through their patterns of consumption rather than by directly taxing their earnings or wealth. Thus, the common feature of all these definitions is that the liability to pay and the actual burden of payment do not fall on the same person, since the tax is transferable from the taxpayer to the final consumer.

Merits or Advantages of Indirect Taxes

1. **Convenient:** Indirect taxes are most convenient to pay. They are mostly levied on commodities and are paid by the consumers when they buy them. The amount of the tax is included in the price of the respective commodity, and the purchaser (consumer) pays the tax without experiencing its pinch.

2. **Elastic:** Indirect taxes may be elastic. The yield from such taxes goes on increasing with the increase in population, wealth and production. For example, luxury goods can be taxed heavily as their demand may be elastic.

3. **No Evasion:** Indirect taxes are generally difficult to evade as they are included in the price of a commodity. A person can evade an indirect tax only if he decides not to purchase the taxed commodity. Excise duties, for example, are quite difficult to evade if the tax authorities are vigilant and there is proper check at the points of production.

4. **Equitable:** Indirect taxes are equitable in the sense that they are paid by all sections of the community at the time of making a purchase of goods in the market.

5. **Social Value:** Indirect taxes are of great social value since the government can restrict the consumption of socially undesirable goods by imposing heavy taxes on them. For example, the Indian government have imposed heavy taxes on intoxicants like wine or opium, etc., as they are harmful to society.

6. **Productive:** Indirect taxes are more productive as compared to direct taxes. Such taxes bring revenue to the government from different sources, and hence, naturally, the income from indirect taxes is higher.

7. **Can be made Progressive:** Indirect taxes can be made progressive by imposing heavy taxes on luxury goods and exempting goods of common consumption.

8. **Increase Production and Investment:** Indirect taxes are a powerful tool in moulding the production and investment activities of the economy. It is generally recognised that indirect taxes are helpful in increasing production and investment.

9. **Selective and Flexible:** Indirect taxes are selective and flexible in the sense that the rates of indirect taxes and their coverage can be quite selective and can be modified more easily and readily to suit the occasion.

Disadvantages of Indirect Taxes

The demerits of indirect taxes are:-

1. **Element of Uncertainty:** Indirect taxes are extremely uncertain because the taxing authority cannot accurately estimate the total yield from different indirect taxes on account of the fact that the demand for different goods, subject to taxes, is influenced by a number of factors.

2. **Uneconomical:** Indirect taxes are uneconomical. The collection of these taxes involves many stages, and thus the cost of collecting them becomes greater.

3. **Inequitable and Unjust:** Indirect taxes are inequitable and unjust. The burden of these taxes falls more heavily on poor persons since they are charged at a proportional rate.

4. **Lack of Social Consciousness:** Indirect taxes do not create any social consciousness, as the taxpayers, in most cases, do not feel the burden of the taxes they pay.

5. **Encourage Dishonesty:** Indirect taxes give a chance for cheating. Levy of a small amount of tax on a particular commodity gives the retailers an opportunity to raise the prices much more in comparison to the tax actually paid by them.

6. **Discourage Savings:** Indirect taxes discourage savings because they are included in the price of goods, and therefore, people have to spend more on the purchase of essential commodities.

7. **Incentive to the Tendency of Inflation:** Indirect taxes increase the price of commodities, which gives birth to the tendency of inflation.

8. **Regressive in Nature:** Indirect taxes are regressive in nature in the sense that their burden, as they cover mostly those items which are generally purchased by the poor, usually falls more on the poor as compared to the rich.

9. **Harmful in Depression:** Indirect taxes are harmful in the sense that during depression, the income of individuals is reduced, with the result that they cannot purchase the requisite amount of goods and services, which ultimately affects production adversely.

10. **Damaging for the Consumers:** Indirect taxes are damaging for the consumers. The shopkeepers charge the tax from them several times but do not pay it to the government. Further, they often charge more money from the consumers in the form of indirect tax.

2.1.3.2 Proportional, Progressive, Regressive and Degressive Taxes

Proportional Taxes

If a tax on all incomes is levied at the same rate, it is called a proportional tax. A schedule of proportional tax rates is one in which the rates of taxation remain constant as the tax base changes. The tax is calculated by multiplying the tax base by the tax rate. In this case, the tax liability increases in the same proportion as the increase in income. This type of taxation is quite simple, and one can understand it without difficulty. For example, we can illustrate proportional taxation with the following schedule:

Table 2.1.1 Proportional Tax

Income (Tax Base)	Tax Rate	Amount of Tax
Rs.10,000	5%	Rs.500
Rs.20,000	5%	Rs.1,000
Rs.30,000	5%	Rs.1,500
Rs.40,000	5%	Rs.2,000
Rs.50,000	5%	Rs.2,500

Advantages of Proportional Taxes

1. **Simplicity:** It is very simple and one can understand it without any difficulty. It is quite easy to estimate and calculate the amount of tax both for the government and the taxpayer.

2. **Based on Capacity:** The proportional system of taxation is based and determined on the basis of capacity of the taxpayer.

3. **Certainty:** The proportional system of taxation satisfies the canon of certainty.

4. **Equality or Justice:** The principle of equality or justice has been justified on the ground that the money burden in this case increases in the same proportion as the income increases.

5. **Willingness to Work, Save and Invest:** A proportional system of taxation encourages the spirit of willingness to work, save money and invest money.

6. **Unchanged position of the taxpayers:** It is claimed that a proportional tax does not change the relative position of the taxpayers. It remains the same even after imposition.

Demerits or Disadvantages of Proportional Taxes

1. **Inelastic:** Proportional taxes are inelastic on all persons; both rich and poor are taxed at the same rate.

2. **Against the principle of Justice:** The proportional system of taxation does not satisfy the principle of justice, as the tax rates for the rich and the poor are the same, whereas the marginal utility of money for the poor is more than that for the rich.

3. **Anti-poor:** A proportional system of taxation is anti-poor as it falls more heavily on the poor than on the rich. The poorer sections of society will have to reduce their consumption, which would adversely affect their health and efficiency.

4. **Unpracticable:** In modern times, the proportional system of taxation is not practicable. That is why it does not exist in any part of the world.

5. **Adverse Effect on Distribution of Wealth:** The proportional system of taxation has an adverse effect on the distribution of wealth. It fails to narrow down the inequalities in the distribution of wealth.

Progressive Tax

A tax, the rate of which increases with every increase in income, is called a progressive tax. A schedule of progressive tax rates is one in which the rate of taxation increases as the tax base increases. In India, we have a progressive tax rate system. For example, we can illustrate the progressive tax rate system with the following schedule:

Table 2.1.2 Progressive Tax

Income (Tax Base)	Tax Rate	Amount of Tax
Rs.10,000	10%	Rs.1000
Rs.20,000	20%	Rs.4000
Rs.30,000	25%	Rs.7000
Rs.40,000	30%	Rs.12000

Advantages of Progressive Tax

1. **Economical:** Progressive taxes are economical in the sense that the cost of collection does not rise with an increase in tax rates of taxes. The cost of collection remains almost the same.

2. **Reduce Inequalities:** Another argument in favour of progressive taxes is that they reduce inequalities of income.

3. **Social Justice:** Progressive taxation has been justified on the grounds that it leads to social justice in the distribution of the burden of taxation, as it is based on the principle of ability to pay. The rich are subject to a higher rate of taxation as compared to the poor.

4. **Economic Stability:** According to Prof. J M Keynes, "Progressive taxation is important from the point of view of full employment and the economic stability can be achieved." The government can adopt the policy of high rate of taxation in a boom period and low rate of taxation in a depression period.

5. **Increase in Public Revenue:** Progressive taxation has been justified on the grounds that public revenue automatically increases with the increase in economic activities and income of the people. Rise in income is automatically taxed at higher rates under this system.

6. **Encourages Savings, Capital Accumulation and Investment:** A Progressive system of taxation encourages savings, capital accumulation and investment. It finally results in an increase in production.

7. **Based on the Canon of Ability to Pay:** The Progressive system of taxation is based on the canon of ability of the tax-payer to pay because with the increase of income, the marginal utility of money is reduced.

8. **Helpful in controlling Inflationary trend:** Progressive tax may be helpful in controlling inflationary trend as it reduces consumption demand and thus resources may be directed towards production, which may increase the supply of goods.

9. **Elastic:** The progressive tax has been justified on the grounds that it is elastic. The income of the government may be increased considerably by a slight increase in the rate of taxation.

10. **Lower Cost:** In the case of progressive taxation, the cost of tax administration and collection would be more lower as compared to proportional taxation.

Disadvantages of Progressive Tax

1. **Arbitrary:** Progressive tax is entirely arbitrary. There is no guiding principle according to which taxes are determined.

2. **Injustice:** Progressive tax is against the canon of justice. It is based on the wrong assumption that the marginal utility of money is less to a rich person as compared to a poor one.

3. **Punishes Prudence and Virtue:** Progressive tax has been criticised on the grounds that it punishes prudence and virtue and rewards extravagance and idleness.

4. **Tax Evasion:** In a Progressive tax, the danger of tax evasion always exists. It encourages rich people to file false income tax returns and make false declarations of income.

5. **Discourages Savings:** Progressive taxation has been criticised on the ground that, beyond a certain limit, it discourages savings because a major part of the income is taken away by way of tax.

6. **Impracticable:** Progressive tax is considered to be impracticable. It is difficult to estimate the taxable capacity of an individual because the human tendency is to keep the income and sources of income confidential.

7. **Discourages the Will to Work, Save and Invest:** The progressive tax has been criticised on the grounds that it discourages the will to work, save and invest.

Regressive Tax

In regressive taxation, the larger the income of the taxpayer, the smaller is the proportion that he contributes. A schedule of regressive tax rate is one in which the rate of taxation decreases as the base increases. The amount of tax payable is calculated by multiplying the tax base by the tax rate. Thus, in a regressive tax system, the tax rate decreases as the income increases. Tax on salt during British rule is a burning example of a regressive tax in India. The following table and diagram will make the concept of regressive taxation clearer:

Table 2.1.3 Regressive Tax

Income (Tax Base)	Tax Rate	Amount of Tax
Rs.10,000	10%	Rs.1000
Rs.20,000	8%	Rs.1600
Rs.30,000	6%	Rs.1800
Rs.40,000	5%	Rs.2000

Advantages of Regressive Taxation

1. **Restricts the Use of Intoxicants:** Regressive taxation has been justified on the grounds that it restricts the use of intoxicants in society.

2. **Public Interest:** From a public interest view, it is essential to impose tax on the use of goods which adversely affect the health of individuals, such as tax on wine, opium, etc.

3. **Improvement in the Economic Position:** A regressive tax has been justified on the ground that it is imposed mostly on luxury items and intoxicants so as to reduce their consumption. It would increase their savings, which would be used for improving the economic position of both the rich and the poor.

Disadvantages of Regressive Taxation

1. **Non-productive and Uneconomic:** The regressive system of taxation has been criticised on the grounds that it is non-productive and uneconomic. Its cost exceeds the income.

2. **Unjust:** It is said that regressive tax is unjust on the grounds that most of its burden falls on the shoulders of the poor.

Degressive Tax

A degressive tax is one on which tax is progressive up to a certain limit, after that it is proportional, i.e., charged at a flat rate. It may be illustrated by the following table given below:

Table 2.1.4 Degressive Tax

Income (Tax Base)	Tax Rate	Amount of Tax
Rs.10,000	10%	Rs.1000
Rs.20,000	15%	Rs.3000
Rs.30,000	20%	Rs.6000
Rs.40,000	10%	Rs.4000
Rs.50,000	10%	Rs.5000
Rs.60,000	10%	Rs.6000

Advantages of Degressive Taxes

1. **Advantage of Both the Systems of Taxation:** A degressive tax is a combination of both the systems of taxation, i.e., proportional and progressive. Thus, it enjoys the benefits of both systems.

2. **Lower Burden on the Rich:** It has been justified on the ground that the burden of a degressive tax is quite low on the rich. Thereby, it encourages savings, capital formation and investment, which can be used for productive purposes.

Disadvantages of Degressive Tax

1. **Injustice:** A degressive tax violates the principle of justice in taxation. It ultimately increases the burden on the poor.

2. **Less Sacrifice:** The amount of sacrifice on account of the degressive tax on the part of the rich is quite low, whereas they are expected to sacrifice more.

2.1.3.3 Specific Tax and Ad Valorem Duties/Taxes

Specific Tax/Duty

When a tax is imposed on the commodity according to its weight, size or measurement, it is called a specific tax. For example, when the excise duty is imposed on sugar on the basis of its weight or the cloth is taxed according to its length, it is known as a specific tax. It is easy to levy and more convenient to collect because it is collected either according to the weight of the commodity or the size of the unit of the commodity.

Merits of Specific Tax

i. Specific tax is easy to estimate and administer.

ii. Specific tax is easy and convenient to collect, and the collection cost is quite low.

Demerits of Specific Tax

i. Specific tax is regressive in nature. It falls heavily on the cheaper varieties of a product which the lower-income group consumes.

ii. Specific tax is less equitable than an ad valorem tax.

Ad Valorem Tax/Duty

When the tax is imposed on a commodity according to its value, it is called an ad valorem tax. Whatever may be the size or weight of the unit of the commodity, the tax is charged according to its value. For example, an ad valorem tax may be imposed at the rate of 10 paise per rupee or 10% of the value of goods.

Merits of Ad Valorem Tax

i. The main advantage of ad valorem tax is that it imposes a greater burden on the rich section of society.

ii. Ad valorem tax is more equitable as it is imposed on the value of goods and thus the canon of ability to pay is fulfilled.

Demerits of Ad Valorem Tax

i. Ad Valorem tax is difficult to administer and collect as it is imposed on the value of goods, which is usually disputed.

ii. Ad Valorem tax increases inflationary pressures when there is a rise in the price level.

2.1.3.4 Single and Multiple Taxes

Single Tax

A single tax means only one kind of tax. It implies a tax on one thing, that is, on one class of things or on one class of people. In this case, there is only one tax which constitutes the source of public revenue. Such a tax is collected not only once but regularly every month or every year, at intervals of shorter or longer duration.

A single tax may be proportional, progressive or regressive, or it may just be a fixed amount. For example, toll tax is a fixed amount imposed per individual or per vehicle, depending on the nature of the vehicle.

Merits of Single Tax

i. It is quite simple, easy and convenient. Since there is only one tax, it simplifies the work of the government and the taxpayer too can easily calculate the conveniently make payment.

ii. It is economical in the sense that its collection cost is less.

Demerits of Single Tax

i. It is inelastic in the sense that if suddenly the need of the government increases, it cannot be met easily by the yield of a single tax;

ii. It is said that the single tax system is only true in theory but not in practice. It is purely imaginary.

iii. In the case of a single tax, the chances of tax evasion increase.

iv. Single tax is not based on the principle of justice as it cannot be imposed in proportion to the ability to pay of the taxpayer.

v. Social and political objectives cannot be achieved by means of a single tax system.

Multiple Tax

A multiple tax refers to the tax system in which there is diversity of taxation, i.e., various types of taxes are levied. Modern economists have laid emphasis on the diversity of taxation. A multiple tax system simply implies that there should be different types of taxes so that everybody may be called upon to contribute something towards the state revenue. Hence, a multiple tax system is generally preferred to a single tax system.

Advantages of Multiple Tax

i. Multiple tax is flexible in the sense that in case of need it can be increased easily.

ii. Multiple tax system reduces the chances of tax evasion by the tax-payers

iii. It is based on the principle of justice in the sense that it can be imposed on the basis of ability to pay of the tax payer

iv. It can yield sufficient revenue as per the requirements of the government

v. All the defects of single tax system have been removed by means of multiple tax system.

vi. It is based on the principle of equity. The rich are required to pay higher tax as compared to the poor.

Demerits of Multiple tax

i. It increases the burden of taxes on the public,

ii. A multiple tax system is complicated.

iii. It is costly in the sense that the cost of collecting multiple taxes is high as compared to single taxation.

iv. Too much multiplicity of taxes may lead to inconveniences to both the taxing authority and the taxpayer as well as to the general public.

Recap

- Public revenue refers to government income from various sources
- Taxes are the primary and compulsory source of public revenue
- Commercial revenues come from the sale of goods/services by public enterprises
- Administrative revenues include fees, fines, penalties, forfeitures, etc
- Gifts are voluntary contributions from private donors
- Grants are intergovernmental or international financial transfers
- Canons of taxation are principles guiding fair and effective taxation
- Adam Smith proposed four main canons: Equity, Certainty, Convenience, and Economy
- Other canons include simplicity, productivity, elasticity, diversity, etc
- Taxes are classified based on shifting, rates, and collection methods
- Direct taxes are non-transferable and based on income or wealth
- Indirect taxes are paid via purchases and are transferable

Objective Questions

1. What is the main source of public revenue?
2. Which economist defined taxes as compulsory payments without direct return?
3. What is the revenue from government enterprises called?
4. Which administrative revenue is collected for special services?
5. What canon stresses the minimum cost of tax collection?
6. Who proposed the four classical canons of taxation?

7. Which canon promotes simplicity in tax understanding?
8. What kind of tax is income tax?
9. What kind of tax is GST?
10. Which tax classification is based on the ability to shift the burden?
11. What tax is levied based on commodity size or weight?
12. Which classification involves many types of taxes?

Answers

1. Taxes
2. P.E. Taylor
3. Commercial revenue
4. Fees
5. Economy
6. Adam Smith
7. Simplicity
8. Direct tax
9. Indirect tax
10. Direct and indirect taxes
11. Specific tax
12. Multiple tax

Assignments

1. List the major sources of public revenue.
2. Mention any four canons of taxation by Adam Smith.
3. Differentiate between direct and indirect taxes with examples.
4. Identify administrative sources of revenue other than taxes.
5. Prepare a note on the merits of direct taxes.
6. Classify taxes based on burden shifting and tax rates.

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2

UNIT

Taxation

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the concept of tax burden and its effects on consumers and producers
- know the concept and implications of the Laffer Curve
- discuss the factors affecting a country's taxable capacity
- describe the principles of optimal commodity taxation

Prerequisites

Taxes are payments that citizens and businesses must make to the government. These funds are used to build infrastructure, provide public services, and run various welfare programmes. However, taxation affects the economy in many ways. When the government taxes goods or income, people may reduce spending or investment. This loss of benefit is known as deadweight loss. Economists are concerned not just with how much tax is paid, but who really bears the burden. For example, even if a shopkeeper collects GST, it is usually the customer who ultimately pays it through higher prices. This is the idea of tax incidence. Governments also have to be careful not to overtax people. The Laffer curve shows that if taxes are too high, people stop working or producing, and tax revenue actually falls. The idea of optimal commodity taxation helps governments design tax systems that balance fairness and efficiency. Economists like Ramsey suggested that goods with fewer substitutes (low elasticity) can bear more tax without reducing overall welfare. Before studying complex taxation systems, it is important to understand these basic principles that guide how taxes are planned and collected. These ideas help governments avoid inefficiencies and make sure taxation supports both revenue collection and public welfare.

Keywords

Tax Burden, Laffer Curve, Taxable Capacity, Deadweight Loss, Optimal Commodity Taxation

Discussion

2.2.1 Tax Burden

Taxation is the main way governments collect money to fund public services and development activities. When people and businesses pay taxes, they are transferring part of their income or resources from the private sector (individuals and companies) to the public sector (government). Government officials, both elected and appointed, then decide how to spend this money for the public good. Unlike voluntary payments like buying a product or a government bond, taxes are compulsory. If someone refuses to pay taxes, they can face legal penalties such as fines or even jail time. So, taxation is said to be coercive at the point of collection. However, taxation can also be considered voluntary in a broader sense when citizens willingly pay taxes to receive essential public services, like education, roads, or healthcare, just like how we choose to spend money in a shop for things we need.

The concept of tax burden refers to the impact that paying a tax has on individuals and firms. This burden can be understood in two main ways. First, we can measure it as the actual money paid to the government, like how much income tax or Value Added Tax (VAT) someone pays. This is the most common method used by macroeconomists, accountants, and in media reports. Second, microeconomists and public finance experts often look at the opportunity cost of taxes-that is, what individuals or businesses have to give up because of the tax. This includes the loss in consumer surplus (how much benefit consumers lose from not being able to buy as much as before) and profit loss for producers.

Taxes usually create something called deadweight loss, which means the total benefit (or social surplus) that society could have gained from trade is reduced because of the tax. For example, due to taxes, some people may stop buying goods or services they otherwise would have, and some firms may reduce production. This leads to a decrease in total market activity.

Also, the person or firm that pays the tax directly-such as writing the check or transferring the amount, is not always the one who truly bears the tax burden. For example, firms may be the ones paying sales tax to the government, but in reality, they usually shift the burden to consumers by raising prices. So, even though consumers do not directly send money to the government for sales tax, they end up paying more at the store. Therefore, understanding the real tax burden involves looking at who actually loses money or economic benefit because of the tax, not just who pays it at first.

Thus, the tax burden tells us how taxation affects people's and businesses' economic well-being. While taxes are necessary for the government to provide services, they also reduce private sector resources and market activity. Hence, economists try to study and measure the burden carefully, both in terms of cash paid and the loss of economic efficiency.

2.2.1.1 Taxable Capacity

The factors affecting taxable capacity are as follows:-

Tax is the most important and trustworthy source of revenue for the government's income. So the increased taxation will mean increased revenue. But the taxes reduce the purchasing power of the people and adversely affect their ability and willingness to work, save and invest. Hence, before imposing any tax, the government will have to take into consideration the maximum tax-bearing capacity of the public, beyond which productive effort and efficiency as a whole begin to suffer.

Taxable capacity refers to the maximum capacity that a country or community can contribute by way of taxation, both in ordinary and extraordinary circumstances. It represents the maximum limit to which the government can tax the people of the country. If the government exceeds this limit, it shall result in over taxation, which, besides being injurious to the long-term interests of the community, will adversely affect productive efforts and efficiency as a whole and may even pose a serious threat to the political stability of the country. Thus, the concept of taxable capacity indicates the limit to which the government can tax its citizens.

2.2.1.2 Factors Affecting Taxable Capacity

1. **Size and Growth of Population:** The size and growth of the population are among the important factors determining taxable capacity. With a given volume of income of a country, the taxable capacity is indirectly proportional to the size of its population, i.e., the larger the population, the lower will be the taxable capacity.

2. **Stage of Economic Development:** The stage of economic development also determines taxable capacity. Generally, there is a positive correlation between the rate of economic development and the taxable capacity of the economy.

3. **Distribution of Income and Wealth:** The distribution of income and wealth also influences the taxable capacity of the people. The greater the inequality in the distribution of income and wealth in the country, the greater is the taxable capacity.

4. **Nature or Pattern of Taxation System:** The taxable capacity also depends on the nature or pattern of the taxation system in a country. If the taxation system of a country has been devised on a scientific basis, a well-thought-out mixture of taxation, the taxable capacity shall be inevitably high.

5. **Nature or Pattern of Public Expenditure:** If the government incurs a major portion of its expenditure on encouraging production and increasing the level of efficiency of workers, this will raise the taxable capacity of the country and vice versa.

6. **Nature of the Government:** The taxable capacity is also influenced by the nature of the government. A democratically elected government, by winning public sympathy and cooperation, is in a position to raise more revenues from the people.

7. **Standard of Living of the People:** If the standard of living of the people is high, their production power shall also be high. Hence, their income shall be high, and consequently, their capacity to pay taxes will also increase in the same proportion.

8. **Psychology of the Taxpayers:** The taxable capacity of a country is influenced by the psychology of the taxpayers. In developed and developing countries, when the people are satisfied that the government is spending the tax revenue on development activities and for the betterment of the whole nation, the taxable capacity naturally goes up.

9. **Stability of Income:** The stability of national income also influences the taxable capacity of the country. For example, the national income in developed countries like the U.S.A., U.K., Japan, Germany, etc., is generally stable in the sense that there are no violent fluctuations in the national income of such countries. The taxable capacity in these developed countries is generally high.

10. **Political Conditions:** Stable political conditions and successful planned economic development create confidence in the minds of taxpayers. They feel that whatever is taken out of their pockets has been properly utilised for the welfare of the community as a whole. This encourages the taxpayers to fulfil their tax obligations in time.

11. **Other Factors:** Besides the above-mentioned factors, fiscal, monetary and income policies of the government, price level, boom conditions, etc., also affect the taxable capacity. For example, a favourable tax balance of a country increases its taxable capacity.

2.2.2 Laffer Curve

The Laffer Curve is a theoretical explanation of the relationship between tax rates set by a government and the tax revenue collected at that tax rate. It was introduced by American supply-side economist Arthur Laffer. The concept was not invented by Laffer; there were other antecedents from the 14^{th}-century writings of Ibn Khaldun. The Laffer Curve says that there is no tax revenue collection at the two extreme tax rates of 0% and 100%. However, there is one optimal tax rate between these two extremes that maximises tax revenue collection.

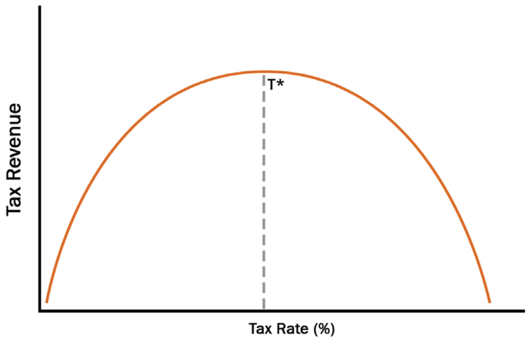

Fig 2.2.1 Laffer Curve

We plot the tax rate on the horizontal axis and the government revenue from taxation on the vertical axis. The curve assumes a parabolic shape. It suggests that at the initial point, the origin, when the tax rate is 0%, there is no revenue for the government. As the government increases the tax rate, the revenue also increases until T*. Beyond point T*, if the tax rate is increased, revenue starts to fall. In short, attempts to tax above a certain level are counterproductive and actually result in less total tax revenue. The Laffer Curve says that there is no tax revenue collection at the two extreme tax rates of 0% and 100%. However, there is one optimal tax rate between these two extremes that maximises tax revenue collection.

2.2.3 Optimal Commodity Taxation

Optimal commodity taxation is a concept in economics that helps governments decide how to set tax rates on different goods in a way that creates the least harm to the economy while still collecting the necessary revenue. When a government imposes taxes on goods and services (called commodity taxes), it often affects the way people buy and consume these goods. If taxes are too high on certain items, people may stop buying them, which reduces market activity and can lead to what economists call deadweight loss-a loss of overall benefit to society.

The main goal of optimal taxation is to keep the economy efficient while also being fair. From the efficiency point of view, the idea is to reduce consumption evenly across all goods in proportion. To do this, economists say that goods which have more elastic demand should have lower tax rates. This helps to avoid large changes in consumption and prevents wasteful losses in both consumer satisfaction and producer profits.

On the other hand, the equity (or fairness) objective of taxation focuses on how tax policies affect people of different income levels. Goods that are mostly consumed by lower-income groups, such as basic food items or public transport-should be taxed at lower rates to avoid putting too much burden on poor households. This ensures that the tax system is not only efficient but also fair.

The foundation of this idea was laid by Frank P. Ramsey, a British economist, in the 1920s. He studied how a government could raise a certain amount of tax revenue with the least possible reduction in people's overall happiness or utility. This is known as the Ramsey Rule or the Ramsey problem. His approach suggested that the best way to reduce the excess burden or deadweight loss of taxes is to design taxes in a way that takes into account how easily the supply and demand of goods can change.

Ramsey proposed that the tax on each good should be proportional to the sum of the reciprocals (inverses) of the price elasticities of both demand and supply. In simple terms, if people easily change their consumption of a good when the price rises (high elasticity), then that good should be taxed less. But if people's consumption changes very little with price (low elasticity), that good can bear a higher tax rate without much harm to the overall economy.

Later, other economists refined and expanded Ramsey's theory. They introduced models that included many different goods and services, and also considered people's different income levels, preferences, and fairness in taxation. These modern versions of Optimal Tax Theory take into account both multiple tax instruments and distributional effects-that is, how the tax affects rich and poor differently.

In real-world policy-making, the theory of Optimal Commodity Taxation helps governments to strike a balance between raising money and protecting both efficiency and equity. While it may not be applied in its pure mathematical form, the ideas from Ramsey and others guide many practical decisions, such as keeping basic necessities tax-free or applying higher taxes on luxury goods. Through this approach, governments aim to design tax systems that are not only effective but also just and economically sensible.

Recap

- Tax burden includes actual and opportunity cost effects of taxes
- Taxes create deadweight loss by reducing overall market efficiency
- The legal payer may not bear the actual tax burden due to shifting
- Taxable capacity is the maximum limit that people can pay without harm
- Many factors affect taxable capacity, like income, psychology, and government efficiency
- The Laffer curve shows the relationship between tax rates and revenue
- Excessively high tax rates reduce revenue after an optimal point

- Optimal commodity taxation seeks efficient and fair tax design
- Ramsey's rule supports taxing goods with inelastic demand more
- Taxes should avoid harming poor households disproportionately

Objective Questions

1. What is the term for the economic effect of taxes on individuals?
2. What does a tax create by reducing consumer and producer surplus?
3. What determines how much tax a country can bear?
4. Which economist proposed the Laffer curve?
5. What happens at 0% and 100% tax rates on the Laffer curve?
6. What curve shows the effect of tax rate on total revenue?
7. What is the economic idea of taxing with the least distortion?
8. Who developed the theory behind optimal taxation?
9. What goods should be taxed less under optimal taxation?
10. What term refers to the real person who bears the tax?
11. Which goods are taxed less for equity in optimal tax theory?
12. Which field of economics mainly studies tax burden effects?

Answers

1. Tax burden
2. Deadweight loss
3. Taxable capacity
4. Arthur Laffer
5. Zero revenue

6. Laffer Curve
7. Optimal commodity taxation
8. Frank Ramsey
9. Elastic goods
10. Incidence
11. Necessities
12. Public finance

Assignments

1. Explain how taxes affect market activity.
2. Elucidate on Laffer Curve.
3. State any four factors affecting taxable capacity.
4. Explain deadweight loss caused by taxation.
5. Outline the equity principle in optimal commodity taxation.
6. Discuss the relevance of Ramsey's Rule in tax policy.

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UNIT 3

Indian Tax System

Learning Outcomes

After completing this unit, the learner will be able to:

- describe the structure and types of taxes within the Indian federal tax system
- distinguish between direct and indirect taxes under the Indian tax administration
- comprehend the key features and benefits of VAT and GST
- know the role of tax authorities like CBDT and CBIC in tax collection

Prerequisites

India is a federal country, which means there are different levels of government, i.e., central, state, and local. Each level of government needs money to carry out its duties. To make this possible, India has a well-defined tax system, where the central and state governments are given specific powers to collect different types of taxes. For example, the central government collects income tax and customs duty, while state governments collect taxes like VAT (before GST) and excise on liquor. After 2017, India introduced the Goods and Services Tax (GST) to simplify the earlier tax system, which had multiple overlapping taxes. GST merged many taxes into one and ensured that goods and services are taxed only on their value addition. Direct taxes like income tax are paid directly by individuals or companies, and indirect taxes like GST are paid through purchases. Various tax bodies like the Central Board of Direct Taxes (CBDT) and the Central Board of Indirect Taxes and Customs (CBIC) manage these taxes. This unit helps learners understand how India's tax system works, what reforms have been made, and why it is important for economic growth and development.

Keywords

Indian Tax System, Goods and Services Tax (GST), Value Added Tax (VAT), Direct Tax and Indirect Tax, CBDT and CBIC

Discussion

2.3.1 Structure of The Indian Tax System

The tax structure in India is a three-tier federal structure. The central government, state governments, and local municipal bodies make up this structure. Article 256 of the Constitution states that "No tax shall be levied or collected except by the authority of law". Hence, each and every tax that is collected needs to be backed by an accompanying law. Interestingly, the tax system in India traces its origin to the prehistoric texts such as the Arthashastra and Manusmriti. As proposed by these manuscripts, the taxes paid by farmers and artisans in that era would be in the form of agricultural produce, silver or gold. Based on these texts, the foundation of the modern tax system in India was conceptualised by Sir James Wilson during the British rule in India in the year 1860. However, post-independence, the newly established Indian Government then solidified the system to propel the economic development of the country. After this period, the Indian tax structure has been subject to a host of changes.

The tax system in India, for long, was a complex one considering the length and breadth of India. Post GST implementation, which is one of the biggest tax reforms in India, the process has become smoother. It serves as an all-inclusive indirect tax, which has helped in eradicating the cascading effect of tax as a whole. It is simpler in nature and has led to an upgrade in the productivity of logistics.

Direct Tax

Direct Tax is levied directly on individuals and corporate entities. This tax cannot be transferred or borne by anybody else. Examples of direct tax include income tax, wealth tax, gift tax, and capital gains tax. Income tax is the most popular tax within this section. Levied on individuals based on the income earned with different tax slabs for income levels. The term 'individuals' includes individuals, Hindu Undivided Family (HUF), Company, firm, Co-operative Societies, and Trusts.

Indirect Tax

Indirect taxes are those that are not paid directly by individuals to the government but are instead collected through goods and services. When people buy goods or use services, the sellers include the tax in the price and then pass it on to the government. Common examples of indirect taxes in India include Value Added Tax (VAT), which is charged on goods sold within a state at rates fixed by the government; Octroi Tax, which is applied on goods moving from one state to another; Service Tax, which is charged on various services provided by businesses; and Customs Duty, which is levied on goods imported into the country from abroad.

Tax Collection Bodies

In India, tax collection is carried out by three main bodies, each with its own clearly defined responsibilities. The Central Government collects taxes such as income tax, customs duties, and central excise duty. The State Governments are responsible for taxes on agricultural income, professional tax, Value-Added Tax (VAT), state excise duty, and stamp duty. Local Bodies, such as municipalities and panchayats, collect property tax, water tax, and other small levies related to drainage and basic services.

The Tax structure in India consists of three-tier federal structure.

1. Central Government
2. State Governments
3. Local Municipal bodies

Taxes are determined by the Central and State Governments, along with local authorities like municipal corporations. The government cannot impose any tax unless it is passed as a law.

The Constitution of India specifies the following allocation of resources between the Union and the State governments.

1. Union Sources of Revenue

a. Taxes on income other than agricultural income
b. Corporation tax
c. Customs duties (except those on alcoholic liquors and narcotics)
d. Estate and succession duties other than on agricultural lands
e. Taxes on the capital value of assets (exclusive of agricultural land) of individuals and companies
f. Rates of stamp duty in respect of certain financial documents
g. Taxes (other than stamp duties) on transactions on stock exchanges and futures markets
h. Taxes on the sale and purchases of newspapers and on advertisements therein
i. Taxes on railway freight and fares
j. Terminal taxes on goods or passengers carried by railway, sea, or air
k. Taxes on the sale or purchase of goods in the course of interstate trade

Moreover, the residuary powers are vested with the Union government

2. **Sources of State Governments**

a. Land revenue

b. Taxes on the sale and purchase of goods, except newspapers

c. Taxes on agricultural income

d. Excise duties on liquors, opium, and other narcotics, and drugs

e. Taxes on land and buildings

f. Irrigation duties

g. Succession duties and estate duty on agricultural land

h. Taxes on betting and gambling, entertainment and amusement

i. Taxes on animals

j. Taxes on professions and traders

k. Taxes on road vehicles

l. Taxes on the consumption of electricity

m. Taxes on the entry of goods into a local area

n. Tolls

There are, however, duties levied by the Union government but collected and appropriated by the states, such as stamp duties, duties or exercise on medical and toilet preparations. Likewise, there are taxes which are levied and collected by the Union but which are assigned to the states within which they are levied. For example, succession and estate duties in respect of land other than agricultural land, terminal taxes, taxes on railway fares, etc.

There are taxes which are levied and collected by the Union, but the revenue from these taxes is shared by the Union governments with the state governments. Income tax and Union excise duties are such taxes which are shared. The proportion in which the revenue from these taxes is to be shared is determined by the Finance Commission. The constitution provides that for this purpose, a Finance Commission should be appointed every five years by the President of India.

2.3.1.1 Features of the Tax System in India

The entire system is clearly demarcated with specific roles for the central and state governments. The Central Government of India levies taxes such as customs duty, income tax, service tax, and central excise duty.

1. Role of The Central and State Governments

The taxation system in India empowers the state governments to levy income tax on agricultural income, professional tax, Value Added Tax (VAT), state excise duty, land revenue and stamp duty. The local bodies are allowed to collect octroi, property tax, and other taxes on various services like drainage and water supply.

2. Types of taxes

Taxes are classified under two categories, namely direct and indirect taxes. The largest difference between these taxes is their implementation. Direct taxes are paid by the assessee, while indirect taxes are levied on goods and services.

A. Direct taxes

Direct taxes are levied on individuals and corporate entities and cannot be transferred to others. These include income tax, wealth tax, and gift tax.

B. Indirect taxes

Indirect taxes are not directly paid by the assessee to the government authorities. These are levied on goods and services and collected by intermediaries (those who sell goods or offer services). Here are the most common indirect taxes in India.

Value Added Tax

This is levied by the state government and was not imposed by all states when first implemented. Presently, all states levy such a tax. It is imposed on goods sold in the state, and the rate is decided by the state governments.

Custom Duty: Imported goods brought into the country are charged with customs duty, which is levied by the Central Government.

Octroi: Goods that move from one state to another are liable to octroi duty. This tax is levied by the respective state governments.

Excise duty: All goods produced domestically are charged with excise duty. Also known as Central Value Added Tax (CENVAT), this is paid by the manufacturers.

Service Tax: All services provided domestically are charged with service tax. The tax is paid by all service providers unless specifically exempted.

C. Goods and Services Tax (GST)

As a significant step towards the reform of indirect taxation in India, the Central Government has introduced the Goods and Services Tax (GST). GST is a comprehensive indirect tax on the manufacture, sale and consumption of goods and services throughout India and will subsume many indirect taxes levied by the Central and State Governments. GST will be implemented through Central GST (CGST), Integrated GST (IGST) and State GST (SGST).

3. **Revenue Authorities**

- **CBDT**

The Central Board of Direct Taxes (CBDT) is a part of the Department of Revenue under the Ministry of Finance. This body provides inputs for policy and planning of direct taxes in India and is also responsible for the administration of direct tax laws through the Income Tax Department.

- **CBEC**

The Central Board of Excise and Customs (CBEC) is also a part of the Department of Revenue under the Ministry of Finance. It is the nodal national agency responsible for administering customs, central excise duty and service tax in India.

- **CBIC**

Under the GST regime, the CBEC has been renamed as the Central Board of Indirect Taxes & Customs (CBIC) post legislative approval. The CBIC would supervise the work of all its field formations and directorates and assist the government in policy making in relation to GST, continuing central excise levy and customs functions.

The Indian taxation system in India has witnessed several modifications over the years. There has been standardisation of income tax rates with simpler governing laws, enabling common people to understand the same. This has resulted in ease of paying taxes, improved compliance, and enhanced enforcement of the laws.

2.3.2 Value Added Tax (VAT)

The Value Added Tax was first introduced in France in 1954 to do away with the evils of the complex and unmanageable French system of turnover taxes. Since then, it has been receiving increasing attention from tax authorities and economists all over the world. It is the latest form of commodity tax, a form of sales tax, different from other types of tax primarily in the method of collection. At present, a large number of countries in Europe, South America and Africa have adopted the Value Added Tax. In India, it was introduced on the recommendation of the L.K.Jha Committee (1976).

The Value Added Tax, as the name clearly denotes, is a tax on the value added to goods in the process of production and distribution. It means that the value added tax is imposed on the value that the business firms add to the goods and services that they purchase from other firms. It adds value by processing or handling these purchased items with its own labour force or its machinery, building or other capital goods. It then sells the resulting product to consumers or to other firms. Thus, the difference between the sale proceeds and the cost of the materials, etc., that it has purchased from other firms is its value added, which is the tax base of the value added tax. In this way, Value Added Tax (VAT) is a tax not on the total value of goods being sold, but on the value added to it by the last trader.

2.3.2.1 Merits or Advantages of VAT

1. **Neutral in Allocation of Resources:** The Value Added Tax is regarded as a neutral tax as regards allocation of resources. It does not influence the businessman's decision as to how he carries on the business.

2. **Minimises Scope of Tax Evasion:** VAT minimises the scope for tax evasion. The tax is divided into parts, and therefore, the incentive to evade tax by any one firm is reduced.

3. **Easier to Enforce:** The Value Added Tax is regarded as superior to retail sales tax because it is easier to enforce through cross-checking.

4. **Spread over a Large Number of Firms:** The Value Added Tax is spread out over a large number of firms instead of being concentrated on a single point in the chain of production as in the case with sales tax or purchase tax, etc.

5. **Incentive to Invest:** The Value Added Tax can be an incentive to invest. The consumption type of Value Added Tax allows deductibility of the tax paid on inputs of capital goods.

6. **Encourages Exports:** The Value Added Tax may encourage exports because the burden of tax under it is quite less, and hence a commodity costs less. This enables the commodity to compete with foreign goods in the international markets.

7. **Conducive to Efficiency:** It is also claimed that Value Added Tax is conducive to efficiency because a firm is not exempted from tax liability even if it runs into a loss. It pays tax not on its profits but on the value produced.

8. **Simple and Single Stage Tax:** A Value Added Tax is considered superior to other indirect taxes on the grounds that it is quite simple and a single stage tax as against the multipoint taxes.

9. **Alternative to Other Taxes:** The value added tax is favoured on the grounds that it is considered to be a better alternative to other types of taxes, such as corporation tax, sales tax, excise duty, etc.

2.3.2.2 Disadvantages of Value Added Tax

1. **Complicated Tax:** It is said that the Value Added Tax is a complicated tax and hence needs an honest and efficient government machinery to do the cross-checking and link up various production activities and the resulting tax liability of each firm. It is not easy to have such a government machinery because in modern times, we find corrupt and inefficient government machinery in most countries.

2. **Additional Burden on Tax Authorities, Producers and Shopkeepers:** Another point of criticism of Value Added Tax is that it entails additional burden on tax authorities, producers and shopkeepers, etc., because it involves maintenance of elaborate and costly accounting records at every stage from the producer to the retailer. The tax authorities should be well-equipped to do all the necessary cross-checking, etc. The whole system becomes uneconomical and tiresome.

3. **Less Collection of Revenue:** Another criticism against the Value Added Tax is that the revenue collected under it is far less than the revenue collected under the sales tax and turnover tax system, etc.

4. **Not Conducive to Efficiency:** Critics of the Value Added Tax (VAT) doubt its efficiency. They argue that in an economy where shortages are common, practices such as speculative hoarding and non-competitive price increase frequently occur. Hence, it is doubtful whether value added tax will prove helpful in improving efficiency.

5. **Inflationary in Nature:** Critics of the value added tax emphasise that value added tax is inflationary in nature as it leaves its consumers with the largest disposable incomes.

6. **Possibility of Tax Evasion:** This system depends a lot upon the active cooperation of taxpayers, which is not easily forthcoming. Once the taxpayer realises that the administrative machinery of the government is ill-equipped to do all the necessary cross-checking, etc., they will resort to the preparation of false accounts by preparing false purchase invoices showing that taxes have already been paid by others, leading to gross tax evasion.

7. **High Collection Cost:** It is argued that in the case of Value Added Tax, the collection cost of revenue is quite high as to the other types of taxes.

8. **It is not a Fully Neutral Tax:** Critics are of the opinion that it is wrong to assume that Value Added Tax is a perfectly neutral tax.

9. **Complicated Procedures:** It is argued that procedures under Value Added Tax are quite complicated. They will have to be simplified, particularly in the case of small traders and artisans.

10. **Possibility of Tax Evasion:** In India, there is a wide scope of tax evasion under VAT. The government machinery is inefficient and is not well-equipped to address with problems of the firm. Thus, it gives a wide scope for tax evasion.

2.3.3 Goods and Service Tax (GST)

The Goods and Services Tax, or GST, is a major indirect tax reform introduced in India by integrating the major indirect taxes of the Centre and States. It is a comprehensive tax levied on the manufacture, sale, and consumption of goods and services. The GST is a destination-based consumption tax made on value addition. It is "collected on value-added goods and services" at each transactional stage of the supply chain or process.

Already, several countries have adopted GST-based VAT systems. In India, the GST came into effect from July 1, 2017.

2.3.3.1 Features of GST

GST belongs to the VAT family as tax revenues are collected on the basis of value added. Unlike in the case of a pure commodity-based VAT system, GST includes a services tax also. Similarly, input credit is given while calculating the tax burden. The following are the main features of the GST as per the final agreement:

1. **Taxes Covered:** Most of the important indirect taxes of the Centre and States are integrated under the GST. The most important tax of the Central government (in terms of tax revenue collection) -the Central Value Added Tax (or Union Excise Duty), Additional Customs Duty (CVD), Special Additional Duty of Customs (SAD), Central Sales Tax (levied by the Centre and collected by the States, the fastest growing tax revenue of the Centre - Service Tax, the most important tax revenue of the states - the State VAT (Sales tax) are now merged into a single tax under the Goods and Service Tax.

There are three important indirect taxes for the centre , the union excise duties, service tax and customs duties. Of these, the central excise duties and service taxes are brought under the GST. Customs duties as a tax on trade were not merged with the GST. States have two important indirect taxes , sales tax and State excise duties. Of these two, only the sales tax is merged with the GST. Along with these four big taxes of the Centre and States, several other low-low-revenue-incurring taxes are also brought under the GST.

Notable Exclusions from GST: Some notable taxes are not covered under GST, and these include; levies on petroleum products, tax on alcoholic products, electricity duties/taxes, stamp duties on immovable properties and vehicle taxes.

The achievement of GST reforms is the unification of the numerous taxes into a single GST. Here, both the Centre and States agreed to sacrifice their fiscal right or power to give way for the common tax.

2. **Unified Tax Regime:** The GST integrates indirect Taxes into one unified tax regime. Previously, the goods and services were imposed and administered differently.
3. **The Four-tier Rate Structure:** The GST proposes a four-tier rate structure. The tax slabs are fixed at 5%, 12%, 18% and 28% besides the 0% tax on essentials. Gold is taxed at 3%. The Centre has strictly demanded and got an additional cess on demerit luxury goods that comes under the high 28% tax. Essential commodities like food items are exempted from taxes under GST. Other consumer goods, which are common items, will be taxed at 5%.
4. **Service Tax Rate under GST**: Under the GST, there is a differential tax structure. A low tax rate of 5% is imposed on essential services. Common services are charged at 12% and some commercial services at 18%. A tax rate of 28% on luxury services is also imposed. Several services like education provided by an educational institution, Post Offices, RBI, etc., are exempted

from service taxation.

5. **Turnover Limit under GST and Tax Right Over Low Turnover Entities:** GST is applied when the turnover of the business exceeds Rs. 20 lakhs per year (Limit is Rs. 10 lakhs for the North-Eastern States). Traders who would like to get input tax credit should make a voluntary registration even if their sales are below Rs. 20 lakh per year. Traders supplying goods to other states have to register under GST, even if their sales are less than Rs. 20 lakh. There is a composition scheme for a selected group of taxpayers whose turnover is up to Rs. 75 lakhs a year.

6. **Tax Revenue Appropriation between the Centre and States:** The Centre and States will share GST tax revenues at a 50:50 ratio (except the IGST). This means that if a service is taxed at 18%, 9% will go to the centre and 9% will go to the concerned state.

7. **Components of GST CGST, SGST and IGST:** When the Centre and States are merging their prominent indirect taxes under GST, both should get their own share in the GST. For this, the GST Council has adopted a dual GST with two components the Central GST (CGST) and the State GST (SGST). The objective of this division is to share the revenue from the unified GST between the centre and states.

8. **Composition Scheme under GST** : The composition levy is an alternative method of levy of tax designed for small taxpayers with a turnover is up to Rs. 75 lakhs. The scheme can be availed by manufacturers and restaurants. Other service providers cannot opt for the scheme. It enables taxpayers to make payments at a flat rate under GST, without input credits. An alternate upper limit of Rs. 50 lakhs is applicable in a few states Assam, Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Sikkim and Himachal Pradesh.

9. **Right to Tax on Territorial Waters:** The right to impose taxes on economic activities carried out within the territorial waters of India-up to 12 nautical miles from the baseline, has been jointly addressed by the central and state governments. It has been mutually agreed that the State governments shall have the authority to levy and collect taxes on activities conducted within this 12-nautical-mile zone.

Recap

- The Indian tax system operates under a federal structure
- Taxes are levied by Central, State, and Local governments
- Direct taxes are levied on income, property, etc

- Indirect taxes include VAT, excise, customs, and GST
- Post-2017 GST reform unified many indirect taxes
- GST has four major rates: 5%, 12%, 18%, 28%
- VAT taxes value added at each stage of production/distribution
- GST includes CGST, SGST, and IGST components
- GST aims to remove cascading tax effects
- Revenue collection is shared between the Centre and the States
- CBIC, CBDT, and CBEC are the tax authorities in India
- Income tax is governed by the Income Tax Act, 1961

Objective Questions

1. Under which article is tax collection legal in India?
2. What type of tax is income tax?
3. Which tax was introduced in India in 2017?
4. Which body oversees direct taxes in India?
5. What is the full form of GST?
6. Which tax applies to imports?
7. Which indirect tax was replaced by GST?
8. Who administers GST and customs in India?
9. How many tiers are in India's federal tax system?
10. What is the standard assessment year duration in India?
11. What kind of tax is levied on services?
12. Which committee recommended VAT in India?

Answers

1. Article 265
2. Direct
3. GST
4. CBDT
5. Goods and Services Tax
6. Customs duty
7. VAT
8. CBIC
9. Three
10. April to March
11. Service tax
12. L.K. Jha Committee

Assignments

1. List the three levels of tax authorities in India.
2. Explain the difference between CGST and SGST.
3. Describe the main features of the GST system.
4. Mention the revenue-sharing structure under GST.
5. Prepare a note on the historical development of the Indian tax system.
6. Write any four differences between VAT and GST.

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3

BLOCK

Public Expenditure & Public Debt

UNIT 1

Public Expenditure

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the concept and evolution of public expenditure
- identify and explain the canons (principles) of public expenditure
- distinguish between developmental and non-developmental expenditure
- recognise the classifications of government spending and their economic relevance

Prerequisites

Before moving into public expenditure, learners must understand the expanding role of the modern state. Historically, government expenditure was minimal and restricted to maintaining law and order. Classical economists like Adam Smith supported the 'laissez-faire' policy, believing private markets could manage economic functions more efficiently. However, in the 20th century, the role of the state significantly increased, especially after the Great Depression. The government started engaging in activities like infrastructure development, education, health, and social welfare to stimulate economic growth and correct market failures. Public expenditure today is a major tool used to influence production, employment, and income distribution. By understanding its classification and principles, learners can analyse how governments manage their financial responsibilities in a balanced and efficient manner. This foundational knowledge is essential for comprehending broader issues in public finance.

Keywords

Public Expenditure, Canons of Public Expenditure, Developmental Expenditure, Non-Developmental Expenditure, Plan and Non-Plan Expenditure

Discussion

3.1.1 Meaning and Scope of Public Expenditure

Public expenditure refers to the expenses incurred by the government for its functioning and for promoting the welfare of society as a whole. In other words, it refers to the expenses made by the public authorities, i.e., State Government, Central Government and other Local bodies to satisfy the common wants of the people which they cannot satisfy individually. It is for protecting the citizens and/or for promoting their economic and social welfare.

Earlier writers opposed the increasing public expenditure for two main reasons. The first was the belief of Adam Smith and his followers. They were of the opinion that the function of the state should be restricted to 'Justice, Police and Arms'. They thought that the government expenditure was wasteful and that money could be used much better by private persons than by the government. Accordingly, they advocated the policy of 'Laissez-faire'. However, Adam Smith in his famous book *Wealth of Nations* observed that the sovereign has three main duties to perform as (a) to protect the society from violence and invasion of other independent societies, (b) to protect against injustice, and (c) to erect and maintain certain public works.

These arguments do not hold good in the present era. As we have already seen, an increase in the activities of the state is inevitable and is indeed essential in the interest of justice and efficiency. It is not universally true that the private person can use money in a better way. The state spends money in a much better way than private persons in the performance of certain types of functions. So, public expenditure has emerged with great importance in modern times for two reasons. Firstly, the economic activities of the state have increased manifold. Secondly, the nature and volume of public expenditure have important effects on production, distribution and the general level of economic activity. Therefore, it is the need of the hour that the state should participate in almost every field, and the government is responsible even for small matters.

3.1.1.1 Aims of Public Expenditure

Public expenditure is not merely a financial mechanism, but it also aims at securing social objectives. Traditional economists held the rigid viewpoint that the government should make the least interference in the general activity. The government is the only agent to keep the political organisation intact. But after the Great Depression of the

1930s, J.M. Keynes revolutionised economic thought. Keynes and onward economists have expressed that public expenditure plays a pioneering role in achieving the definite ends.

In the present era, a democratic government has to perform many functions within its territory for the betterment of its citizens, which might not other wise be provided by the private sector.

Prof. Dalton classified the aims and objectives of public expenditure into two parts:

a. Security of human life against external aggression and internal disorder, and injustice;

b. Promoting maximum social welfare of the community.

Therefore, its goal is maximising social and economic welfare on one side and controlling the depressive tendency in the market economy on the other side. Public spending is also designed to optimise the level of investment in order to maintain full employment alongside economic growth. It further aims to accelerate the pace of economic development by creating infrastructure and promoting capital formation for sustained progress.

To achieve these aims, Prof. Musgrave assigned different functions to public expenditure in a mature economy.

They are:

a. To secure a reallocation of resources and to check imperfections in the market economy.

b. To make measures to reduce inequalities and for the reallocation of resources.

c. To avoid business fluctuations and to maintain economic stability.

d. To maintain commercial activities for the benefit of the community.

Traditional thinking and philosophy did not favour public expenditure because they felt that rated market mechanism is a better guide for the working of the economy and allocation of its resources. According to Robert Peel, "Money can be more fruitful in the hands of the public as compared to government." Public expenditure is the expenditure incurred by public authorities - central, state or local governments - either for the satisfaction of collective needs of the citizens or for promoting their economic and social welfare or for protecting the citizens and the country. It is aimed to provide maximum socio-economic welfare for the society. It is considered to be the backbone of the economic development of a country.

3.1.2 Canons of Public Expenditure

Rules or principles that govern the expenditure policy of the government are called canons of public expenditure. Fundamental principles of public spending determine the efficiency and propriety of the expenditure itself. While making its spending programme, the government must follow these principles. These principles, in short, are called canons of public expenditure. The following are the principles or canons of public expenditure:

1. **Canon of Benefit:** The idea of this canon is maximum social advantage, i.e., public expenditure should be planned in such a way as to yield maximum social advantage and social welfare to the community as a whole and not to a particular group of the community. The government should incur its public expenditure in a manner that promotes the greatest good of the greatest number.

2. **Canon of Economy:** The principle of economy does not mean being miserly or stingy. It simply means avoiding wasteful and unnecessary spending. First, the government should spend money only on the most essential needs. Second, it should focus on increasing the productive capacity of the community. This is the positive side of the canon of economy.

3. **Canon of Sanction:** It implies that before incurring any expenditure, the concerned government department should obtain prior proper sanction from the competent authority. The objective of this canon again is to avoid misappropriation of public money and to secure its proper use.

4. **Canon of Surplus:** This canon implies that public authorities should aim at a surplus of income over their expenditure and that they should avoid deficits. Just as every prudent man will attempt to adjust his expenditure to his income, and if possible, to see that his expenditure is less than his income, so also every government should attempt to balance its income and expenditure and, if possible, aim at a moderate surplus.

5. **Canon of Elasticity:** This canon requires that the expenditure policy of the state should be such that changes may be possible in accordance with the requirements of different circumstances. This necessitates that the expenditure policy be elastic rather than rigid in its nature. In other words, there should be scope for changes in public expenditure according to the requirements of the country.

6. **Canon of Productivity:** This canon implies that expenditure policy should be designed to encourage production in a country. In short, as per this canon, the major part of the public expenditure should be allocated towards productive and developmental purposes.

7. **Canon of Equitable Distribution:** This canon implies that public expenditure should be carried out in such a way that it reduces inequalities in the distribution of income. In other words, public spending should ensure a just and equitable distribution of income among different groups in the community.

8. **Canon of Coordination:** In case of countries having a Federal or Democratic set-up, there are central, state and local governments. All these governments have their separate budget and incur expenditure accordingly. There must

be close coordination between them so that there is no duplication of expenditure.

3.1.3 Public Expenditure

Public expenditure is incurred in the form of purchases of goods and services, transfer payments and lending. Purchase of goods and services is intended to carry out governmental activities by the direct utilisation of economic resources; for example, the purchase of articles from the market, from paper clips to military aircraft. Transfer payments and lending are intended to provide enterprises and households with purchasing power to enable them to buy goods and services in the market. In many developed countries, transfer payments for social welfare constitute a sizeable portion of government budgets. In developing countries, some of the functions of transfer payments are performed by subsidies to consumers in the form of below-cost sales by state enterprises.

Classification of Expenditure: Government expenditure can be broadly classified into four categories: (i) Functional Classification or Budget Classification, (ii) Economic Classification, (iii) Cross Classification and (iv) Accounting Classification. As already mentioned, each classification of expenditure in government serves one objective or another, i.e., financial control, economic growth, price stability, etc.

i. **Functional or Budget Classification:** In India, the classification of accounts was structured so as to correspond to the organisation in which the transaction occurred and, within the organisation, to the inputs on which expenditure was incurred. For example, the construction of a hospital would be classified and displayed in accounts as 'public works expenditure' and not as expenditure on a programme like 'Medical Relief' under social services. The classification indicated the nature of expenditure but not its purpose. It did not enable identification of expenditure with functions, programmes, activities and projects. It lacked a management-oriented approach to accounting, as it did not provide facilities for monitoring and analysing expenditure on functions, programmes, activities, and projects..

ii. **Economic Classification:** Economic classification refers to the way government resources are allocated to different economic activities. It involves organising public expenditure and receipts into meaningful categories, such as distinguishing current expenditure from capital outlays, spending on goods and services from transfer payments to individuals and institutions, and receipts from other sources like borrowing, grants, and inter-governmental loans. This classification helps to highlight important aggregates such as public consumption expenditure, public investment, and the extent to which public authorities draw on public savings to finance development programmes in the public sector. In short, it provides a clear picture of total government transactions and shows how the government influences different sectors of the economy.

iii. **Cross Classification or Economic-cum-Functional Classification:** Cross classification provides the breakup of government expenditure not only by economic categories but also by functional heads. For instance, expenditure on medical facilities, a functional head is split between economic categories such as current expenditure, capital expenditure, and various types of transfers and loans. Conversely, cross-classification shows how expenditure on a particular economic category, say capital formation, is divided according to different public activities like education, labour welfare, family planning, etc.

iv. **Accounting Classification:** Accounting classification of government expenditure can be analysed under (i) Revenue and Capital, (ii) Developmental and Non- Non-Developmental and (iii) Plan and Non-Plan. Each classification of expenditure serves one objective or another of the government. For instance, revenue and capital expenditure classification indicates how much government expenditure results in the creation of assets in the economy and how much expenditure is unproductive. Again, developmental and non-developmental classification indicates how much government expenditure is spent on social and community services and economic services, as against general services. Similarly, the plan and non-plan expenditure classification helps the Planning Commission and Finance Commission in determining the pattern of central assistance on plan schemes to state governments and union territories. Thus, each classification of government expenditure serves one objective or another in government.

3.1.3.1 Plan and Non-Plan Expenditure

Government expenditure can also be classified into 'plan' and 'non-plan' expenditure. Plan expenditure refers to the expenditure incurred by the Central Government on programmes/projects, which are recommended by the Planning Commission. Non-plan expenditure, on the contrary, is a generic term used to cover all expenditure of the government, not included in the plan. Non-plan expenditure consists of many items of expenditure, which are obligatory in nature and also essential obligations of a state. Items of expenditure, such as interest payments, pensionary charges, and statutory transfer to states, come under the obligatory nature. Defence, internal security are essential obligations of a State. Any neglect of these activities can lead to the collapse of the government. Besides, there are special responsibilities of the Central Government like external affairs, currency and mint, cooperation with other countries and the expenditure incurred in this connection is treated as "non-plan" expenditure. Of all the major items of non-plan expenditure of the Central Government, interest payments, defence, and subsidies take the lion's share of expenditure.

The distinction between 'plan expenditure' and non-plan expenditure' is purely an administrative classification and is in no way related to economic or national accounting principles. For instance, in many cases, 'plan expenditure' becomes non-plan expenditure after the plan is over. Again, an item of plan expenditure during a particular five year plan becomes "non-plan" in the following plan, if its responsibility is shifted on to the State Governments as in the case of centrally sponsored and central sector schemes or if the expenditure spills over from one plan to the next or the expenditure is agreed to be incurred outside the plan outlay of the state governments approved by the Planning Commission.

The way the government divides its spending into 'plan' and 'non-plan', or 'developmental' and 'non-developmental', can sometimes give a misleading picture of how money is actually used. In reality, the real value of public spending should be judged by how much benefit or satisfaction it gives to the public, through the quality or quantity of services provided.

But this kind of classification can ignore that point, unless there is a proper balance. For example, money for maintenance of a government building may be reduced, while a less important plan scheme may get more attention and money, just because it is labelled a 'plan' item. Also, even if there is a ban on creating new government jobs, posts can still be created under planned schemes. So, this system of classifying expenditure can give unnecessary importance to some schemes and create a wrong understanding of how public money is being spent.

3.1.4 Developmental and Non-Developmental Expenditure

Government expenditure is commonly classified into two broad categories, viz developmental expenditure and non-developmental expenditure. Developmental expenditure refers to the spending undertaken by the government to promote economic growth and improve the social well-being of the population. It includes expenditure on education, medical care, public health, family planning, labour and employment, agriculture, cooperation, irrigation, transport, communication, and other economic and community services. This type of spending can be on both revenue and capital accounts. Revenue expenditure includes day-to-day operational costs such as staff salaries and supplies, while capital expenditure involves investments in physical assets like infrastructure, schools, and hospitals. Both are considered developmental if they contribute to long-term growth.

Developmental expenditure is a concept closely linked to economic planning. It plays a vital role in the implementation of economic plans by setting measurable targets for progress. During planning, specific amounts are allocated for sectors such as health, education, and infrastructure to help guide the economy toward desired developmental outcomes. In some cases, by administrative order or policy decision-referred to as 'by fiat', certain types of expenditure are officially treated as developmental even if they do not traditionally fall under that category, provided they support economic growth in some indirect way. These expenditures are then included under plan expenditure and are seen as part of the government's contribution to national development.

In contrast, non-developmental expenditure consists of government spending that does not directly contribute to economic growth but is necessary for the smooth functioning of the administration and governance. It includes spending on defence, the collection of taxes and duties, general administrative services, interest payments on public debt, stationery, printing, and other general services. These expenses are essential to maintaining the government's basic functions, though they do not directly result in increased output or national income.

In practice, however, the distinction between developmental and non-developmental expenditure is not always clear-cut. Many items of non-developmental spending may have indirect effects on growth. For instance, capital expenditure on administration, rehabilitation, and relief efforts, though often classified as non-developmental, can contribute positively to economic development by ensuring stability, improving governance, or supporting vulnerable populations during times of crisis. Similarly, expenditure on defence, while considered non-developmental, plays a crucial role in maintaining national security, which in turn creates a safe environment for investment and economic activity.

Thus, while the classification of expenditure into developmental and non-developmental is useful for planning and analysis, it should not be followed too rigidly. In reality, both categories of spending play important roles in the development process. No developmental expenditure remains truly productive indefinitely, nor is non-developmental expenditure entirely unproductive. From a policy perspective, each item of public expenditure, whether developmental or non-developmental should ideally contribute equally, at the margin, to the overall economic welfare of the country.

Overemphasis on developmental and plan expenditure may sometimes lead to a reduction in necessary non-developmental expenditure. This could weaken important government functions and unintentionally hamper economic progress. Therefore, while developmental expenditure is directly associated with economic growth, non-developmental expenditure should not be disregarded, as it also supports the overall development framework indirectly. The distinction, though useful for broad analysis, must be applied with care to avoid a distorted understanding of the true role and impact of government spending in the economy.

Recap

- Public expenditure is government spending for societal welfare
- It addresses both economic growth and social equity
- Canons include economy, benefit, sanction, productivity, etc.
- Developmental spending includes health, education, and transport
- Non-developmental covers defence, administration etc.
- Plan expenditure is based on approved development schemes
- Non-plan expenditure includes obligatory and operational costs

- Economic classification shows resource allocation
- Functional classification is activity-based expenditure mapping
- Cross-classification links functions with economic types
- Revenue and capital classify asset-creating capacity
- Coordination between governments is essential in spending
- Effective public expenditure boosts national productivity
- Spending efficiency is judged by public satisfaction outcomes

Objective Questions

1. Who bears the responsibility for public expenditure in an economy?
2. Which canon focuses on avoiding unnecessary spending?
3. Expenditure on public education falls under which category?
4. Interest payments are a form of what expenditure?
5. Which authority classified plan and non-plan expenditure in India?
6. Which principle mandates prior approval for government spending?
7. Spending on general services like police is what kind of expenditure?
8. Canon, aiming at maximum community benefit, is called?
9. Spending meant to promote equity and justice follows which canon?
10. Which principle ensures flexibility in expenditure planning?
11. What type of expenditure helps in reducing income inequality?
12. Government maintenance costs are classified under?

Answers

1. Government
2. Economy
3. Developmental
4. Non-Developmental
5. Planning Commission
6. Sanction
7. Non-Developmental
8. Benefit
9. Equitable Distribution
10. Elasticity
11. Developmental
12. Non-Plan

Assignments

1. Describe the modern significance of public expenditure.
2. Explain the canons of public expenditure using current examples.
3. Categorise expenditure into developmental and non-developmental heads.
4. Differentiate between economic and accounting classification.
5. Discuss the relationship between plan and non-plan spending.
6. Analyse the effects of public expenditure on social equity.

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2

UNIT

Theories of Public Expenditure

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the meaning and importance of public expenditure
- explain Wagner's hypothesis on the growth of public expenditure
- describe the Peacock-Wiseman hypothesis
- analyse the factors behind government expenditure growth

Prerequisites

In a country just after independence, roads are broken, schools are few, and hospitals are found only in cities. People demand better services, and the government has a huge task ahead: to spend wisely and rebuild the nation. Over time, as societies grow and develop, the government's role in public spending changes. But why does this happen? Why do governments start spending more and more over the years? Is it because of population growth, economic needs, public pressure, or political priorities?

Understanding how and why public expenditure grows is one of the key questions in public economics. Economists have long tried to explain this growing pattern through different theories. Two important explanations come from Wagner's Law and the Peacock-Wiseman Hypothesis. These theories help us understand how government spending behaves over time-whether it grows naturally with economic progress or whether it responds to sudden social and political pressures. Let us examine these theories in detail in this unit.

Keywords

Wagner's Law, Peacock-Wiseman, Displacement, Inspection, Concentration

Discussion

3.2.1 Theories of Public Expenditure

In ancient times, classical theorists did not pay much attention to framing any theory regarding the increase in public expenditure. They simply regarded it as an administrative institution which only concerned with performing certain protective functions. The states have to do very little with the provision of public services, but in the 20th century concept of government has changed altogether. The modern state is termed a Welfare State in which the Government has enormous functions to perform. Adolph Wagner, a fiscal theorist, was the first to propose an empirical theory suggesting that government expenditure tends to grow disproportionately over time.The following are the major theories explaining the increase in public expenditure:

3.2.2 Adolph Wagner's Hypothesis

The famous German economist (1835-1917) Adolph Wagner argued that a nation, as it experiences economic development and growth, will experience an increase in the activities of the State. A number of early economists discussed the relationship between the level of economic development and public expenditure. However, Wagner was first to buttress such a remark with an extensive theoretical background. Wagner's concept was known as the 'Law of Increasing State Activities'. He explained that the comparison of different countries and at different times indicates that there is a tendency for increasing state activities (all governments, whether central or state) of both types, i.e., extensive and intensive. These increasing activities lead to an increase in public expenditure.

To justify his generalisation, Wagner divided public expenditure into two major categories: expenditure for external and internal security and expenditure for cultural activities and welfare, which should include health, education, recreation, transportation, banking, etc. Expenditure for external security would increase in a growing economy as the nature of the use of force by the State changes from aggression to prevention of attacks as armies use more costlier equipment. For internal security, Wagner foresaw greater expenditure because of greater friction between economic limits and people as urbanisation progressed. Similarly, public expenditure on cultural and welfare activities is liable to increase on account of the economic development of a country. Wagner was of the opinion that the development of the public sector takes place along with the development of the economy. The relationship between these two is based on the principle of 'cause and effect'. He illustrated by quoting several examples that the scope of the public sector increases along with the development of the economy.

3.2.2.1 Causes of Application of Adolph Wagner's Law

The main causes of the application of Wagner's law are as follows.

1. **Government Traditional Functions are More Complex and Expensive:** There are three fundamental traditional functions of the government: (i) Defence, (ii) Internal Administration, and (iii) Justice. In accordance with the prevailing conditions of each country, the scope of all these three major functions is expanding rapidly, and thereby, the compliance of these functions is becoming complex and expensive day by day. This factor is responsible for the intensive increase in the government expenditure.

2. **Expansion of Government Functions:** Besides an increase in the three above traditional functions of the government, it is also required to perform several social and welfare functions, such as education, medical, relief works, old age pension, water, parks, housing, roads, financial assistance, subsidised food, etc.

3. **Expansion of the Scope of Public Goods:** The Government is also required to expand the investment activities for expanding the scope of public goods. The government is required to establish large-scale industries for the manufacture of public goods, which involves huge investment.

3.2.2.2 Critical Study of the Hypothesis

No doubt that Wagner's law is based on historical facts and indicates a long-term tendency. However, this law has been criticised on the ground that (i) it is applicable in long term and not in short term which is the need of the hour; (ii) It lacks inter-disciplinary relationship; (iii) It lacks a comprehensive analytical framework; (iv) It is not acceptable to western countries; and (v) It ignores the influence was war on government's spending activities.

3.2.3 Wiseman-Peacock Hypothesis

The Wiseman-Peacock Hypothesis was introduced by two economists, Jack Wiseman and Allan T. Peacock, after they studied how government spending changed in the United Kingdom between 1890 and 1955. Their main idea was that public expenditure does not grow smoothly or steadily, but instead grows in sudden jumps or steps, especially during times of crisis.This theory is based on three important effects.

1. **Displacement Effect :** According to Wiseman and Peacock, when a serious social or economic disturbance occurs, like a war, natural disaster, or major economic crisis, the government needs to spend more money to deal with the situation. However, the money it collects through taxes is not enough to

cover the new expenses.So, the government raises taxes or introduces new ones. At first, this extra spending and taxation are seen as temporary. But once the crisis is over, the government does not return to the old, lower level of spending. Instead, it continues to spend more than before. This 'shift' in the level of public spending is called the Displacement Effect because one level of expenditure is replaced or displaced by a higher one.

2. **Inspection or Perception Effect :** Over time, people begin to accept higher taxes as a normal part of life. Their tolerance for taxation increases, and so the government finds it easier to collect more revenue. In this new environment, both the public and the government become more aware of problems that were previously ignored, such as poverty, health care, education, and infrastructure. This awareness leads to more public pressure and political will to solve these problems, which results in even more government spending. This change in the public's attitude and expectations is called the Inspection Effect.

3. **Concentration Effect :** This effect refers to the idea that, during periods of economic growth, the central national government tends to expand its activities faster than local or State governments. This happens because the central government is often better equipped to handle large-scale economic tasks and also has greater control over major tax resources. The political system of the country also influences this effect. In a centralised system, for example, more responsibilities and spending are concentrated in the hands of the national government.

The Wiseman-Peacock Hypothesis gives us a realistic picture of how and why public spending increases over time. It shows that government spending does not just rise due to natural economic growth, as Wagner suggested, but also because of unexpected events, changing public attitudes, and the growing role of the central government. It also explains how factors like population growth, urbanisation, people's rising awareness of their rights, and the government's increasing role in both economic and social sectors all contribute to higher levels of public expenditure.

Although this theory helps us understand the trend of rising government spending, it does not explain every single cause behind it. Still, it is considered more practical and closer to reality compared to Wagner's Law, especially in the modern context.

Recap

- Wagner linked economic growth with rising public expenditure
- His law is based on long-term historical patterns
- Expenditure grows in both security and welfare areas
- Peacock-Wiseman emphasised the effects of social disturbances

- Inspection effect leads to long-term spending acceptance
- The concentration effect shifts more power to the central government
- Wagner saw the state as expanding alongside economic progress
- Wiseman and Peacock observed the UK's spending over 65 years
- Both theories stress the inevitability of rising State spending
- They differ in approach: Wagner is theoretical, Peacock is empirical
- Urbanisation and modernisation boost state roles
- Crisis moments redefine government functions
- Public finance must adapt to societal needs over time

Objective Questions

1. Who formulated the Law of Increasing State Activities?
2. Which theory includes the Displacement Effect?
3. Who linked state expansion to economic development?
4. Which effect leads to a higher tax tolerance?
5. What type of events trigger sudden spending rises?
6. Which effect centralises fiscal authority?
7. Wagner's theory is considered to be?
8. The Wiseman-Peacock hypothesis was based on data from?
9. Who highlighted long-term public sector growth?
10. What is the core of Wagner's law?
11. Which economist criticised Wagner's lack of framework?
12. What kind of law is Wagner's hypothesis?
13. Who proposed that spending increases occur in jerks?
14. What effect involves redefining neglected responsibilities?

Answers

1. Wagner
2. Peacock-Wiseman
3. Wagner
4. Inspection
5. Disturbances
6. Concentration
7. Empirical
8. UK
9. Wagner
10. State Expansion
11. Critics
12. Long-Term
13. Wiseman
14. Inspection

Assignments

1. Discuss Wagner's Law with supporting arguments.
2. Explain the three effects of Peacock-Wiseman theory.
3. Compare the Wagner and Peacock-Wiseman hypotheses.
4. Analyse the causes of the rise in public expenditure.

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UNIT 3

Public Debt

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend types and sources of public debt
- analyse theories on the desirability of government borrowing
- identify the burdens of debt
- describe the methods of debt redemption and management

Prerequisites

When a person borrows money to build a house, the expectation is that one day the house will provide comfort and security. However, if the borrowed money is spent carelessly or left unpaid, it turns into a burden rather than a benefit. The same principle applies to governments. Across the world, governments often borrow money to build roads, schools, hospitals, or to respond to emergencies like natural disasters or pandemics. This borrowing, known as public debt, is a common tool in modern economics. But just like personal loans, public debt comes with responsibilities, risks, and long-term consequences.

When does borrowing help a country grow, and when does it create a burden for future generations? Why do governments borrow even when they already collect taxes? How is this debt managed or paid back?

To answer these questions, we must understand the types of public debt, the economic theories behind it, the burden it may cause, and the various ways of repaying it-known as debt redemption. In this unit, we will examine all these aspects in detail and try to understand how public debt affects not just governments, but also citizens and the economy.

Keywords

Public Debt, Internal, External, Burden, Redemption, Management

Discussion

3.3.1 Meanings and Definitions of Public Debt

Public debt refers to the borrowings of the government from its own people as well as from foreign countries. It is a term used for short-term and long-term borrowings of the government/state. The government may borrow from banks, business organisations, individuals and also from foreign countries. Thus, borrowings of the government may be within the country or outside the country or both. According to J.K. Mehta, "Public debt is a comparatively modern phenomenon and has come into existence with the development of democratic form of governments in the world."

3.3.2 Types of Public Debt

Different economists have classified public debt in different ways, viewing different aspects. The main classification of public debt is given below.

1. Internal and External Debt
2. Productive and Unproductive Debt
3. Compulsory and Voluntary Debt
4. Redeemable and Irredeemable Debt
5. Funded and Unfunded Debt

1. **Internal and External Debt :** Internal debt refers to the public loans floated within the country, whereas external debt refers to the loans taken from foreign governments, foreign nationals and international institutions. External debt represents a claim of foreigners against the gross national income of the country when it borrows from other countries and has to repay at the time of maturity.

2. **Productive and Unproductive Debt :** Public debts may be classified on the basis of productive and unproductive. Productive debts are those which are used for projects which yield an income to the government. For example, public debts may be raised for the construction of railways, irrigation and power projects, etc. On the contrary, unproductive debts are those which create neither any assets nor any income for the government. It is a dead

weight or a useless burden on the community. For example, public debts can be raised for financing a war, meeting famines, droughts, earthquakes, budgetary deficits, etc.

3. **Compulsory and Voluntary Debt :** When the government borrows from the public by using coercive methods, loans so raised are called compulsory debts. For example, the loans may be raised during an emergency such as wartime expenditure or to control inflationary pressures. On the contrary, when the government borrows money from the public, both individuals and institutions, by issuing securities like bonds, etc., it is called voluntary debt.

4. **Redeemable and Irredeemable Debt :** The redeemable public debts are those which the government promises to pay off in future at a specified date. They are terminable loans. When a loan is redeemable, the government has to make some arrangement for its repayment. On the contrary, irredeemable debts are those which are raised without any intention to repay the same, though the government continues to pay interest on such debts (loans). These loans may also be known as perpetual debts.

5. **Funded and Unfunded Debt :** Public debt is also classified into funded and unfunded debt. Funded debt is a long-term debt, undertaken for creating a permanent asset, and the government normally makes arrangements about the mode and time of repayment. In contrast, unfunded or floating debt is a relatively short-term debt, meant to meet current needs. The government undertakes to pay off the unfunded debt in a very short period, say within a year at the most. Treasury bills are unfunded debts as they are issued for three or six months, never for a longer period than a year. The unfunded debts are usually incurred to fill temporary gaps in the budgets.

3.3.2.1 Sources of Public Debt

Every government has two major sources of borrowing: (I) internal and (II) external. Internally, the government can borrow from individuals, financial institutions, commercial banks, nonbanking institutions, and the central bank. Externally, the government borrows from individuals and banks, international institutions and foreign governments. Now we shall discuss both the sources of raising debts.

I. Internal Sources of Public Debt

Internal sources of raising public debt are as follows.

1. **Borrowing from Individuals :** One of the important methods of raising public debt from individuals is in the form of bonds or loans. They bear a fixed rate of interest and are repayable on due dates. They are purchased by individuals from the government and are repaid by the government on due dates.

2. **Borrowing from Commercial Banks :** Public debts are also raised by the government from commercial banks in the form of loans. Commercial banks can subscribe to government loans through the creation of credit.

3. **Borrowing from Nonbanking Financial Institutions :** Nonbanking financial institutions, such as insurance companies, trusts, mutual funds etc., subscribe to government bonds and thus it is also an important source of raising public debt. Those nonbanking financial institutions prefer government bonds because of the security provided by the latter and also due to their high negotiability and liquidity.

4. **Borrowing from the Central Bank :** The central bank of the country is also an important subscriber to the government loans. Central bank purchases bonds of the government, both the Central Government and the State Governments. By purchasing government bonds, the central government credits the account of the government concerned.

II. Borrowing from External Sources

External sources of borrowings include foreign individuals and foreign banks, international institutions and foreign governments. In recent years, apart from other foreign sources, two important sources of raising foreign public debts have become prominent. They are (i) I.M.F., I.D.A., I.F.C., I.B.R.D., which give loans for short-term term mainly for overcoming temporary balance of payment difficulties and also for the long term development purposes. (ii) Government assistance is generally for development projects mainly in underdeveloped and developing countries like India. External sources of borrowing have become considerably important in recent years.

3.3.3 Theories of Public Debt

Public debt refers to the money borrowed by the government to meet its expenses when its income is not enough. Over time, economists have had different views about whether public debt is good or bad, depending on how they thought the government should act in the economy. These views have changed from support to opposition and later to controlled acceptance, leading to the development of different theories of public debt.

Mercantilist View (18th Century)

During the 18th century, the mercantilist school of thought supported the idea of public debt. At that time, economists believed that the state had a major role in promoting national wealth and increasing the power of the nation. Borrowing by the government was seen as a useful tool to finance activities like trade expansion, military strength, and national development. Public debt was not considered harmful because it was thought to be used for purposes that directly benefited the economy and increased state power. This belief was based on the idea that the government is a productive force and its spending supports economic growth.

Classical View (19th and Early 20th Century)

In the 19th century and the early part of the 20th century, the classical economists strongly opposed public debt. Thinkers like David Hume, Adam Smith, and David Ricardo argued that public borrowing was harmful and dangerous for a country's economy. They believed in the concept of a 'Laissez-faire' economy, where the government should interfere as little as possible. According to them, government expenditure is often wasteful, unproductive, and inefficient, and any money borrowed would increase the future burden on taxpayers.

David Hume feared that once borrowing begins, a country may continue to borrow without control, eventually leading to bankruptcy. Adam Smith believed that when rulers borrow money instead of collecting taxes, they become less dependent on citizens and are more likely to start unnecessary wars, which adds to wasteful spending. David Ricardo went even further and described national debt as one of the most terrible evils ever created to harm a nation. The classical economists also believed that public borrowing reduces private investment, which they called 'crowding out', and that governments should aim for balanced budgets.

Modified Classical View (Later 19th Century Thinkers)

As time progressed, some classical economists developed more flexible ideas about public debt. Economists such as Thomas Malthus, John Stuart Mill, Henry Sidgwick, and J.E. Cairnes did not fully oppose government borrowing. They recognised that under certain circumstances, public debt could be useful and necessary. For example, Malthus argued that public debt was not as bad as most people believed. He said that the people who receive interest from public debt, such as soldiers, sailors, and government employees, also contribute to economic demand and consumption. This consumption helps to stimulate production and keeps the economy active. According to these economists, public debt can play a positive role in increasing demand and maintaining economic balance, especially during times of low economic activity.

Keynesian or Modern View (After the 1930s)

The modern theory of public debt developed during the Great Depression of the 1930s, a period when the world experienced massive unemployment and economic decline. The Keynesian economists, led by John Maynard Keynes, argued that government spending is necessary to keep the economy moving, especially when the private sector is not investing enough. According to Keynes and modern economists like Professor A.H. Hansen and S.E. Harris, during times of unemployment and low demand, the government must borrow and spend money to increase employment, income, and investment. Public borrowing in such situations is not harmful but is actually an important tool of fiscal policy to revive the economy.

The modern theory also believes that government expenditure can be productive, and not all public spending is wasteful. They suggest that internally held public debt, where the government borrows from its own citizens or institutions, is not a real burden, because the money remains within the country. However, they warn that external public debt, borrowing from foreign countries or international organisations, is a real burden because it requires repayment in the form of real goods and services going out of the country. This can affect national income and weaken the economy if not properly managed.

Thus, the theory of public debt has moved through several stages. The mercantilists supported it as a way to build state power. The classical economists strongly criticised it, thinking that government borrowing was wasteful and harmful. The modified classical thinkers accepted that debt might be helpful in some cases, especially when it boosts demand. Finally, the Keynesian or modern view sees public debt as a powerful tool to manage the economy, especially during periods of unemployment or economic crisis.

Today, most economists agree that public debt is not always bad, but it must be used wisely and responsibly, especially to support productive activities that lead to growth. While internal debt is seen as manageable, external debt must be handled carefully to avoid long-term economic problems. The main focus of the modern theory is on the overall health of the economy, not just individual burdens or government limits.

3.3.4 Burden of Public Debt

The burden of public debt is of two kinds.

a. Internal Burden of Public Debt

b. External Burden of Public Debt

a. Internal Burden of Public Debt

Prof. Dalton defines internal debt as "A loan is internal if subscribed by persons or institutions within the area controlled by the public authority which raises the loan." In the opinion of Prof. Dalton, the burden of internal public debt is not as significant as the payment of the principal amount and its interest involves taxation. It is merely a transfer of purchasing power from one person to another. In other words, money does not flow out of the national money market.

1. **Direct Money Burden :** Direct money burden is equal to the amount of goods and services sacrificed by the people due to a rise in taxes. It is measured by the amount of money payment involved and the amount of taxes, are to be raised to meet the revenue requirements. In fact, the internal public debt is of no importance because the payment of interest on the debt and the principal amount taken as a loan involves taxation, and it is nothing but the transfer of purchasing power from the taxpayers to the bond-holders; when the taxpayers and the bond-holders are the same people.

2. **Indirect Money Burden :** When loans taken by the government are to be spent on development projects, it results in the creation of demand for several commodities and services. As a result of this, prices of goods and services rise and thus impose a new burden on society. Sometimes, taxes are increased to meet the repayments. Such an increase in taxation affects the level of production. This adversely affects people's desire to work, save and ability to work.

3. **Direct Real Burden :** In the case of internal debt, the government repays the principal amount along with the interest by imposing new taxes on the people. It is obvious that the taxpayers are poor people while the lenders are relatively rich. In such a case, it results in the transfer of the purchasing power from the poorer sections to the richer sections of the community. With this change in the distribution of income, more burden will fall on the poor sections of society.

Thus, the result of the repayment of internal public debt is that the wealth gets transferred from the active sections of society to the passive sections of society. This is not in favour of the national interests. Hence, it is the direct real burden of internal public debt.

4. **Indirect Real Burden :** For the repayment of public borrowings, the government imposes additional taxes on the common masses. Generally, most of the taxes are imposed on poor people in the form of indirect taxes, which results in the rise of economic disparities and inequalities. It adversely affects the willingness to work and save. It discourages the individual, and they do not wish to work and save more because of a heavy dose of taxation.

b. Burden of External Public Debt

External debt means the money borrowed from individuals, associates belonging to foreign countries. External debt also consists of loans taken from foreign governments.

1. **Direct Money Burden :** In an effort to repay the loan and interest, the debtor nation is deprived of certain goods and services. Every year, a large amount of money has to be paid by the debtor country in lieu of interest on the loan. After the maturity period, the principal amount has to be paid in the form of foreign exchange. This is possible only through making exports without getting any payment from foreign countries. Such types of exports are called 'unrequired exports'. This is the direct money burden of an external debt.

2. **Indirect Money Burden :** The debtor nation often pays interest in terms of goods and services to the creditor country. That means the debtor has to export goods and services in a huge quantity. As a result of this, the price of these goods and services in the country shoots up, and sometimes, it creates a scarcity of these goods. This leads to the loss of economic welfare of the nation.

3. **Direct Real Burden :** The debtor government imposes new taxes on the people to pay off the external debt. It is obvious that the burden of these taxes will fall more on the weaker sections of society. Hence, it is the direct real burden of external public debt. Not only that, in an effort to pay the external debt, the debtor community is deprived of certain benefits; in a real sense, it represents the direct real burden.

4. **Indirect Real Burden :** To pay off the external debt, taxes are imposed on the people. Heavy taxes adversely affect the willingness and ability of the people to work and save. This has an unfavourable effect on production. Further, the heavy debt payment also checks the public expenditure on productive channels, which is otherwise socially desirable.

3.3.5 Redemption of Public Debt

Redemption means repayment of a debt. Just as the private individual or organisation has to repay the loan it has borrowed, so also the government has to pay not only interest on the public debt but also repay the principal on the due date. The approach to redemption depends on the nature of the debt. If debt is taken for productive purposes, it may not be strictly necessary to redeem it at the earliest because the government is also getting a source of income to pay off the interest on the debt. On the contrary, if a loan is taken for non-productive purposes such as war debt, the sooner it is paid off, the better, both for the government as well as for the public, because it is a burden without any return. Accumulation of such a debt may cause bankruptcy.

3.3.5.1 Methods of Redemption of Public Debt

The following are the main methods of the redemption or repayment of public debt.

1. **Repudiation :** Repudiation of public debt means refusal to repay a public debt by the government. It means that the concerned government does not recognise its obligation and refuses to repay the loan taken by it. Repudiation is not paying off a loan but destroying it. However, this method is most undesirable because (i) it shakes the confidence of the people in public debt, (ii) it may provoke retaliation from the creditor countries, and (iii) it is considered immoral and dishonest. That is why this method of redemption of public debt has not been used recently anywhere in the world.

2. **Refunding :** Refunding is the process by which the maturing bonds are replaced by new bonds. In this case, new bonds are issued by the government in order to pay off the matured loans.

3. **Conversion :** Conversion of public debt means the exchange of new debts for the old ones. In this method, the loan is actually not repaid, but it is converted into a new loan.

4. **Annual Repayment :** Under this method of redemption of public debt, the public debt is repaid in equal instalments, which include both the interest and the principal. It is done annually and hence is also called a terminal annuity. The main benefit of this method is that it leads to a fall in the burden of public debt every year.

5. **Sinking Fund :** Sinking fund is probably the most popular and systematic method of redeeming public debt. Under this method, the government establishes a separate fund known as the 'Sinking Fund' for the repayment of the public debt. The government goes on crediting every year a fixed sum of money to this fund. By the time the debt matures, the fund accumulates enough to pay off not only the principal but also the interest charges.

6. **Serial Bond Redemption :** The government may decide to pay off every year a certain portion of the bonds issued previously. Therefore, a provision may be made so that a certain portion of the public debt may mature every year, and a decision may also be taken in the beginning about the serial numbers of bonds which are to mature every year. This method enables a portion of the debt to be paid off every year.

7. **Buying up Loans :** The government may redeem its public debt through buying up loans from the market. Whenever the government has surplus

income in its budget, it may spend the amount for buying off government bonds from the market where they are bought and sold. It is a good method, provided the government can secure a budget surplus. However, this is not a redemption of debt but buying up a debt.

8. **Capital Levy :** Public debt may also be redeemed through a capital levy, which may be levied once in a way with the special objective of redeeming public debt. In fact, a capital levy is usually advocated immediately after the war to repay the unproductive war debts. It is imposed on the net assets on a progressive scale.

9. **New Taxation :** Another method of redemption of public debt is to levy new taxes, both direct and indirect, and thus secure necessary revenue to pay off the old public debts.

10. **Redemption of External Debt :** The redemption of external debt can be made only through the accumulation of necessary foreign exchange to pay it off. This can be done by creating export surpluses, i.e., exporting more than imports. Temporarily, the redemption of an old debt can be made through the floating of new foreign debts.

3.3.6 Public Debt Management

The term 'debt management' refers to the debt policy designed to achieve certain objectives and the actual implementation of this policy. The public debt management is concerned with the decisions regarding the forms of public debt issued, the terms on which new bonds are sold, maturing debts are redeemed or refunded, the proportion in which different forms of public debt should be issued, the pattern of maturities of the debt, its ownership, etc. In short, it is concerned with the determination of the structural characteristics of the public debt. Hence, the management of public debt is concerned with refunding, floating or retirement of public debt, etc. The management of public debt is very significant because there can be important economic effects of the changes in the size of the public debt on the operation of an economy.

Public debt management must ensure that the public debt policy is not pursued in isolation. It should be well coordinated with the monetary and fiscal policies to secure national objectives. During a depression, borrowings should be from banks and during inflation, loans should be taken from the public to siphon off the excess purchasing power. Borrowings from banks during inflation will aggravate the situation by creating excess purchasing power in the economy. In India, the task of coordination in all these respects is achieved through the RBI. It is the agent of both the Central and State governments in all debt operations. It also advises them regarding the timings, terms and amounts of loans that can be raised in the market without undue difficulty.

Objectives of Public Debt Management

i. Public debt management must subserve the economic policy of the government. During the period of depression, it should help to raise the purchasing power and effective demand in the economy and vice versa in inflation.

ii. In times of war and for economic development, it should provide sufficient funds to meet the requirements of the economy.

iii. It should be undertaken in such a way that it is the most beneficial activity of the government.

iv. It should not have any adverse effect on the economic condition of the country.

v. It should also be undertaken in such a way as to strengthen the money market.

Principles of Public Debt Management

The main principles of public debt management are as follows:

1. **The Interest Cost of Serving Public Debts must be Minimised :** According to this principle, the government must be in a position to create and reduce public debts at minimum interest cost. The interest cost of serving public debt should be kept at a minimum because the government has to impose additional taxes or the rates of existing taxes have to be raised for the payment of interest cost. If the interest cost is minimum, the government will have to impose a smaller amount of additional taxes and vice versa.

2. **Funding of Short-Term Debt into Long-Term Debt:** According to this principle, the debt management should help in funding short-term debt into long-term debt as far as possible. However, it should be done in such a way that the economic stability is not disturbed.

3. **Public Debt Policy must be Coordinated with Fiscal and Monetary Policy:** According to this principle, the debt management policy must be coordinated with fiscal and monetary policy. It is essential to maintain economic stability and economic growth in a country. Thus, the public debt policy, along with the fiscal and monetary policy, must be operated in such a way that all three policies contribute to economic stability and economic growth.

4. **Satisfaction of the Needs of Investors :** According to this principle, the public debt should be managed in such a way that the needs of investors with regard to the types of government securities and the terms of issues are satisfied. In case the needs of investors are not satisfied, then the government may find it difficult to manage the public debts.

5. **Maturity, Distribution and Kinds of Debt Holders :** According to this principle, the government should keep in mind the maturity, distribution and kinds of debt holders. The public debts must be repaid on maturity. Similarly, there should be a proper distribution of public debts. Furthermore, the interests of all types of debt holders should be safeguarded, and an appropriate balance should be maintained between short-term and long-term public debts, as both are essential.

Recap

- Public debt fills the gap between income and expenditure
- Internal debt is borrowed from domestic sources
- External debt is borrowed from foreign agencies
- The classical view opposed public borrowing
- Keynesians support debt during recessions
- Productive debt funds income-generating projects
- Unproductive debt funds wars or deficits
- Redemption methods include sinking funds and taxation
- Debt burden includes direct and indirect effects
- Internal debt burdens are mostly redistributive
- External debt requires repayment in foreign exchange
- Refunding replaces maturing bonds with new ones
- Effective debt management ensures fiscal stability
- RBI manages debt operations in India

Objective Questions

1. Which term is used to refer to loans taken by the government? What is the debt raised from within the country called?
2. Under which category of public debt does borrowing from the IMF fall?
3. What is productive debt used for?
4. What kind of needs are funded by unproductive debt?
5. Who opposed public debt as harmful?

6. Who supported debt during economic depression?
7. Which fund is created for the repayment of debt?
8. What replaces maturing debt with new issues?
9. Which burden involves wealth redistribution?
10. What principle links debt with monetary policy?
11. In which operations does the RBI act as an agent??
12. Export surplus is needed to repay which debt?
13. What does repudiation mean in the context of public debt?

Answers

1. Public Debt
2. Internal Debt
3. External Debt
4. Investment
5. Emergencies
6. Classical
7. Keynes
8. Sinking
9. Refunding
10. Real
11. Coordination
12. Debt Management
13. External
14. Refusal

Assignments

1. List the types of public debt and give suitable examples for each.
2. Differentiate between internal and external debt.
3. Describe the classical and Keynesian views on debt.
4. Write a note on the direct and indirect burden of public debt.
5. Explain the redemption methods of public debt.
6. Discuss the principles of debt management.

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4

BLOCK

Fiscal Federalism

UNIT 1

Principles of Fiscal Federalism

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the meaning of fiscal federalism
- identify the principles of federal finance
- recognise the causes of fiscal imbalances
- describe measures to correct fiscal imbalances

Prerequisites

A country with wide differences in geography, population and economic capacity faces an important question. Some regions are rich in natural resources while others struggle with poverty, so how can a single national government meet the needs of every region effectively? This is where fiscal federalism becomes essential. It recognises that while central coordination is necessary, local governments are often best placed to deliver important public services. But with responsibilities come costs - and not every state has equal financial strength. If resources are not fairly divided, strong states become stronger, and weaker states fall further behind. Fiscal federalism asks: Who should do what - and with whose money? It is not just about dividing revenue, but about ensuring that every citizen, regardless of region, has equal access to public services. In countries like India, this balance of power and resources must constantly evolve with changing social and economic demands. Learners will come across these issues in this unit.

Keywords

Fiscal Autonomy, Vertical Imbalance, Federal Finance, Fiscal Policy, Fiscal Deficit Development Finance

Discussion

4.1.1 Meaning of Fiscal Federalism

The idea of fiscal federalism was introduced in economics by the economist Richard Musgrave in 1959. Fiscal federalism deals with the division of governmental functions and financial relations among different levels of government. In fiscal federalism, importance is given to the financial relations between different layers of the government. Fiscal federalism can be able to create a conducive atmosphere to solve the problems that the government will face all the time. It includes the just distribution of income, efficient and effective allocation of resources, and maintaining economic stability. All these problems can be solved easily under the federal system of government with proper federal government intervention, including state and local self-governments. Musgrave has the view that attainment of distributive justice is the duty of the Central government, whereas the allocation of resources should be the responsibility of other layers of the government.

Federalism is derived from the Latin word 'Foedus', which means agreement. It refers to a form of political organisation in which two or more states come together to form a political union with a common government, while the individual states retain their internal autonomy. In a federal system of government, sovereignty is constitutionally divided between the central (or union) government and the state governments. The authority is shared, and both levels of government operate independently within their own spheres. Although the Constitution defines separate powers for each level, in practice, modern federalism often takes the form of cooperative federalism, where both the central and state governments work together and their functions frequently overlap. Therefore, neither level of government has complete exclusive control over all matters.

Federal finance refers to the financial system involving both the Federal (Central) and State governments, as well as the financial relationship between them. In a federation, both levels of government require funds to fulfil their respective responsibilities. Therefore, different sources of revenue must be identified and allocated appropriately. The various means of income need to be divided among the different levels of government in such a way that each receives an equitable share. Moreover, there should be a proper adjustment between the financial needs and the income of each government.

Fiscal federalism is about dividing responsibilities and financial powers between different levels of government. It involves deciding which level of government should do what, and giving them the right sources of income to carry out those tasks, based on who can do it better.

In India, the central (federal) government is given control over taxes that apply to the whole country, such as income tax and goods and services tax, as well as control over money supply and borrowing. State governments, which are closer to the people, are given the duty to provide services like health, education, and local welfare. These social and economic services usually require large amounts of spending, so state governments need more money. However, they often do not have enough income sources to meet this demand. This leads to a vertical imbalance, where there is a gap between what a government needs to spend and what it can earn. This is common in many federal systems, including India.

In addition, not all states have the same capacity to raise money. Differences in natural resources, historical development, and economic progress cause some states to be richer than others. This creates a horizontal imbalance between states. The makers of the Indian Constitution were aware of these imbalances. So, they provided for financial arrangements like the sharing of taxes and grants-in-aid to help fix the gaps. They also created an institution called the Finance Commission, which regularly reviews and recommends how money should be fairly distributed between the Centre and the States.

4.1.2 Principles of Federal Finance

Principles of federal finance mean the principle of allocation of resources between the central and state governments. The important principles are as follows.

i. **Fiscal Autonomy and Independence :** Fiscal autonomy and independence emphasise that each government should have a separate and independent source of revenues. Apart from this, they have full power to tax, to incur expenditure and to borrow. According to Prof. Adarkar, taxing autonomy and spending autonomy should go hand in hand.

ii. **Adequacy and Elasticity :** In a fiscal system, allocation of resources is based on the principle of distribution of functions. The sources of revenue of each government should be adequate to perform these functions efficiently. The financial structure as a whole should be elastic and flexible to changes in the conditions of the economy. It is recognised that in India, the resources made available to the states by the constitution have not been adequate to meet their functions.

iii. **Equity and Transference :** One of the fundamental principles of federal finance is equity of the burden of taxation. Under the federal system, the level of economic development of different states is not uniform. A federation may have disparity in the level of economic development, income distribution, wealth, etc. In order to reduce interstate regional disparity, the machinery of public finance should transfer resources from relatively more developed areas to less developed areas.

iv. **Economy in Cost :** The union of economy is an essential principle of good finance. The administrative cost of finance should be minimal. If the resources are allocated properly between the central and state governments, administrative efficiency can be achieved.

v. **Integration and Coordination :** The success of the federal finance depends upon the integration and coordination of the financial systems of the federal and state governments. Judicious use of resources is made possible by coordinated, integrated and harmonious inter-governmental fiscal policy.

vi. **Efficiency :** Each layer of government should be assigned such sources of revenue which can be administered efficiently. The allocation of revenue is closely related to the principle of the distribution function.

vii. **Fiscal Access :** This canon implies that the resources should grow with the increase in functions and responsibilities. The state should hence access to develop new sources of revenue to meet its financial needs.

viii. **Flexibility and Adaptability :** The allocation of resources should be subject to flexibility and adaptability. Due to the changing conditions, there cannot be a final solution to the allocation of financial resources in a federal system. Then, adjustment and reallocation can be made. Thus, every government should continuously adapt itself to the changing needs and circumstances of society.

ix. **Uniformity :** Uniformity implies that the system of taxation and pattern of expenditure should be uniform in all the states. This principle also emphasises that the federal government should perform its responsibilities towards the states in such a way that all the states in the federation should receive a uniform treatment.

4.1.2.1 Fiscal Policy and Federal Finance

Development is the prime duty of any modern state. Thus, public finance tends to be development-oriented. Developing countries aim at increasing the per capita income and its equitable distribution. Fiscal activities of the government should be designed to promote development objectives.

Rapid economic development is the fundamental objective of a developing economy like India. Budgetary policy in a developing economy has the following objectives.

1. To increase the rate of investment and capital formation in the economy.
2. To expand the public sector without hindering the growth of the private sector.
3. To mobilise ideal resources for productive uses.
4. To maintain price stability
5. To reduce inequalities
6. To eradicate poverty
7. To increase employment opportunities with social justice.

For all these purposes, resources need to be tapped, mobilised and utilised. There are various methods of mobilising resources in a developing economy -they are taxation, public borrowing, profit of the public sector, deficit financing and foreign capital. This can be explained as below.

1. **Taxation as a Means of Resource Mobilisation for Development**

   Taxation is always the main source of public revenue in any economy. It also plays a significant role in development finance. Taxes help to reduce excessive consumption and competition for resources, which in turn leads to forced savings. These savings can then be directed towards capital-intensive industries, helping to increase overall production. An increase in taxation often results in the transfer of resources from household consumption to public sector investment, thereby supporting economic development.

2. **Resource Mobilisation through Public Borrowing**

   In modern public finance, resources are also mobilised through public borrowings -both internal and external sources. The government offers savings certificates, securities, etc, in order to borrow from the citizens, institutions like banks, insurance companies, etc. It is referred to as internal public debt. Government may also raise loans from foreign international institutions like the World Bank, which is referred to as external borrowing. However, for a successful programme of public borrowing, the government security market should be strong. It requires well well-developed capital and money market.

3. **Profit of Public Undertaking**

   Among other sources of current revenue, the profit of the state enterprises should assume an important position in a public sector-based mixed economy. But it depends on the efficient working condition of public enterprises.

4. **Deficit Financing for Development**

   Deficit financing is a method of financing public expenditure. The theoretical justification for the deficit financing in the underdeveloped countries is that it is designed to promote increased mobilisation of savings and building up of real capital. It makes use of unutilised resources. But an unlimited deficit financing lends to produce more harm than good because of its inflationary impacts.

5. **Foreign Capital for Economic Development**

   To meet the development requirements of poor countries, have to depend on foreign capital to some extent. Foreign capital can be obtained through foreign aid, private foreign investment, public foreign investment, etc. Foreign aid depends on the general capacity of the developed nation in giving grants to less developed economies. Its availability depends on international political relations. But excessively depending on foreign aid is dangerous to the country's sovereignty.

4.1.3 Fiscal Imbalances

Fiscal imbalance in India happens when the government spends more money than it earns. This situation is called a budget deficit. It means that the government's total expenditure is greater than its total revenue collected through taxes and other income sources. To manage this gap, the government often borrows money, which adds to its financial burden. Fiscal imbalance is generally explained using three important types of deficits, viz; revenue deficit, fiscal deficit, and primary deficit. Before understanding these types, it is important to know some basic economic terms related to government income and expenditure.

In economics, revenue refers to the money the government earns without increasing its liabilities. This includes money collected through taxes such as income tax, GST, customs duty, and other non-tax sources like profits from public sector companies, interest on loans given to states or PSUs, and fees from services such as postage, licensing, or fines. Revenue that does not increase financial obligations is called revenue receipts. However, the government also receives money through borrowing, which increases future repayment obligations. This borrowed money comes under non-revenue receipts.

When we talk about the total income of the government, we use the term 'receipts.' Receipts include both revenue and borrowing. Revenue receipts are divided into two categories, viz, tax revenue and non-tax revenue. Tax revenue comes from direct and indirect taxes, while non-tax revenue includes all other sources, like public sector profits and service fees. On the other side, revenue expenditure refers to the routine spending by the government on services and administration. This includes salaries, pensions, interest payments on loans, subsidies, defence, police, and social services like education and healthcare. These expenses are essential for the functioning of the government, but they do not result in the creation of assets like roads, bridges, or buildings. When the government's revenue expenditure is more than its revenue receipts, it leads to a revenue deficit.

Fiscal deficit occurs when the total expenditure of the government (including capital spending) is greater than the total receipts (excluding borrowings). Primary deficit is the fiscal deficit minus the interest payments on earlier loans. These three measures help in understanding the seriousness of the fiscal imbalance.

In India, fiscal imbalance is a continuing challenge due to increasing social sector spending, interest payments, and subsidies, while revenue growth often remains limited. Managing this imbalance requires careful budgeting, efficient tax collection, and responsible borrowing. A high fiscal imbalance, if not controlled, can lead to inflation, rising debt burden, and reduced public investment in future growth. Therefore, reducing fiscal imbalances is crucial for long-term economic stability and development.

The concept of fiscal imbalance is further discussed in the next unit, where we will also examine the concept of horizontal and vertical imbalances in detail.

Recap

- Fiscal federalism defines the division of functions and financial powers among government levels
- India's federal setup needs effective financial coordination for equitable growth
- Principles of federal finance include autonomy, adequacy, elasticity, equity, economy, coordination, efficiency, access, and flexibility
- Vertical imbalance is a mismatch between the Centre's revenue power and the States' expenditure duties
- Horizontal imbalance reflects economic disparities between states
- Fiscal policy plays a crucial role in mobilising resources for development
- Revenue mobilisation tools include taxation, borrowing, public sector profits, deficit financing, and foreign capital

Objective Questions

1. Who introduced the concept of fiscal federalism?
2. Vertical imbalance exists between which levels of government?
3. Horizontal imbalance exists among whom?
4. What is the prime source of public revenue?
5. What principle demands minimum administrative cost?
6. Which principle relates to fairness in taxation?
7. Which canon implies growing resources with responsibilities?
8. Income tax is collected by which government in India?
9. Which deficit excludes interest payments?
10. Which type of revenue includes tax and non-tax sources?

11. What is the main goal of fiscal policy in a developing country?

12. What kind of grants aim to bring uniformity?

Answers

1. Musgrave
2. Centre-States
3. States
4. Taxation
5. Economy
6. Equity
7. Fiscal Access
8. Central
9. Primary
10. Revenue
11. Development
12. Grants-in-aid

Assignments

1. Examine the concept of fiscal federalism and its origin.
2. Discuss the key principles of federal finance with examples.
3. Describe vertical and horizontal fiscal imbalances.
4. Explain the objectives of fiscal policy in India.
5. Analyse the role of taxation and public borrowing in resource mobilisation.
6. Discuss how fiscal imbalances affect development in India.

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2

UNIT

Intergovernmental Transfers and Equity

Learning Outcomes

After completing this unit, the learner will be able to:

- examine various mechanisms of intergovernmental transfers in federal systems
- distinguish between vertical and horizontal fiscal equity
- comprehend the Finance Commission's role in balancing fiscal capacities
- analyse the criteria used in fiscal transfers and their implications

Prerequisites

Consider this : If two states have the same population, should they receive the same funds from the Centre? What if one has better healthcare but worse roads, and the other is rich in minerals but poor in education? In a federal country like India, financial equality is not about equal sharing-it is about fair sharing. Some states naturally generate more revenue, while others have higher needs. Intergovernmental transfers are designed not only to fill financial gaps but also to create opportunities for balanced development. But how do we decide who gets what? Should effort be rewarded, or should need take priority? The concept of equity-both vertical (between Centre and States) and horizontal (among States), adds layers of complexity to fiscal federalism. The Finance Commission's decisions shape the very functioning of India's federal democracy. In this unit, learners will come across topics like intergovernmental transfer, horizontal and vertical equity, etc, in detail.

Keywords

Intergovernmental Transfers, Grants-in-aid, Vertical Equity, Horizontal Equity, Income Distance

Discussion

4.2.1 Inter-governmental Transfers

In a federal system like India, financial cooperation between different levels of government is essential for smooth functioning and balanced development. The central and state governments have different responsibilities and financial capacities, so it becomes necessary to make financial adjustments between them. These adjustments, known as intergovernmental transfers, help in ensuring that each level of government has adequate funds to carry out its functions. Such transfers are made through various methods, including sharing of taxes, provision of loans, supplementary levies, and grants-in-aid. Each of these methods plays a key role in maintaining financial harmony and supporting states with limited resources.

Financial adjustments between the central and state governments can be made in the following ways.

1. **Tax Sharing :** Tax sharing refers to the method of tax collection by one layer of government and the sharing of the proceeds by other layers of the government. Generally, the tax is collected by the central government, and the proceeds are shared with the state. According to this method, a predetermined proportion of the proceeds of certain central taxes is confined to a single pool and then distributed to different states on a predetermined basis. In India, the Finance Commission fixes the proportion according to the needs of the states.

2. **Loans :** Loans play a special role in a federal set-up. Loans can be given by the central government to the state or by the state to the Centre. However, in almost all countries, the common practice has been loan given by the Centre to the state.

3. **Supplementary Levy :** Under this method, principal taxes are levied by the central government, and supplementary taxes are levied by the state government.

4. **Grants - in - aid :** Grants-in aid constitutes the most important device in the financial adjustment in a federal set-up. The central government gives grants to the state government because most of the states have insufficient resources compared to the services they have to perform. The grants are also used to bring some kind of uniformity and balance between the functions and resources within the state. Actually, grants-in-aid are provided to the

state to meet the gap between its functions and resources. The grants may be of different types, such as specific grants or conditional grants and general grants or unconditional grants. Conditional grants are provided to meet some specific purposes, and there is no condition in the case of general grants.

4.2.2 Vertical and Horizontal Equity in Fiscal Federalism

In the earlier unit, we discussed the meaning of federalism and the principles of federalism. In the federal form of government, there may be a clear-cut division of powers and functions between different layers of the government. India is a federation, and we have clear demarcation between the functions of states and the union government, and at the same time, they have their own sources of revenue to meet their responsibilities. But even though separate functions and revenue sources, relative to the central government, state governments are performing more functions than the Centre. But their sources of revenue are relatively small. Then some mismatch between income and expenditure is happening. Such an imbalance between functions and sources of revenue is termed a fiscal imbalance. Generally, we can divide the fiscal imbalance into two such as Vertical imbalance, and Horizontal imbalance.

Fiscal imbalances, both vertical and horizontal, are common to federations, and India is no exception. The Indian Constitution provides for instruments-shared taxes, and grant-in-aid to address such imbalances and institutional mechanisms. The Finance Commission with specified terms of reference is there to negotiate such imbalances. Here, we can have a discussion on how the 14 different finance commissions have dealt with their constitutionally assigned roles and strengthened the fabric of fiscal federalism in India. It further examines how the role of the Finance Commission was enlarged with additional terms in the interest of sound finance. It discusses, as an illustration, how the finance commission has addressed one of the major fiscal concerns, restoring budgetary balances and maintaining macroeconomic stability in the economy.

4.2.2.1 Vertical Distribution

The distribution of net proceeds, which constitutes the divisible pool of taxes between the Union and the state, is called vertical distribution. Until the 10th Finance Commission, a separate percentage had been recommended for the devolution of income tax and Union excise duties. However, after the 8th Amendment of the Constitution, net proceeds of tax collected by the Union are shareable with the states. State share in the divisible pool, as recommended by the last four Finance Commissions, is given in the following table.

	11th FC (2000-2005)	12th FC (2005-2010)	13th FC 2010-2015)	14th FC (2015-2020)
State share in the divisible pool	29.5 %	30.5 %	32.0 %	42.0 %

The 15th Finance Commission recommended an aggregate share of 41 % of the net proceeds of Union taxes (divisible pool) to be devolved to states in the year 2020-21.

Tax devolutions are a more objective form of transfer of resources as compared to other forms of transfer, which are more discretionary and empirically found to be less progressive. Stability and predictability of resources are essential components of good long-term budgeting for both the Union and the States. The flow of resources, for both core administrative functions and development initiatives, is determined by policy. Therefore, the considered view is that broad continuity in the availability of resources must be maintained. A higher proportion of tax devolution vis-à-vis grants enables higher revenue to the states, especially when there is higher buoyancy of Union taxes. In the event of any decline in revenue, the burden is shared by both. However, the Union is best studied to take measures to impart macro-economic stability and should be left with a sufficient fiscal cushion to take those steps.

4.2.2.2 Vertical Imbalance

Vertical imbalance means inequality in vertical sharing. India has a federal administration with a federal system of finance. In the financial field, the Indian constitution has very elaborate provisions which are not found in other federations. There is a constitutional division of resources between the Centre and states. In spite of this clear-cut division of taxing power, there exists an imbalance between financial resources and functions among different levels of government. In order to remove this imbalance constitution contains a number of provisions such as sharing of income tax and union excise duties, assigning a certain tax entire to states like succession duty, estate duty in respect of property other than agricultural land, tax on railway fares and freights, appreciation of taxes which are imposed by the Centre such as stamp duties, excise duty on medicinal and toilet preparations. Besides, the constitution also provides for grants in aid by the central government under articles 275 and 282.

Besides, Article 280 (a) of the constitution contains a provision for setting up a Finance Commission after every five years to make recommendations to the president regarding the distribution of shared taxes and duties between the Centre and States and principles governing grants-in-aid. While these arrangements provided a flexible mechanism for the operation of fiscal federalism. In India, they have provided to be inadequate and there has been a trend towards growing centralisation of resources and dependence of the states upon the Centre. The shortage of resources is inherent in the constitutional division of functions and resources. The central government enjoys a very comfortable position with many protective and elastic sources of revenue like union excise duties, income taxes, customs duties, corporation taxes, etc. In contrast, states are given an inadequate and less elastic source of revenue, like land revenue. On the other hand, states have to shoulder major developmental functions like agriculture, irrigation, power, health, social welfare, law and order, which are of an expanding nature. The needs of the state have also gone up, not only because of increasing plan expenditure, and non- non-plan expenditure on schemes completed earlier. Apart from these states' expenditure has gone up because of an increase in state functions in various directions and an increase in salaries and allowances. Thus, it is admitted that the division of responsibilities and resources is marked by chronic imbalances. The constitution itself is responsible for the existence of a financially strong Centre and weak States.

The assignment of inelastic taxes to the states and most productive revenue to the Centre has added in high degree of concentration of revenue collection. Taking tax and non-tax revenue together, the Centre collects 59 per cent of total revenue, while only 41 per cent is collected by states and local bodies. Nearly 86 per cent of the direct taxes and 54 per cent of taxes on commodities are collected by the Centre. At the same time, about 60 per cent of the expenditure responsibilities have been bestowed on the state governments. This has resulted in a marked degree of vertical imbalances.

The only elastic and productive source of revenue assigned to the states in India was the sales tax. However, its scope has gradually been reduced by the central government through several measures. These include the centralisation of sales tax on inter-state trade, the assumption of power to levy sales tax on declared goods, and the replacement of state sales tax on three major commodities viz; sugar, tobacco, and textiles with additional excise duties levied and collected by the Centre. Moreover, frequent raising of excise duties is likely to impinge sales tax collection, a point being persistently emphasised by the states and recommended by the Jha committee. Another elastic source of revenue for the states was the tax on railway passenger fares. This tax was levied by the government of India under Article 269 in 1957. The net proceeds of this tax were wholly assigned to the states. But this tax was abolished in 1961, and states were given grants in lieu of this tax. But the grant was increased in the different Finance Commission, but its due share was not allocated to the states.

Article 269 of the Constitution lists 7 items of taxation which are to be levied by the states, but the entire proceeds, except the proceeds attributable to union territories, have to be distributed to the states. However, of these, only inter-state sales taxes and estate duty have been levied. But the estate duty was abolished in 1985. The spirit of the Constitution requires that in the levy of these taxes, they are intended for the benefit of the state. The unwillingness of the Centre to levy these taxes shows gross disregard towards the interests of the state.

The corporation tax was excluded from the scope of sharing with the states from the very beginning. The states feel sore because their contribution to the development of the corporate sector is quite large. For example, they incur considerable expenditure in providing the direct infrastructural facilities like power, water, raw materials, roads, and land, etc. Besides, they provide considerable financial incentives for setting up industries. Moreover, the yield from corporation tax has been increasing at a faster rate than income tax and other central taxes.

With regard to income tax, there is a constitutional provision that allows the central government to levy surcharges on income tax. The Constitution authorises the Centre to impose such surcharges in order to raise additional resources during emergencies or times of war. However, the Centre has made it a permanent feature of the income tax structure, and the states have been deprived of their fair share even during normal, peacetime conditions. The Sarkaria Commission on Centre-State relations was of the view that surcharges on income tax should not be levied except for specified purposes and for strictly limited periods.

The manner in which resources are transferred from the Centre to the States has also contributed to vertical imbalances. The Finance Commission, which is a statutory body, determines the share of the divisible pool allocated to each state. However, the Finance Commission is responsible for recommending only about one-third of the total transfers to states. The remaining two-thirds consist of plan transfers and discretionary transfers made by central ministries, which are often influenced by political and administrative considerations. This imbalance in the structure of transfers has weakened the financial autonomy of the states.

Further, grants are given to states under Article 275 of the Constitution, which are known as statutory grants. However, these grants are not available to all states, even if they face difficulties in balancing their budgets after receiving their share of the divisible taxes. This indicates that grants-in-aid are a less assured source of revenue for the states and contribute to their growing financial dependence on the Centre.

The magnitude of resource inadequacy is further highlighted by the increasing indebtedness of the states to the Centre, and their frequent resort to overdrafts, including unauthorised overdrafts. The entire system of tax sharing and grants tends to prevent states from generating a revenue surplus that could be used for capital account purposes. This capital account gap has to be filled by the Centre. The gap becomes substantial due to the limited market borrowing powers of the states on one hand, and the additional burden of previous indebtedness to the Centre on the other. Central aid is also provided partly in the form of loans under Article 282. Nearly 60% of the total debt of the states consists of loans from the Centre. This reflects the extent of the states' indebtedness and has led to a debtor–creditor relationship between the Centre and the states.

The Centre also has the power to resort to deficit financing. The RBI cannot request for loan or advance from the Centre. The nationalisation of major commercial banks and the creation and control of a number of financial institutions, etc, have enabled the Centre to augment its resources tremendously. It also connects savings of the economy and deposits from its various forms. The states, on the other hand, are in a very weak position in this regard.

Now, we must also examine the other side of the picture. While it is true that the transfers made by the Centre are often inadequate, it is equally true that the states have become accustomed to relying on the Centre for resources and are not making sufficient efforts toward resource mobilisation. The states' complaints about inadequate financial resources and their demands for greater taxation powers would be more reasonable if they had fully exploited the revenue sources already under their control. For instance, many states are reluctant to tax agricultural income and have even abolished land taxes, despite widening deficits in their budgets. Taxing agricultural income is politically inconvenient for them. As a result, a significant part of their financial difficulties arises from a lack of political will and courage.

A similar problem exists with state public sector undertakings such as electricity boards, road transport corporations, and irrigation projects. These entities often fail to generate adequate returns on the capital invested in them. It is also a widely accepted fact that tax administration at the state level is plagued by inefficiency and corruption. Apart from widespread tax evasion, there are also large amounts of tax arrears. Additionally, state expenditure on financial celebrations, luxury buildings, hotels, political rallies, and even cinema house construction reflects a wasteful use of public funds that needs to be effectively curbed. This suggests that states have not proved themselves to be optimal spending units.

The populist politics pursued by states and their unrestrained free-rider behaviour are at the root of many fiscal imbalances. There is also a clear lack of accountability in how states utilise transferred resources. Therefore, the justification for granting states additional financial powers can arise only when they demonstrate a high degree of financial discipline and the political will to mobilise additional resources responsibly.

4.2.2.3 Horizontal Imbalance: Inequality in Horizontal Sharing of Resources

Horizontal imbalance refers to inequity in the distribution of funds among states. In order to achieve equity in federal financial transfers, it is necessary to reduce horizontal fiscal imbalance which is to reduce inter-state disparities. It may be noted that federal financial transfers are made through 3 channels. Finance Commission, Planning Commission and through various Central Ministries. We may analyse how federal financial transfers have helped to reduce interstate disparities.

Horizontal Distribution

The horizontal aspect of transfers relates to the sharing of the total shareable pool between the states. If all the states in India have the same or almost the same per capita income, and if all the state have similar fiscal capabilities, the problem of transfer between the states would be simple-namely, equal per capita transfer to every state. In practice, there are considerable horizontal imbalances-states differ in area, size of population, income, tax base, forest and mineral wealth, etc. There are differential capacities, and the need of the states as also difference in the cost of providing services. These horizontal imbalances have to be corrected while distributing resources among all the states in the economy.

4.2.2.4 Vertical Sharing and Horizontal Distribution of Fiscal Resources in India

In India's federal financial system, the central government collects more revenue than the state governments, but the state governments have more spending responsibilities. On average, the Centre collects about 63-64% of total revenue but spends only 43% of total public money. On the other hand, state governments collect only 36-37% of total revenue but have to cover about 57% of total expenditure. This leads to an imbalance known as vertical fiscal imbalance.

At the same time, not all states have the same capacity to collect taxes. Poorer states often have a smaller tax base, which results in differences in revenue between states. This is called horizontal fiscal imbalance. To correct these imbalances, the Constitution of India requires the central government to share a portion of central taxes with the states. Every five years, a Finance Commission is set up to decide how much money the Centre should share and what rules should be followed in sharing it.

Over the years, experts and Finance Commissions have studied how well these transfers are helping to balance the system. They have divided the transfers into two purposes as follows.

Vertical sharing - To correct the gap between Central and State government finances.

Horizontal distribution - To reduce inequality between rich and poor states.

A study by Rangarajan and Srivastava (2008) found that the 12th Finance Commission transfers managed to reduce about 88% of the inequality between states, and 50% of the funds were used to fix the vertical imbalance. Similarly, Srivastava (2010) found that the 13th Finance Commission transfers helped reduce about 90% of the inequality between states, with 54% of funds used to correct the vertical imbalance. However, many other types of central spending and schemes, which do not go directly through the state budgets, also affect state-level development. Therefore, when we study fiscal transfers, it is better to include all kinds of central spending that affect regional welfare; not just the funds directly transferred to state governments. Finally, researchers have also looked into better ways to measure and divide these transfers into vertical and horizontal parts, so that the process becomes more transparent and fair.

Criteria for Transfer of Resources

In India's federal system, the central government collects the majority of tax revenue, while the states are responsible for large parts of public expenditure. To reduce this imbalance and ensure fairness, a portion of the central taxes is shared with the states. The Finance Commission, a constitutional body, recommends how this tax revenue should be divided. The Commission uses specific criteria to determine each state's share and assigns weights to these criteria. These criteria aim to promote equity, efficiency, and sustainability in public finance. Below are the key criteria used by the 14th Finance Commission (2015-2020) and the 15th Finance Commission for the periods 2020-21 and 2021-26. While the criteria remain largely the same, some reference years used in calculations have changed, which may affect the share each state receives.

- **Income Distance :** It is a way to measure how much poorer a state is compared to the richest state in India. If a state has a lower income level, it receives a higher share of central funds to help it grow and catch up with richer states. This helps reduce inequality and supports balanced development across the country. The 14th Finance Commission gave this factor a weight of 50%, but the 15th Finance Commission reduced it slightly to 45%.

- **Area:** It is another important factor. Larger states have to spend more money to provide public services like health, education, and transport across wide regions. To support this, both the 14th and 15th Finance Commissions kept the weight of the area factor at 15%. This ensures that big states receive enough funds to manage their larger responsibilities.

- **Demographic Performance :** It relates to how well a state has managed its population growth. The 14th Finance Commission used population data from 1971 to encourage states to control their population. The 15th Finance Commission changed this by using 2011 data and also rewarded states that reduced fertility rates and improved health indicators. This approach supports sustainable development and good population policies.

- **Forest and Ecology :** This criterion gives importance to the environmental role of states. States with large forest areas help protect nature and keep the ecological balance. The Finance Commissions rewarded these states by giving them more funds. The basis for this was the share of dense forest area each state had compared to the total forest area in the country.

- **Tax and Fiscal Effort :** It means how well a state collects its own taxes. States that raise more revenue on their own, compared to their income (GSDP), are given more funds. This encourages states to be more responsible in managing their finances and reduces their dependence on central government transfers. The 15th Finance Commission looked at tax collection from 2016-17 to 2018-19 to assess this.

Recap

- Intergovernmental transfers adjust fiscal resources between the Centre and States to maintain equity
- Tax sharing allows the Centre to collect and distribute taxes to the States
- Loans are given mainly by the Centre to States in a federal setup
- Supplementary levies allow States to collect additional taxes on top of central ones
- Grants-in-aid are central to correcting fiscal imbalances, especially for financially weaker states
- Vertical equity ensures a balance between the Centre's resources and the States' responsibilities
- Horizontal equity reduces inequality in development across states
- The Finance Commission recommends distribution based on criteria like income, distance, population, area, tax effort, and ecology
- Transfers like grants and tax devolution aim to stabilise budgets and promote equal opportunity

Objective Questions

1. What is the main objective of intergovernmental transfers?
2. Who recommends the tax-sharing formula in India?
3. What is tax collected by the Centre and shared with states called?
4. Which type of grant is given without conditions?
5. Which grant is given for a specific purpose?
6. What type of imbalance exists between rich and poor states?
7. Which article provides for the Finance Commission?
8. Which grant is mentioned under Article 275?
9. Grants under Article 282 are mostly in the form of?
10. Which factor is used to measure income differences among states?
11. What encourages tax effort by states?
12. Which state received the highest share under the 15th FC?

Answers

1. Adjustment
2. Finance Commission
3. Tax Sharing
4. Unconditional
5. Conditional
6. Horizontal
7. 280
8. Statutory

9. Loans
10. Income Distance
11. Fiscal Incentive
12. Uttar Pradesh

Assignments

1. Discuss the major forms of intergovernmental transfers.
2. Explain the meaning of vertical and horizontal equity in fiscal federalism.
3. Describe the role of the Finance Commission in India.
4. Compare conditional and unconditional grants.
5. Analyse the significance of demographic performance in fund allocation.
6. Illustrate the recent Finance Commission's approach to fiscal equity.

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UNIT 3

Fiscal Federalism in India

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the meaning of fiscal federalism in the Indian context
- identify the role and functions of the Finance Commission
- recognise the features of cooperative and competitive federalism in India
- explain the challenges faced in implementing cooperative and competitive federalism

Prerequisites

India's federalism is unique-not just in its constitutional structure, but also in how it manages cooperation and competition. While the Constitution clearly outlines who can tax and spend on what, the actual fiscal power is tilted in favour of the Centre. This imbalance challenges the autonomy of states, especially when their responsibilities, like healthcare, education, and agriculture, are expanding. At the same time, the Finance Commission emerges as a guardian of fiscal fairness, recommending how central revenues should be shared. India's evolution from a centralised planning system to a more decentralised one, especially with the rise of GST and the NITI Aayog, has introduced new patterns of cooperation and rivalry among states. This unit comprises the idea of fiscal federalism in detail.

Keywords

Union and State Lists, Finance Commission, Cooperative Federalism, Competitive Federalism, NITI Aayog

Discussion

4.3.1 Fiscal Federalism in India

India has chosen a federal structure in which a clear distinction is made between the central and state functions and sources of revenue, but the residual power belongs to the Centre. The transfer of resources from the central government to the state is an essential feature of the present financial system. India has a federal constitution. It specifies the allocation of resources between the Centre and state government into three lists: Union list, State list and Concurrent list. The principle adopted for this classification is that taxes which have been inter-state base are levied by the union, while those with local bases are levied by the state.

The Union List contains 97 items in which Parliament has exclusive power to make laws. These are enumerated in List 1 in the 7th schedule of the Constitution. The State List II consists of 66 items on the Legislature if any state has exclusive power to make laws for any of the matters enumerated in the list. The Concurrent List III contains 46 items on which the Parliament and Legislature of any state have the power to make laws with respect to any of the matters enumerated in the list. Thus, there is a clear-cut division of taxing power between both layers of government. This satisfied the principle of independence and efficiency. The inter-governmental transfers are decided by the finance commission appointed once every 5 years.

4.3.1.1 Finance Commission

The Finance Commission is a salient feature of the Indian Constitution. It is a quasi-judicial body under the Article 280 of the Constitution of India. The President is required to appoint a Finance Commission every 5 years or earlier based on the recommendations of the central government.

Importance of the Finance Commission

As a federal nation, India suffers from both vertical and horizontal fiscal imbalances. Vertical imbalances between the central and state governments result from states incurring expenditure disproportionate to their sources of revenue, in the process of fulfilling their responsibilities. However, states are better able to meet the needs and concerns of their inhabitants and, therefore, more efficient at addressing them. Horizontal imbalances among state governments result from different historical backgrounds or resource endowments and can widen over time. The Finance Commission plays a crucial role in correcting these imbalances by recommending a fair distribution of financial resources between the Union and the States.

Functions of the Finance Commission

The functions of the Finance Commission are to make recommendations to the President in respect of the following matters.

a. The distribution of net proceeds of taxes to be shared between the Union and states, and the allocation of the share of such proceeds among the states.

b. The principles which should govern the grants-in-aid of revenue to the states.

c. Continuance of the modification of any agreement entered into between the state and Centre.

d. Any other matter concerning the financial relation between the Union and the States.

4.3.1.2 Cooperative and Competitive Federalism in India : An Overview

All of you know that federalism is an agreement between two layers of government regarding their functions and resources to meet those functions. It is an agreement relating to sharing powers and controlling their respective spheres. That is, our constitution itself assigned some autonomous spheres to national as well as federating units, and they are coming under a common sovereignty. As we said earlier, India adopted a quasi-federal structure after independence. But the term 'federal' is not mentioned in the Constitution, but the working structure of Indian democracy has the feature of federalism, which brought the concept of cooperative and competitive federalism. For achieving the all-round inclusive development in India, the present government is stressing the need to leverage the potential of cooperative and competitive federalism. Hence, we can have a discussion on cooperative and competitive federalism.

The concept of federalism can be divided into cooperative federalism and competitive federalism on the basis of the relationship between the central and state governments. In cooperative federalism, the centre and states share a horizontal relationship, where they cooperate on issues of public interest. In this federalism, states are actively participating in the formulation and implementation of national policies. Moreover, the Union and the States have a constitutional obligation to cooperate with each other on certain matters specified in the VII Schedule of the Constitution.

In the competitive federalism, the centre-state relations of the government are vertical, and between the states, the relation is horizontal. The competitive federalism became important in India since the adoption of economic reforms in 1990. With the acceptance of liberalised economic policy, a spirit of competition is enlarging with the endowments of the state's resource base and their comparative advantages and at the same time, with the increased globalised spirit, can cause expansion of inequalities and imbalances between the states. To increase benefits, under competitive federalism, states need to compete among themselves and also with the Centre. The competition between the states is such a manner to attract more investment and funds, which will facilitate efficient administration and speed up the momentum of growth. In such a situation, the investors prefer to invest in developed states, and states may get funds from the central government on the basis of the usage of money already allotted to them. The healthy competition between the states will encourage each of them to improve their social and economic infrastructure within the state. Actually, in the Indian constitution, competitive federalism is not a basic part, but it is the decision of the executives.

Competitive federalism is not yet implemented by all the states, but a good number of states are taking steps to strengthen their business atmosphere, including in the case of land reforms and labour flexibility. Federalism brought about a new definition to the partnership for team India. Through this federalism, the central government promised decentralisation of power and minimum interference in state affairs. Through the implementation of Goods and Services Taxes (GST), the structure of federalism was cemented further. Moreover, the introduction of NITI Aayog in the place of Planning Commission, mandated to develop competitive federalism. Under this new guideline, there is no need to look at the centre for policy guidelines and fiscal resources. States have their own freedom to make expenditures based on their priorities. To achieve national objectives, the state should stand alongside the Centre. At present, state-wise ease-of-doing-business rankings also create a strong sense of competition NITI Aayog is trying to promote cooperative and competitive federalism. The competitive cooperative federalism can redefine the relationship between the centre and states. The functioning of NITI Aayog enables states to compete to promote the spirit of cooperative, competitive federalism in governance.

But some difficulties are there to attaining competitive federalism. They are;

1. Deficit and shrinkage of the divisible pool will create difficulty in cooperation.

2. Even though the centre has increased the share of states from 32 per cent to 42 per cent, in reality, the states are getting a lesser share, and it is not enough to undertake welfare schemes, and badly affecting the state's health.

3. The socio-economic indicators of development of each state in India are different, and a few of them have made their own progress in terms of employment, literacy and creating a good environment for ease of doing business, and the majority of them are lagging.

4. The economic conditions of the states are different, and states with backwardness should not be treated on par with the well-off states.

5. Some well-off states are expressing their unwillingness to participate in competitive federalism due to the revenue loss in the implementation of the GST system.

In short, in India, we need a mix of cooperative and competitive federalism to move ahead. We need cooperative federalism to balance competitive federalism. The implementation of one nation-one tax (GST) would bring a change in the working of federalism in the country, and it can be described as pooled sovereignty.

Recap

- India's Constitution provides a three - tier division of tax and expenditure responsibilities
- Union List, State List, and Concurrent List form the backbone of fiscal assignments
- The Finance Commission is a constitutional body (Article 280) that ensures fair distribution of resources
- Vertical and horizontal imbalances are addressed through tax sharing and grants-in-aid
- Cooperative federalism stresses collaboration between the Centre and States on national issues
- Competitive federalism encourages states to compete for funds, investments, and performance rankings
- The NITI Aayog replaced the Planning Commission and promotes both cooperative and competitive federalism
- GST implementation has created a common tax framework, promoting fiscal unity
- Criticisms include states' dependency on the Centre, misuse of funds, and unequal development among states
- A balance between decentralisation and national unity is essential for India's fiscal health

Objective Questions

1. Which Article establishes the Finance Commission?
2. Who appoints the Finance Commission?
3. What is the key function of the Finance Commission?
4. Cooperative federalism promotes which type of relation?
5. Competitive federalism is encouraged by which body?
6. What tax system replaced many indirect taxes in India?

7. Which Commission recommended 42% tax devolution?

8. Who was the Chairman of the 15^{th} Finance Commission?

9. What does Article 275 deal with?

10. Which constitutional schedule details the division of powers?

11. What federal structure does India follow?

12. What is the significance of the GST Council?

13. Competitive federalism promotes what among states?

14. Which body replaced the Planning Commission?

Answers

1. 280
2. President
3. Distribution
4. Horizontal
5. NITI Aayog
6. GST
7. 14^{th}
8. N.K. Singh
9. Grants
10. Seventh
11. Quasi-federal
12. Fiscal Coordination
13. Investment
14. NITI Aayog

Assignments

1. Explain the structure of fiscal federalism in India.
2. Discuss the role and functions of the Finance Commission.
3. Compare cooperative and competitive federalism in India.
4. Analyse the impact of GST on Indian federal relations.
5. Describe the role of NITI Aayog in promoting federalism.
6. Assess the significance of vertical and horizontal transfers in the Indian context.

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5

BLOCK

Fiscal Decentralisation

1

UNIT

Finance Commissions

Learning Outcomes

After completing this unit, the learner will be able to:

- describe the role and functions of Finance Commissions
- define and explain fiscal decentralisation
- know the purpose and duties of State Finance Commissions (SFCs)
- identify financial sources for Panchayati Raj Institutions (PRIs)

Prerequisites

Do you think about how money is shared between the central government and the states in a large country like India? Or who decides how much your village council or town municipality receives to build roads, run schools, or provide safe drinking water? These choices are never made by chance. They are guided by important bodies such as the Finance Commission of India and the State Finance Commissions, which help decide how funds and responsibilities are shared between different levels of government.

In a federal country like India, the central and state governments each have their own duties such as defence for the Centre, and education or healthcare for the states. But where does the money come from to carry out these tasks? And how do we make sure that poorer regions or rural areas are not left behind? The answer lies in fiscal decentralisation; a process that gives more financial power and responsibility to lower levels of government.

In this unit, you will examine how the Finance Commissions work, why they matter for everyday governance, and how the State Finance Commissions make sure that local bodies like Panchayati Raj Institutions receive their fair share to meet the needs of people at the grassroots.

Keywords

Finance Commission, Fiscal Federalism, Grants-in-Aid, Panchayati Raj Institutions, Local Self-Government, Grama Sabha, Three Tier System

Discussion

5.1.1 Finance Commission

The Finance Commission of India came into existence in 1951. It was established under Article 280 of the Indian Constitution by the President of India. It was formed to define the financial relations between the Centre and the State. The Finance Commission Act of 1951 states the terms of qualification, appointment and disqualification, the term, eligibility and powers of the Finance Commission. As per the Constitution, the commission is appointed every five years and consists of a chairman and four other members. Since the institution of the first finance commission, stark changes have occurred in the Indian economy, causing changes in the macroeconomic scenario. This has led to major changes in the Finance Commission's recommendations over the years. To date, sixteen Finance Commissions have submitted their reports.

The Finance Commission is a constitutional body in India, established under Article 280 of the Constitution. Its main role is to recommend how the revenues of the central government should be distributed between the Centre and the States, and among the States themselves.

5.1.1.1 Members

The members of Finance Commission of India should consist of a chairman and 4 other members. Also, the chairman should have adequate experience in public affairs. Furthermore, the four members should be selected based on the following criteria:

- The person should have specialised knowledge of the accounts and finances of the government.
- A judge of the High Court or someone qualified to be appointed as a judge of the High Court.
- A person who has a wide knowledge of the field of economics.
- The person should have wide experience in the field of administration and financial matters.

5.1.1.2 Functions

The functions of the Finance Commission can be explicitly stated as follows :

1. Distribution of net proceeds of taxes between the Centre and the States, to be divided as per their respective contributions to the taxes.

2. Determine factors governing Grants-in-Aid to the States and the magnitude of the same.

3. Work with the State Finance Commissions and suggest measures to augment the Consolidated Fund of the States to provide additional resources to Panchayats and Municipalities in the State.

Apart from the main functions mentioned above, the other functions of FCI include:

Advising the president based on his request on any matters that are related to sound financial practice. Also, this is done to strengthen the financial status of the state and central governments.

The study related to the financial situation and financial status of the State and Central governments based on the request by the President of India.

Table 5.1.1 List of Finance Commissions Appointed in India

Finance Commission	Year of Establishment	Chairman	Operational Duration
First	1951	K. C. Neogy	1952–57
Second	1956	K. Santhanam	1957–62
Third	1960	A. K. Chanda	1962–66
Fourth	1964	P. V. Rajamannar	1966–69
Fifth	1968	Mahavir Tyagi	1969–74
Sixth	1972	K. Brahmananda Reddy	1974–79
Seventh	1977	J. M. Shelat	1979–84
Eighth	1983	Y. B. Chavan	1984–89
Ninth	1987	N. K. P. Salve	1989–95
Tenth	1992	K. C. Pant	1995–00

Eleventh	1998	A. M. Khusro	2000–05
Twelfth	2002	C. Rangarajan	2005–10
Thirteenth	2007	Dr. Vijay L. Kelkar	2010–15
Fourteenth	2013	Dr. Y. V. Reddy	2015–20
Fifteenth	2017	N. K. Singh	2020-21; 2021–26
Sixteenth	2023	Arvind Panagariya	2026–31

5.1.1.3 Recommendations of Sixteenth Finance Commission

The 16th Finance Commission, commencing April 1, 2026, is chaired by Dr Arvind Panagariya and addresses vital responsibilities such as equitable resource distribution, grants-in-aid principles, and strengthening local governance. It also focuses on disaster management financing and urbanisation challenges.

The Commission is currently chaired by Dr Arvind Panagariya, and its members include Ajay Narayan Jha, Annie George Mathew, Manoj Panda, and Soumya Kanti Ghosh (part-time), with Ritvik Ranjan Pandey serving as Secretary.

5.1.1.4 Terms of Reference and Key Responsibilities

The terms of reference for the 16th Finance Commission encompass several key responsibilities that guide its operations. The Finance Commission advises on tax revenue sharing, grants-in-aid principles, resource support for local bodies and disaster management funding to strengthen state and local governance.

Tax distribution : The commission will recommend how to distribute the net proceeds of taxes between the Union and the States.

Grants-in-Aid : The commission will recommend principles for grants-in-aid of State revenues.

Consolidated Fund : The commission will recommend measures to increase the Consolidated Fund of a State.

Disaster management : The commission will review the current arrangements for financing disaster management initiatives.

5.1.2 Fiscal Decentralisation

Fiscal decentralisation in India refers to the transfer of financial power and responsibility from the central government to state and local governments. This process involves shifting decision-making on expenditure, revenue collection, and resource allocation to lower levels of government. In India, this concept gained significance after the 73rd and 74th Constitutional Amendments, which aimed to devolve functions, personnel, and funds to local self-government institutions.

5.1.2.1 Key Aspects of Fiscal Decentralisation in India

Fiscal decentralisation is the process of giving state and local governments more authority and responsibility to manage their own finances. This means they have the power to make decisions about their budgets, collect certain taxes, and spend money on public services such as health, education, and infrastructure. To support this, the Indian Constitution has provisions for transferring funds from the central government to the states through tax devolution and grants-in-aid. The Finance Commission plays a key role in deciding how central tax revenues are shared among the states and in providing grants to those that need extra help. At the state level, State Finance Commissions are set up to improve the financial position of local bodies like panchayats and municipalities. They recommend ways to strengthen local government finances and ensure these bodies have enough resources to carry out their responsibilities effectively. This system aims to bring decision-making closer to the people and improve the delivery of public services.

5.1.3 State Finance Commission

A State Finance Commission (SFC) is a constitutional body in India, established by the governor of a state under Article 243-I of the Constitution. Its primary function is to review the financial position of local bodies like Panchayats and Municipalities within the state and make recommendations to the governor on improving their finances. These recommendations focus on the distribution of state tax revenue, allocation of grants-in-aid, and assigning specific taxes to local bodies.

5.1.3.1 Key Functions and Objectives

- **Reviewing Financial Position :** The SFC assesses the financial health of local bodies, identifying areas where they need financial support.
- **Making Recommendations :** The SFC proposes measures to enhance the financial resources of local bodies, including suggestions for revenue augmentation, resource allocation, and vertical/horizontal imbalances.
- **Distribution of Resources :** The SFC recommends how the net proceeds of state taxes, duties, tolls, and fees should be distributed between the state government and local bodies.
- **Assigning Taxes :** The SFC determines which taxes can be assigned to or appropriated by local bodies.
- **Grants-in-Aid :** The SFC recommends the amount and nature of grants-in-aid to be provided to local bodies from the state's consolidated fund.

Constitutional Provisions

According to Article 243-I of the Constitution, the governor of a state must set up a State Finance Commission within one year of the 73rd Constitutional Amendment Act of 1992 and then every five years after that. The governor is responsible for appointing the chairman and other members of the State Finance Commission. Once the State Finance Commission completes its work and prepares its recommendations, these are submitted to the governor. The governor then places the recommendations before the state legislature for discussion and consideration. This process ensures regular review and improvement of the financial position of local governments.

5.1.3.2 Importance of Appointing State Finance Commissions (SFCs)

Appointing State Finance Commissions is important for several reasons. First, it is a constitutional requirement under Article 243-I to set up State Finance Commissions every five years. This ensures that local bodies have the financial health and autonomy needed to function effectively. One of the main roles of State Finance Commissions is to oversee fiscal devolution, which means fairly distributing state revenues among different local levels of government. This balances the financial strength of local bodies and complements the work of the Union Finance Commission, which allocates central funds to states and local bodies.

State Finance Commissions also play a key role in enhancing accountability. They assess the financial needs of local governments, suggest ways to use resources effectively, and recommend fiscal measures to improve service delivery. By introducing performance-based evaluations, State Finance Commissions can encourage better governance through systems of rewards and penalties. This makes local governments more responsive to citizens' needs.

Importantly, State Finance Commissions help address local needs directly. Local bodies are responsible for services like sanitation, health, education, and infrastructure, which affect people's daily lives. For these services to improve, proper funding and financial independence are essential, and State Finance Commissions recommendations help secure this. They also work to bridge the gap between responsibilities and resources by recommending financial transfers based on the functions assigned to local governments. This ensures that local bodies have enough funds to meet their obligations and reduces uncertainty in funding.

Finally, State Finance Commissions contribute to political and administrative decentralisation by empowering local elected representatives, such as municipal councillors and panchayat leaders, to make decisions that directly impact their communities. In this way, State Finance Commissions strengthen both local governance and democracy.

5.1.4 Panchayati Raj Institutions

The 73rd Constitutional Amendment established the Constitutional Provisions of the Panchayati Raj System in India. PRI was constitutionalised through the 73rd Constitutional Amendment Act, 1992, to build democracy at the grassroots level and was entrusted with the task of rural development in the country.

It created two new schedules in the Constitution- the 11th and 12th schedules, which list down the powers of Panchayats and Municipalities.

5.1.4.1 73rd Amendment Act (1992) - Constitutional Provisions

The 73rd Amendment Act of 1992 gave constitutional status to local governments in India. It came into force on 24th April 1993. Through this amendment, the 11th Schedule was added to the Constitution, listing 29 subjects that fall under the responsibilities of Panchayats. The amendment also introduced Part IX, titled 'The Panchayats', which includes provisions from Articles 243 to 243O. With this change, state governments were placed under a constitutional obligation to establish the Panchayati Raj system in line with the provisions of the Act, ensuring a uniform and legally recognised framework for rural local governance across the country.

5.1.4.2 Salient Features of the Act

- **Gram Sabha :** Gram Sabha is the primary body of the Panchayati Raj system. It is a village assembly consisting of all the registered voters within the area of the panchayat. It will exercise powers and perform such functions as determined by the state legislature. Candidates can refer to the functions of the gram panchayat and gram panchayat work on the government official website – https://grammanchitra.gov.in/.
- **Three-tier system :** The Act provides for the establishment of the three-tier system of Panchayati Raj in the states (village, intermediate and district level). States with a population of less than 20 lakhs may not constitute the intermediate level.
- **Election of members and chairperson :** The members at all levels of the Panchayati Raj are elected directly, and the chairpersons at the intermediate and district levels are elected indirectly from the elected members and at the village level, the Chairperson is elected as determined by the state government.

Reservation of seats

For SC and ST: Reservation to be provided at all three tiers in accordance with their population percentage.

For women: Not less than one-third of the total number of seats to be reserved for women, further not less than one-third of the total number of offices for chairperson at all levels of the panchayat to be reserved for women

- Duration of Panchayat: The Act provides for a five-year term of office at all levels of the panchayat. However, the panchayat can be dissolved before the completion of its term.

State Election Commission

The State Election Commission is responsible for overseeing, directing, and controlling the preparation of electoral rolls and for conducting elections to the panchayats. It ensures that the election process is carried out fairly and smoothly. The state legislature also has the power to make laws on all matters related to panchayat elections, providing the necessary rules and procedures to guide the process.

5.1.4.3 74th Amendment Act, 1992 - Constitutional Provisions

The 74th Constitutional Amendment Act of 1992 established the system of Municipalities, or Urban Local Governments, in India. It came into effect on 1st June 1993 and is also known as the Nagarpalika Act. This amendment gave local self-government in urban areas a constitutional status. It introduced a new Part IX-A in the Constitution, titled 'The Municipalities', which includes provisions from Articles 243-P to 243-ZG. The amendment also added the Twelfth Schedule to the Constitution, listing 18 functions that municipalities are responsible for. This ensured a clear framework for urban governance and strengthened the role of local bodies in managing city affairs.

5.1.4.4 Features of 74th Amendment Act, 1992

The main provisions introduced by the above Act were as follows:-

Constitution of Municipalities : The Act provides for the constitution 3 types of municipalities, depending upon the size and area in every state.

1. Nagar Panchayat (for an area in transition from rural to urban);
2. Municipal Council for the smaller urban area; and
3. Municipal Corporation for a larger urban area.

The composition of municipalities is designed so that members are chosen through direct elections. For this, each municipal area is divided into territorial constituencies called wards. The state legislature has the authority to decide how the chairperson of a municipality will be elected, providing specific rules and procedures for the process.

Reservation of seats

The Act provides for the reservation of seats for the scheduled castes and the scheduled tribes in every municipality in the proportion of their population to the total population in the municipal area. Further, it provides for the reservation of not less than one-third of the total number of seats for women (including the number of seats reserved for women belonging to the SCs and the STs).

Duration of Municipalities

The municipality has a fixed term of 5 years from the date appointed for its first meeting. Elections to constitute a municipality are required to be completed before the expiration of the duration of the municipality.

Elections to Municipalities

The superintendence, direction and control of the preparation of the electoral rolls for, and the conduct of, all elections to the panchayats and municipalities shall be vested in the State Election Commission.

5.1.4.5 Significance of 73rd and 74th Amendments

The 73rd and 74th Constitutional Amendments hold great significance as they gave constitutional status and authority to local self-governments in both rural and urban areas. This means that Panchayats in villages and Municipalities in towns and cities are now recognised as an essential part of the democratic system. These amendments ensure that elections to local bodies are held regularly, preventing delays and keeping the decision-making process active at the grassroots level. They also guarantee that local bodies receive adequate funds to carry out their functions effectively, allowing them to deliver essential services such as water supply, sanitation, health care, and education.

By involving people directly in governance, these amendments have made politics more democratic. Ordinary citizens now have a greater say in how their communities are run, which strengthens trust in the system. The reservation of seats based on population proportions, along with a specific quota for women, has encouraged inclusive governance. This has given marginalised groups and women better opportunities to participate in decision-making, helping to uplift disadvantaged sections of society.

Another important outcome is that local bodies, empowered with authority, can address local problems more efficiently. Since they are closer to the people, they have a better understanding of local needs and can respond quickly. Overall, the 73rd and 74th Amendments have made governance more participatory, inclusive, and responsive to the needs of communities.

Recap

- Finance Commission recommends Centre-State tax sharing and grants
- 16th Finance Commission focuses on tax devolution, disaster funds, and post-COVID recovery
- 73rd and 74th Amendments boosted fiscal decentralisation to local bodies
- State Finance Commissions suggest revenue sharing with Panchayats and Municipalities
- Local governance was strengthened through elected bodies and assigned grassroots functions

Objective Questions

1. Under which Article of the Indian Constitution was the Finance Commission Established?
2. How often is the Finance Commission of India constituted?
3. Who is the chairman of the 16th Finance Commission?
4. Which constitutional amendments provided the foundation for fiscal decentralisation in India?
5. State Finance Commissions are constituted under which Article of the Constitution?
6. Which schedule was added to the constitution through the 73rd Amendment Act, 1992 ?
7. Which body conducts elections to Panchayats and Municipalities?

Answers

1. Article 280
2. Every 5 years
3. Dr. Arvind Panagariya
4. 73rd and 74th
5. Article 243-I
6. 11th Schedule
7. 30%
8. State Election Commission

Assignments

1. Explain the constitutional provisions related to the Finance Commission of India. How has its role evolved since its inception in 1951?

2. Discuss the key responsibilities and challenges faced by the 16th Finance Commission.

3. Evaluate the impact of fiscal decentralisation on the autonomy and functioning of local self-government bodies.

4. Discuss the constitutional mandate and role of State Finance Commissions in fiscal governance at the state level.

5. Explain the structure and key features of the 73rd Amendment Act. How has it empowered rural local bodies?

6. Compare the provisions of the 73rd and 74th Constitutional Amendments. How do they complement each other in strengthening grassroots democracy?

7. Critically assess how effective the Finance Commission has been in addressing regional disparities in India.

8. Suggest reforms to improve the performance of State Finance Commissions in ensuring the financial sustainability of local bodies.

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2

UNIT

Budget

Learning Outcomes

After completing this unit, the learner will be able to:

- learn the key components of the union budget
- gain an insight into the stages of budget preparation
- differentiate between tax and non-tax revenue
- distinguish between revenue and capital expenditure

Prerequisites

Have you ever thought about how the government decides how much money to spend on building roads, paying salaries, running schools, or giving pensions? Just like a family plans its income and spending, the government also prepares a financial plan every year-this is called the Budget.

The Budget is not just about numbers. It reflects the government's goals and priorities-how it plans to raise money through taxes and other sources, and how it will spend that money for the benefit of the people. Every rupee collected and spent must be carefully planned and justified, because it directly affects the economy and your daily life.

In this unit, learners will examine the process of budget making in India, which involves various steps from planning to approval in Parliament, concepts like Revenue Receipts (money the government earns), Revenue Expenditure (money spent on routine services), and Capital Expenditure (spending on long-term assets like roads and schools) etc.

Keywords

Union Budget, Revenue Receipts, Tax Revenue, Non-Tax Revenue, Revenue Expenditure, Capital Expenditure, Fiscal Deficit, Capital Receipts

Discussion

5.2.1 Budget

The term 'budget' is said to have its origin from the French word 'bougette', meaning a small bag. The word came to be used in the sense of a bag containing financial proposals.

Although the Constitution does not mention the term 'Budget', Article 112 says that the President shall, in respect of every financial year, cause to be laid before both the Houses of Parliament, the House of People (Lok Sabha) and the Council of States (Rajya Sabha), a statement of the estimated receipts and expenditure of the Government for that year. This statement is known as the 'Annual Financial Statement'.

The financial year for the Union and the State Governments in India is from 1st April to 31st March. Each financial year is, therefore, spread over two calendar years. The period of the financial year from 1st April to 31st March was introduced in India in 1867. Prior to that, the financial year in India used to commence on 1st May and end on 30th April (L.K. Jha Committee's Report of the Committee on Change in Financial Year).

Presently, the Union Budget of India is presented each year on the 1st February or any other suitable date by the Finance Minister to the Parliament.

Some of the important definitions of budget are as given below:

Bastable has defined budget in the following words: "A budget is at once a report on estimates and proposals, that it is the instrument by which all the processes of financial administration are correlated and coordinated."

Prof. Edward Dimock and Gladys Dimock defined budget as: "A budget is a balanced estimate of expenditures and receipts for a given period of time. In the hands of the administration, the budget is a record of past performance, a method of current control and a projection of future plans."

Budget is not only a financial statement of actual and anticipated revenues and expenditures of the government, but is also a document of detailed programmes and policies of action which it desires to pursue for raising the level of economic activity. The above definitions show that the budget has the following features.

a. It is a statement of expected revenue and proposed expenditure of a public authority.

b. It possesses periodicity, which is generally one financial year.

c. It has the sanction of public authority.

d. It sets the procedure for executing collection of revenue and administration of expenditure.

e. Anticipations of revenue and expenditure are made with a view to making a positive contribution towards achieving the important economic goals of the state.

5.2.2 Process of Budget Making in India

The budget goes through the following six stages in the Parliament:

- Presentation of the budget
- General Discussion
- Scrutiny by departmental committees
- Voting on demands for grants
- Passing on appropriation bill
- Passing of the finance bill

Presentation of The Budget

The Union Budget of India is presented to the Lok Sabha by the Finance Minister on the 1st of February each year. On the day of its presentation, no discussion takes place. After the Finance Minister delivers the budget speech, the budget is placed before the Rajya Sabha, which may discuss it but does not have the power to vote on the demands for grants. At present, the Union Budget is presented through a number of documents, some of which are required by the Constitution or by law, while others serve as explanatory references.

List of Budget documents presented to the Parliament.

1. Budget Speech
2. Annual Financial Statement
3. Demands for Grants
4. Finance Bill
5. Statements mandated under the FRBM Act:
    - Macro-Economic Framework Statement
    - Medium-Term Fiscal Policy Statement
    - Fiscal Policy Strategy Statement

6. Expenditure Budget
7. Receipt Budget
8. Budget at a Glance
9. Memorandum explaining the provisions in the Finance Bill.

The Economic Survey is presented one day or a few days before the presentation of the budget.

General Discussion

The general discussion on the budget begins a few days after its presentation and is held in both Houses of Parliament, usually lasting for three to four days. During this stage, members of the Lok Sabha can discuss the budget as a whole or raise questions on the principles involved. However, no cut motions can be moved, and no voting takes place at this stage.

Scrutiny by Departmental Committees

After the general discussion on the budget, both Houses of Parliament are adjourned for a period of three to four weeks. During this time, the 24 departmental standing committees of Parliament examine the demands for grants of the respective ministries and prepare detailed reports on them. The system of departmental standing committees, introduced in 1993, has strengthened parliamentary financial control by making the scrutiny of ministries more detailed and comprehensive.

Voting on Demands for Grants

Based on the reports of the departmental standing committees, the Lok Sabha begins the process of voting on the demands for grants. This is an exclusive privilege of the Lok Sabha, as the Rajya Sabha does not have the power to vote on these demands. The voting is limited to the votable portion of the budget, while expenditures charged on the Consolidated Fund of India are not put to a vote. Each demand is taken up and voted on separately, and during this stage, the budget is discussed in detail.

Various motions are used to scrutinise the demands for grants. Such motions are called 'cut motion'. They are of three types:

Policy Cut Motion: This motion is moved to oppose a specific policy of the government. It states that the amount be reduced to 1Rupee. When a policy-cut motion is adopted, it signifies that the House does not agree with the policy proposed by the government.

Economy Cut Motion: An economy cut motion is used to reduce the amount of demand presented by the government in the budget or the reduction of items in the demand. It implies that the amount proposed in the demand is considered excessive or unnecessary.

Token Cut Motion: A token cut motion is used to register a specific grievance. It does not seek to reduce the amount of demand but is aimed at drawing the attention of the government to a particular issue or concern. It states that the amount of the demand is reduced by 100 rupees.

A cut motion is an important tool that upholds the principle of responsible government by allowing Parliament to examine the activities of the government. If a cut motion is passed by the Lok Sabha, it indicates a loss of parliamentary confidence in the government and can even lead to its resignation. On the final day of the time allocated for discussing the demands for grants, the Speaker puts all the remaining demands to vote and disposes of them without any discussion. This process is known as the 'guillotine.'

Passage of Appropriation Bill

Article 114 of the Constitution states that no money can be withdrawn from the Consolidated Fund of India without an appropriation made by law. To meet this requirement, an appropriation bill is introduced to authorise the withdrawal of funds from the Consolidated Fund of India. This covers both the money needed to meet the grants voted by the Lok Sabha and the expenditure charged on the Consolidated Fund of India. No amendments can be made to this bill in either House of Parliament that would change the amount, alter the purpose of a voted grant, or vary any expenditure charged on the Consolidated Fund. Once the President gives assent, the bill becomes the Appropriation Act. The process usually continues until April, but since the government requires funds to carry out its normal activities after 31st March, the Constitution provides for a 'vote on account.' This is passed after the general discussion on the budget is over and generally grants funds for two months.

Passing of Finance Bill

The Finance Bill is introduced to implement the financial proposals of the Government of India for the upcoming year. It is treated like a Money Bill and is subject to the same conditions. However, unlike the Appropriation Bill, amendments aimed at reducing or rejecting taxes can be moved in the case of the Finance Bill. As per the Provisional Collection of Taxes Act of 1931, the Finance Bill must be passed within 75 days. Once enacted, the Finance Act gives legal effect to the income side of the budget, completing the process of budget enactment. The budget-making process in Parliament is a vital part of democratic governance, representing the collective will of the people through their elected representatives. It is a tool for directing resources towards national priorities, balancing different needs, and ensuring financial discipline. A well-prepared budget reflects the aspirations and requirements of the people, shaping the nation's economic growth and social progress.

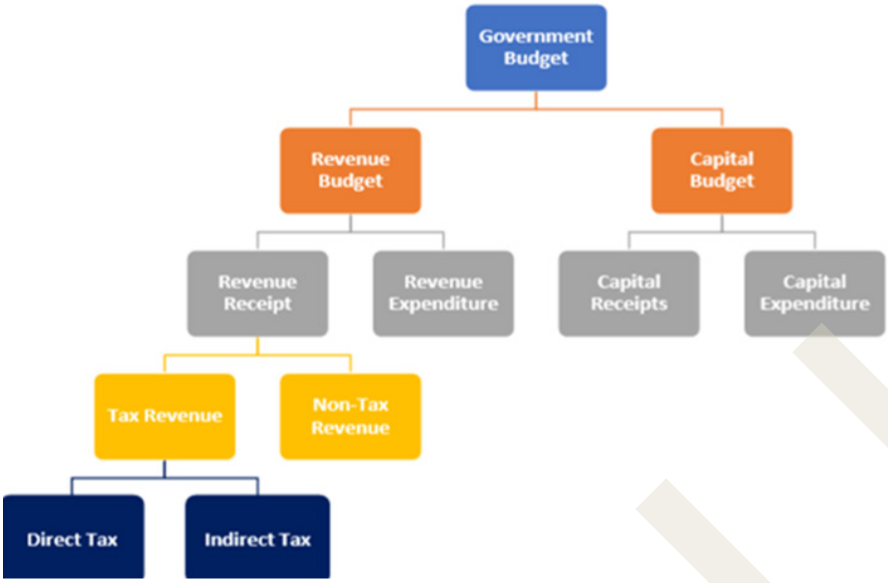

Fig 5.2.1 Components of Government Budget

Components of Budget

Two major components of the Budget are:

Revenue Budget: It deals with the revenue aspect of the government budget. It explains how revenue is generated or collected.

Capital Budget: Capital Budget consists of capital receipts and payments. It also incorporates transactions in the Public Accounts. The components of the Budget can also be categorised according to receipts and expenditure.

On this basis, two broad components are :

1. Budget Receipts
2. Budget Expenditure

Budget Receipts: Budget receipts refer to the estimated money received by the government from all sources during a given fiscal year.

Revenue Receipts : Revenue Receipts refer to those receipts which create any liability or cause any reduction in the assets of the government. They are regular and recurring in nature, and the government receives them in its normal course of activities.

A receipt is revenue receipt when it satisfies the following two essential conditions:

i. The receipt must not create a liability for the government, for example taxes levied by the government are revenue receipts as they do not create any liability. However, any amount borrowed by the government is not a revenue receipt as it causes an increase in the liability in terms of repayment of borrowings.

ii. The receipt must not cause a decrease in the asset, for example receipts from the sale of shares of a public enterprise are not a revenue receipt as they lead to a reduction in assets of the government.

5.2.3 Sources of Revenue

Revenue Receipts: Tax Revenue and Non-Tax Revenue

The receipts that do not create any liabilities and do not lead to a claim on the government are called revenue receipts. These revenue receipts are non-redeemable and can be classified into two categories, namely: tax revenue and non-tax revenue. Tax revenues are the vital components of revenue receipts that have been bifurcated for the long term into direct taxes, enterprises and indirect taxes such as customs duties, excise taxes and service tax.

Non-tax revenues, on the other hand, are the recurring income that is earned from sources other than taxes by the government.

Revenue Receipts

The money received by a business through normal business operations is known as revenue receipts. The revenue receipts are recurring and affect the profit and loss of the business on the income statement. They are the government receipts which neither create an asset nor reduce any liability and are considered as the current income receipts for the government from all sources.

A receipt is considered a revenue receipt if it fulfils the following two criteria:

● It should not create any liability for the government. For example, the taxes that are levied by the government are regarded as revenue receipts, but any amount that is borrowed by the government is not a revenue receipt.

● It should not result in any decrease in the assets.These revenue receipts are non-redeemable and can be classified into two categories, namely: tax revenue and non-tax revenue.

Tax Revenue- Direct Tax and Indirect Tax

Tax is a compulsory payment which is made to the government by the people or companies without having any direct benefit in return. The sum of all receipts from taxes and all other duties under the government is referred to as tax revenue. They are either from direct taxes or indirect taxes. It is the main source of regular receipts of the government and is categorised into Direct Taxes and Indirect Taxes.

Direct Taxes : The taxes that are imposed on the property and income of an individual and a company are known as direct taxes. Direct taxes are paid directly to the government by companies and individuals. The income level, as well as the purchasing power of the people, is affected by direct taxes. It also helps in changing the level of aggregate demand of the economy. Direct Tax Systems can be progressive, regressive or proportional.

Indirect Taxes : The taxes that affect the income and property of an individual and a company through their consumption expenditure are called indirect taxes. Indirect taxes are imposed on goods and services and are known to be compulsory payments.

Non-Tax Revenue

Non-Tax Revenue is the recurring income that is earned from sources other than taxes by the government. They are the revenue receipts which are not generated by taxing the public.

Some of the major sources of non-tax revenue are mentioned below:

1. I**nterests** which are received by the government through the loans provided by it to the state governments, UTs, private enterprises and the general public are an important source of non-tax revenue.

2. **Power Supply Fees**: This includes fees received by the central power authority of any nation. In the case of India, this includes fees received by the Central Electricity Authority.

3. **Fees:** They are the charges that cover the cost of recurring services that are provided and imposed by the government. It is a compulsory contribution like a tax.

4. **License Fee:** It is a form of tax charged by the government and its allied entities forconducting an activity that can be anything, such as opening a restaurant or operating a heavy vehicle.

5. **Fines and Penalties**: Fines are mostly used in the context of criminal law, wherein a court of law will punish a person convicted of a crime by imposing a fine. Penalty, meanwhile, is used in both civil as well as criminal law. It includes both monetary and physical forms of punishment.

6. **Escheats**: Escheats is the transfer of estate assets or property to the government in the event that an individual passes away without leaving a legally binding will or legal heirs.

7. **Several grants** are received by the government from the various International Organisations and foreign governments. Such grants are not a fixed source of revenue and are generally received during a national crisis, such as war, flood, etc.

8. **Forfeitures**: Forfeiture is the loss of any property without compensation as a result of defaulting on the obligations of a contract or a penalty for illegal conduct. Under the terms of a contract, forfeiture refers to the requirement by the defaulting party to give up ownership of an asset or cash flows from an asset, as compensation for the resulting losses to the other party.

9. **Interests**: It comprises of interests of loans and insurance given to the government for non-plan schemes and planned schemes, and also interest on loans that have been advanced to Public Sector Enterprises or other statutory bodies.

10. **Fees for Communication Services:** This mainly includes the license fees from telecom operators on account of spectrum usage charges that licensed Telecom Service Providers pay to the government ministry that handles telecommunications.

5.2.4 Components of the Capital Budget

Capital Receipts

Capital receipts refer to those receipts which either create a liability or cause a reduction in the assets of the government. They are non-recurring and non-routine in nature.

The receipts that create a liability for the government borrowings are capital receipts as they lead to an increase in the liability of the government . However tax received is not a capital receipt as it does not result in creation of any liability.

The receipts that cause a decrease in the assets receipts from, the scale of share of public enterprises is a capital receipt as it leads to a reduction in assets of the government.

Capital Receipts are broadly classified into three groups :

Borrowings: Borrowings are the funds raised by the government to meet excess expenditure. Borrowings are capital receipts as they create a liability for the government

Recovery of Loans: The Government grants various loans to the state government or union territories assets of the government

Other Receipts: These include the following :

Disinvestment: Refers to the act of selling a part or the whole of shares of selected public sector undertakings held by the government. They are termed as capital receipts as they reduce the assets of the government. A part of or whole of its shares leads to the transfer of ownership PSU to the private enterprises

Small Saving: Refers to funds raised from the public in the form of post office deposits, National Saving Certificates, Kisan Vikas Patras, etc. They are treated as capital receipts as they lead to an increase in liability.

Items Categorised as Revenue and Capital Receipts

Loan from the World Bank: It is a capital receipt as it creates a liability for the government.

Corporation Tax: It is a revenue receipt as it neither creates any liability nor reduces any asset.

Grants received from World Bank: It is a revenue receipt as it creates no liability nor reduces any asset of the government.

Profits of Public Sector Undertaking: It is a revenue receipt as it neither creates a liability nor reduces the asset of the government.

Sale of a Public Sector Undertaking: It is a capital receipt as it reduces the assets of the government.

Foreign Aid against earthquake victims: It is a revenue receipt as it neither creates any liability nor reduces any asset of the government.

Dividends on Investment made Government: It is a revenue receipt as it neither incurs any liability nor reduces any asset of the government.

Borrowings from Public: It is a capital receipt as it creates a liability.

Recovery of Loans: It is a capital receipt as it reduces the assets of the government.

Interest received: It is a revenue receipt as it neither creates any liability nor reduces any liability or asset of the government.

5.2.5 Budget Expenditure

Budget expenditure refers to the estimated expenditure of the government during a given fiscal year. The budget expenditure can be broadly classified as:

1. Revenue Expenditure
2. Capital Expenditure

Revenue Expenditure

- Revenue expenditure refers to the expenditure which neither creates any asset nor causes a reduction in any liability of the government
- It is recurring in nature.
- It is incurred on the normal functioning of the government.

The expenditure must not create an asset for the government. Payment of salaries or pension is revenue expenditure as it does not create any assets. The development of the Delhi metro is not a revenue expenditure as it leads to the creation of an asset.

Capital Expenditure

- Capital Expenditure refers to the expenditure which either creates an asset or causes a reduction in the liabilities of the government. It is non-recurring in nature.
- It adds to the capital stock of the economy and increases its productivity through expenditure on long-term projects like Metro or Flyover.
- The expenditure must create an asset for the government, for example: school building construction is capital expenditure as it leads to the creation of an asset. However, any amount paid as salaries to teachers is not a capital expenditure.

- Examples: loan to states and union territories expenditure on building, roads, flyovers, etc.

Plan and Non Plan Expenditure

- **Plan Expenditure:** Plan Expenditure refers to the expenditure that is incurred on the programs detailed in the current five year plan, for example: Expenditure on agriculture and allied activities, irrigation, energy, transport, etc.
    - Projects covered under the central plans
    - Central assistance for the state and Union Territory.
- **Non-Plan Expenditure:** Non-plan Expenditure refers to the expenditure other than the expenditure related to the current five-year plan and other schemes.

Development and Non Development Expenditure

Development Expenditure : It refers to the expenditure which is directly related to the economic and social development of the country. Expenditure on such services is not a part of the essential functioning of the government. Developmental expenditure adds to the flow of goods and services in the economy.

Non-Developmental Expenditure: It refers to the expenditure which is incurred on the essential general services of the government. It does not directly contribute to economic development, but it directly helps in the development of the economy, such expenditure is essential, from an administrative point of view.

Recap

- The word budget is derived from the French word 'bougette' (small bag), now refers to financial proposals
- Article 112 mandates the 'Annual Financial Statement' (Budget) for estimated receipts/expenditure
- Financial Year: April 1–March 31 (introduced in 1867; earlier May 1–April 30)
- Budget presented on February 1 by the Finance Minister; includes documents like Finance Bill, Demands for Grants, etc
- Budget process includes Presentation → General Discussion → Scrutiny by Committees → Voting on Demands → Appropriation Bill → Finance Bill
- Cut Motions: Policy Cut (reject policy), Economy Cut (reduce expenditure), Token Cut (highlight grievances)

- Revenue Budget: Tax/Non-Tax receipts; recurring (e.g., taxes, fines)
- Capital Budget: Asset-creating/reducing liability (e.g., loans, disinvestment)
- Revenue Expenditure: Recurring, no asset creation (e.g., salaries)
- Capital Expenditure: Asset creation (e.g., infrastructure)
- Plan/Non-Plan: Linked to Five-Year Plans vs. administrative costs
- Developmental/Non-Developmental: Direct economic impact vs. essential services

Objective Questions

1. What is the origin of the term 'budget'?
2. Which constitutional article mandates the Annual Financial Statement?
3. When is the Union Budget presented in India?
4. What is a 'Token Cut Motion' used for?
5. Which receipts are non-redeemable and classified as Tax/Non-Tax?
6. What type of expenditure is 'salaries' under?
7. What reduces government assets in Capital Receipts?

Answers

1. French word 'bougette' (small bag)
2. Article 112
3. February 1
4. Highlight grievances (reduces demand by ₹100)
5. Revenue Receipts
6. Revenue Expenditure
7. Disinvestment

Assignments

1. Explain the constitutional basis of the Union Budget under Article 112.
2. Differentiate between Revenue Receipts and Capital Receipts with examples.
3. Describe the stages of the Budget approval process in Parliament.
4. Compare Plan Expenditure and Non-Plan Expenditure.
5. How do 'Cut Motions' ensure parliamentary control over the Budget?
6. Why is disinvestment considered a Capital Receipt?

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3

UNIT

Deficits and Centre-State Fiscal Relations

Learning Outcomes

After completing this unit, the learner will be able to:

- know the budget-making process in India
- differentiate between revenue and capital components of the budget
- analyse the economic impact of government spending

Prerequisites

Think about a situation where your monthly expenses are more than your income. You might borrow money to manage the gap. Governments face the same issue - when their spending is more than their income, it creates a deficit. But unlike individuals, government deficits affect the entire economy. They can lead to more borrowing, higher interest payments, and future tax burdens.

Why do governments keep spending more? Is it always a bad thing? Can deficits be used for good, like building schools, roads, or creating jobs? These are key questions in public finance.

In a country like India, where both the Centre and States share financial powers and duties, one government's deficit can affect another. So, understanding how resources are divided and how deficits are managed becomes important.

This unit introduces learners to the main types of deficits – fiscal, revenue, and primary – and explains how they matter not just for budgets, but for people's lives. It also explores how Centre-State financial relations shape the way our country manages its money.

Keywords

Deficits, Fiscal Deficit, Revenue Deficit, Primary Deficit, Centre-State relations, Grants in-Aid, Finance Commission, GST

Discussion

5.3.1 Concepts of Deficit

A budgetary deficit is referred to as a situation in which spending is more than income. Although it is mostly used for governments, this can also be broadly applied to individuals and businesses.

In other words, a budgetary deficit is said to have taken place when the individual, government, or business budgets have more spending than the income that they can generate as revenue.

5.3.1.1 Types of Budget Deficits

There are three types of budget deficit. They are explained as follows:

1. Fiscal deficit
2. Revenue deficit
3. Primary deficit

5.3.2 Fiscal Deficit

Fiscal deficit is defined as the excess of total expenditures over total receipts, excluding borrowings in a year. In other words, this can be defined as the amount that the government needs to borrow in order to meet all expenses.

The more the fiscal deficit, the more will be the amount borrowed. Fiscal deficit helps in understanding the shortfall that the government faces while paying for the expenditures in the absence of sufficient funds.

The formula for calculating the fiscal deficit is as follows:

Fiscal deficit = Total expenditures – Total receipts excluding borrowings

Impact of Fiscal Deficit

The following impacts of the fiscal deficit should be kept in mind:

1. Unnecessary expenditure: A high fiscal deficit leads to unnecessary expenditure by the government, which leads to potential inflationary pressure on the economy.

2. Printing more currency by the RBI to meet the deficit, also known as deficit financing, leads to the availability of more money in the market, leading to inflation.

3. Borrowing more will hinder the future growth of the economy, as most of the revenue will be utilised towards meeting debt payments.

Remedial Measures for Fiscal Deficit

Fiscal deficit can be reduced in the following ways:

1. Reduced public expenditure
2. Reduction in bonuses, leave encashments, and subsidies
3. Increase tax to generate revenue
4. Disinvestment of public sector units

5.3.3 Revenue Deficit

Revenue expenditure is defined as the excess of total revenue expenditure over the total revenue receipts. In other words, the shortfall of revenue receipts as compared to that of the revenue expenditure is known as revenue deficit.

Revenue deficit signals to economists that the revenue earned by the government is insufficient to meet the requirements of the expenditures required for the essential government functions.

The formula for revenue deficit can be expressed as follows:

Revenue deficit = Total revenue expenditure – Total revenue receipts

Impact of Revenue Deficit

Revenue deficit has the following impacts on the economy.

Reduction in assets: To meet the shortfall in the form of revenue deficit, the government has to sell some assets.

It leads to conditions of inflation in the economy.

A large amount of borrowing leads to a greater debt burden on the economy.

Remedial Measures for Revenue Deficit

The following remedial measures can be taken by the government to reduce the revenue deficit.

5.3.4 Primary Deficit

1. By reducing unnecessary spending
2. By raising the rate of taxes and applying new taxes wherever possible

Primary deficit is said to be the fiscal deficit of the current year subtracted by the interest payments that are owed on previous borrowings. In other words, the primary deficit is the requirement of borrowing without the interest payment.

Primary deficit, therefore, shows the expenses that government borrowings are going to fulfil while not paying for the interest income payment.

A zero deficit shows that there is a requirement for availing credit or borrowing for clearing the interest payments pending.

The formula for the primary deficit is expressed as follows:

Primary deficit = Fiscal deficit – Interest payments

Measures to reduce the primary deficit can be similar to the steps taken to reduce the fiscal deficit, as the primary deficit is any borrowing that is above the existing deficit or borrowings.

This concludes the topic of budget deficit, which is one of the metrics of measuring the economic growth of a nation, along with GDP.

5.3.5 Centre-State Financial Relations

By centre-state financial relations, we mean the allocation of functions and revenues between the centre and states. Unlike other federal constitutions, the Constitution of India contains elaborate provisions in the financial field to govern centre-state financial relations. Generally, our Constitution follows the pattern of division of powers, functions and revenues (or resources) as adopted in the Government of India Act of 1935.

A discussion of the centre-state financial relations as given in the Constitution of India is furnished below:

Provisions under the Constitution: Under Article 246 of the Constitution, there is a threefold distribution of legislative powers between the centre and the states. This threefold division is represented by three lists, namely the Union List, States List and Concurrent List given in the seventh schedule of the Constitution.

The Union List or List I enumerates matters in which the parliament has exclusive power to make laws. Matters in which the state legislatures have exclusive power to make laws are included in List II or the States List. As regards matters included in List III, i.e., the Concurrent List, both the parliament and state legislatures have the power to make laws, subject to certain restrictions. In case a conflict arises between the law made by the parliament and the law made by any state assembly, the law enacted by the parliament will prevail. The residuary powers of legislation vest with the parliament.

This means that the parliament has exclusive power to make any law regarding any matter not enumerated in the concurrent or state lists. Such power includes the power to make laws for imposing a tax not covered under either of the above lists.

1. **Distribution of Functions:** Depending on the powers distributed as above, there are functions which are exclusively assigned to the Union government, others exclusively assigned to the state governments and some others assigned to the concurrent jurisdiction of the union and state governments. If any item is still left out, as a residuary item, it is assigned to the union government.

   The functions of the union government include nearly 97 subjects. They include defence, atomic energy, foreign affairs, defence industries, citizenship, railways, national highways, airways, shipping and navigation, post and telegraph, currency, coinage, banking, foreign exchange, foreign trade, interstate trade, important industries and institutions of national importance, etc. The state government functions comprise 66 items, including public sector, police, administration of justice, education, public health, agriculture, irrigation, forests, fisheries, other industries, etc. Functions under the concurrent list contain 46 items that include commercial and industrial monopolies, criminal law, bankruptcy, labour disputes, social security, charities, price control, adulteration of foodstuffs, social legislation like marriage and divorce, economic and social planning, etc. This distribution of powers and functions satisfies the principles of independence and efficiency.

2. **Distribution of Revenues or Resources:** The allocation of tax revenues between the centre and states is according to the pattern laid down in the Government of India Act of 1935. The principle adopted for this division is that taxes having an interstate basis are assigned to be levied by the Union, while those with a local base are left to be levied by the states, and the residuary powers are vested with the union government.

   The Constitution contains provisions for the sharing of revenues from certain union taxes among the states. Therefore, taxes within the union jurisdiction can be classified into four parts: (a) taxes which are levied, collected and wholly retained by the union, (b) taxes which are levied and collected by the union but the proceeds are shared with the states, (c) taxes which are levied and collected by the union, but the entire proceeds are given to the states, and (d) taxes which are levied by the union, but collected and appropriated by the states.

The division of tax powers and revenue resources between the centre and states is termed as the tax structure or tax system by the Taxation Enquiry Commission. The detailed tax structure is given below:

a. Central sources of revenue (Union List) Taxes within the jurisdiction of the Centre, as given in List 1, are the following:

i. Taxes on income other than agricultural income

ii. Customs duties, including export duties.

iii. Excise duties on tobacco and other goods manufactured in India except alcoholic liquor for human consumption, opium, Indian hemp and other narcotics.

iv. Corporation Tax

v. Taxes on the capital value of assets (exclusive of agricultural land) on individuals and companies, and taxes on the capital of companies.

vi. Estate duty on property other than agricultural land.

vii. Terminal taxes on goods or passengers carried by railways, sea and air, and taxes on railway fares and freight.

viii. Succession duties on property other than agricultural land.

ix. Taxes on transactions in stock exchanges and futures markets (exclusive of stamp duties).

x. Rates of stamp duty in respect of certain financial documents.

xi. Taxes on the sale or purchase of newspapers and on advertisements published therein.

xii. Taxes on the sale or purchase of goods other than newspapers where they occur as a course of interstate trade.

xiii. Taxes not specifically enumerated in the states and concurrent lists.

Besides the above, there are certain other sources of revenue of the union government, namely (i) railways, (ii) airways, (iii) posts and telegraphs, telephones, wireless broadcasting and other means of communication. (iv) property of the union and revenue therefrom, (v) fees in respect of any matter in the union list (vi) public debt of the union, (vii) currency, coinage and legal tender, and foreign exchange, (vüi) foreign loans, (ix) Reserve Bank of India, (x) post office savings bank, (xi) lotteries organised by the Government of India or by the government of a state.

b. States' Sources of Revenue (State List): Taxes within the jurisdiction of the states are enumerated in List II, seventh schedule, as under:

i. Land Revenue.

ii. Taxes on agricultural income.

iii. Duties in respect of succession to agricultural land.

iv. Estate duty in respect of agricultural land.

v. Taxes on land and buildings.

vi. Taxes on mineral rights are subject to limitations imposed by the Parliament.

vii. Excise duty on alcoholic liquor and narcotics manufactured in the state and countervailing duties on the same goods manufactured in other states.

viii. Taxes on the entry of goods into local areas.

ix. Taxes on the consumption and sale of electricity.

x. Taxes on the sale or purchase of goods other than newspapers.

xi. Taxes on goods and passengers carried by road or inland waterways.

xii. Taxes on vehicles for use on roads.

xiii. Taxes on animals and boats.

xiv. Tolls.

xv. Taxes on professions, trades, callings and employment.

xvi. Capitation taxes.

xvii. Taxes on luxuries including entertainment, amusements, betting and gambling

xviii. Rates of stamp duty in respect of documents not included in List 1.

xix. Fee in respect of matters in the State List.

c. Taxes Levied and Collected by the Union but assigned to the States: These are taxes, the net proceeds of which have to be distributed among the states as per Article 269. They are the following:

i. Duties in respect of succession to property other than agricultural land.

ii. Estate duty in respect of property other than agricultural land.

iii. Terminal taxes on goods or passengers carried by railway, sea or air.

iv. Taxes on railway fares and freight.

v. Taxes other than stamp duties on transactions in stock exchanges and futures markets.

vi. Taxes on the sale or purchase of newspapers and on advertisements published therein.

d. Duties Levied by the Union, but Collected and Appropriated by the States: These are duties in the Union list, which though levied by the centre, are collected and appropriated by the states if they are levied in the states. This provision is given in Article 268. Examples are stamp duties and duties of excise on medicinal and toilet preparations.

e. Taxes and duties levied and collected by the Union but distributed between the Union and the States:

i. Taxes on income other than agricultural income.

ii. Union duties of excise on tobacco and other goods manufactured in India, except liquor and narcotics.

f. Loans: Normally, even though both the central and state governments can borrow from outside the country, it can be done on better terms and in larger quantities only by the central government, because of its better creditworthiness, control over banks and better economic circumstances. If the state governments have no outstanding loans from the centre, they can borrow independently, but it is a rare case, so they have to borrow with the consent of the centre. External borrowing is mainly the privilege of the central government.

g. Grants-in-aid: Provisions have been made under the constitution for giving central grants-in-aid to the states in order to cover the gap between their revenues and expenditures, to remove interstate disparities in resources, to bring about a balanced development of the country, to provide assistance under Article 275(1) and to provide resources in lieu of export duty on jute and jute products under Article 273. Grants may be general or specific grants, and plan and non-plan grants. Plan grants are determined by the Planning Commission, whereas non-plan grants are determined by the. Finance Commission. Sometimes, grants are given on an ad hoc basis for unforeseen situations.

h. Distribution of IncomeTax and Jute Export Duty: In the Government of India Act of 1935, fixed percentages were determined for the distribution of income tax proceeds between the centre and states. Presently, the percentage of the net proceeds of income tax is to be distributed among the states as recommended by the Finance Commission. Thus, the states now do not have any constitutional right to any fixed percentage of income tax, but the percentage varies according to the Finance Commission recommendations.

In the case of export duty of jute, the GOI Act 1935 had provided for no less than one-half of the net proceeds of the export duty on jute in each year to be distributed to the provinces where jute was grown. Now, under the constitution, export duty on jute and jute export products is not divided between the Union and jute-growing states. Instead, in lieu of jute export duty, grants-in-aid out of the Consolidated Fund of India are to be paid to each of the jute-growing provinces as prescribed by the President on the recommendations of the Finance Commission.

i. Local Finance: The constitution does not reserve any taxes for the local bodies. But the states may assign any tax on the State List to local bodies wholly or partly. The main taxes now usually assigned are property taxes, octroi, terminal taxes, taxes on professions and taxes on vehicles and animals. In a few states, a fixed share of land revenue is also assigned. Recently, in a few states, the proceeds of entertainment duties are also assigned to local bodies.

j. Finance Commission: Constitution of a Finance Commission under Article 280 was a departure in the financial provision of our constitution from the scheme laid down in the GOI Act of 1935. The provision for the Finance Commission is made with respect to the obligatory sharing of income tax, the optional sharing of excise duties and for making provision of grants-in-aid.

5.3.5.1 Shortcomings of Centre-State Financial Relations

Federal principles require that the centre as well as the states are independent of each other in each of their spheres of functions, and both have independent control of financial resources sufficient to perform their respective functions. However, in practice, the resources and functions are not always harmoniously adjusted in the case of the states. Thus, there have been several anomalies or shortcomings in our federal finance. The most important of them are explained below.

1. Financial Stringency of States

The taxes assigned to the states are generally less elastic and less productive as compared to the central taxes. Moreover, the commitments of state governments on both revenue and capital accounts are also increasing at a faster rate than their revenues and transferred resources. Agricultural loans given from state budgets are in large arrears of recovery. The states do not get reasonable returns on their investments in projects like irrigation and power. They have also been unable to tax agricultural incomes and other tax potentials of the rural sector. All these factors together have made the states financially stringent.

2. Increasing Debt Burden of States

The financial stringency of the states has compelled them to increase dependence on the centre. The central assistance to states comes in the form of loans and grants in the proportion of 70:30, except in the case of a few states, especially the north-eastern states.

A considerable portion of the loans taken by the states is spent on social purposes like education and health, which do not yield any income. A significant portion of loans is also spent on works like roads, minor irrigation, etc., in which the burden of repayment and interest falls on the states. With the increase in loans from the centre, the debt service burden of states has also increased. A considerable part of this burden is met from new loans and transfers they get from the centre. Thus, the debt services go on increasing.

3. Eroded State Autonomy

The notion which guided the framers of the Indian Constitution was 'strong centre and weak states. The single-party rule in India for a long time hardened this notion. The fact that the concurrent list includes as many as 47 functions is a sign of the large extent to which the centre interferes in the functioning of state governments. The residuary powers are also vested in the centre. In this way, the continued financial dependence has increasingly eroded the autonomy of states.

4. Improper Division of Responsibility

The responsibilities of the Planning Commission and Finance Commission are not clearly demarcated on the basis of proper guidelines. This has resulted in an overlap of the functions of these two commissions in regard to grants. While the Planning Commission provided plan assistance and the central government provided relief grants, the Finance Commission's responsibility was to provide revenue gap assistance. But in practice, the Planning Commission encroached on the area of others regarding grants. The sixth Finance Commission even took the stand that the states should not be given plan grants against those expenditures which the commission has considered. Moreover, by promising a larger tax effort and by showing the states' large revenue gap, states could obtain larger financial assistance from both the Planning and Finance Commissions. About two-thirds of central transfers are from the Planning Commission and central ministries. This has reduced the significance of the Finance Commission.

5. Lack of Criteria for the Distribution of Resources

There were no objective criteria for the central transfer of resources. So, the decisions of the central authority were highly arbitrary. For example, the Finance Commission had to distribute the income tax proceeds among the states according to their fiscal needs. But there were no scientific criteria to determine such fiscal need. If the sharing out of income tax proceeds is on the basis of the derivation of income in each state, the states could have received their legitimate share. Similarly, Finance Commissions before the sixth commission did not give any weightage to the economic backwardness of the state. The guarantee of transferable duties to each state was determined on the basis of the principle of derivation, ie, on the basis of the estimation of amounts that could have been collected by the states, if the collection had been under their jurisdiction. Regarding the Planning Commission, it also used to send schemes with pre-determined grants and loans, rather than determining plan assistance for certain schemes according to plan priorities.

6. Improper Estimation of Resource Gap

In regard to the grants-in-aid recommended by the Finance Commission to help states meet their budgetary deficits, the major difficulty relates to a proper scrutiny of the budgetary forecasts of states. This requires a proper study of the taxable capacity of the state concerned, its legitimate tax effort and success in achieving an adequate economy in expenditure. But most often, instead of such a proper study, reliance is placed on the estimates of forecasts submitted by the states. On the part of the states, they tend to show larger deficits through overestimated expenditures and underestimated tax revenues.

7. Failure to Reduce Regional Imbalance

Centre-state financial relations have, by and large, failed to correct the imbalances among states. The disparity in per capita incomes between states has therefore increased. In determining grants to states, the simple principle that the assistance to advanced states must be mainly in the form of loans and that to the weaker states must be mainly in the form of grants is not followed. As a result, in many cases, the richer states received a larger amount of per capita grant than the poorer states.

8. Lack of Consistency in Devolution

There have been many inconsistencies in the process of resource transfer from the centre to the states. For instance, in the case of income tax, distribution on a basis of population varied from 80 per cent to 25 per cent. In the case of excise duties, distribution on the population criterion varied between 100 per cent to 25 per cent in the course of nine Finance Commissions. The element of backwardness received different weightages in the hands of different commissions. The eighth and ninth finance commissions have also introduced a new principle of directly linking excise duty devolution to deficits to the extent of 5 per cent instead of dealing with them only through grants-in-aid.

5.3.5.2 Suggestions For Improvement in Centre-State Financial Relations

Several committees, such as the Raja Mannar Committee, the Sarkaria Commission and the Finance Commission have suggested reforming centre-state financial relations. The important directions for improvement are the following:

1. Greater State Autonomy

Various states of India have for long demanded persistently for greater state autonomy. The states have raised a strong voice against the long concurrent list of 47 items, which enables the central government to wield practically unlimited powers to interfere in the activitiesof the states. The states should be allowed to function without interference from the centre, at least in the area originally specified by the Constitution. Corresponding with increasing state activities, the financial powers of the states also need to be enlarged, and greater financial autonomy should be granted to them.

2. Removal of the Overlapping of Functions of the Planning Commission and Finance Commission

The Finance Commission cannot fulfil its legitimate role because of a lack of a clear definition of its role as against that of the Planning Commission, and also because of its ad hoc nature. These two commissions need to have a clear-cut jurisdiction of powers. This will make both bodies more attentive to their individual tasks. For instance, the sixth Finance Commission has remarked that the government and the Planning Commission, before making any plan grant, should verify that the Finance Commission has not sanctioned any grant for the same purpose.

3. Reduction of Financial Dependence

The dependence of states on the centre and their indebtedness have increased over the years. On the other hand, the states are also unable to implement their planned programmes for want of funds. While the activities of states are increasing rapidly, their revenues have failed to increase correspondingly. Hence, more taxes should be brought to the divisible pool and a larger share allowed to the states.

4. More Effective Use of Loans and Unconditional grants

At present, planning assistance is mainly in the form of loans. But lending is not used efficiently and economically. In this regard, Lakdawala has suggested that loans should be better administered through the organisation of a Development Bank in order to ensure the productivity and efficiency of capital outlays of states. Similarly, the amount of unconditional grants should be determined on the basis of past performance and present programmes. These grants should be more directed towards backward states to help them strengthen overhead facilities and social services. The responsibility of recommending unconditional grants should be entrusted to a quasi-judicial body.

5. Proper use of Conditional Grants

In several cases, conditional grants obtained for specific purposes, such as plan schemes or relief works, are seen to be diverted to other uses. This is improper and goes against the proposals submitted by the states themselves for getting them. This type of diversion results in allocational distortion

6. Enlargement of Divisible Pool

It has been proposed to enlarge the divisible pool by including in it corporation tax, customs duties and all excise duties. These taxes are elastic sources of revenue and can enlarge the revenue base of states considerably. When the divisible pool is enlarged, the states will get larger resources through tax sharing. Some states have proposed forming a fiscal commission to review the existing system of centre-state financial relations.

7. Removal of Interstate Disparity: To remove interstate disparity, there is a need to evolve a new set of criteria in favour of backward states. This can be done by choosing criteria like per capita income, literacy level, standard of health measures, level of social overhead facilities, poverty of the people, etc., to determine the amount of resource transfer to states. The loan-grant ratio for central assistance is at present 70:30, and it is fixed for all states except for the north-eastern states, irrespective of their level of development. The Sarkaria Commission suggested the replacement of this ratio by a suitable three or fourfold pattern, which also will discriminate between advanced and backward states.

8. Reconstitution of the National Development Council: Presently, the National Development Council, where the Chief Ministers are consulted by the centre is only a conventional practice and an informal get-together. The Sarkaria Commission has recommended formalising the council by a presidential order and firmly specifying its duties. The commission has proposed to rename it as the National Economic and Development Council, where the chief ministers should have a wider role in finalising the development plans.

9. Wider scope of the Finance Commission: At present, the Finance Commission has only a limited scope. Owing to this, there has been a lot of interference by the centre in the financial management of states, as also a lot of arbitrariness in the discretionary grants from the centre. The Finance Commission feels that it has to depend on the Planning Commission for many decisions, and the Planning Commission also feels that its legitimate sphere of central resource transfer is encroached upon by the Finance Commission. If the scope of the Finance Commission is widened, this envious relationship and discretion in resource transfer can be considerably reduced. Since the Finance Commission is a quasi-judicial body, an increase in its scope will also reduce the suspicion and distrust of the states.

10. Permanent Status to the Finance Commission: Many states have demanded that the Finance Commission should be given a permanent status. The Finance Commission, being an impartial body, will be free from any political bias. This will reduce the arbitrariness of the centre in matters relating to the discretionary transfer of funds to the states. Also, the permanent nature of the Finance Commission will help the commission to bring under review various aspects of finances of the centre and states, special needs of Particular states, and day-to-day changes in the direction of the state's economy.

Recap

- ♦ Budget Deficits: Occur when spending > income (applies to governments, businesses, individuals)
- ♦ Fiscal Deficit: Total expenditure – (Total receipts – Borrowings)
- ♦ Revenue Deficit: Revenue expenditure – Revenue receipts
- ♦ Primary Deficit: Fiscal deficit – Interest payments
- ♦ Impacts of Deficits: Inflation, debt burden, reduced future growth
- ♦ Centre-State Financial Relations: Governed by Constitution (Article 246, 268–273)
- ♦ Shared Taxes: GST, stamp duties
- ♦ Challenges: State financial stringency, eroded autonomy, unequal resource distribution
- ♦ Reforms Suggested: Greater state autonomy, clearer Finance Commission role, divisible pool expansion

Objective Questions

1. What is the formula for calculating fiscal deficit?
2. Which deficit excludes interest payments on past borrowings?
3. Which constitutional article governs the Finance Commission?
4. Name one tax levied by the Union but assigned to states.
5. What is the main cause of revenue deficit?
6. Which body recommends the distribution of income tax between centre and states?
7. What type of grants are given to reduce interstate disparities?
8. Which tax is exclusively under state jurisdiction as per the State List?

Answers

1. Total expenditures – Total receipts (excluding borrowings)
2. Primary deficit
3. Article 280
4. Stamp duties
5. Revenue expenditure > Revenue receipts
6. Finance Commission
7. Conditional grants
8. Land revenue

Assignments

1. Compare fiscal deficit and revenue deficit with examples.
2. Analyse the impact of high fiscal deficit on inflation and debt burden.
3. Explain how the Finance Commission determines resource sharing between centre and states.
4. Discuss the challenges faced by states due to overlapping functions of Finance and Planning Commissions.
5. Evaluate the role of GST in improving centre-state financial relations.
6. Suggest measures to reduce interstate disparities in resource allocation.

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6

BLOCK

Indian Experience

UNIT 1

Fiscal Responsibility and Budget Reforms in India

Learning Outcomes

After completing this unit, the learner will be able to:

- know the purpose and key features of the FRBM Act, 2003
- differentiate between traditional budgeting, zero-based budgeting, and outcome budgeting
- assess the advantages and limitations of FRBM, ZBB, and outcome budgeting
- describe the trends in India's fiscal and primary deficits from 2016 to 2026

Prerequisites

Consider a country where the government spends endlessly, borrows without limits, and allocates funds without assessing impact. Could such a system sustain itself? Would roads, hospitals, and schools improve, or would the economy collapse?

For any nation, budgeting is more than a financial exercise. It reflects a country's priorities and commitment to a sustainable future. India, a growing economy with vast developmental needs, has evolved its budgeting practices to address deficits, efficiency, and accountability. But how effective are these reforms?

The Fiscal Responsibility and Budget Management (FRBM) Act aims to ensure financial discipline, yet governments often struggle to control deficits. Zero-Based Budgeting (ZBB), where each expense must be justified afresh, promises efficiency - but is it realistic for large-scale governance? Outcome Budgeting links spending to real results-better healthcare, education, and infrastructure - but how well is it applied?

Before moving into the details, ask yourself: Should a country's budget focus only on numbers, or also on outcomes? Should we accept deficits for the sake of development? Is financial discipline always beneficial, or can it restrict growth?

Let us examine how budgeting tools shape India's economy and the lives of its people.

Keywords

Fiscal Responsibility, Budgetary Reforms, Deficit Management, FRBM Act, Zero Budgeting, Outcome Budget

Discussion

6.1.1 Fiscal Responsibility and Budget Management (FRBM) Act

Consider a household that continuously spends more than it earns, borrowing money to cover daily expenses while struggling to repay previous debts. Over time, this cycle of borrowing leads to financial instability, making it harder to invest in necessities such as education, healthcare, or infrastructure.

Countries face similar challenges when their governments consistently spend more than they generate in revenue. During the 1990s and early 2000s, India encountered severe fiscal difficulties, marked by high revenue and fiscal deficits, excessive government borrowing, and a growing debt-to-GDP ratio. These issues raised concerns about economic sustainability, prompting the need for fiscal discipline.

To address fiscal concerns, the Fiscal Responsibility and Budget Management (FRBM) Bill was introduced in December 2000 and enacted into law in August 2003. Its key objectives included institutionalising financial discipline, reducing fiscal deficits, enhancing macroeconomic stability, and promoting transparency in public fund management. The Act set a target to lower the fiscal deficit to 3% of GDP by March 2008, but the 2007 global financial crisis forced its suspension in 2009. Later, in 2011, the Economic Advisory Council recommended reviving the FRBM Act's provisions as the economy began recovering.

6.1.1.1 The Fiscal Challenges Lead to FRBM

Before the FRBM Act, India's fiscal situation was alarming:

- **High Revenue Deficit:** Government spending on subsidies, salaries, defence, and welfare programmes exceeded its revenue.

- **Rising Fiscal Deficit:** The combined fiscal deficit of the central and state governments exceeded 8% of GDP, indicating excessive borrowing.
- **Mounting Interest Payments:** Borrowing resulted in high interest payments, making debt repayment the largest government expenditure.
- **Threat of Credit Rating Downgrade:** Excessive borrowing and fiscal mismanagement jeopardised India's financial stability, increasing concerns among investors and global financial institutions.

Recognising that unchecked fiscal deficits could undermine economic growth and erode investor confidence, policymakers introduced the FRBM Act to institutionalise fiscal discipline. This landmark legislation has played a pivotal role in shaping India's fiscal policy, promoting sustainable stability and sound economic governance through structured consolidation.

6.1.1.2 Salient Features of the FRBM Act

The following are the key features of the Act.

1. **Fiscal Policy Statements:** The Act requires the Central Government to present four fiscal policy statements every financial year, along with the Union Budget. These are the Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement, Macro-Economic Framework Statement, and the Medium-Term Expenditure Framework Statement. Together, these statements provide a comprehensive outlook on the government's fiscal strategy, rolling targets for key fiscal indicators, and an assessment of the macroeconomic environment.
2. **Targets for Fiscal Indicators:** The FRBM Act specifies clear numerical targets for key fiscal indicators. The government is required to reduce the fiscal deficit to three per cent of the GDP by March 31, 2021. Additionally, it mandates the reduction of Central Government debt to forty per cent of GDP by March 31, 2025, while ensuring that the combined debt of the Centre and States does not exceed sixty per cent of GDP. These targets are aimed at promoting sustainable public finances and maintaining macroeconomic stability.
3. **Restrictions on Borrowing:** To discourage inflationary financing, the Act prohibits the Central Government from borrowing directly from the Reserve Bank of India, except for temporary needs through Ways and Means Advances. This provision helps ensure that government borrowing is market-driven and transparent.
4. **Escape Clause:** Recognising the need for flexibility under extraordinary circumstances, the FRBM Act includes an 'escape clause.' This provision allows the government to temporarily deviate from fiscal targets in situations such as a national security threat, natural calamity, severe agricultural distress, major structural reforms, or a significant decline in GDP growth. However, such deviation is restricted to a maximum of 0.5% of GDP in any given year.
5. **Measures for Fiscal Transparency:** The Act emphasises the importance of transparency in fiscal operations. It mandates the disclosure of detailed information on fiscal indicators, contingent liabilities, government guarantees,

and changes in accounting standards. These disclosures aim to provide a clearer and more accurate picture of the government's financial position to Parliament and the public.

6. **Corrective Measures for Deviations:** If there is a significant deviation from fiscal targets, the government is required to take corrective measures. These include steps to rationalise expenditure or enhance revenue, and such deviations must be reported to Parliament along with the proposed corrective actions. This ensures accountability and prompt rectification.

7. **Monitoring, Review, and Reporting:** The Act provides for continuous monitoring and review of fiscal developments. It mandates that the Finance Ministry conduct half-yearly reviews of the trends in receipts and expenditures, which must be placed before Parliament. Additionally, the Comptroller and Auditor General (CAG) of India may be assigned the responsibility of assessing the government's compliance with the FRBM Act.

8. **Rule-Making Powers:** The Central Government is vested with the authority to make rules for implementing the provisions of the FRBM Act. These rules specify the format, content, and manner of presentation of fiscal reports, and also elaborate on the disclosure norms to enhance fiscal discipline.

9. **Protection of Officials Acting in Good Faith:** To safeguard public officials implementing the Act, the FRBM Act provides that no legal action shall lie against any person for anything done or intended to be done in good faith under the provisions of the Act or the rules framed thereunder.

Table 6.1.1

Salient Features of the FRBM Act

Feature	Summary
Fiscal Policy Statements	Four key fiscal statements are presented annually with the Union Budget.
Fiscal Targets	Fiscal deficit to be reduced to 3% of GDP; debt capped at 40% (Centre).
Borrowing Limits	No direct borrowing from the RBI, except for temporary needs.
Escape Clause	Allows deviation (up to 0.5% of GDP) in exceptional situations.
Fiscal Transparency	Mandates disclosure of liabilities, guarantees, and accounting changes.
Corrective Actions	Deviations must be reported with corrective measures.
Monitoring & Review	Half-yearly fiscal reviews; CAG may assess compliance.
Rule-Making Powers	The Centre can frame rules for implementation and reporting.
Protection Clause	Officials acting in good faith are protected from legal action.

6.1.1.3 Objectives of the FRBM Act

The Fiscal Responsibility and Budget Management (FRBM) Act, 2003, was a landmark legislation enacted by the Government of India to institutionalise financial discipline, improve the management of public funds, and ensure long-term macroeconomic stability. Below are the major objectives explained in a detailed and academic manner:

1. **Ensure Inter-generational Equity:** One of the primary objectives of the FRBM Act is to promote inter-generational equity in fiscal management. This means that the present generation should not excessively borrow or accumulate debts that would burden future generations. The act aims to ensure that public resources are managed prudently so that future citizens inherit a financially stable nation.

2. **Achieve Long-Term Macroeconomic Stability:** The FRBM Act seeks to maintain macroeconomic stability by ensuring sustainable fiscal practices. High fiscal deficits can lead to inflation, currency depreciation, and instability in financial markets. By mandating fiscal prudence, the act contributes to a stable economic environment that is conducive to growth and investment.

3. **Facilitate Effective Conduct of Monetary Policy:** Another important objective is to remove fiscal impediments in the conduct of monetary policy. Large fiscal deficits can force the Reserve Bank of India (RBI) to monetise the deficit (i.e., print more money), which can undermine monetary policy efforts to control inflation. By restraining government borrowing from the RBI, the FRBM Act strengthens the effectiveness of the country's monetary policy.

4. **Enhance Fiscal Transparency:** The act promotes greater transparency in the government's fiscal operations. It mandates the disclosure of fiscal indicators such as revenue deficits, fiscal deficits, and public debt. It also requires the presentation of multiple fiscal policy documents before Parliament, including the Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement, and Macro-Economic Framework Statement, thus ensuring that fiscal decisions are made in an open and accountable manner.

5. **Institutionalise Fiscal Discipline:** The FRBM Act aims to legally bind the Central Government to maintain fiscal discipline by setting annual targets for reducing fiscal and revenue deficits and maintaining a sustainable level of debt. This ensures that fiscal indiscipline, such as unplanned borrowing and excessive spending, is curtailed through a structured legal framework.

6. **Promote Sustainable Economic Growth:** By reducing the fiscal deficit and managing public debt efficiently, the FRBM Act creates an economic environment that encourages investments, reduces inflationary pressures, and promotes sustainable long-term economic growth. Fiscal prudence creates confidence among investors and credit rating agencies regarding the government's ability to manage its finances.

7. **Create a Medium-Term Fiscal Policy Framework:** The Act requires the Government to adopt a medium-term approach to fiscal management rather than short-term, ad-hoc measures. The rolling three-year targets and strategic fiscal planning introduced under the FRBM Act help in long-term resource planning and management.

Table 6.1.2

Summary Table : Objectives of the FRBM Act

Objective	Summary
Inter-generational Equity	Prevents excessive debt burden on future generations.
Macroeconomic Stability	Controls deficits to maintain economic stability.
Effective Monetary Policy	Limits RBI borrowing to aid inflation control.
Fiscal Transparency	Ensures open disclosure of fiscal data and documents.
Institutional Fiscal Discipline	Legally enforces prudent fiscal behaviour.
Sustainable Economic Growth	Supports growth through deficit and debt control.
Medium-Term Fiscal Framework	Promotes strategic, multi-year fiscal planning.

6.1.1.4 Advantages and Disadvantages of Implementing the FRBM Act, 2003

Advantages

1. **Fiscal Discipline and Responsibility:** The FRBM Act mandated strict targets for fiscal deficit and public debt, thereby enforcing fiscal discipline on the government. It created a rule-based framework that limited unplanned government spending and reckless borrowing.
2. **Enhanced Transparency and Accountability:** The Act requires the government to disclose detailed fiscal statements such as the Medium-Term Fiscal Policy Statement and Fiscal Policy Strategy Statement, thereby promoting greater transparency and accountability in fiscal operations.
3. **Improved Macro-Economic Stability:** By reducing fiscal deficits, the act helped control inflation, stabilise interest rates, and strengthen investor confidence in the Indian economy. A stable macroeconomic environment encourages both domestic and foreign investment.
4. **Better Monetary Policy Implementation:** The Act restricted the government's borrowing from the Reserve Bank of India (RBI), which in turn minimised the monetisation of deficits. This separation enabled the RBI to conduct a more independent and effective monetary policy focused on price stability.
5. **Facilitates Inter-generational Equity:** By reducing the burden of public debt, the act ensures that future generations are not overburdened with repayment obligations, thus promoting inter-generational equity.

6. **Predictability in Fiscal Management:** The Act introduced a predictable and systematic fiscal consolidation framework. It set explicit targets for fiscal and revenue deficits, making public finance management more consistent and reliable.

Disadvantages

1. **Rigidity During Economic Shocks:** One major criticism of the FRBM Act is that it imposed rigid fiscal targets even during times of economic slowdown, national calamities, or financial crises. Such rigidity often restricted the government's ability to undertake counter-cyclical spending.

2. **Focus on Numerical Targets Rather Than Quality of Expenditure:** The act emphasised meeting fiscal numbers but did not adequately address the composition and quality of government expenditure. As a result, governments sometimes cut productive capital expenditure to meet deficit targets, which adversely affected long-term growth.

3. **Operational Challenges in Measurement:** In practice, determining the fiscal deficit accurately is complex due to off-budget borrowings, contingent liabilities, and creative accounting practices. This sometimes undermined the spirit of transparency envisioned by the act.

4. **Inadequate Flexibility Mechanisms:** Although later amendments allowed for deviations under extraordinary circumstances (such as national security or natural disasters), the act initially lacked effective flexibility mechanisms to deal with unforeseen fiscal shocks.

5. **Limited Coverage:** The FRBM Act primarily targeted the Central Government's finances and did not extend effectively to the state governments initially. Although states adopted their own versions (State FRBM Acts), fiscal consolidation at the state level remained uneven.

Table 6.1.3
Advantages and Disadvantages of the FRBM Act

Advantages	Disadvantages
1. Fiscal discipline and responsibility	1. Rigidity during economic shocks
2. Enhanced transparency and accountability	2. Focus on numerical targets rather than quality of expenditure
3. Improved macro-economic stability	3. Operational challenges in measurement
4. Better monetary policy implementation	4. Inadequate flexibility mechanisms
5. Facilitates inter-generational equity	5. Limited coverage
6. Predictability in fiscal management	

6.1.1.5 Development of the FRBM Act, 2003 - 2025

The FRBM Act, 2003, marks a significant milestone in India's journey towards fiscal consolidation and macroeconomic stability. Over the years, the FRBM Act evolved through various amendments, policy changes, and responses to economic shocks. This section traces the key phases of the development of the FRBM Act from 2003 to 2025.

The FRBM Act was passed in August 2003 and came into effect on July 5, 2004. The principal aim of the act was to institutionalise fiscal discipline by setting numerical targets for reducing the fiscal deficit and eliminating the revenue deficit. The Central Government was mandated to reduce its fiscal deficit to no more than 3% of the GDP by March 31, 2008, and to eliminate the revenue deficit by the same date.

The global financial crisis of 2008–09 posed serious challenges to economies worldwide, including India. Faced with the need to stimulate economic growth, the Indian government implemented fiscal stimulus packages, leading to a sharp rise in the fiscal deficit. Consequently, the fiscal targets prescribed by the FRBM Act had to be suspended temporarily. The crisis revealed a major shortcoming of the FRBM framework—its lack of adequate flexibility to accommodate extraordinary economic circumstances. This phase underlined the need for an inbuilt mechanism allowing deviations under exceptional conditions.

In response to the post-crisis fiscal stress, the government set up the Kelkar Committee in 2012 to review the fiscal consolidation roadmap. The Committee recommended a calibrated and credible path to return to fiscal prudence, emphasising the need to limit the fiscal deficit to 3% of GDP by 2016–17. It also stressed improving the quality of expenditure by prioritising capital investments over subsidies. Although the government broadly accepted the recommendations, implementation remained challenging due to persistent structural and cyclical pressures on public finances.

By 2015, recognising the dynamic nature of fiscal challenges, the government amended the FRBM Rules. These amendments reaffirmed the government's commitment to fiscal consolidation and introduced a target to limit the general government debt (Centre and States combined) to 60% of GDP. The Medium-Term Fiscal Policy Statements and Outcome Budgets became essential instruments to enhance fiscal transparency and accountability. These changes indicated a gradual shift towards a more structured and strategic approach to fiscal management.

In 2016, the government appointed the N.K. Singh Committee to review the FRBM framework comprehensively. The Committee recommended focusing on a 'debt anchor', proposing that Central Government debt should be reduced to 40% of GDP by 2024–25. It advocated replacing rigid deficit targets with a more flexible fiscal framework, allowing deviations of up to 0.5% of GDP under clearly defined circumstances like natural calamities or war. Furthermore, the Committee recommended establishing an independent fiscal council to monitor adherence to fiscal rules. Many of these suggestions were accepted and incorporated through amendments introduced in the Finance Act, 2018.

The COVID-19 pandemic severely disrupted India's fiscal management. The sudden contraction in economic activity resulted in a drastic fall in revenues, while the need for enhanced health and social sector spending led to a spike in government expenditure. Consequently, the fiscal deficit for 2020–21 surged to 9.2% of GDP, far exceeding FRBM targets. In response, the government invoked the escape clause provisions and revised the fiscal consolidation roadmap. In Budget 2021–22, the government announced a new medium-term fiscal path, targeting a fiscal deficit of 4.5% of GDP by 2025–26. This phase highlighted the need for greater flexibility within the FRBM framework to accommodate severe economic shocks.

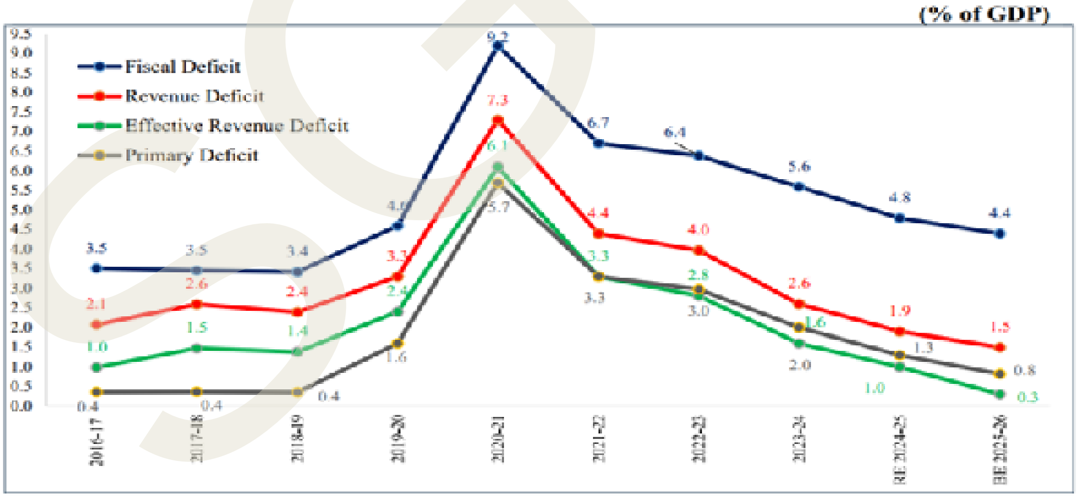
As of 2025, the FRBM Act continues to form the foundation of India's fiscal discipline framework. However, post-pandemic realities have made strict adherence to the original targets difficult. While the long-term debt-to-GDP target of 40% for the Central Government remains a guiding benchmark, fiscal policy has become more flexible to prioritise economic recovery and growth.

6.1.1.6 India's Deficit Trends (2016 - 2026)

The graph titled deficit trends illustrates India's fiscal performance over a decade, tracking four critical deficit indicators as percentages of GDP: fiscal deficit, revenue deficit, effective revenue deficit, and primary deficit. These metrics provide insights into the government's borrowing needs, revenue management, and expenditure priorities.

Figure 6.1.1

India's Fiscal Indicators as % of GDP (2016-2026)



Source: Government of India, Ministry of Finance.
(https://www.indiabudget.gov.in/doc/Budget_at_Glance/bag2.pdf)

The fiscal deficit, representing the gap between the government's total expenditure and its receipts (excluding borrowings), is the broadest measure of fiscal health. The data reveals a significant spike in 2020–21, when the deficit surged to 9.2% of GDP due to pandemic-induced stimulus spending and reduced revenues. However, post-2021, a gradual recovery is evident, with the deficit projected to decline to 4.4% by 2025–

26. This reflects the government's efforts toward fiscal consolidation, supported by economic revival and tighter expenditure controls. The revenue deficit, which measures the shortfall in the government's day-to-day operational expenses relative to its income, shows a similar trend. It peaked during the pandemic at 7.3% of GDP (2020–21) but is expected to drop sharply to 1.5% by 2025–26. This improvement indicates better alignment between revenue inflows and essential expenditures, reducing the need for borrowing to fund routine operations. The effective revenue deficit (unproductive spending) is expected to drop sharply to 0.3% by 2025–26, highlighting a shift toward productive investments like infrastructure. Meanwhile, the primary deficit (borrowing excluding interest payments) halved to 0.8%, signalling reduced debt pressure.

The trends demonstrate India's progress in post-pandemic fiscal recovery, with narrowing deficits and improved revenue management. By prioritising capital investments and reducing unproductive expenditures, the government is steering toward sustainable growth. However, challenges such as tax buoyancy and expenditure efficiency will remain critical in maintaining this trajectory.

6.1.2 Zero - Based Budgeting (ZBB)

Following our discussion of the FRBM Act 2003, it is important to examine another innovative budgeting approach adopted by the Indian government, Zero-Based Budgeting (ZBB). Given India's ongoing fiscal challenges, such methods are critical for ensuring responsible financial management. Rising budgetary deficits have made it necessary to move beyond traditional practices and explore more effective solutions.

Zero Based Budgeting offers a fresh perspective by requiring every expense to be justified a new, rather than relying on previous budgets. This approach eliminates unnecessary spending and directs resources toward programmes with clear outcomes. By thoroughly reviewing all expenditures, it promotes efficiency and accountability for India's fiscal stability.

6.1.2.1 Meaning of Zero-Based Budgeting

Zero-Based Budgeting is a method of budgeting where every expense must be justified for each new period. In this approach, the budgeting process starts from a "zero base", meaning that no expenses are automatically carried over from previous years. Each department or unit must explain why it needs money and how it plans to use it effectively. The main idea is that nothing is assumed to be essential without proper evaluation. Every activity is analysed, and budgets are built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than before.

The concept of Zero-Based Budgeting traces back to British budget expert Edward Hilton Young in 1924, who emphasised justifying every budget item from scratch. In India, the need for a new method of budgeting arose during the 1980s when the government faced severe resource shortages. The Department of Science and Technology was the first to adopt ZBB in India. After seeing positive results, the Ministry of Finance encouraged all government departments to apply it from 1987 – 88 onwards.

Many departments, like the Department of Space, the Department of Science and Technology, and the Department of Electronics, implemented ZBB with positive results. Public Sector Undertakings (PSUs) like BHEL and IOC also adopted ZBB to identify non-essential projects and redirect funds.

However, the application of ZBB across all government sectors has not been uniform. Some departments effectively used ZBB to cut costs and eliminate wasteful programmes, but many others faced challenges due to the complexity of the process and a lack of trained personnel.

Although India's Union Budget is not fully based on ZBB even today, the principles of ZBB have influenced many budgeting reforms. The government now emphasises 'Outcome Budgeting', where ministries must link their spending to specific results. There is also a greater focus on 'Performance Budgeting', where spending is tied to measurable performance outcomes.

6.1.2.2 Features of Zero-Based Budgeting

Zero-Based Budgeting has some unique features that set it apart from traditional budgeting systems:

1. **Fresh Evaluation Every Year:** In ZBB, the budget process starts from zero. Unlike traditional budgeting, past spending is not automatically continued. Every activity, old or new, has to prove its value again. This ensures that no money is spent without a valid reason. For example, imagine that the educational department received ₹10,00,000 for organising a school fest last year. In ZBB, the education department won't automatically get the same amount this year. This year, they need to explain what the fest will achieve, how much it will cost this time, and whether it's worth funding again, etc. Then only they will be able to get the amount sanctioned.

2. **Priority-Based Planning:** Departments must list their activities in order of importance. This helps decision-makers choose which programme to fund first, especially when resources are limited. The most important and useful programme gets priority. For instance, in the health department, the vaccination programme for children might be ranked higher than awareness workshops. So, more funds are allocated to vaccinations.

3. **Use of Decision Packages:** Each department must prepare a 'decision package' for every activity or project. This package includes details like objectives, benefits, costs, and alternatives. These packages are then ranked and reviewed, making budgeting more objective and structured. Suppose a department wants to launch a new mobile app for public complaints, the decision package will compare options like developing an app in-house, outsourcing it, or using an existing government platform.

4. **Focus on Alternatives:** ZBB encourages departments to think creatively and consider different ways to achieve their goals. For example, if there are two ways to run a training programme, the more cost-effective or impactful method is chosen.

5. **Improves Accountability:** Since departments must justify each expense, they become more responsible with how they use public money. This accountability also improves trust in government spending. For example, a manager proposing funds for an annual staff retreat must show its benefits like improved morale or teamwork and not assume it will be approved just because it was done in the past.

6. **Results-Oriented Approach:** ZBB links financial allocation with performance. It supports a shift from simply spending money to achieving outcomes, such as improving literacy rates, building roads, or reducing pollution. For example, in an education department, ZBB would fund a reading programme only if it improves literacy rates, not just because it's been running for years.

6.1.2.3 Traditional Budgeting vs Zero-Based Budgeting

Traditional budgeting and Zero-Based Budgeting are different in many ways:

Table 6.1.4

Difference between Traditional Budgeting and Zero-Based Budgeting

Aspect	Traditional Budgeting	Zero-Based Budgeting
Starting Point	Uses last year's budget as a base	Starts from zero for each new period
Justification	Only extra costs are explained	Every expense, old or new, must be justified
Approach	Based on routine, status quo	Focuses on review, analysis, and change
Flexibility	Less flexible, assumes ongoing needs	More flexible, adapts to current priorities
Innovation	Little room for new ideas	Encourages new methods and efficient solutions

Traditional budgeting works like copying and pasting last year's budget with minor changes. This can lead to inefficient or outdated programmes. Zero-Based Budgeting, on the other hand, examines all expenses carefully and funds only those that are useful now. It allows for changes and new ideas, making it more responsive to current needs.

6.1.2.4 Advantages and Disadvantages of Zero-Based Budgeting

Advantages of Zero-Based Budgeting

1. **Better Use of Resources:** Zero-Based Budgeting ensures that money is allocated only to those activities that are necessary and effective. It prevents departments from continuing to receive funds for programmes that no longer deliver results. Each expense must be justified with clear outcomes, which helps the government or organisation focus on current needs rather than past habits. This leads to a smarter use of limited financial resources. In a country like India, where public resources

are scarce, this approach helps direct funds toward development goals. Overall, it improves the alignment of spending with national priorities.

2. **Elimination of Wasteful Expenditure:** ZBB helps identify and eliminate outdated or unnecessary programmes that often go unnoticed in traditional budgeting. By forcing every department to justify its existence and its costs, it becomes easier to spot overlapping, duplicated, or redundant schemes. This prevents tax money from being spent on projects that no longer add value. It also discourages departments from inflating budgets just to match or exceed past allocations. Over time, this contributes to reducing the fiscal burden on the government.

3. **Encourages Efficiency and Innovation:** Since every programme has to prove its usefulness, departments are motivated to look for new ways to achieve results at lower costs. This can lead to innovation in public services, including the use of technology, public-private partnerships, or better project designs. For example, instead of conducting in-person training workshops in every district, a department might shift to online modules, saving time and money. This environment pushes administrators to become problem solvers and better planners. As a result, government services become more performance-oriented.

4. **Promotes Transparency and Accountability:** ZBB increases transparency by clearly showing how and why each rupee is being spent. Every decision package includes the goals, costs, and outcomes expected from a programme, which makes the budgeting process easier to audit and understand. This openness reduces opportunities for corruption or favouritism. It also makes it easier for elected representatives and the public to question ineffective programmes. This builds public trust in how the government uses money.

5. **Improves Alignment with Organisational Goals:** With ZBB, each activity must demonstrate how it contributes to the overall mission or objectives of the organisation or government. This helps in eliminating programmes that may have grown irrelevant or off-track over time. It ensures that resources are consistently supporting the most important areas of need. For instance, a ministry focused on digital education will gradually reduce spending on printed materials and invest more in devices, apps, and internet access. This direct alignment makes the budget a strategic tool, not just a financial document.

Disadvantages and Limitations of Zero-Based Budgeting

1. **Time-Consuming and Labour-Intensive:** Preparing a Zero-Based Budget is much more time-consuming than traditional budgeting. Every department must justify all its expenses from the ground up, which requires detailed analysis, report writing, and review. This becomes a significant administrative burden, especially in large ministries with hundreds of schemes. As a result, the entire process takes longer and may delay decision-making. It also increases the workload for already busy staff.

2. **Difficulty in Ranking Programme:** ZBB involves comparing and ranking programmes based on their usefulness and cost-effectiveness. But when many programmes are equally important such as education, health, and food security it becomes difficult to choose which one should receive funding first. Ranking can become subjective, depending on who is making the decisions. Political

influence or personal bias may affect the order of priorities. This can lead to good programmes being ignored just because they appear less urgent in the short term.

3. **Resistance to Change:** Implementing ZBB often faces opposition from within the system. Many managers and officials prefer traditional budgeting because it is easier and allows them to protect their programmes without scrutiny. The extra effort and transparency that ZBB demands can be uncomfortable, especially if it challenges long-standing practices.

4. **High Paperwork and Administrative Costs:** ZBB generates a large volume of documentation, with each department preparing detailed decision packages. Reviewing and analysing all this information takes time, energy, and skilled manpower. In a country like India, where administrative capacity is already stretched, this can lead to delays and inefficiencies. The cost of managing such a complex process may outweigh the savings it produces, especially if it is applied to every programme.

5. **Risk of Ignoring Long-Term Programmes:** One of the criticisms of ZBB is that it can favour short-term, visible results over long-term investments. Programmes that take years to show benefits like environmental sustainability or rural infrastructure may be dropped in favour of quick wins. This happens because it's easier to justify programmes with immediate output than those whose impact comes after several years.

6.1.3 Outcome Budget

The concept of outcome budgeting in India is a natural progression in public financial reforms. The FRBM Act aimed to maintain fiscal discipline and Zero Based Budgeting allows efficient allocation, whereas Outcome Budgeting adds another dimension, accountability for results. In simple terms, it links the money allocated in the budget to the actual outcomes the government wants to achieve.

6.1.3.1 Meaning of Outcome Budget

An Outcome Budget is a budget that does more than just show how much money will be spent. It shows what results the government expects from spending that money. Instead of focusing only on inputs (like salaries, buildings, and infrastructure), it focuses on outputs (services delivered) and outcomes (impact on people's lives).

For example, instead of just stating that ₹500 crore is allocated for primary education, the outcome budget will mention how many schools are expected to be built, how many teachers hired, and what improvement is expected in enrolment or learning levels.

The Outcome Budget in India emerged as part of the government's broader effort to improve the effectiveness and accountability of public spending. Earlier, India used performance budgeting (introduced in 1968), which focused mainly on tracking physical targets like kilometres of roads built or the number of schools constructed. However, it did not measure whether such spending improved people's lives. Over time, it became clear that tracking outputs alone was not enough; there was a growing need to evaluate the real results or outcomes of government programmes. The Outcome Budget was formally introduced in 2005–06 by the Finance Ministry.

6.1.3.2 Features of Outcome Budget

1. **Focus on Results, Not Just Spending:** The Outcome Budget shifts attention from how much money is allocated or spent to what is achieved with that money. It links financial inputs to measurable outcomes. This helps ensure that the purpose behind the spending is clear and results-oriented. It is a move from "how much we spend" to "what we achieve".

2. **Use of Output and Outcome Indicators:** Each programme or scheme includes clear indicators showing what outputs (e.g., number of schools built) and outcomes (e.g., improvement in literacy) are expected. These indicators help track the performance of schemes in a structured way. Ministries are required to set annual physical and financial targets. This allows for easier monitoring and comparison across years.

3. **Enhanced Transparency and Accountability:** By showing both budget allocation and expected outcomes, the Outcome Budget helps the public and Parliament understand how taxpayer money is being used. It allows citizens to see if the government is delivering on its promises. This improves trust in governance and promotes responsible spending. It also encourages better planning within ministries.

4. **Ministry - and Scheme - Level Reporting:** The Outcome Budget is prepared by each ministry for its major schemes. It contains detailed scheme-wise performance expectations and targets. These are reviewed periodically to assess implementation. This structure makes the budgeting process more organised and focused.

5. **Annual Updates:** The Outcome Budget is prepared and presented every year along with the Union Budget, ensuring that outcome targets and progress are updated regularly. This annual cycle helps ministries plan their work in advance and assess their performance at the end of the year. The yearly updates maintain the relevance of the document and help align it with current government priorities and socio-economic conditions.

6. **Centralised Digital Dashboard:** Since 2017, a centralised Outcome Budget Dashboard has been developed and managed by the Development Monitoring and Evaluation Office (DMEO) under NITI Aayog. The dashboard enables real-time tracking and data-driven decision-making. It also improves transparency, as stakeholders can monitor the progress of schemes from anywhere. Since 2017, dashboard has tracked over 5000 indicators across 67 ministers and departments

6.1.3.3 Traditional Budgeting vs Outcome Budgeting

Traditional Budgeting focuses on tracking inputs and expenditures, emphasising financial accountability and post-spending evaluation. In contrast, Outcome Budgeting shifts the focus to results and impacts, prioritising performance accountability, measurable objectives, and real-time transparency. The key differences between the two approaches are summarised below:

Table 6.1.5
Difference between Traditional Budgeting and Outcome Budgeting

Criteria	Traditional Budgeting	Outcome Budgeting
Focus	Inputs and expenditures	Results and impacts
Accountability	Financial accountability	Performance accountability
Evaluation Basis	Budget spent	Objectives achieved
Transparency	Limited	High (due to measurable indicators)
Monitoring Approach	Ex-post (after spending)	Real-time or periodic tracking

6.1.3.4 Advantages and Disadvantages of Outcome Budgeting

Advantages of Outcome Budget

1. **Improves Efficiency and Effectiveness:** Since every rupee spent is linked to a measurable result, ministries are encouraged to plan and implement schemes more effectively. This helps in achieving better results with the same or fewer resources. It also reduces unnecessary or unproductive spending. Over time, this leads to more efficient use of public money.

2. **Strengthens Monitoring and Evaluation:** Outcome Budgeting provides clear performance indicators for schemes, making it easier to evaluate their success or failure. Real-time dashboards and data allow early identification of problems. Ministries can make mid-year corrections based on performance. This improves policy implementation across departments.

3. **Encourages Accountability and Transparency:** Since outcomes are made public, it becomes easier for the public, media, and auditors to evaluate government performance. It holds ministries accountable for the results, not just for spending. This increases pressure on departments to perform better. It also improves public trust in governance.

4. **Supports Informed Decision-Making:** Policymakers can use data from the Outcome Budget to assess which programmes are working and which are not. This helps them make better policy and funding decisions. Schemes that are not achieving results can be restructured or discontinued. It ensures that limited resources are directed to the most impactful programmes.

Disadvantages of Outcome Budget

1. **Lack of Reliable Data:** A major challenge is the lack of up-to-date and accurate data to measure outcomes. Many departments still struggle to set meaningful and realistic performance indicators. Without proper data, tracking outcomes becomes difficult. This weakens the reliability of the Outcome Budget.

2. **Varying Quality Across Ministries:** Not all ministries follow the same standards while preparing outcome budgets. Some provide detailed, clear indicators, while others submit vague or incomplete information. This inconsistency affects comparability and overall usefulness. It shows the need for stronger guidelines and training.

3. **Focus on Short-Term Results:** Sometimes, ministries may focus only on easily measurable and short-term goals to show quick success. Long-term outcomes that take time to develop (like improvement in learning outcomes or environmental sustainability) may be ignored. This distorts priorities and weakens long-term planning.

4. **Capacity Constraints:** Many departments lack the trained staff or technical skills needed to effectively design and track outcome indicators. There is also limited coordination between the finance and monitoring units. As a result, implementation remains uneven and often mechanical. Without capacity building, the full benefits of outcome budgeting cannot be realised.

6.1.3.5 Outcome Budget in India: Recent Developments

By the early 2000s, policymakers recognised a gap between financial allocations and development results. Simply put, increasing the budget for a scheme didn't always lead to better outcomes. As the Indian economy grew and public spending expanded, the government realised the need for a budgeting tool that could hold ministries accountable not just for spending, but for achieving results.

This led to the introduction of the Outcome Budget in 2005–06 by the then Finance Minister P. Chidambaram. Initially, it covered only Plan expenditure which was related to development schemes, while Non-Plan expenditure like salaries, interest payments, etc. was excluded. By 2006–07, both Plan and Non-Plan expenditures were included, making the Outcome Budget a more comprehensive tool.

A key shift occurred in 2007–08, when the Performance Budget and Outcome Budget were merged into a single document. This created a more unified approach to planning, budgeting, and evaluating government performance. Since then, the Ministry of Finance has required every major ministry and department to present an outcome budget along with the Union Budget each year.

Another important reform was the removal of the Plan vs. Non-Plan distinction in 2017–18, which made budgeting more outcome-focused across all government functions. The General Financial Rules (GFR) 2017, especially Rule 54, made it mandatory for all ministries and departments to prepare Output-Outcome Monitoring Frameworks (OOMFs). This laid the foundation for structured, measurable, and transparent reporting of what government programmes deliver.

To further institutionalise monitoring and evaluation, the Development Monitoring and Evaluation Office (DMEO) was created under NITI Aayog in 2015. DMEO developed an Outcome Budget Dashboard a digital platform that tracks over 5,000 indicators across 67 central ministries and departments. This marks a shift from paper-based reports to real-time performance monitoring using data and analytics.

Several Indian states including Delhi, Assam, Karnataka, Odisha, and Jharkhand have also adopted Outcome Budgeting at the state level. These state-level efforts demonstrate the growing acceptance of the outcome-based approach in governance across India.

In short, the introduction and development of the Outcome Budget in India is part of a larger shift toward evidence-based policymaking, where results matter more than just how much money is spent. It reflects a move from input-driven planning to a performance-oriented culture in public administration.

Recap

- The FRBM Act (2003) was enacted to ensure fiscal discipline, transparency, and macroeconomic stability in India
- The FRBM Act introduced targets for fiscal deficit, revenue deficit, and public debt, and restricted direct borrowing from the RBI
- The Act has evolved through amendments and flexibility mechanisms, especially during crises like the global financial crisis and the COVID-19 pandemic
- Despite setbacks, FRBM remains a foundational tool for India's long-term fiscal management and policy planning
- ZBB is a budgeting method where each expense must be justified from scratch for every new period
- ZBB begins with a 'zero base', requiring departments to justify the need and cost of every activity or project before funds are allocated
- Key features of ZBB include fresh evaluation, priority-based planning, decision packages, and a focus on cost-effective alternatives
- ZBB enhances efficiency, accountability, and transparency, encouraging innovation and alignment with organisational goals
- ZBB can be time-consuming, resource-intensive, and difficult to implement, especially in large public systems with limited administrative capacity
- Outcome Budget links government spending with measurable results and real-life impact
- Outcome Budget in India in 2005–06, it moves beyond input tracking to output and outcome evaluation
- Outcome Budget promotes transparency, accountability, and informed decision-making
- The features of outcome budget include the use of indicators, scheme-wise reporting, annual updates, and real-time dashboards via DMEO

- Several states in India have also adopted Outcome Budgeting, reinforcing its importance in public financial management

Objective Questions

1. In which year was the FRBM Act passed?
2. What is the fiscal deficit target under the FRBM Act?
3. What is the debt-to-GDP target for the Central Government?
4. Which clause allows deviation from fiscal targets under special conditions?
5. What does ZBB stand for in budgeting reforms?
6. What institution manages the Outcome Budget dashboard in India?
7. What document is prepared in ZBB for each activity?
8. Which budgeting method starts from scratch each year?
9. What type of budgeting is linked to measurable results?
10. What kind of approach does traditional budgeting follow?

Answers

1. 2003
2. 3%
3. 40%
4. Escape Clause
5. Zero-Based Budgeting
6. DMEO (NITI Aayog)

7. Decision Package
8. Zero-Based Budgeting
9. Outcome Budgeting
10. Incremental

Assignments

1. Explain the importance of fiscal discipline in a developing economy like India.
2. Discuss the objectives and key provisions of the FRBM Act, 2003.
3. Compare traditional budgeting and outcome budgeting with examples.
4. Discuss the advantages and challenges of implementing Zero-Based Budgeting in Indian governance.
5. Compare and contrast ZBB and Outcome Budgeting.
6. Explain any three features of Outcome Budgeting with examples.
7. Discuss the advantages of Outcome Budgeting in improving governance and financial accountability.

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UNIT 2

Trends in Revenue Receipts

Learning Outcomes

After completing this unit, the learner will be able to:

- know the meaning and components of revenue receipts, and distinguish them clearly from capital receipts in the government budget
- describe the factors influencing revenue receipts in India
- discuss trends in revenue receipts

Prerequisites

Before diving into the trends of revenue receipts in India, it is essential to revisit a fundamental question: how does the government earn money to function, govern, and serve the people? Students of public finance would recall from earlier studies that just as individuals need income to sustain their lives, the government, too, needs revenue to meet its growing administrative and developmental responsibilities. This inflow of funds, known as revenue receipts, forms the lifeline of the public budget, enabling the state to maintain law and order, provide public goods, fund welfare schemes, and invest in infrastructure.

This chapter builds on your foundational understanding of taxation and public finance. By now, you would have encountered the basic distinction between tax and non-tax revenues, and perhaps heard terms like GST, disinvestment, and Finance Commission in news and classroom discussions. But have you ever wondered how these components evolve over time? What drives their growth, or decline, and how do they impact the Union and State finances?

This chapter aims to sharpen your analytical lens by tracing the historical and recent patterns in India's revenue mobilisation efforts. It will encourage you to not just look at numbers, but to interpret them within the broader economic and policy context that shapes a nation's fiscal health.

Keywords

Tax Revenue, Non-Tax Revenue, Fiscal Policy, Tax, GST, Revenue-GDP Ratio

Discussion

6.2.1 Revenue Receipts

Revenue receipts are the lifeblood of any government, enabling it to fund public services, infrastructure, and welfare programmes. This chapter examines the trends in revenue receipts, focusing on how governments generate income through taxes (like income tax and GST) and non-tax sources (such as fees, dividends, and interest). We will explore how these revenues have changed over time, the factors influencing their growth, and the challenges governments face in maintaining stable revenue streams. By comparing historical patterns and recent developments, this chapter aims to provide a clear understanding of why revenue trends matter for economic stability and public policy. Whether you are analysing budget documents or debating tax reforms, grasping these trends is essential for future economists and policymakers.

Revenue receipts are the income earned by the government that does not create any liability and does not lead to a reduction in government assets. In other words, revenue receipts are regular and recurring incomes received by the government during a financial year to meet its day-to-day expenses. These receipts do not have to be repaid, and they help fund activities such as education, health, defence, and administration. In India, revenue receipts are classified into two broad categories: tax revenue and non-tax revenue.

6.2.1.1 Difference Between Revenue Receipts and Capital Receipts

The distinction between revenue receipts and capital receipts can be expressed as follows

Table 6.2.1 Difference Between Revenue Receipts and Capital Receipts

Basis	Revenue Receipts	Capital Receipts
Nature	Regular and recurring income	One-time or non-recurring income
Impact on Assets/ Liabilities	No impact on assets or liabilities	May create liability (like loans) or reduce assets (like disinvestment)
Examples	Taxes, interest income, fees, fines	Borrowings, recovery of loans, and sale of government assets
Purpose	Used for routine government expenses	Used for creating assets or reducing liabilities

In simple terms, revenue receipts help the government run daily operations, while capital receipts help finance long-term investments or repay debts.

6.2.1.2 Components of Revenue Receipts

Revenue receipts are the regular income sources of the government that do not create any liability or reduce its assets. In India, revenue receipts are broadly classified into two main categories: tax revenue and non-tax revenue.

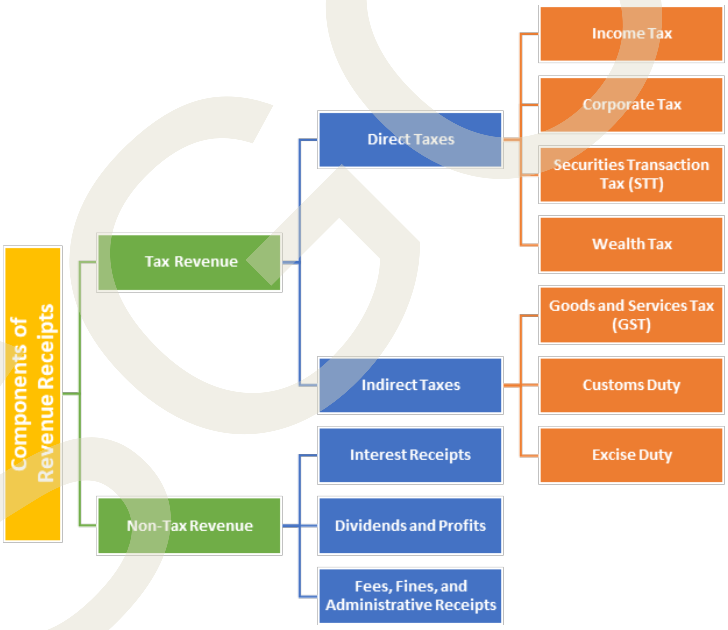

Figure 6.2.1 Components of Revenue Receipts

A. Tax Revenue

Tax revenue is the income collected by the government through various taxes imposed on individuals, businesses, and goods and services. Taxes are compulsory payments made to the government, and they are not returned to the taxpayer in direct exchange for any service. In India, tax revenue is further divided into direct taxes and indirect taxes.

1. Direct Taxes: Direct taxes are those that are paid directly by individuals or organisations to the government. These taxes are based on the income or profits of the taxpayer. Major types of direct taxes in India include:

a. **Income Tax:** Paid by individuals and Hindu Undivided Families (HUFs) on their annual income, based on applicable tax slabs.

b. **Corporate Tax:** Paid by companies on their profits. The rates may vary for domestic companies and foreign companies.

c. **Securities Transaction Tax (STT):** Collected on transactions made through recognised stock exchanges.

d. **Wealth Tax (now abolished):** Was previously levied on the net wealth of high-net-worth individuals.

Direct taxes play a major role in ensuring equity, as they are based on the principle of "ability to pay".

2. Indirect Taxes: Indirect taxes are those that are collected by intermediaries (like sellers or service providers) from consumers and then paid to the government. The burden of the tax is passed on to the final consumer. Key indirect taxes in India are:

a. **Goods and Services Tax (GST):** Introduced in 2017, GST is a comprehensive indirect tax levied on the supply of goods and services across India. It replaced multiple indirect taxes like VAT, excise duty, and service tax.

b. **Customs Duty:** Levied on goods imported into (and in some cases exported from) India.

c. **Excise Duty:** A tax on the manufacture of goods within the country. Post-GST, central excise duty is now limited to a few items like petroleum and tobacco.

Indirect taxes are generally considered regressive, as they are the same for all consumers regardless of their income level.

B. Non-Tax Revenue

Non-tax revenue refers to the income the government earns from sources other than taxes. These receipts are also regular in nature and contribute significantly to the revenue budget. The major sources of non-tax revenue in India include:

1. **Interest Receipts:** The government provides loans to states, union territories, and public sector undertakings (PSUs). The interest received from these loans forms a part of non-tax revenue. It may also include interest from investments or savings of government departments.

2. **Dividends and Profits:** The government owns several PSUs, such as Indian Oil Corporation, ONGC, and State Bank of India. These companies, when profitable, pay a share of their profits to the government in the form of dividends. Additionally, the Reserve Bank of India (RBI) also transfers

surplus income to the central government, which is recorded under this category.

3. **Fees, Fines, and Administrative Receipts:** This includes charges collected by the government for providing services such as issuing passports, driving licenses, and registration of land or vehicles. It also includes court fees, fines imposed for violating laws, and penalties collected by regulatory bodies like SEBI and TRAI.

Other forms of non-tax revenue include receipts from natural resource auctions (like coal blocks, spectrum), escheat property (unclaimed property), and proceeds from licenses or royalties.

6.2.1.3 Factors Influencing Revenue Receipts

Revenue receipts are the main source of income for the government. Several factors influence the level and growth of revenue receipts. They are:

1. **Growth of National Income (GDP):** One of the most important factors influencing revenue receipts is the size and growth rate of the country's GDP. When the economy grows, incomes rise, business activities expand, and consumption increases, all of which result in higher tax collections.

2. **Tax Policy and Rates:** The structure of taxation, such as the rates of income tax, corporate tax, customs duty, and GST, directly affects revenue receipts. Rational and moderate tax rates encourage compliance and improve collections.

3. **Tax Compliance and Administration:** Efficient tax collection systems, use of technology, digital filing, and strict enforcement help increase compliance. India's introduction of GST and the Income Tax Department's digital reforms have significantly improved the tax base and collections.

4. **Inflation Rate:** Inflation increases the nominal value of goods and services, which can lead to higher tax collections, especially under indirect taxes like GST. However, high inflation may also reduce real incomes and consumption, negatively affecting revenue in the long run.

5. **Level of Economic Formalisation:** When businesses register under tax laws, use digital payments, and file returns, it increases the tax base and revenue. For instance, schemes like 'Digital India' and 'Startup India' encourage more businesses to enter the formal economy.

6. **Non-Tax Revenue Sources:** Non-tax revenues such as dividends from public sector enterprises (PSUs), interest income from loans to states, fees for services, and spectrum sales also contribute to revenue receipts.

7. **Global Economic Conditions:** External factors like crude oil prices, export-import trends, and global demand affect customs duties and corporate earnings, which in turn impact tax collections. For example, a slowdown in global trade may reduce customs revenue and income tax from export businesses.

8. **Political and Administrative Will:** Strong political commitment and efficient administrative machinery are key to implementing policies that ensure better revenue generation.

6.2.2 Importance of Analysing Revenue Trends for Economic Policy

Understanding and analysing the trends in revenue receipts is crucial for designing and implementing sound economic policies. In a developing country like India, the government plays a major role in providing public goods and services, maintaining infrastructure, and supporting welfare schemes. All of these activities require sufficient and stable sources of revenue.

By studying the trends in tax and non-tax revenue over time, policymakers can evaluate how effectively the government is mobilising financial resources. For instance, if tax revenue is consistently growing in line with GDP, it suggests that the tax system is buoyant and responsive to economic growth. On the other hand, if revenue growth is slow despite a growing economy, it may signal the need for tax reforms, better enforcement, or widening the tax base.

Analysing revenue trends also helps in planning the government's expenditure. A predictable and growing revenue stream allows the government to make long-term investments in sectors like education, health, and infrastructure. It also helps maintain fiscal discipline by reducing dependence on borrowing.

Furthermore, trends in revenue receipts reveal the structure of the government's income, whether it relies more on direct taxes or indirect taxes, or how much it earns from non-tax sources like dividends and fees. This information is essential to ensure fairness and efficiency in taxation and to assess the sustainability of government finances.

In short, regular analysis of revenue trends provides valuable insights that help the government make informed, effective, and equitable policy decisions.

6.2.3 Historical Trends in Revenue Receipts in India

Revenue receipts in India have evolved significantly over the years, especially in response to economic reforms and shifts in public finance management. These trends provide insight into the country's fiscal capacity and the effectiveness of policy decisions related to taxation and public income generation.

6.2.3.1 Long - Term Trends: Pre and Post Liberalisation

Before the 1991 economic liberalisation, India followed a socialist-oriented economic model. The government had high control over production, trade, and pricing, and public sector undertakings (PSUs) dominated most industries. During this period, revenue receipts were largely dependent on indirect taxes such as excise duty and customs duty.

Direct tax collections were relatively low due to a narrow tax base, high evasion, and complicated laws.

Following economic liberalisation in 1991, India witnessed significant changes in its revenue collection patterns. The government's decision to open the economy to foreign investment, reduce trade barriers, and implement comprehensive tax reforms led to notable improvements in revenue mobilisation. Direct tax collections, including income tax and corporate tax, saw substantial growth due to streamlined administration, simplified procedures, and better compliance mechanisms. At the same time, customs duties were progressively reduced as part of trade liberalisation policies, shifting the focus from import tariffs to domestic taxation. These reforms not only enhanced the efficiency of tax collection but also brought structural changes to both tax and non-tax revenue systems. As a result, the share of direct taxes in total revenue increased consistently, reflecting a more balanced and sustainable revenue framework for the Indian economy.

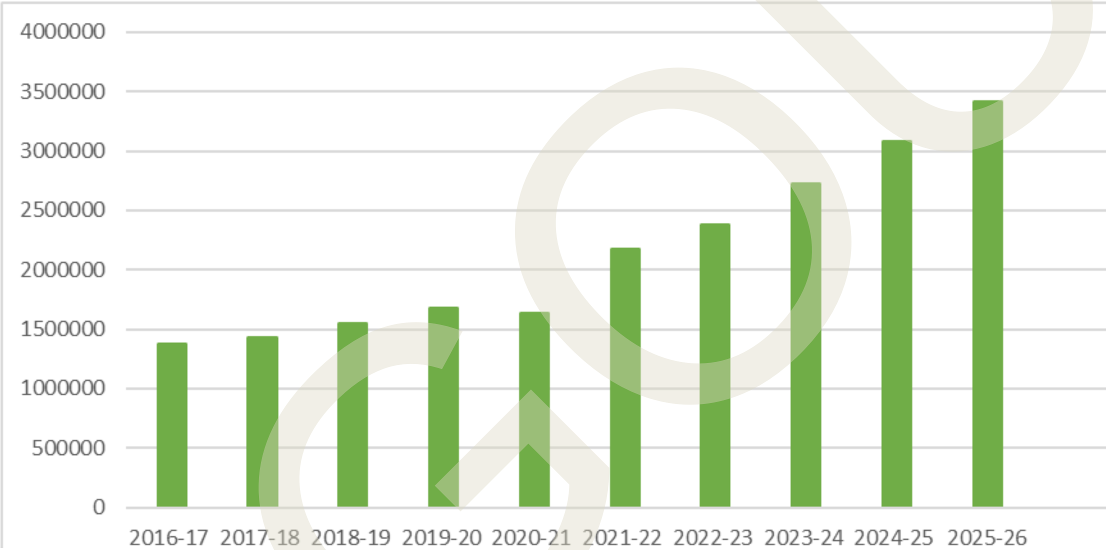

Figure 6.2.2 Total Revenue Receipts of the Central Govt (In crores)
Source: Annexe – 2, Receipt Budget, 2025-2026, https://www.indiabudget.gov.in/doc/rec/annex2.pdf

The data on the total revenue receipts of the Central Government from 2016–17 to 2025–26 reveals a generally upward trend, reflecting the evolving fiscal capacity of the central government. In 2016–17, the total revenue receipts stood at ₹13.74 lakh crore. Over the next three years, this figure rose steadily, reaching ₹16.84 lakh crore by 2019–20. This growth can be attributed to an expanding tax base and improved compliance, especially following the implementation of the Goods and Services Tax (GST) in 2017.

However, the financial year 2020–21 marked a temporary setback. The total revenue receipts declined slightly to ₹16.33 lakh crore, primarily due to the adverse impact of the COVID-19 pandemic on economic activity and tax collections.

A significant recovery began in 2021–22, with revenue receipts increasing to ₹21.69 lakh crore, indicating strong economic revival and effective tax administration. This trend continued in subsequent years, with collections rising to ₹23.83 lakh crore in 2022–23 and further to an estimated ₹27.29 lakh crore in 2023–24. Projections for the next year suggest continued growth, with revenue receipts expected to reach ₹34.20 lakh crore in 2025–26.

Overall, the data highlights the resilience and recovery of India's public finances in the post-pandemic period. It also reflects the central government's success in strengthening revenue generation through better tax administration, digital monitoring, and policy reforms.

6.2.3.2 Comparative Analysis of Tax vs. Non-Tax Revenue Growth

In India, revenue receipts are primarily composed of tax revenue and non-tax revenue. Over the years, tax revenue has shown more consistent and stronger growth compared to non-tax revenue, both in absolute terms and as a percentage of GDP. This trend highlights the government's increasing reliance on taxation to fund its expenditures.

Table 6.2.2 Percentage of Tax and Non-Tax Revenue to GDP (2009–10 to 2020–21)

Year	%Tax Revenue of GDP	%Non-Tax Revenue of GDP
2009-10	9.64	1.79
2010-11	10.19	2.81
2011-12	10.18	1.39
2012-13	10.42	1.38
2013-14	10.14	1.77
2014-15	9.98	1.59
2015-16	10.58	1.83
2016-17	11.17	1.78
2017-18	11.23	1.13
2018-19	11.02	1.25
2019-20	9.88	1.61
2020-21	10.27	1.05

Source: https://www.data.gov.in/

Table 6.2.2 shows the share of tax and non-tax revenue in India's GDP from 2009–10 to 2020–21. Tax revenue as a percentage of GDP remained relatively stable, ranging between 9.64% and 11.23%, with a peak in 2017–18. Non-tax revenue was more volatile, peaking at 2.81% in 2010–11 and falling to 1.05% in 2020–21. This suggests that tax revenue is a more consistent source of income for the government, while non-tax revenue is less predictable.

Tax revenue constitutes the largest share of revenue receipts. Historically, indirect taxes such as excise duties and customs duties made up the bulk of the tax revenue due to easier collection mechanisms and a wider base. However, with economic liberalisation and tax reforms in the post-1991 period, there has been a noticeable shift in the composition of tax revenue. Direct taxes, such as income tax and corporate tax, have grown significantly as a result of improved tax administration, broader tax bases, and rising incomes. On the other hand, non-tax revenue, which includes interest receipts, dividends from public sector undertakings (PSUs), fees, fines, and other administrative charges, has grown at a slower pace.

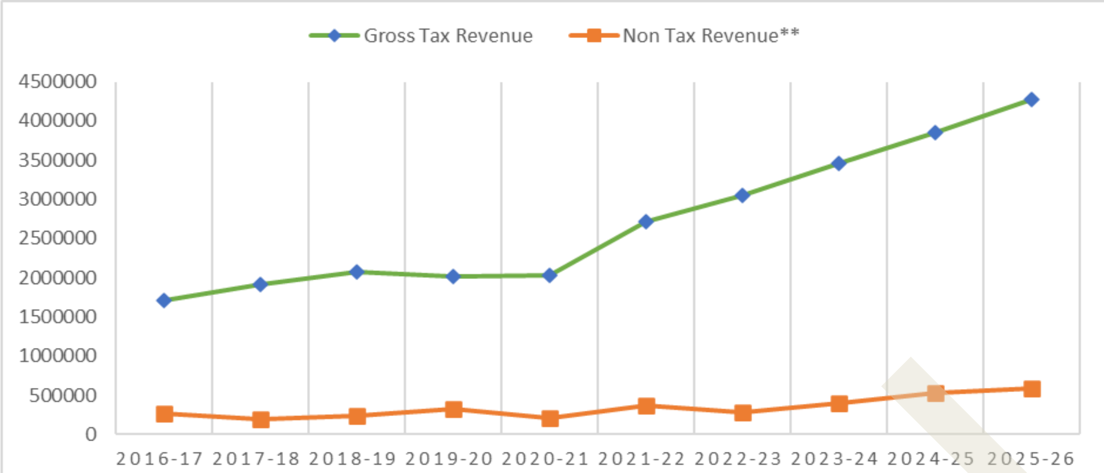

Figure 6.2.3 Trends in Gross Tax Revenue and Non-Tax Revenue o (2016–17 to 2025–26) (In crores) Source: Annexe – 2, Receipt Budget, 2025-2026, https://www.indiabudget.gov.in/doc/rec/annex2.pdf

The fiscal data for India between 2016–17 and 2025–26 highlights a consistent rise in both gross tax revenue and non-tax revenue of the central government, demonstrating efforts to strengthen public finances and enhance fiscal capacity.

In 2016–17, the gross tax revenue stood at ₹17.15 lakh crore, which increased to ₹19.19 lakh crore in 2017–18 and ₹20.80 lakh crore in 2018–19. Despite a minor dip to ₹20.10 lakh crore in 2019–20, likely reflecting a slowdown in economic activity, revenue collections resumed growth in subsequent years. By 2020–21, even during the COVID-19 pandemic, the gross tax revenue marginally improved to ₹20.27 lakh crore, suggesting resilient tax collection mechanisms. A significant jump occurred post-pandemic, with collections rising to ₹27.09 lakh crore in 2021–22 and further to ₹30.54 lakh crore in 2022–23. Forecasts for the coming years show continued expansion, reaching ₹42.70 lakh crore by 2025–26, indicating improved compliance, better tax administration, and economic recovery.

Non-tax revenue, though comparatively smaller, also shows interesting trends. It was ₹2.73 lakh crore in 2016–17 but fell to ₹1.92 lakh crore in 2017–18. This decline could be attributed to lower collections from dividends and spectrum auctions. However, non-tax revenue rebounded in subsequent years, reaching ₹3.27 lakh crore in 2019–20. Although there was another dip in 2020–21 (₹2.07 lakh crore), likely due to disruptions in public sector undertakings' (PSUs) profitability and reduced receipts from asset monetisation, it rose again to ₹3.65 lakh crore in 2021–22. The projected figures for 2025–26 indicate a steady rise to ₹5.83 lakh crore, supported by higher dividends from PSUs, disinvestment efforts, and increasing revenue from fees, fines, and user charges.

The data highlights two key observations. First, gross tax revenue continues to be the dominant contributor to the central government's total revenue receipts, while non-tax revenue serves as a supplementary but important source. Second, the fluctuations in non-tax revenue reveal its sensitivity to external economic conditions and public sector performance. Together, these trends underline the importance of maintaining a balanced and diversified revenue structure to ensure fiscal sustainability and responsiveness to economic shifts.

6.2.3.3 Breakdown of India's Revenue Receipts

The pie chart below (Figure 6.2.4) illustrates the percentage-wise distribution of the total revenue receipts of the Government of India from various sources according to the Budget 2025–26. It provides insight into how the government generate its income.

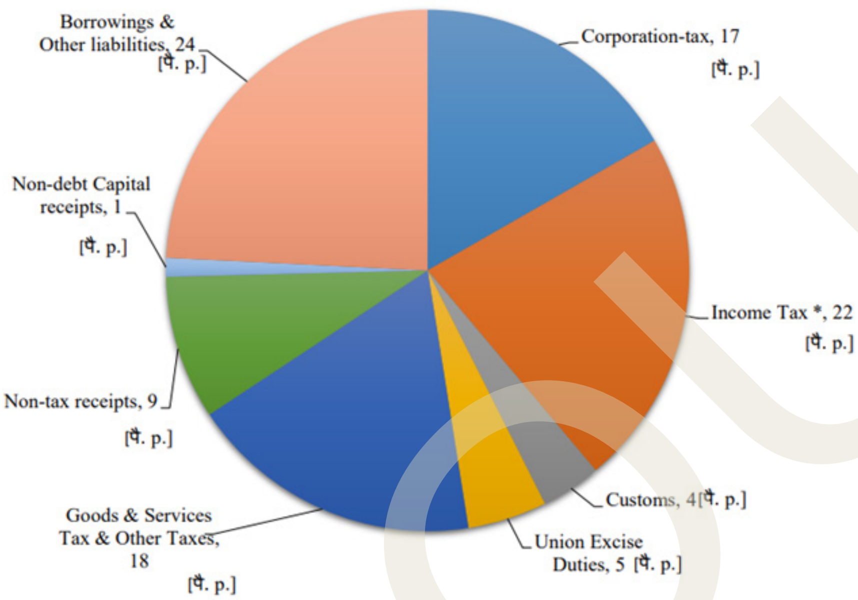

Figure 6.2.4 Sources of Government Revenue in the 2025–26 Budget
Source: Government of India, Ministry of Finance. (2024). Budget at a glance 2024-2025

The largest share of revenue comes from borrowings and other liabilities, which account for 24% of the total receipts. Income tax is the second-highest contributor, forming 22% of the total revenue, reflecting the growing role of personal income taxation in the country's fiscal framework. This is followed closely by corporation tax, which contributes 17%, representing the taxes collected from business profits. Goods and Services Tax (GST) and other indirect taxes make up 18%, highlighting the importance of indirect taxation in the post-GST regime. Non-tax revenue, which includes dividends from public enterprises, interest receipts, and other administrative fees, contributes 9% to the total. Finally, non-debt capital receipts, such as disinvestment proceeds and loan recoveries, account for just 1%, showing the limited role of asset sales and repayments in the overall revenue mix.

This distribution reflects the government's dependence on both tax and non-tax sources.

6.2.4 Challenges in Revenue Mobilisation in India

India faces several challenges in generating sufficient revenue efficiently and equitably. Some of the key challenges include:

1. **Tax Evasion and Avoidance:** A major hurdle in revenue collection is tax evasion (illegally hiding income to avoid taxes) and tax avoidance (using

legal loopholes to reduce tax liability). Many individuals and businesses underreport income or shift profits to tax havens, reducing the government's revenue.

2. **Narrow Tax Base:** Despite India's large population, only a small percentage of people pay income taxes. Many workers are in the informal sector, making it difficult to track their income. As a result, the tax burden falls disproportionately on salaried employees and large businesses.

3. **Dependency on Indirect Taxes (Regressive Impact):** A significant portion of India's revenue comes from indirect taxes. While these taxes are easier to collect, they are regressive—meaning they take up a larger share of income from the poor than the rich. For example, a daily wage worker pays the same GST on basic goods as a high-income earner, even though the tax affects their budget much more.

4. **Fiscal Federalism (Central vs. State Revenue Sharing):** India follows a federal system, where both the central and state governments have the power to levy taxes. However, disputes often arise over revenue sharing—how much money states should get from central taxes like income tax and GST. States with fewer industries or lower economic activity argue that they receive insufficient funds, while richer states contribute more but may not get proportional benefits.

6.2.5 Impact of Digital Economy on Revenue Receipts in India

India's digital economy, powered by innovations like UPI and E-Invoicing, has significantly improved tax collection and reduced evasion. Digital payments have brought more transparency in payments and expanded the tax base. Since demonetisation (2016) and the rise of UPI, more transactions are recorded digitally, making it harder to hide income.

The introduction of E-Invoicing under GST has curbed fraud by eliminating fake invoices and ensuring real-time tracking of transactions. This has boosted GST compliance and increased revenue. Additionally, digital tools have formalised small businesses and gig workers, bringing them into the tax net through recorded transactions on UPI platforms.

However, to sustain progress, the government must promote digital literacy, strengthen cybersecurity, and simplify tax laws to encourage voluntary compliance.

Recap

- Revenue receipts are regular government incomes that do not create liabilities or reduce assets
- Tax revenue includes direct taxes like income tax, corporate tax and STT, and indirect taxes like GST, customs duty and excise duty
- Non-tax revenue includes interest receipts, dividends and profits from PSUs, fees, fines and royalties
- Revenue receipts differ from capital receipts as they are recurring and used for routine expenses
- Analysing revenue trends helps in better policy planning, fiscal discipline and sustainable public finance
- Post-1991 reforms increased direct tax share and reduced reliance on customs duties
- Revenue receipts have shown long-term growth with a dip during COVID-19 and strong recovery thereafter
- Tax revenue is more stable than non-tax revenue, which is sensitive to economic and PSU performance
- GST simplified indirect taxation, increased compliance and steadily boosted collections since 2017
- India's revenue-to-GDP ratio (20.8%) is higher than Pakistan but below Bhutan, China and developed nations
- Challenges include tax evasion, narrow tax base, high reliance on regressive indirect taxes and Centre-State revenue sharing disputes
- Digital economy initiatives like UPI and e-invoicing improved compliance and reduced tax evasion
- Sustaining revenue growth requires digital literacy, strong cybersecurity and simplified tax laws

Objective Questions

1. Write one example of a direct tax?
2. The Goods and Services Tax (GST) was implemented in India in which year?
3. Write one example for non-tax revenue?
4. Which ministry launched the Outcome Budget in India?
5. What is the main objective of analysing revenue trends?
6. Which revenue source is more predictable: tax or non-tax revenue?
7. Revenue from which source is considered regressive?
8. Which tax replaced VAT, service tax, and excise duty in India?
9. What does UPI stand for in the context of India's digital economy?
10. Name one major non-tax revenue source for the Indian government.

Answers

1. Income tax
2. 2017
3. Dividends from PSUs
4. Ministry of Finance
5. To help in effective policy formulation and fiscal planning
6. Tax revenue
7. Indirect taxes
8. GST
9. Unified Payments Interface
10. Dividends

Assignments

1. Explain the meaning of revenue receipts. How are they different from capital receipts?
2. Distinguish between direct and indirect taxes with suitable examples.
3. Describe the major components of tax revenue and non-tax revenue in India.
4. Discuss the importance of analysing revenue trends for economic policy-making.
5. Explain how the implementation of GST has impacted revenue receipts in India.
6. Critically evaluate the role of non-tax revenue in the Indian public finance system. Why is it considered less stable?
7. What are the factors influencing revenue receipts in India? How can the government improve its revenue base?
8. Discuss the challenges faced by India in mobilising sufficient tax revenue.
9. How has the digital economy influenced revenue collection in India?
10. How does inflation impact government revenue collection? Provide examples from the Indian context.

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3 UNIT

Public Expenditure and Debt

Learning Outcomes

After completing this unit, the learner will be able to:

- define public expenditure and explain its principles, structure, and major components
- describe the causes and effects of the growth of public expenditure in India
- differentiate between internal and external public debt
- interpret trends in India's public debt and interest payments

Prerequisites

Think of a nation where every rupee spent and borrowed shapes the future. Public expenditure and debt are not just numbers; they are the building blocks of a nation's progress. In India, these financial tools determine whether we build schools or highways, provide healthcare or defence, and support farmers or industry. Every budget decision reflects our values and priorities.

Consider the balance between spending on immediate needs and investing in long-term growth. How do we decide where to allocate limited resources? Should we prioritise reducing debt to ensure financial stability, or increase social spending to improve lives today? The Fiscal Responsibility and Budget Management (FRBM) Act aims to guide these choices, but how effective is it in practice?

As we examine the trends and policies in this chapter, think about the real-world impact of these decisions. How do they affect your life and the lives of millions of Indians? Let us uncover the stories behind the numbers and understand how public expenditure and debt shape our nation's future.

Keywords

Public Expenditure, Classification of Public Expenditure, Public Debt, Composition of Public Debt

Discussion

6.3.1 Public Expenditure

Public Expenditure refers to the spending by government entities (central, state, and local) to provide public goods and services, implement welfare schemes, and manage administration. It includes both developmental spending and non-developmental expenditure. Governments incur such expenses to achieve economic growth, reduce inequality, and maintain law and order. In India, major components include subsidies, social programmes (MGNREGA, PM-Kisan), and infrastructure projects. Public expenditure is financed through tax revenues, borrowings, and other receipts. Its structure and growth reflect a nation's priorities and fiscal health, directly impacting citizens' lives and economic development.

6.3.1.1 Principles of Public Expenditure

1. **Principle of Social Welfare Maximisation:** Government spending should be strategically planned to generate the greatest benefit for society. Resources must be allocated across sectors to ensure equal marginal utility, similar to how individuals budget for maximum satisfaction. This approach promotes equitable development by preventing favouritism toward specific groups while enhancing overall productivity.

2. **Principle of Cost-Effectiveness Evaluation:** When selecting projects, governments must carefully assess potential costs against expected benefits. Limited financial resources necessitate prioritising initiatives that deliver optimal outcomes relative to their expenses. This analytical process helps identify which investments will yield the highest social returns.

3. **Principle of Fiscal Prudence:** Public money should be spent judiciously, avoiding unnecessary or redundant expenditures. Governments must implement safeguards against wasteful spending and fund duplication across departments.

4. **Principle of Authorised Spending:** All government expenditures require proper approval through established budgetary processes. In democratic systems, legislative bodies must review and authorise spending proposals before implementation. Clear accounting practices ensure that funds are used for their designated purposes only.

5. **Principle of Expenditure Flexibility:** Public spending frameworks should accommodate changing national circumstances and priorities. The system must allow for adjustments during emergencies or economic downturns when revenue streams may shrink. This adaptability ensures that governments can respond effectively to unexpected challenges.

6. **Principle of Developmental Focus:** Government expenditures should primarily target initiatives that enhance productive capacity and human welfare. Investments in education, healthcare, and essential infrastructure create long-term economic benefits. Such spending generates positive ripple effects throughout the economy.

7. **Principle of Fiscal Equilibrium:** Ideally, government spending should align with revenue generation to maintain financial stability. Chronic budget surpluses may indicate underutilisation of available resources for the public good.

8. **Principle of Equitable Allocation:** Public spending should actively work to reduce socioeconomic disparities across population segments. Resources should be distributed to address regional imbalances and uplift disadvantaged communities.

Fig. 6.3.1 Principles of Public Expenditure

6.3.1.2 Structure of Public Expenditure in India

In India, public expenditure is classified in different ways to help understand how and where government funds are being used. These classifications are important for planning, managing the budget, and analysing economic priorities. The following are the major classifications of public expenditure.

1. Developmental vs. Non-developmental Expenditure

i. **Developmental Expenditure** is spending that directly contributes to economic and social development. This includes expenditure on education, healthcare, infrastructure, agriculture, and industry. For example, money spent on building rural roads, promoting digital education, or providing healthcare services falls under developmental expenditure.

ii. **Non-developmental Expenditure** includes the costs of running the government and maintaining law and order, such as defence, interest payments, pensions, and administrative services. Although these are essential, they do not directly contribute to economic development. For instance, salaries paid to police officers or defence spending are non-developmental expenditures.

2. Plan vs. Non-plan Expenditure

Before 2017, India's budget classified expenditure as plan and non-plan.

i. **Plan Expenditure** was linked to the Five-Year Plans and included spending on development projects and welfare programmes.

ii. **Non-plan Expenditure** refers to routine expenses like salaries, pensions, subsidies, and interest payments.

However, this classification was discontinued in the Union Budget 2017–18, as it created confusion and was not aligned with modern budgeting practices. Now, expenditure is classified more clearly into revenue and capital expenditure.

3. Revenue Expenditure vs. Capital Expenditure

i. **Revenue Expenditure** refers to the day-to-day expenses of the government that do not result in the creation of physical assets. This includes salaries, pensions, subsidies, interest payments, and operational costs. For example, spending on midday meals in schools or fertiliser subsidies is revenue expenditure.

ii. **Capital Expenditure** is spending on assets that will benefit the economy in the long term. It includes investments in infrastructure like highways, airports, hospitals, and schools. Capital expenditure leads to the creation of durable assets and helps increase the country's productive capacity.

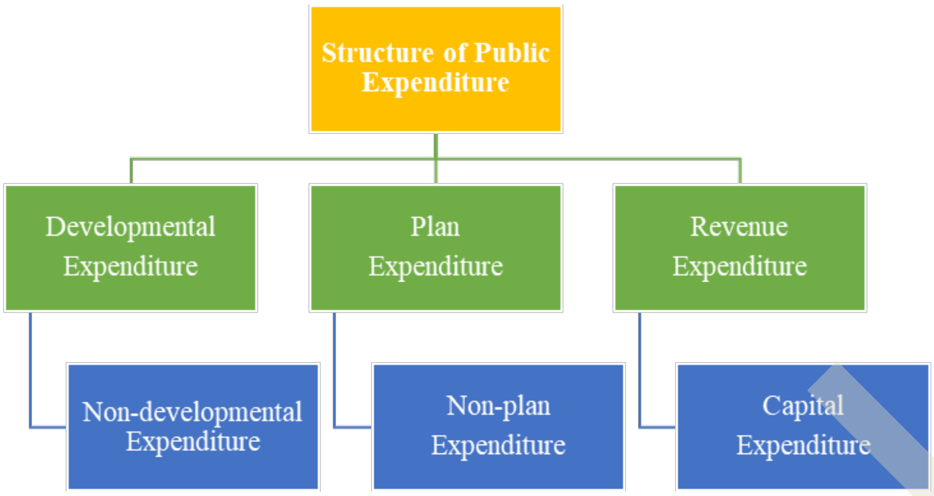

Fig.6.3.2 Structure of Public Expenditure

6.3.1.3 Major Components of Public Expenditure in India

1. **Social Services:** Social services include government spending on education, health, housing, and welfare programmes. In India, a significant part of the budget is allocated to social services to improve the standard of living and promote inclusive growth. For instance, programmes like Ayushman Bharat (health insurance), Samagra Shiksha Abhiyan (education), and Pradhan Mantri Awas Yojana (housing) are major social sector expenditures.

2. **Economic Services:** Economic services refer to spending on sectors that support economic development, such as agriculture, industry, energy, transport, and communication. The government invests in these areas to boost productivity, create jobs, and improve infrastructure. For example, subsidies to farmers, support for small businesses, and highway development projects are part of economic services.

3. **Defence Expenditure:** This includes spending on the Army, Navy, Air Force, and defence infrastructure. India, being a large country with significant security needs, allocates a substantial portion of its budget to defence.

4. **Subsidies:** Subsidies are financial support provided to keep the prices of essential goods and services low. Common subsidies include food, fertilisers, and fuel. While these help the poor, they also place a heavy burden on the budget.

5. **Interest payments:** Interest payments are made on the money the government has borrowed. A large part of revenue expenditure goes toward paying interest on loans taken from internal and external sources.

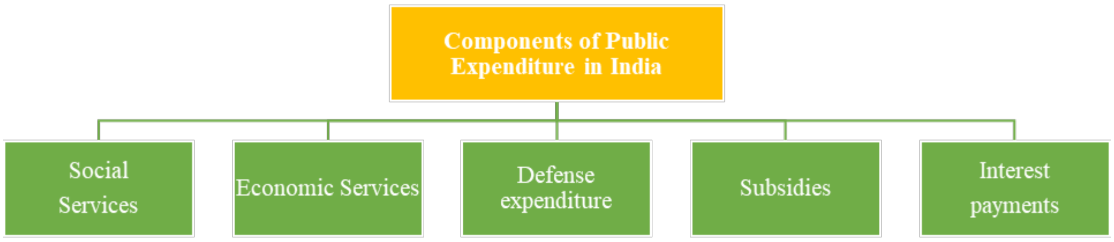

Fig.6.3.3 Components of Public Expenditure in India

Understanding the structure of public expenditure helps us evaluate how the government prioritises its spending and how these decisions impact economic development and social welfare.

6.3.1.4 Reasons for the Growth of Public Spending

1. **Support for Economic Progress:** To facilitate sustained economic advancement, the Indian government has progressively increased its spending across essential sectors. Investments in infrastructure development—such as roadways, urban amenities, and public transport—have been prioritised to stimulate economic activity and improve connectivity. Additionally, greater emphasis on human capital development has led to higher allocations in education and healthcare.

2. **Impact of Population Growth:** India's expanding population has heightened the demand for public goods and services. As the number of citizens requiring access to basic services like schooling, hospitals, sanitation, and transportation grows, the government is compelled to raise its expenditure to meet these rising needs. This demographic pressure directly contributes to the upward trend in public spending.

3. **Commitment to Social Equity and Welfare:** Public expenditure has also risen due to the government's efforts to address poverty and reduce inequality. Numerous welfare schemes aimed at improving rural livelihoods, supporting farmers, and offering financial protection to vulnerable groups have resulted in increased fiscal outlays. Notable programmes such as rural employment guarantees and direct benefit transfers to farmers reflect the state's ongoing commitment to inclusive development.

4. **Infrastructure Development:** The need for improved infrastructure is a significant driver of public expenditure. The government has increased spending in sectors such as transportation, energy, and urban infrastructure to support economic growth and development. For instance, the government's focus on building highways and improving urban infrastructure has led to increased spending.

5. **National Defence and Strategic Preparedness:** Safeguarding the country from external threats is a fundamental duty of any government. Over the years, India has stepped up its defence outlays to strengthen military readiness, upgrade technology, and respond to evolving geopolitical challenges. Modernisation of the armed forces and investment in defense infrastructure have been key drivers

of this rise in public expenditure.

6. **Influence of Political and Policy Agendas:** Public spending is also shaped by the government's strategic priorities and policy commitments. New initiatives launched in alignment with electoral promises or long-term development goals often result in targeted increases in funding. As administrations focus on sectors deemed vital for national progress or political support, these choices significantly affect expenditure patterns.

6.3.1.5 Effects of Public Expenditure

1. **Economic Growth:** Public expenditure fuels economic development by investing in infrastructure, education, and industry. These investments enhance productivity and create a conducive environment for private sector growth. By boosting aggregate demand, it drives income generation and economic expansion.

2. **Employment Generation:** Government spending on public works programmes, rural employment schemes, and infrastructure projects directly creates jobs. It also stimulates allied industries, generating indirect employment. This helps reduce unemployment and supports income generation, especially in rural and underdeveloped areas.

3. **Poverty Reduction and Social Welfare:** Targeted public expenditure on food security, healthcare, housing, and education helps uplift marginalised groups. Social welfare schemes improve living standards and reduce income disparities. These programmes act as safety nets for the poor, promoting inclusive growth.

4. **Enhanced Public Services:** Government investment in sectors like education, health, sanitation, and transport improves the quality and accessibility of essential services. Better public services lead to healthier, more educated, and productive citizens. This contributes to human capital development and social wellbeing.

5. **Redistribution of Income and Wealth:** Public expenditure supports economic equity through subsidies, pensions, and social security schemes. By transferring resources to the underprivileged, the government reduces income inequality. Progressive taxation and welfare spending promote a more balanced distribution of wealth.

6. **Improved Infrastructure:** Investment in physical infrastructure like roads, bridges, electricity, and digital networks enhances connectivity and economic efficiency. It reduces production and transportation costs, attracting private investment. Strong infrastructure is the backbone of industrial and commercial growth.

7. **Macroeconomic Stability:** During economic downturns, increased government spending sustains demand and mitigates the effects of recession. In periods of inflation or boom, reduced spending can help cool the economy. Thus, public expenditure is a vital tool for maintaining overall economic stability.

8. **Long-term Investments:** Strategic public spending on education, research, renewable energy, and innovation fosters future-ready growth. These investments build resilience and support sustainable development. They ensure that the economy is equipped to handle emerging challenges and global competition.

6.3.1.6 Trends in Public Expenditure in India

India is a country with a quasi-federal structure, which means that power and responsibilities are shared between the Central Government and the State Governments. There are 28 States and 8 Union Territories, and the Constitution of India divides responsibilities among these different levels of government. This will help to maintain a healthy financial system at both the central and state levels.

Distribution of Spending Between the Centre and the State

The Constitution divides the subjects of expenditure between the Union List, the State List, and the Concurrent List. The Union List includes subjects that are the responsibility of the Central Government. These are areas with national importance, such as defence, macroeconomic stability, money and banking, and international trade. Also, projects with benefits that spread across multiple states, like railways, national highways, and space research, are managed by the Centre. The State List includes subjects managed by State Governments, such as public order, agriculture, health and sanitation, water supply, irrigation, and canals. The Concurrent List covers subjects that are handled by both the Centre and the States. These include important areas like education, transportation, and social insurance.

Transformations in India's Public Expenditure Pattern

Before India gained independence, the British government mainly spent public funds on defence and civil administration. The primary objective was to maintain law and order, with little attention paid to social or economic development. However, after independence in 1947, the focus of public expenditure shifted significantly. The main aim of the Indian government—both at the central and state levels—became the promotion of social development and poverty eradication.

Over the years, the pattern and priorities of public expenditure have changed in response to the economic needs of different time periods, especially during the various Five-Year Plans. Each plan had a distinct focus based on the country's developmental requirements at that time.

In July 1991, the government introduced a macroeconomic stabilisation programme. This was followed by the adoption of the New Economic Policy, which promoted Liberalisation, Privatisation, and Globalisation (LPG). As a result, the Eighth Five-Year Plan (1992-1997) shifted its focus to removing infrastructure bottlenecks, investing heavily in sectors such as energy, transport, and communication. This approach continued into the Ninth Plan (1997-2002).

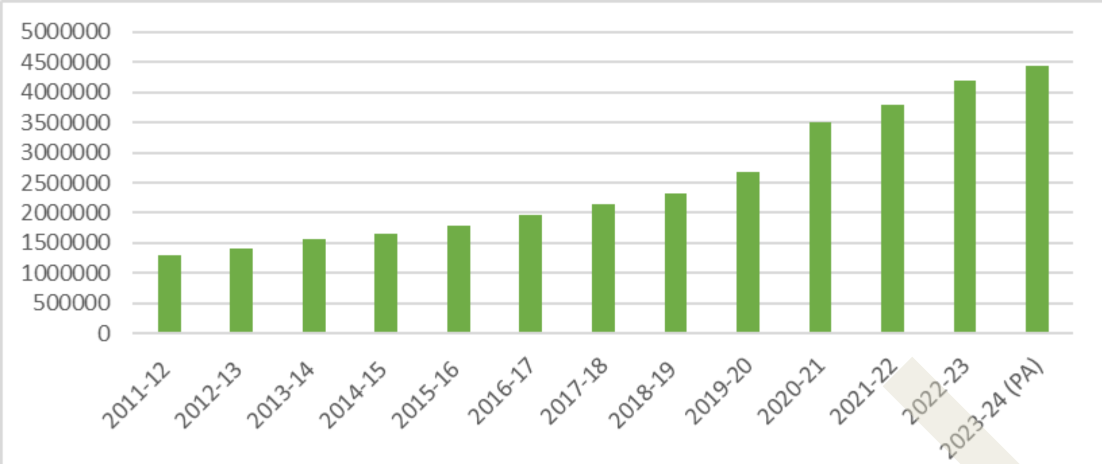

Fig. 6.3.4 Total Expenditure of the Central Government (₹ crore)
Source: Union Budget documents and Controller General of Accounts

The total expenditure of the Central Government has shown a steady upward trend from ₹13.04 lakh crore in 2011–12 to a projected ₹44.42 lakh crore in 2023–24. This indicates a more than threefold increase over the period. Notably, there was a significant jump between 2019–20 and 2020–21, primarily due to pandemic-related spending. Since then, expenditure has continued to rise annually, reflecting increased commitments towards welfare, infrastructure, and recovery measures.

These shifts in public spending reflect the changing developmental priorities of the Indian government over time. Initially, the emphasis was on creating the necessary foundation for a mixed economy, where the public sector played a leading role in infrastructure development and capital formation to drive growth.

Table 6.3.1 Total Expenditure of the Central Government as a percentage of GDP (%)

Year	Total Expenditure as a percentage of GDP
2011-12	14.9
2012-13	14.2
2013-14	13.9
2014-15	13.3
2015-16	13
2016-17	12.8
2017-18	12.5
2018-19	12.3
2019-20	13.4
2020-21	17.7
2021-22	16.1
2022-23	15.6
2023-24 (PA)	15

Source: Union Budget documents and Controller General of Accounts
Notes: PA: Provisional Actuals

While total central government expenditure has risen significantly in absolute terms, its share as a percentage of GDP has fluctuated. From 14.9% in 2011–12, it declined steadily to around 12.2% by 2018–19, reflecting tighter fiscal discipline and improved GDP growth. However, 2020–21 saw a sharp rise to 17.7% due to extensive COVID-19 relief measures. This was followed by a gradual correction, with expenditure settling around 15% in 2023–24 (PA). This trend highlights a responsive fiscal policy during crises and a return to moderation in later years, though the ratio remains above pre-pandemic levels, indicating a more proactive governmental role in economic affairs.

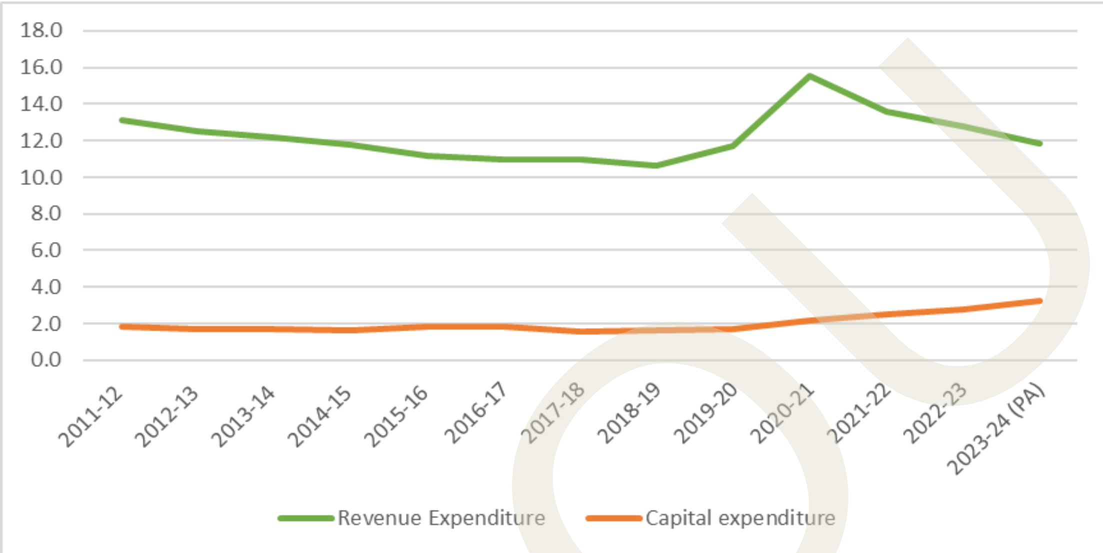

Fig. 6.3.5 Revenue and Capital Expenditure of the Central Government
Source: Union Budget documents and Controller General of Accounts
Notes: PA: Provisional Actuals

A closer look at the composition of expenditure reveals a declining trend in revenue expenditure (as % of GDP) from 13.1% in 2011–12 to 11.8% in 2023–24 (PA), indicating improved fiscal prudence. Simultaneously, capital expenditure has steadily increased from 1.8% to 3.2% during the same period. This shift reflects the government's growing focus on asset creation and infrastructure development. The pandemic year 2020–21 saw a sharp rise in both revenue (15.5%) and capital (2.1%) expenditure. Post-pandemic, capital spending has consistently risen, highlighting a structural pivot towards growth-oriented public investment - a positive sign for long-term economic sustainability and productivity enhancement.

Table 6.3.2

Components of Revenue Expenditure of the Central Government

Year	Interest Payments (₹ cr.)	Major Subsidies (₹ cr.)	Defence Expenditure (₹ cr.)	Interest Payments (% of GDP)	Major Subsidies (% of GDP)	Defence Expenditure (% of GDP)
2011-12	273150	217941	103011	3.1	2.5	1.2
2012-13	313170	257079	111277	3.1	2.6	1.1

2013-14	374254	254632	124374	3.3	2.3	1.1
2014-15	402444	258258	136807	3.2	2.1	2.1
2015-16	441659	241833	145937	3.2	1.8	1.1
2016-17	480714	204025	165410	3.1	1.3	1.1
2017-18	528952	191210	186127	3.1	1.1	1.1
2018-19	582648	196769	195572	3.1	1.0	1.0
2019-20	612070	228341	207572	3.0	1.1	1.0
2020-21	679869	707707	205789	3.4	3.6	1.0
2021-22	805499	446150	228558.9	3.4	1.9	1.0
2022-23	928517	530958	256183.4	3.4	2.0	1.0
2023-24 (PA)	1063871	413542	290437	3.6	1.4	1.0

Source: Union Budget documents and Controller General of Accounts

Notes: PA: Provisional Actuals

Alongside the shift towards capital expenditure, key components of revenue expenditure reveal significant trends. Interest payments have steadily risen from 3.1% of GDP in 2011–12 to 3.6% in 2023–24 (PA), reflecting a growing debt burden. In absolute terms, they have surged nearly fourfold during this period. Major subsidies, which peaked in 2020–21 due to COVID-19 relief measures, have since declined from 2.5% to 1.4% of GDP, indicating a clear rationalisation of subsidy policies and a return to fiscal discipline. Defence expenditure has remained relatively stable as a percentage of GDP (around 1%) but has more than doubled in value, reflecting a sustained strategic focus. The volatility in subsidies contrasts with the steady rise in interest and defence outlays, highlighting the government's efforts to rebalance expenditure. Overall, this shift from consumption-driven spending towards investment and fiscal consolidation-while maintaining essential commitments-underscores a balanced and growth-oriented public finance strategy.

6.3.1.7 Government Expenditure-to-GDP Ratio Comparison (India vs. Other Economies)

India's government expenditure accounted for 29.1% of GDP in 2023, reflecting a balanced approach between welfare spending and fiscal constraints.

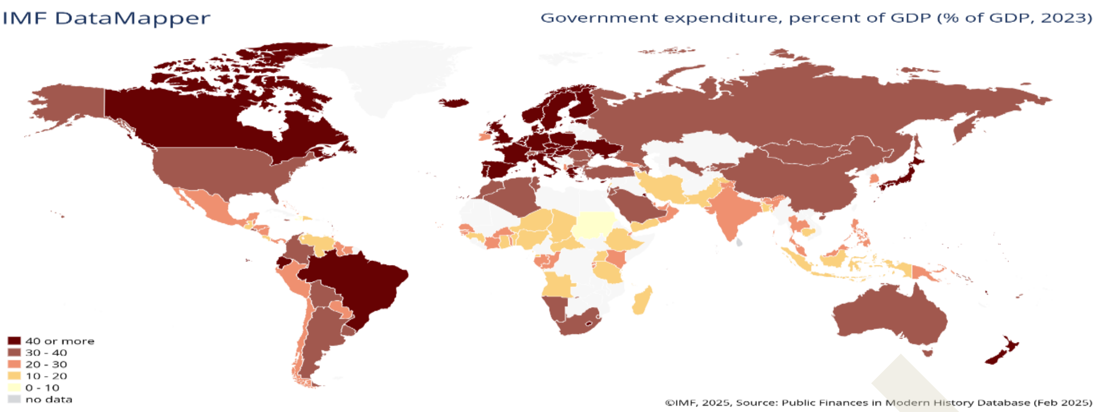

Fig.6.3.6 International Comparison of Government Expenditure-to-GDP Ratio

This places India slightly above Bhutan (28.9%) but significantly higher than Pakistan (19.2%), indicating greater state involvement in development. However, India's spending remains modest compared to advanced economies like Germany (48.4%), Sweden (47.5%), and the UK (44.2%), where robust social security systems dominate budgets. Even China (33.2%) and the US (36.3%) allocate larger shares to public programmes and infrastructure.

6.3.2 Composition of Public Debt in India

Public debt refers to the total amount of borrowing by the government to meet its expenditure needs when its revenue is insufficient. In the Indian context, public debt plays a major role in financing budget deficits and supporting economic development. The debt is raised through various instruments and sources, and its composition is typically classified based on its origin and duration.

The composition of public debt refers to the various types and sources of borrowings made by the government. It is broadly classified into internal debt and external debt, each with specific instruments and lenders.

1. Internal Debt vs. External Debt

i. **Internal Debt:** Internal debt is the borrowing that the government raises within the country. It includes loans taken from domestic financial institutions, individuals, banks, and other entities. Instruments used for internal borrowing include: Government bonds, Treasury Bills, Market Stabilisation Scheme (MSS) bonds, Ways and Means Advances (WMA) from the Reserve Bank of India (RBI).

ii. **External Debt:** When a country borrows money from sources outside its borders, this is referred to as External Debt. Such debts are typically obtained from international banks or financial institutions in other nations. The government may resort to external borrowing when substantial investments or loans are needed that cannot be met domestically. Moreover, external debt can potentially jeopardise a country's economic and political autonomy. Examples for external debts are- Loans from multilateral institutions like the World Bank, IMF, and ADB, etc.

Public Debt = Internal Debt + External Debt

Internal debt is predominant in most economies, including India. The effective management of its composition - such as maturity period, interest rate, and currency denomination - is crucial to ensure debt sustainability.

6.3.2.1 Reasons for Increasing Public Debt

In the contemporary era, public debt is surging at an alarming rate. Without prudent management, this can lead to chaotic and unstable economic conditions. Several factors contribute to this increase.

1. **Developmental Planning:** Governments undertake ambitious projects to enhance infrastructure, create jobs, and improve healthcare and education. These initiatives require substantial initial investments and ongoing costs. Developing countries, with limited tax revenues, often resort to borrowing to fund such projects. Even developed nations may borrow for large-scale construction projects.

2. **Unpopularity of Taxation:** Taxation is crucial for public services and government operations. However, many individuals, especially those with low incomes, view it as an unnecessary burden. The complex tax system and perceived misuse of funds further deter taxpayers. This reluctance to pay taxes forces governments to borrow to meet their financial needs.

3. **Natural Calamities:** Disasters such as floods and earthquakes cause significant damage, disrupting both the environment and the economy. Recovery efforts are costly, requiring funds for housing, food, and employment support for victims. Governments often take on public debt to finance these efforts.

4. **Waging Wars:** Wars necessitate substantial financial resources for weapons, soldier safety, and post-service pensions. These expenses strain government budgets, leading to increased borrowing to cover the shortfall.

5. **Temporary Budget Deficits:** Governments sometimes face temporary budget shortfalls, necessitating borrowing to bridge the gap between revenue and expenditure. While this provides short-term relief, the accumulating interest exacerbates the debt burden.

6. **Dealing with Depression**: Economic, financial, and environmental factors can trigger depression, increasing government expenditure and reducing tax revenues. Natural calamities and economic downturns force governments to borrow to fund relief efforts and stimulate recovery.

7. **Controlling Inflation:** During inflation, the value of money drops, increasing the cost of government expenditures. Borrowing becomes more expensive due to higher interest rates, further straining the economy. Governments resort to public debt to manage these challenges and stabilise the economy.

These factors collectively drive the increase in public debt, highlighting the need for careful fiscal management to ensure long-term economic stability.

6.3.2.2 Economic Effects of Public Debt

Public debt significantly impacts various aspects of the economy as follows.

1. **Consumption:** Public debt can reduce consumer purchasing power, as funds diverted to debt repayment leave individuals with less disposable income. This contractionary effect can limit consumption. However, foreign loans used to import needed goods and services can boost consumption and mitigate inflationary pressures.

2. **Private Investment:** Public debt can crowd out private investment by reducing the availability of investible funds. When a significant portion of funds is tied up in public debt, less capital is available for private sector investment, potentially stifling economic growth.

3. **Distribution:** Public debt can influence income distribution. If wealthier individuals subscribe to public loans and the government uses these funds to support low-income groups, it can reduce income inequality. Conversely, if the burden of public debt falls disproportionately on lower-income groups, it can exacerbate income disparities.

4. **Production:** Public debt can negatively affect production if funds are withdrawn from industrial investments to buy government bonds. However, if the government reinvests these funds into productive public enterprises, the overall impact on production may be neutral or even positive.

5. **Credit Control:** Public debt can impact the effectiveness of credit control measures by central banks. Commercial banks, major contributors to public loans, are required to invest a portion of their funds in government bonds. These bonds, being highly liquid, can be quickly converted into cash, potentially affecting monetary policy.

6. **Cost of Production:** Public debt can influence production costs. The government can use borrowed funds to provide raw materials at concessional rates or support industrial research and subsidies, thereby potentially lowering production costs and enhancing competitiveness.

7. **Foreign Loans:** External borrowing enables underdeveloped and developing countries to import high-priority goods and capital goods, which are crucial for building capacity and accelerating economic growth.

6.3.2.3 Trends of Public Debt and Interest Payments in India

India's public debt has grown significantly since the 1980s. During that decade, combined central and state government debt rose by 18% annually—faster than GDP growth (14% at current prices). As a result, the debt-to-GDP ratio surged from 50% in 1980-81 to 75% by 1990-91. Internal debt grew more rapidly than external debt during this period. From 1990-91 to 1997-98, fiscal reforms helped reduce debt levels, with internal debt falling to 25.7% of GDP.

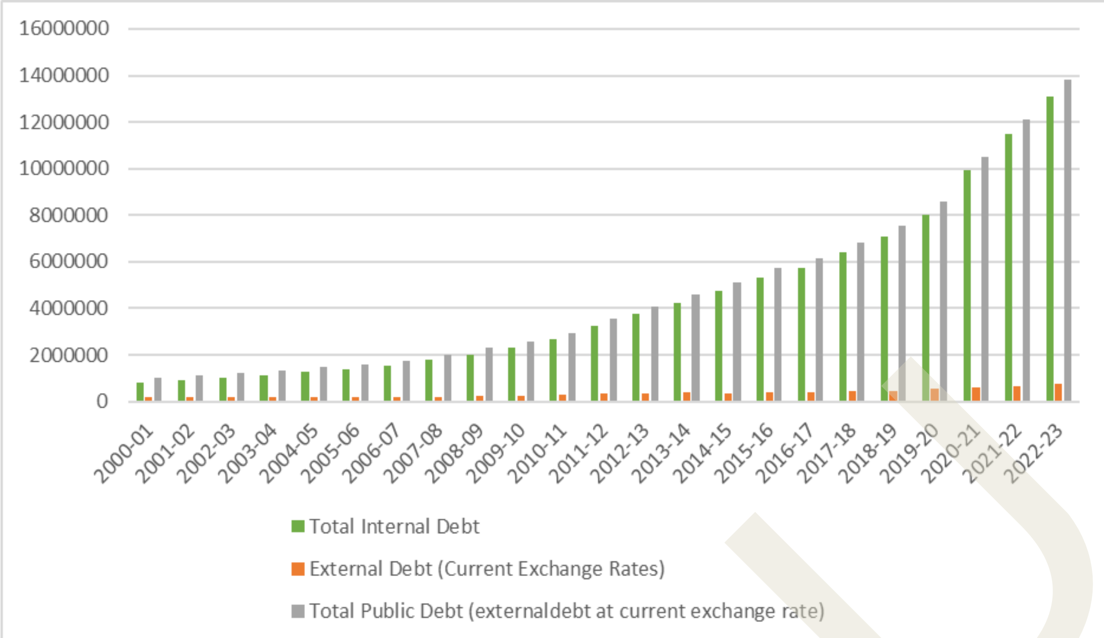

Fig 6.3.7 Central Government Debt - Public Debt
Source: Union Budget and Finance Accounts (Various Issues)

Between 2000–01 and 2022–23, India's total public debt witnessed a steady and substantial increase, rising from ₹9.94 lakh crore to ₹138.22 lakh crore. A major portion of this debt was internal, accounting for over 90% in most years. Internal debt grew significantly faster than external debt, reflecting the government's preference for domestic borrowing due to lower risk and greater control. External debt rose modestly from ₹1.9 lakh crore to ₹7.48 lakh crore during the same period, indicating a cautious approach to foreign liabilities.

A sharper increase in public debt is noticeable post-2010, driven by fiscal expansion, welfare programmes, and later, pandemic-related spending. The COVID-19 years (2020–21 onward) marked a steep rise in both internal and total public debt, with borrowing used to support economic recovery. While rising debt signals persistent fiscal deficits and higher interest burdens, reliance on internal sources reduces currency risk and offers policy flexibility.

In summary, India's public debt profile is marked by a dominant share of internal borrowing and moderate foreign debt exposure. The trend reflects both developmental needs and prudent debt management strategies suited to domestic macroeconomic conditions.

6.3.2.4 Gross Public Debt-to-GDP Ratio Comparison (India vs. Other Economies)

Based on IMF data from 1947 to 2023, India's gross public debt as a percentage of GDP shows significant fluctuations. It remained relatively stable until the 1980s, followed by a sharp rise in the early 1990s, peaking in 1992 due to economic crisis and liberalisation reforms.

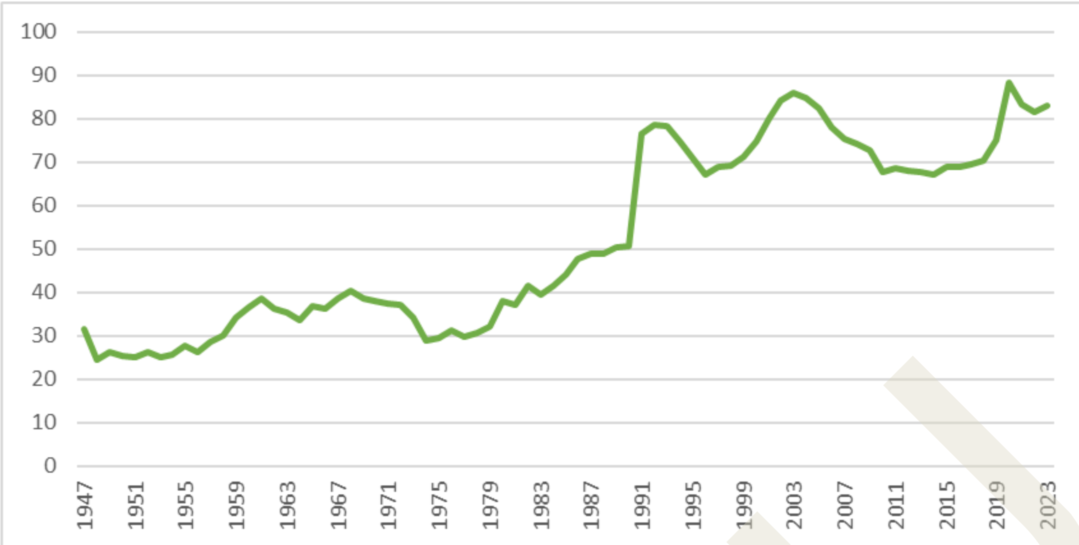

Fig.6.3.8 Gross public debt of India, per cent of GDP (% of GDP)
Source: Union Budget and Finance Accounts (Various Issues)

Debt gradually declined after 2003 but surged again during the COVID-19 pandemic, reaching 88.4% in 2020. Although it slightly declined post-pandemic, it remains above 80%, indicating persistent fiscal stress. The overall trend reflects India's growing developmental expenditure, crisis responses, and fiscal deficits, underscoring the need for prudent debt management and sustainable fiscal policies.

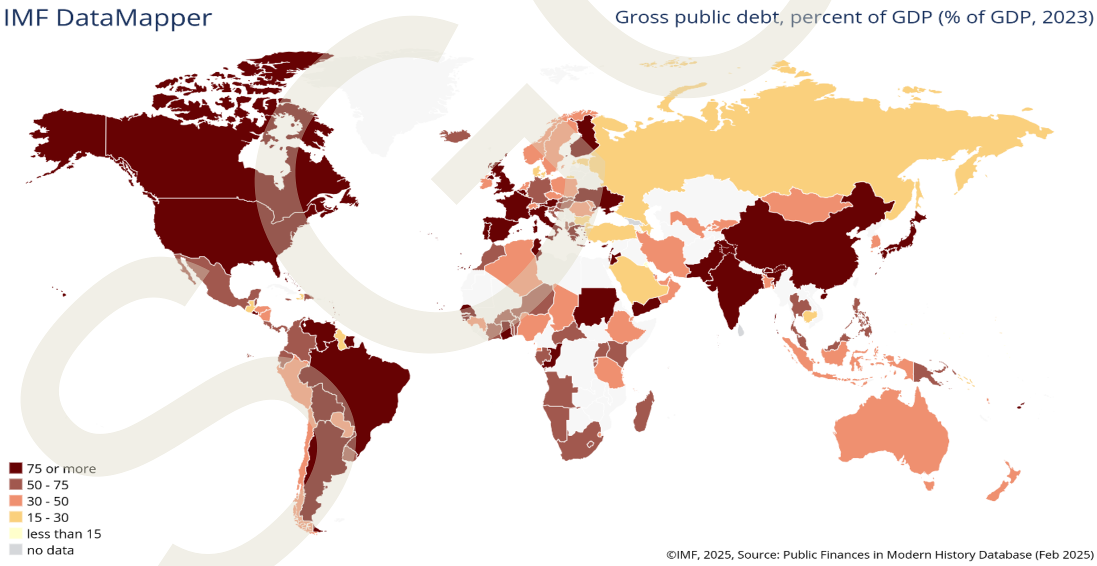

Fig.6.3.9 Gross Public Debt-to-GDP Ratio Comparison (India vs. Other Economies

In 2023, India's gross public debt stood at 83.02% of GDP, higher than Germany (62.66%) and Pakistan (77.29%), but lower than China (84.38%), the UK (100.03%), Bhutan (116.06%), and the US (118.72%). This comparison highlights India's relatively high debt burden among emerging economies, though still below advanced economies like the US and UK.

6.3.2.5 Key Concerns for Public Debt Management in India

Managing public debt is one of the biggest challenges for the Indian government today. The Central Government debt/liabilities, including external debt at current exchange rate, is estimated at 185.11 lakh crore and 200.16 lakh crore as on 31st March, 2025 & 31st March, 2026, respectively. When we include the debt of state governments, the total public debt goes much higher than this figure. Though this is not the highest in the world, it is still a matter of concern, especially when compared to emerging economies.

One of the biggest problems is the high interest payments. In 2025-26, outstanding liabilities are estimated to be 56.1% of the GDP. This is more than what the government spends on important sectors like education and healthcare. This reduces the money available for public welfare and development projects.

Another issue is the limited flexibility in fiscal policy. When debt is too high, the government finds it difficult to borrow more money during emergencies like a financial crisis or natural disaster. This limits the government's ability to support the economy during hard times.

Lower credit ratings are also a risk. If India continues to have high debt and fiscal deficits, international rating agencies may reduce its credit rating. This makes it more expensive for India to borrow money from global markets.

Misuse of public funds is another concern. Corruption and inefficiency in government departments can lead to the wastage of borrowed money. This creates a burden on future generations who will have to repay these loans.

High government borrowing may also reduce private investment, as it takes up a large share of the available funds in the economy. This is known as the 'crowding out' effect.

Lastly, too much debt in the financial system can lead to systemic risks, which may threaten the stability of banks and financial institutions.

Therefore, India needs to focus on reducing its debt levels, improving spending efficiency, and strengthening public financial management.

6.3.2.6 Public Debt in India: The Way Forward

Public debt in India has become a major fiscal concern due to increasing deficits and inefficient deployment of borrowed funds. To address this, a multifaceted strategy is needed, focusing on fiscal consolidation, enhanced revenue mobilisation, and efficient expenditure.

The foremost priority should be to achieve fiscal consolidation. The NK Singh Committee on the FRBM Act recommended a general government debt-to-GDP ratio of 60%, with 40% for the Centre and 20% for the States. To realise this goal, both central and state governments must adhere to prudent fiscal policies. Incentivising fiscally responsible states can encourage better financial discipline.

Enhancing tax revenue is equally crucial. Improving tax compliance through advanced technologies, such as cross-matching GST and income tax returns, can reduce evasion and improve collection. Administrative streamlining and the efficient introduction of new taxes can also contribute to increased revenue. Additionally, strategic disinvestment and better asset management can optimise public resources.

Public expenditure should be redirected towards productive sectors, particularly infrastructure, human capital, and green initiatives. Privatising loss-making PSUs and adopting public-private partnerships in social schemes like Deen Dayal Upadhyay Grameen Kaushalya Yojna (DDU-GKY) can reduce the fiscal burden. Green debt swaps offer a sustainable solution by converting debt obligations into investments in climate and social sectors, particularly for low-income regions.

It is also vital to address the black economy, as reducing its size would boost taxable income and reduce the government's reliance on borrowing. In line with E.D. Domar's theory, if public spending enhances national income, then public debt does not pose a significant burden.

Finally, institutional mechanisms like the Public Financial Management System (PFMS) and the establishment of a Public Debt Management Agency (PDMA) will ensure transparency, better monitoring, and strategic handling of debt.

Thus, India's path to sustainable debt management lies in balancing borrowing with growth-oriented, transparent, and efficient governance.

Recap

- Public expenditure and debt are key tools for government economic management and service delivery
- Public expenditure refers to government spending on infrastructure, education, healthcare, and administration
- Public debt involves borrowings to cover budget deficits from internal or external sources
- Principles of public expenditure include welfare maximisation, cost-effectiveness, and fiscal prudence
- Expenditure is structured as developmental vs non-developmental and revenue vs capital
- Major components of public expenditure in India are social services, economic services, defence, and subsidies

- Effects of public expenditure includes boosting growth, employment, poverty reduction, and infrastructure
- India's trends show rising spending post-independence and post-1991 reforms
- Expenditure is divided between Centre (defence, railways) and States (health, agriculture)
- Public debt comprises internal (bonds) and external (IMF, World Bank loans) borrowings
- Debt rises due to development projects, disasters, wars, and economic crises
- India's debt has grown steadily since the 1980s with internal debt dominating
- Key concerns are high interest payments, fiscal risks, and crowding out private investment
- Solutions include fiscal consolidation, tax reforms, and better debt management

Objective Questions

1. What is the main goal of public expenditure?
2. Which type of expenditure includes salaries and pensions?
3. Building roads is an example of which expenditure type?
4. What replaced the Plan/Non-Plan classification in 2017?
5. What is the primary source of India's public debt?
6. Which institution lends Ways and Means Advances (WMA) to the Indian government?
7. What economic phenomenon occurs when government borrowing reduces private investment?
8. Which tax reform improved revenue mobilisation in India?

Answers

1. Welfare
2. Revenue
3. Capital
4. Capital/Revenue
5. Internal
6. RBI
7. Crowding-out
8. GST

Assignments

1. Explain the key principles guiding public expenditure in India. How do these principles ensure efficient and equitable use of government funds?
2. Compare revenue expenditure and capital expenditure in India. Discuss their respective impacts on economic growth and fiscal health.
3. Explain the causes behind the rising public expenditure in India.
4. Explain the composition of India's public debt.
5. Evaluate the economic effects of public debt in India, focusing on production, consumption, and income distribution.

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MODEL QUESTION PAPER SETS

SREENARAYANAGURU OPEN UNIVERSITY

QP CODE: ……… **Reg. No. : ....**

Name: ……..................................

FIFTH SEMESTER B.A. ECONOMICS EXAMINATION

DISCIPLINE SPECIFIC ELECTIVE COURSE

B21EC06DE-Public Economics

(CBCS - UG)

2022-23 - Admission Onwards

MODEL QUESTION PAPER- SET A

Time: 3 Hour Max Marks: 70

SECTION A

Answer any **ten** *questions of the following. Each question carries* **one** *mark.*

(10 × 1 = 10 Marks)

1. Define Public Finance.
2. State one Canon of Taxation.
3. Give an example of a pure public good.
4. What is meant by quasi-public goods?
5. Define externality in economics.
6. Mention one source of commercial revenue.
7. Define developmental expenditure.
8. What is meant by debt redemption?
9. Who formulated the Law of Increasing State Activities?
10. Define fiscal federalism.
11. What is vertical equity?
12. Expand FRBM Act.
13. Define fiscal deficit.

14. Mention one objective of the Finance Commission.

15. State one feature of Indian Tax System.

SECTION B

Answer any **ten** *questions of the following. Each question carries* **two** *marks.*

(10×2 =20 Marks)

16. Differentiate between positive and normative aspects of Public Finance.

17. Explain the free-rider problem in one or two sentences.

18. State two main sources of public revenue.

19. Distinguish between direct and indirect taxes.

20. What is Laffer Curve ?

21. Write two features of VAT.

22. Differentiate between developmental and non-developmental expenditure.

23. Write two assumptions of Wagner's Law.

24. Define burden of public debt.

25. What is the meaning of intergovernmental transfers?

26. Distinguish between revenue deficit and primary deficit.

27. What is zero-based budgeting?

28. Write two objectives of fiscal decentralisation.

29. Define outcome budgeting.

30. State any two achievements of FRBM Act.

SECTION C

Write a short note on any **five** *questions of the following.*
Each question carries **four** *marks.*

(5×4 = 20 Marks)

31. Explain allocation, distribution, and stabilisation functions of public finance.

32. Discuss the features of pure and impure public goods.

33. Write a note on Pigouvian tax with a suitable example.

34. Explain the canons of taxation by Adam Smith.

35. Discuss Wagner's Law of Public Expenditure.

36. Explain the different types of Public Debt.

37. What are the principles of federal finance?

38. Discuss the role of State Finance Commissions.

39. Write a note on Revenue and Capital Expenditure.

40. Explain the importance of outcome budget in India.

SECTION D

Answer any **two** *questions of the following. Each question carries* **ten** *marks.*

(2×10 =20 Marks)

41. Discuss the theories of public expenditure with reference to Wagner's and Peacock-Wiseman hypothesis.

42. Examine the structure and growth of Public Debt in India.

43. Analyse the principles of fiscal federalism and the problem of fiscal imbalance.

44. Evaluate the trends in revenue receipts in India since liberalisation.

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FIFTH SEMESTER B.A. ECONOMICS EXAMINATION

DISCIPLINE SPECIFIC ELECTIVE COURSE

B21EC06DE-Public Economics

(CBCS - UG)

2022-23 - Admission Onwards

MODEL QUESTION PAPER- SET B

Time: 3 Hour Max Marks: 70

SECTION A

Answer any **ten** *questions of the following. Each question carries* **one** *mark.*

(10 × 1 = 10 Marks)

1. Mention one fiscal function of the government.
2. What is meant by market failure?
3. Give an example of a quasi-public good.
4. Define externality.
5. Who introduced the concept of functional finance?
6. Mention one source of administrative revenue.
7. Define non-developmental expenditure.
8. What is meant by public borrowing?
9. Who propounded the Compensatory Finance theory?
10. Define horizontal equity.
11. What is meant by fiscal imbalance?
12. Mention one function of the Finance Commission.
13. What is the primary deficit?

14. What is GST?

15. Mention one objective of the FRBM Act.

SECTION B

Answer any **ten** *questions of the following. Each question carries* **two** *marks.*

(10×2 =20 Marks)

16. State the three fiscal functions identified by Musgrave.

17. What is the difference between pure and impure public goods?

18. Define the free-rider problem.

19. Mention two types of public revenue other than taxes.

20. What is Laffer Curve?

21. Define tax burden.

22. Distinguish between developmental and non-developmental expenditure.

23. Define Peacock–Wiseman Hypothesis.

24. Mention two types of public debt.

25. Distinguish between vertical and horizontal equity in fiscal federalism.

26. What is outcome budgeting?

27. State any two objectives of fiscal decentralisation.

28. Write two features of zero-based budgeting.

29. Define stabilisation function of fiscal policy.

30. Write two features of the Indian Tax System.

SECTION C

Write a short note on any **five** *questions of the following.*
Each question carries **four** *marks.*

(5×4 = 20 Marks)

31. Explain the scope and importance of public finance.

32. Discuss quasi-public goods with examples.

33. Explain the concept of Pigouvian tax.

34. Discuss the classification of taxes.

35. Explain the theories of public expenditure.

36. Distinguish between different types of public debt.

37. Write a note on criteria for transfer of resources.

38. Explain the role of State Finance Commissions in fiscal decentralisation.

39. What are the different types of fiscal deficits?

40. Analyse the objectives of FRBM Act.

SECTION D

Answer any **two** *questions of the following. Each question carries* **ten** *marks.*

(2×10 =20 Marks)

41. Analyse the role of fiscal policy in correcting market failure.

42. Examine the impact of GST on the Indian Tax System.

43. Critically discuss fiscal federalism in India.

44. Evaluate the trends in public expenditure and fiscal deficits in India.

സർവ്വകലാശാലാഗീതം

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