SELF LEARNING MATERIAL

M.A. ECONOMICS

COURSE : ECO - 103

(1st Semester)

PUBLIC FINANCE : THEORY AND PRACTICE

BLOCK - 1 & 2

Directorate of Distance Education
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ECONOMICS

COURSE : ECO - 103

PUBLIC FINANCE : THEORY AND PRACTICE

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ECONOMICS

COURSE : ECO - 103

PUBLIC FINANCE : THEORY AND PRACTICE

			Pages
Block – 1	:	Public Finance : Role, Approach and Some Basic Concepts	1-82
Block – 2	:	Taxation	83-106

BLOCK - I: PUBLIC FINANCE - ROLE, APPROACH AND SOME BASIC CONCEPTS

UNIT- 1: ROLE AND APPROACH

STRUCTURE

1.0 Objectives

1.1 Introduction.

1.2 Role of Public Finance in Developing Economies and its Distinction from Developed Economies

1.3 Government as an Agent for Economic Planning and Development.

1.4 Government in Different Economic Set up.

1.4.1 Role of the Government in Capitalism

1.4.2 Role of the Government in Socialism.

1.4.3 Role of the Government in Mixed Economy

1.5 Functional Finance Approach to Public Finance

1.6 Normative Approach to Public Finance

1.7 Optimum Budget Model

1.8 Let us Sum up

1.0 OBJECTIVES :

After reading this unit you should be able to :

1. Explain the major important role of public finance in developing countries in different periods.
2. Discuss the role of fiscal instruments as an active tools in the attainment of fiscal objectives in developing countries.
3. Point out the differences and role of the theory of Functional Finance and Normative theory in the attainment of economic goals.
4. Understand the concept of optimum budget model.

1.1 INTRODUCTION :

There is hardly any economy which is not directly or indirectly regulated by the government and fiscal policy. Govt. utilizes the fiscal instruments like taxation, public expenditure, public debt, and budget for the attainment of its well defined aims and objectives which are different from economy to economy. Government's multifarious activities influence the level of income, production, employment, consumption, and saving-investment.

As we go along this unit we shall review the role played by the government as an agent for economic development and economic planning.

1.2 ROLE OF PUBLIC FINANCE IN DEVELOPING ECONOMIES AND ITS DISTINCTION FROM DEVELOPED ECONOMIES :

It is a recognized fact that the role and importance of public finance are gaining its popularity in the 20th century. The attachment of the significance to the study of public finance in the context of socio-economic development is of recent origin.

But it was observed that some times ago it was “a dull, unimaginative extremely limited and almost irrelevant discipline”, but nowadays it is “one of the most exciting areas in political economy” (James Bachanan). The classical economists were the ardent supporters of ‘Laissez Faire Policy’ and they believed in the minimum state intervention in the affairs of the people. There was the existence of ‘Police State’ as against the 20th century’s welfare state. I Generation of maximum social welfare is one of the formidable objectives of modern welfare state. Thus the socio-economic responsibility of the modem government is expanding. The economic scenario of the developing economy is abit different from that of developed economics. Government finance can do a lot in accelerating the pace of economic development, promoting economic stability, ensuring equitable distribution of income and wealth, generating full-employment, optimizing and utilizing country’s resources. Public finance can play vital role in stepping up the level of capital formation, saving, income, standard of living of the mass people, national income, employment, reduction of poverty etc. in a planned way. According to RJ .Chelliah, “Public finance has a positive and significant role in the context of economic development.” Without government’s active role and fiscal instruments, rapid economic developments as well as economic stability are quite unthinkable in the developing economics. To quote A.R. Prest, “It is now not only accepted but expected that government should take strong positive action to foaster development.” Therefore a stem regulation and efficient control of all productive activities are urgently required to attain at these objectives. It can be said that public finance determines the structure; the face and bent of economic development of the developing counties. The role of public finance in affecting The

planning which is the penacea of economic development in noticeable.

A radical change has been brought about by the writings of Lord Keynes on the impact of Great Depression of thirties on the role of public finance. Public finance was called upon to play an active role to raise the volume of effective demand, level of income and employment in the country. Deficit financing can activate the depressed economy by creating more income as well as employment through the process of multiplier.

Role of public finance is quite different in developed economies with its different characteristics. Being influenced by 'Laissez Faire Policy', the classical economists had neglected the role to be played by public finance.

But as stated earlier, with the beginning of the 20th century, the study of public finance and its role have assumed great importance. Fiscal policy and fiscal instruments viz. taxation, public expenditure, public debt, budget and public works can be .effectively utilized for influencing the level of economic activities.. It is to be noted here that formidable problem of developed countries is economic stability. While the unemployment, price hike, poverty, inequality etc. are the major problems faced by the developing countries. Thus public finance may act as an effective means of stabilization in developed economy. After Keynesian revolution public finance assumed a functional role of maintaining economic stability at full employment level. It may be used to remove economic fluctuation and distortions in the economy. Thus in a developed economy, the problem is not so much of promoting economic growth as that of achieving economic stability. Fiscal 'policy, if properly planned and coordinated may generate favourable

results to bring economic stability in advanced developed economies.

It is an accepted fact that the economic structure of developed countries is so sensitive, interdependent and complicated that a slight disturbance may disturb the entire economy to a greater extent. To bring economic stability, it is necessary to keep the level of consumption and investment up to the level of production. Thus there is an urgent need of expansion of the volume of investment for keeping the productive process in the same rate.

Public finance through its budget policy helps in stabilizing the aggregate demand for bringing about economic stabilization. There components, viz., public revenue, public expenditure, public debt; can be taken into account to reshape the foundation of economic development and stability.

1.3 GOVERNMENT AS AN AGENT FOR ECONOMIC PLANNING AND DEVELOPMENT:

It is universally accepted that government plays a significant role in accelerating the pace of economic development in developing countries. Being the guide, friend and philosopher of the citizens from the cradle to grave, governments are capable of influencing the economic life of the people. It inf1uences their creative as well as productive activities through various channels of fiscal policy. Public revenue and other tools are used to bring a revolutionary change in the life of the people. Economic development is quite unthinkable without government intervention in different aspects of life. Nowadays, government is acting a role as entrepreneur in most of the countries of the world. **1.**

Private sector fails to satisfy the need and aspirations of larger number of people due to its profit motive.

Government's functions differ from country to country and from time to time. In developing countries, government castes its eyes towards the attainment of twin objectives i.e. growth with stability. To attain these objectives, government utilizes its fiscal weapons in a planned manner. A welfare and stable government is necessary for speedy and desired change in economic structure. While corrupt, inefficient and weak government is a great obstacle to economic development. It has to create an efficient public sector and government has to undertake the responsibility of proper mobilization of necessary resources and invest it in the most urgent priority sector. It is a recognized fact that economic development without enlightened political leadership is quite unthinkable. A congenial atmosphere is the Sin quanon of economic development. Continuous war, internal disturbance, fears atmosphere are responsible for economic backwardness. The patriotic popular government incurs lot of money to fight against these economic maladies in a planed ways. Similarly in a situation of risk and uncertainty, investors (Foreign and domestic) are reluctant to invest their investable fund in risky enterprises. Government has to come forward to set up a congenial atmosphere which leads to economic development. Here role of public expenditure is of immense.

Development of entrepreneurial ability which is treated as an important determinant of economic development depends upon the government. In weak nations, there are lots of hurdles which restrict the supply of entrepreneurs and therefore, government may come forward to save the economy from market imperfection. Government is to create favourable

condition by planed used of fiscal, monetary and budgetary policies. The building up of capital assets of various types depends upon the wishes of the government. These assets raise the productivity, creativity of the workers who are associated with production operation of the country. Dual saving is to stepped up by fiscal incentives in the form of tax concession, tax exemption and policy of tax holiday. It is estimated that the proportion of saving to national income is 4 p.c. to 5 p.c. in developing countries while it is 15 p.c. to 20 p.c. in developed ones. Technological progress which is dependent upon the government leads to faster economic development for any country. Natural resources, the economic indicators of economic development have made rapid economic development in most of the advanced nations and government is responsible for its proper extraction and utilization in right direction. Natural resources should not be allowed to be decayed by the government particularly in the LDCs.

Deficit financing by the government during economic depression helps to start the stagnant wheels of production operation and thus promotes economic development. When government resorts to deficit financing for economic development, large sums are invested in basic industries with long gestation period. Deficit financing as a method of resource mobilization has assumed a significant place in public finance.

Now we conclude that government has emerged as an active participant in the long process of economic development. It should play strategic role in reducing various rigidities which are inherent in most of the LDCs. This task of economic development can be done by two measures. They are - 1. Direct Measures 2. Indirect Measures.

Direct Measures: Organizational changes, social as well an economic overheads, education and public health, family planning, changes in industrial framework, agricultural and industrial development, optimum allocation of resources etc.

2. **Indirect Measures:** Monetary fiscal and price policies, expansion of public sector, rise in foreign trade, and economic planning etc.

Government and Economic Planning :

Today planning is supposed to be the sovereign remedy of all economic ills. It is considered “grand panacea” of modern age. Robbins said: “To plan is to act with purpose, to choose and choice is the essence of economic activity.” (Robbins: “Economic Planning and International Order”.) Economic planning means planning by the central or state authority. It decides what goods and services are to be produced and in what quantity. The government has assigned a positive role in providing public utility services, public health services, education etc. to the common man and of ensuring welfare of the mass people. The government must play an active role in the adoption and implementation of economic planning for promoting economic development and public finance is a tool that the government should use sincerely. Government should come forward to undertake multiple responsibilities with bold, comprehensive and well integrated plan and programmes for the removal of bottlenecks which stand as hurdles in the path of economic development. It is said that an unplanned economy is like a ship moving rudderless on uncharted sea with no fixed destination and unlikely to reach it if there be any.

Government adopts economic planning for the attainment of certain well defined objectives like equitable distribution of income and wealth, economic stability, avoids wasteful consumption, optimum resource utilization, keeping down social cost, generation of more gainful employment opportunities, rapid industrialization, self sufficiency in food and raw materials etc. It is observed that the entire planning machinery functions well through the mechanism of public finance. Underdeveloped countries can not escape planning to develop themselves within a short span of time. Without economic planning, socialism is unthinkable. Public finance is a major factor tending towards the growth of planned economy. If economic planning is applied not by the state, but by the manager of a factory or industry, it can not cover the whole of national life.

1.4 GOVERNMENT IN DIFFERENT ECONOMIC SET UP :

There is a big gulf of difference between different economic systems prevailed in different parts of the world in different periods. Before the advent of capitalism, there were the existence of the mercantilism and physiocracy in England and France respectively. It is observed that the mercantilists advocated government intervention in economic and commercial activities for the attainment of material self sufficiency. They were of the views that the realization of taxes for the maintenance of a centrally organized state had been urgently necessary. While the physiocrats, the counterpart of the mercantilists were the ardent supporters of the policy of 'Laissey Faire' (let thing alone, let them take their own course). They were of the

the material happiness of mankind and they wanted minimum government control and maximum economic freedom. They were against heavy taxation realized by the king from subjects.

1.4.1 Role of the Government in Capitalism

Capitalism is the basic economic system of the modem age. Different economists have defined the term “capitalism” in different forms. These economists are Cunningham. Max Webber, Nussbaum, Hobson. In capitalistic system, state intervention is not only foolish and unjust but also wasteful. Govt. 1ntervention corrupts business and makes efficient production impossible. State intervention leads to burdensome and necessary control on industry. The functions of maintaining law and order and protection of the country from external aggression are the only function to be performed by the government. On the whole, all restrictions by the state were injurious to economic life of people.

Outstanding Features of Capitalism :

The study of capitalism reveals the following features:

1. Private property and inheritance.
2. Private ownership of means of production.
3. Class conflict
4. Economic freedom
5. Importance of price system
6. Dominant role of entrepreneur.
7. Economic inequalities.

But it is true that capitalism is not an unmixed blessing. Certain achievements and failures are visible in this economic system. A new system comes into existence to remove the glaring defects of capitalism and it is socialism which has the widest appeal in modem times.

1.4.2 Role of Government in Socialism:

Socialism is a revolt against capitalism. A revolutionary change came into the minds of the people to have an alternative economic system which can satisfy the needs and aspiration of the larger section of people of the society. Civic sense develops and social life becomes more complex and government comes forward to take the responsibility to perform multiple expensive functions for the uplift of the mass people. It is a new economic policy, making a complete departure from capitalism. Late Lord Keynes advocated that government should use it formidable power to tax, spend and change the quantity of money and rate of interest. Thus socialism wants the maximization of the state intervention in economic field. It holds that absence of state intervention has led to gross inequality of income and wealth, exploitation of workers, product for profit, economic instability and unemployment.

The Salient Features of Socialism :

We can draw the salient features of socialism from the definitions provided by different economists like Sindney, Beatrice Webb, B. Russell, Morris, Bernard Shaw and Dickinson etc.

1. Abolition of private property,
2. State production,

opinion that the natural order should be followed to raise
3. Economic equality,

4. Equality of opportunity ,

5. Economic planning,

6. Maximum social welfare,

7. Establishment of classless society.

As capitalism is incapable of lifting an underdeveloped economy from its present depth; so socialism is regarded as the only way out. It is beneficial to better allocation of country's resources, rapid economic development and efficient use of productive resources, economic stability, social justice and welfare of the mass people.

However, the critics have pointed out some drawbacks to socialism and they are corruption, nepotism, redtapism, favouritism etc. In spite of having these drawbacks, this movement is necessary for every society. Socialism shows that political democracy is useless with economic democracy. This type of economic system is appreciated and widely accepted by all for all times to come.

1.4.3 Role of Government in Mixed Economy :

A mixed economy is a planned economy. Planning helps in the efficient uses of scarce resources in this type of economy. It is of recent origin. A new economic system lying midway between capitalism and socialism has been taking shape in some of the countries of the world. It is popularly known as mixed economy or the 'Middle of the road" economic system. This system can be termed as democratic socialism also. There is joint responsibility of the individual and the state to undertake the entire work of both production and distribution. It is observed that most countries of Western Europe have been

marching towards this new system to reap its benefits. Underdeveloped and developing countries are also under its impact. One noticeable feature of mixed economy is that here private sector is not allowed to function freely to earn more profits at the cost of the weaker section of the society. Here government intervention is permitted to control and regulate private sector in many ways and to remove economic ills like depression, unemployment problem, inflation, deflation, inequalities of income and wealth etc. The state comes forward to protect the interest of the weaker and vulnerable sections of the society. In this system of economy spheres of the two sectors viz., public sectors and private sectors are clearly demarcated and accordingly investment is made by the government. Government regulates the private sectors through its monetary and fiscal policies. More alternative package of incentives in the shape of reduction of tax rate, tax exemption, tax holiday, subsidy on investment and production are to be provided timely by the government. These measures are already adopted by the government in different countries like the USA, UK, Norway, Sweden etc. Keeping this end in view, government of India too has adopted socialistic pattern of society since the dawn of second five year plan.

Now we can conclude that in a mixed economy there is the existence of both private and public sectors and both the sectors function harmoniously for the larger interest of the people. It is said that both sectors are the two necessary limbs of the economy and both must be in good health.

1.5 FUNCTIONAL FINANCE APPROACH TO PUBLIC FINANCE :

Credit goes to Keynes for the coinage of the concept 'Functional Finance'. This is the indeed a Keynesian approach on public finance which is a departure from the classical 'sound finance' approach. The very essence of functional finance is that public finance should be used as an active instrument for the achievement of certain socio-economic objectives. Before the birth of Keynes the main concern of public finance was to mobilize sufficient revenue from various types of taxation for meeting the government expenditure. But Keynes was capable of bringing about a revolutionary change in the nature and principle of public finance. Thus the Keynesian approach of public finance is called 'Functional Finance' by Prof. A.P. Lerner and Hansen, the two stanch supporters of Keynes. Functional finance is the system of judging fiscal measures by the way they function in the economy. Now public finance becomes functional finance which studies various functions of the government.

Public finance has the important function to perform both in developed and developing nations of the world. According to the theory of functional finance, the important function of public finance in the LDCs is to break the vicious circle' of 'poverty and to more towards economic development while in underdeveloped economics, public finance is to play developmental role. Taxation and expenditure policy of the government affect the level of income and employment of the country. Keynes is of the opinion that taxation, public expenditure; public debt, budget and public works can remove economic depression and raise the volume of income and employment of the country. To Keynes, level of income and employment can be raised to a greater extent by raising

investment expenditure on public works. This is called 'Income Multiplier' by Keynes.

Thus it is clear that the very essence of functional finance is that government should solve the problem of economic depression and inflation by adopting suitable tax and public expenditure policy. Keynes remarkable contribution to the theory of functional finance has changed the face of public finance.

1.6 NORMATIVE APPROACH TO PUBLIC FINANCE :

A.R. Musgrove gave the theory of public finance by dividing it into two approaches viz., The Normative or Optimum Theory of Public Finance and The Theory of Budget policy. This normative theory is developed to explain economic, fiscal and budgetary policies. This theory refers to some 'norms' or ideal which are required for ideal allocation of country's resources or ideal distribution of income. Thus budgetary operations as well as allocation are the need of the hour. Musgrave observed that the state should chalk out principles and norms to attain at the goal of the highest degree of public economy. The state should prepare an optimal budget plan, based on certain predetermined programmes. Musgrave called this as the normative or optimal theory of public finance. There is close coordination between the two approaches of public finance. According to Musgrave legislative action is to be taken to implement the above cited approaches of public finance. The nature or attitude of the market should be taken into account to get maximum possible results from different types of taxation and accordingly the government should suggest the tax authority to impose ;the best of the taxes. In reality public economy is confronted with

multiple problems which can not be solved with a single principle. So, state machinery is to be properly utilized for the salvation of these problems in a phased manner. Musgrave pointed out three objectives to be achieved by the state machinery or by the fiscal department. These objectives are as follows :

1. Allocational objective
2. Distributional objective
3. Stabilizational objective

To achieve the above cited objectives, there is an urgent need of the creation of three branches in the budget. They are the allocation branch, distribution branch and stabilization branch.

1. Securing adjustment in the allocation of resources and allocation branch of the budget determines how to allocate tax burden. The main function of the allocation branch is to provide for public goods. Public goods are to be provided not by market mechanism but by budget. Optimum allocation of economic resources for getting maximum return is one of the important objectives of the public budgeting. Modern welfare Governments have to perform variety of function viz., maintenance of peace and harmony, defence, promotion of agriculture and industry and development of infrastructures like roads, railways, education etc. Public expenditure on these functions is directed towards the generation of maximum social welfare. Optimum allocation of resources is attained at a level of production where price equals cost.
2. The distributional objectives can be achieved through the distribution budget. Thus the distribution budget is to bring about equality of income and wealth in the society by means

of tax expenditure mechanism. It requires government interference to improve the distribution system of the country. Distribution branch of the budget may impose various kinds of taxes on the better off class and diversify the tax revenue for the well being of the worse off. The distribution budget will be balanced one, because whatever is collected from the better off class is spent for another class viz., the worse off.

There exist large disparities of income and wealth in the capitalist economy. Through redistribution of income and wealth in favour of the poor, inequality of income and wealth can be reduced to a larger extent. Public Finance correlates revenue expenditure and growing policies for the eradication of economic inequalities.

3. While the stabilization objective is to be achieved through the stabilization budget of the government. One of the major objectives of the budget is to maintain price stability and full employment. It requires the adoption of compensatory fiscal policy. Government must formulate this policy so that economic instability can be removed and save the economy from its adverse impact. According to Musgrave, three golden rules of compensatory finance are to be followed to achieve at this objective. It requires coordination among the fiscal policy, monetary policy and debt policy for the attainment of this objective. The budget of the stabilization branch will be a surplus or a deficit budget depending upon the nature of circumstances.

GROWTH OBJECTIVES :

Economic growth is treated as one of the major objectives of the budget for developing countries where idle resources are available. The allocation branch, distribution branch of the budget are to take the responsibility for the attainment of this objective. Of course it calls for fiscal action. This objective can be realized provided productivity in raised by raising willingness to save and invest through public expenditure and subsidy programmes of the government. According to Mrs. U.K. Hicks, the budget policy can contribute a lot to the growth of an economy. Thus the role of budgetary measures in the shape of deficit spending, taxation, public expenditure is of immense in economic growth.

From the above discussion we may come to conclude that a proper budget policy is a crucial instrument *for* the attainment of economic growth. It depends upon the coordinated effort of all the three branches of the budget. Musgrave's optimum budget model is very important mean to achieve at the desired end of an economy.

The stabilization function differs from allocation and distribution function of the budget. The Government budget is to secure and maintain full employment with price level stability. The visibility of economic maladies like unemployment, inflation and deflation, poverty, dissatisfaction, class struggle are the course of the society. Compensatory fiscal policy can check both unemployment and instability of price level. Welfare of the people is maximized if there is stability in the economy. This can be maintained by the judicious application of the fiscal weapons.

1.7 OPTIMUM BUDGET MODEL :

The Optimum Budget Model explains how economic resources are to be optimally allocated in regard to both taxation and public expenditure. It is already stated that a budgetary allocation is made to the manufacture of social goods or social wants. These goods are under the jurisdiction of private sector due to more financial involvement and more gestation periods. Moreover, maximization of profit is not involved in the production and distribution of social goods, public goods and merit goods. Therefore, there is an urgent need of the formulation of sound budget. According to Musgrave, three branches of budget are to be framed for it. Discussion on these branches of the budget is already made along with their objectives. Besides Musgrave, F. Due has divided the optimum budget into four parts and they are as follows:

1. Resource allocation
2. Operational efficiency in resource
3. Income redistribution
4. Economic stabilization and growth

Though the optimum budget model is purely an indigenous good attempt, it is based on certain assumptions. But the assumptions are unreal, hypothetical and as such problems of valuation on scientific footings remain unsolved. In spite of all these problems, this formulation is undoubtedly a bold step forward. It is already stated that three formulations are to be followed to prepare three branches of the budget. The sum total of three formulations gives us a complete picture of the optimum budget.

It is assumed that there are only two individuals are there in the society and they are X and Y and expenditure of the budget will be incurred on one type of service. Following symbols are used in the preparation of the optimum budget model.

Y = full employment income

C =private consumption expenditure

I = Investment expenditure

G =Government expenditure

C^X = private consumption expenditure of individual x

C^Z =private consumption expenditure of individual x

E^X= Earnings of individual x

E^Z = earnings of individual z

T_a^x =Tax paid by x in allocation branch

T_a^z= Tax paid by z in allocation branch

T^d_x= Tax paid by individual x in distribution branch

T_d^z= Tax paid by z in distribution branch

T_s^x= Tax paid by individual x in stabilization branch

T_s^x= Tax paid by z in stabilization branch

P_a^x= Price paid by x for goods provided by allocation branch

P_p^x= Price paid by x for private goods

P_p^z= Price paid by z for private goods.

U_a^p= Cost of goods provided for by the allocation branch

U_p = Cost of goods supplied to satisfy private wants. P

M = Fraction of earnings from sales of private buyers, going to x

V = Factor of earnings from sales to government going to x

J = Fraction of available income under proper distribution going to x

Optimum budget model depends upon the above cited symbols. It can be graphically represented. The concept of Musgrave's optimum budget is important in the theory of public finance. It is proved that a crude concept of optimum budget is definitely superior to that of taxable capacity which neglects the expenditure side of the budget. (Musgrave).

1.8 LETUS SUM UP :

In a developing economy public finance serves as an important tool in the achievement of specific objectives like economic development, full employment, price stability, improvement in distribution etc.

In this unit we have discussed the government as an agent for economic development and adopting economic planning, the panacea of economic development in most of the developing and developed countries along with its role in different economic set up viz., capitalist economy, socialist economy and mixed economy.

We have also examined the impact of the functional finance, theory of Keynes and normative theory of Musgrave. Musgrave lays more emphasis on normative or optimal theory of public finance.

KEY WORDS :

1. **Gestation Period:** It measures the period taken from the initiation of a project till its final completion.
2. **Great Depression:** World wide economic depression of 1929-35.
3. **Debt Trap:** An economic situation when a debtor country fails to repay the principal and interest charges and thereby it is forced to borrow to repay the old debt.

SUGGESTED READINGS :

1. Hugh Dalton, Public Finance, 1956.
2. U. Hicks, Public Finance, 1964.
3. Govt. Budgeting, 1956, John Woiley & Sons, New Delhi.
4. R. Nurkse, Problems of Capital Formation in underdeveloped countries.

CHECK YOUR PROGRESS :

1. Mention the salient problems of developed economy (Answer in twenty five wards)

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2. Mention the salient features of socialism:

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TERMINALQUESTIONS :

1. Differentiate Developing economy and developed economy. Explain the role of public finance in developing economy.
2. Discuss the role of Government in different economic system.
3. State and explain the Normative Theory of Public Finance. Mention its objectives.
4. What is meant by Functional Finance? Discuss its importance in the formulation of Fiscal Policy in Developing Economy.

HINTS TO CHECK YOUR PROGRESS EXERCISES :

Check Your Progress- 1

Economic structure of developed economy is so sensitive, interdependent and complicated and single disturbance may disturb the entire economy. The formidable problem of the developed economy is economic instability.

Check Your Progress- 2

Abolition of private property, State production, Economic equality, Equality of opportunity, Economic planning, Maximum Social Welfare, Establishment of classless society, State intervention, economic field.

UNIT 2 : CONCEPTS OF PUBLIC GOODS AND PRIVATE GOODS

STRUCTURE

2.0 Objectives.

2.1 Introduction.

2.2 Characteristics of Public Goods

2.3 Market Failure

2.4 Imperfection

2.5 Decreasing Cost

2.6 Externalities

2.7 Public Goods Vs Private Goods

2.8 Merit Goods

2.8.1 Characteristics of Merit Goods

2.9 Mixed Goods

2.10 Market Failure -Imperfection, Decreasing Cost, Externalities

2.11 Let us Sum up

2.0 OBJECTIVES :

In this unit you will be able to—

1. Differentiate Public Goods and Private Goods depending upon the definitions offered by different economists.
2. Know the various socio economic effects of various type of goods
3. Analyzes the salient characteristics of Public Goods
4. Explain the relationship as well as differences between Public, Private, Merit and Mixed Goods.
5. Know the causes and effects of Market failure

2.1 INTRODUCTION :

Public goods have been defined by different economists in different ways. Prof. Musgrave defined public goods / wants as the wants satisfied by services that must be consumed in equal amounts by all. Nobody is excluded from the consumption of public goods.

The contribution contributed by the Government or Public authority in the production and distribution of public goods in particular and private goods in general can not be under estimated. A budgetary provision is to be made in public goods. With a view to safeguard the interest of certain selected sections of the people of the society, merit goods are to be provided by the public authority.

2.2 CHARACTERISTICS OF PUBLIC GOODS :

Quite a good number of characteristics of public goods are there which are enumerated below:

1. Equal consumption by all consumers. R.A. Musgrave in his book "The Theory of Public Finance" defined public goods or wants as those wants satisfied by services that must be consumed in equal amount by all. As they are lumpy, they are to be supplied in different packages to different individuals. One example of such goods is national park.
2. Applicability of the principles of inclusion. They are indivisible. Consumers will not voluntarily reveal there preference pattern. It is due to the operation of the principle of inclusion. Consumers will not volunteer to show there preference pattern of public goods.
3. Consumer's demand schedule is vertical. Demand schedule for public goods are added vertically. It means different prices are paid for the same amount of commodities by different consumers but demand curve for private goods are added horizontally.
4. Externality of cost benefit (an economic effect on third parties) Public goods have the property of externality which means an economic effect on the third parties. For example, public Goods like National Highways offers benefits of transportation of all passengers and goods, saving of time, creation of market facilities. Similarly many garages, way side hotels and shops are the products of the construction of National Highways.
5. The benefits of public goods are wholly external (non-rival). Non rival implies jointness in consumption.

There is no substitution. No rival producer comes forward to supply these goods at lower prices. Public Goods are consumed i.e, same amount of benefit can be enjoyed by the neighbours.

6. Marginal cost of public goods is equal to zero or closed to zero. A likely characteristic of pure public goods is that its marginal cost is equal to zero or closed to zero. Additional member of the society can enjoyed public goods like Radio Set, Bridge etc. without adding to its total cost.
7. Subjected to decreasing cost and it is due to internal and external economics of scale. Another likely characteristic of public goods which are lumpy in nature is that it would be subject to the law decreasing cost. It is due to the emergence of internal and external economies of scale and efficient management.
8. Political process is involved in the determination of supply of public goods to the consumers. Public Goods are produced and supplied through the budgetary allocation. The Government is directly involved in both production and distribution operation. Cost of production and distribution are covered through taxation and public borrowing.
9. Public goods may be pure and impure. Most goods would possess the elements of both publicness and privateness, but the difference between the two is the difference of degree and lot of kind. Goods which are neither pure public goods nor pure private goods are called Impure Public Goods. But if the elements of publicness are

predominant, it may be called a public goods and in opposite case, a private goods.

10. Pure public goods are extremely scarce and govt. control is inherent. Pure public goods are extremely scarce and so Government regulation on output, price and quality etc is a must. It is due to huge investment of capital and long gestation period.

11. They belong to the category of social goods or merit goods. Social Goods and Merit Goods are to important components of public goods. Both social and merit wants or goods involved Government interference and they can not be satisfied through market mechanism. Budgetary provision is inevitable for their production and supply.

2.3 MARKET FAILURE :

There is direct relationship between public goods, private goods and market failure. Factors which stands as hurdle in the path of smooth functioning and healthy growth of an economy are known as market failure. The failure of the market in the achievement of allocative efficiency of public goods is termed as market failure. Market may fail to attain efficient allocation of resources when external benefits are associated with the production or consumption activities. It is the product of market imperfection, decreasing cost and externalities which are analyzed below.

2.4 MARKET IMPERFECTION :

There are three major obstacles which stand in the path of economic development in underdeveloped and developing

countries of the world. Among the three, market imperfection is one of the formidable obstacles. It refers to those forces which hinder the smooth functioning of an economy. It is also responsible for keeping the economy at lower level of out put, income and employment. The underdeveloped and poor countries suffer more from market imperfection due to the following factors:

1. Immobility of factors of production. They are immobile due to traditional custom, belief, habits and attitude of the people. Factor immobility leads to factor disequilibrium which acts as a drag on economic development. Lack of vertical mobility due to illiteracy, influence of religious superstitions, lack of resource for potential entrepreneur is one salient cause for lower production in the country. The old social institutions like caste system, joint family system present a hurdle in economic development by restricting occupational and geographic mobility of labour, occupation of a person is decided by birth, joint family system developed personal relationships and attachment to one's family and place of residence.

2. Rigid social structure which is unchangeable. The path of economic development is being obstructed by various socio economic factors like joint family system, universal marriage, costly social structure, custom and law of inheritance.

3. Workers have no perfect knowledge about the prevailing market condition and job opportunities. Due to mass illiteracy, ignorance, apathy of the workers, lack of proper training facilities, workers have no perfect to

knowledge about the market condition and job opportunities.

4. Entrepreneurial class is very small in number. Development of Entrepreneurial ability and small dynamic class is another hindrance of productivity and economic development.

5. There is no change in methods of production. Price and income do not act as incentives for expanding production. Weak traditional base and uses of primitive methods of production are responsible for reduction of production and as such price of the product and income do not act as incentives for expanding production. Government is reluctant to create a class of active Entrepreneur through training and incentives in the form of fiscal concessions.

6. Lack of specialization is one of the important hurdles which stand in the path of economic development of LDCs. There is also lack of specialization resulting in adequate trained personal and technical know-how. Thus there is a terrivable dearth of skilled personal and it results in inefficient as well as insufficient production.

7. Inefficient use of resources and lack of optimum allocation of resources are treated obstacles for economic development. It is due to the utilization of inferior techniques of production. Vast natural resources are not fully and properly utilized in profitable channels. Very little capital per head is utilized in production of operation in most of the LDC's of the world. Government of these countries have assigned a positive role to remove these obstacles Market imperfection can be removed in a phased manner through economic planning as well as budget

which are financed by tax revenue, public debt, deficit financing etc.

2.5 DECREASING COST :

It is observed that decreasing cost is associated with public goods which are produced and supplied through budgetary allocation. There are economies (external and internal) of large scale production of public goods are there and it is due to huge investment of financial and human resources. Cost per unit has a tendency to decline along with the rise of the scale of production. Moreover, infrastructural facilities in public goods are much more and it leads to the reduction of average cost of production. Average cost of production of these goods will have a tendency to rise provided budgetary provision is not up to the satisfaction. It can be explained with the help of an example. If a small area of a big city is provided for street lighting facility by the government, average cost of operation of this facility will be a bit higher than if it is provided to the entire city. Similarly average cost of public goods like defense service is much more in small countries than in big ones. While the impure goods and services like post & telegraph, generation and supply of electricity, gas, water etc. can be produced under decreasing cost industries. Decreasing cost is due to heavy investment in the projects, elimination of duplication cost due to economies of concentration, information, disintegration, technical, managerial, marketing, financial and risk bearing.

2.6 EXTERNALITIES :

It is an important feature of public goods. Externalities mean the economic effects which occur from the use of goods

other parties. It is significant phenomenon in modern world. It refers to costs and benefits which the private firm ignores in making net product value (NPV) analysis (i.e. cost and benefit which are external to firm but internal for the society). Setting up of a new project may change the surrounding economic activities. These linkages may be positive and negative. Positive linkages may generate new economic activity and additional benefits. While negative linkages may adversely affect the working of other economic activities in the area originate social costs. These interlinkages are referred to as externalities. In short, externalities refer to cost and benefit which the private firm ignores in making its net preset value (NPV) analysis. Costs and benefits which are external to a firm may be internal for the entire society. This can be analyzed with the help of a concrete example. Suppose a steel plant to be set up at a location will pollutes air and water around it. The plant will be permitted to discharge these pollution freely into the environment and no price is imposed. The plant assumes that there is no cost for environmental preservation. Accordingly, plant is built in that location. But real costs are involved in the installation of the plant on the part of the society resulting in the discharge of pollution. Thus it follows that NPV maximization for the firm may not maximize welfare of the society. This neighborhood effects or third party effects may be an economic gain or benefits or an economic loss or cost to other economic units. Credit goes to P.A. Samuelson and R.A. Musgrave for establishing a relationship between the theory of public goods and externalities. The benefit from public goods may be enjoyed by third party automatically. Private goods have no such type of externality.

2.7 PUBLIC GOODS VS PRIVATE GOODS :

Public goods mean a commodity or service which if supplied to one person can be made available to other at no extra cost. It must be supplied communally because it can not be withheld from one individual without withholding them from all. For example, it may not be possible to exclude anyone individual from consuming national defence or street lighting or general police protection.

While those goods which are priced in the market and those may be allowed to use it, are called private goods. Private goods are divisible.

Public goods can be grouped into three classes' viz., social goods, merit goods and mixed goods. Public goods may be pure public goods and private goods may be pure private goods. In case of pure public goods, principle of exclusion does not apply due to their indivisibility. On the other hand, pure private goods are divisible and principle of exclusion is applicable. Private goods are purchased in varying amount at a common price. But it is not applicable to public goods due to the fact that the same amount of goods and services must be consumed by all the consumers. Moreover, the benefits of some public goods are enjoyed automatically by some groups of people other than those for whom the original project is installed. Example of such project is national highways. This is called externality.

Marginal cost of providing public goods is almost zero or closed to zero. They are also jointly demanded and supplied. Most of the public goods are subjected to increasing return or decreasing costs. It is due to the economies of scale. While private goods are subjected to the law of decreasing return or increasing cost resulting in diseconomies of scale.

Impure public goods are known as quasi-public goods or quasi private goods. These impure public goods are neither pure public goods nor pure private goods. Pure private goods have no externality. If the elements of publicness are predominant in the mixture of characteristics of a good, it is called public good and in the opposite case, a private goods. Element of subsidy is there on the part of pure public goods, while it is zero in case of purely private goods. In the case of mixed goods the cost of goods is covered partly by private contribution and partly by public subsidy.

The administrative machinery of the state may not be efficient enough to provide all public goods for satisfying the needs and aspirations of the people or the consumers. The efficiency of public undertakings is notoriously low. Production and distribution of such goods depend upon political as well as social consideration.

We have already mentioned that public wants can not be satisfied through the mechanism of market due to the reason that their enjoyment can not be made subject to price payments. Thus market system fails to supply the public goods as they do not have market price and they are to be provided by the public authority through budgetary provision of public expenditure. Taxes imposed by the allocation branch are to meet the cost of public goods. Moreover, consumption of public goods is non rival unlike in the case of private goods for which consumption is rival i.e. presence of competitiveness in consumption.

Private goods are produced by the private individual and supplied to earn profit. Here principle of exclusion is followed to provide for these goods through the market. The consumers are liable to pay the price of private goods and

therefore, who can afford to pay the price are eligible to purchase and enjoy them and those who fail to pay the price fixed for are excluded from the enjoyment of it. Thus principles of exclusion and inclusion are followed in case of private goods. Consumers are allowed to show their preferences for private goods. As a matter of fact, different consumers are eligible to purchase and consume different units of commodities at the same price. It depends upon the purchasing power of the consumers.

Moreover, private goods are divisible in nature and so their amount can be reduced and increased depending upon their demand. Private goods are competitive in character and their consumption is rival. Market economy provides it efficiently and exclusion principle and revealed preference principle are applicable.

2.8 MERIT GOODS:

Definition of merit goods :

Merit goods are a category of public goods. These goods are one of the important components of public goods and these are provided for the satisfaction of wants of some selected sections of people of the society. Examples of merit goods are—educational service, medical service, public health, sanitation, social security measures like old age pension, widow's pension, unemployment grants, food subsidy to the poor etc.

2.8.1 CHARACTERISTICS OF MERIT GOODS :

A number of distinct characteristics are there in merit goods. These are mentioned below:

1. Merit goods are provided to the consumers through market mechanism and hence they are subjected to exclusion principle. Merit goods become public goods when they are supplied by government or its agencies from of charges.
2. A budgetary provision is to be made to the manufacture of these merit goods. No private individual comes forward to provide them to the consumers due to the absence of profit motive.
3. Merit goods are those goods which lie in the border line of private goods and public goods.
4. Merit goods require government intervention. Government wants to generate welfare of the society through its judicious decision. These goods are more advantageous and useful to the society.

   To meet the cost of production and distribution of merit goods, there is the need of budgetary expenses through taxation.
5. These goods are meant not for all sections of the people of the society but only for selected sections of people for the satisfaction of needs and aspirations. Here consumer's preferences may be underestimated by the government. The satisfaction of merit wants involves interference with consumer preferences.
6. Goods or wants that appear to be merit goods or wants may involve substantial elements of social goods or wants. Satisfaction of merit wants may come within the umbrella of normative model of public finance. Merit good /wants may not be consumed equally by all unlike the social or public wants. Principle of exclusion is followed on the part of some merit wants.

2.9 MIXED GOODS :

Goods which are supplied through the private market and through the budgetary provision are known as mixed goods. Therefore, price paid for the satisfaction of mixed goods is lesser than the price of same goods provided by private sector. The public distribution system (PDS) provides some essential goods to the weaker poor people of the society at subsidized prices. For example, kerosene, sugar, wheat, rice etc. are mixed goods. These goods are supplied both by the open market and by the cooperative societies, ration shop at lower price. So, government subsidy is a budgetary provision. These commodities are treated as public goods. These are mixed goods which are partly private and partly public goods. Mixed goods are entirely provided for through the government budget. The cost of mixed goods is partly covered by private contribution and partly by government subsidy.

2.10 MARKET FAILURE - IMPERFECTION, DECREASING COST, EXTERNALITIES :

MARKET FAILURE :

Economic development of a country, productivity and efficiency of productive agents depend upon a number of socio-politico and economic factors. But these factors may not be available in all these LDC's of the world. Certain bottle necks may stand in the path of smooth functioning and healthy growth of the economy and these hurdles are the potent causes of market failure. It is observed that market failure is the out come of market imperfection, decreasing cost and externalities which are analyzed below—

MARKET IMPERFECTION :

By market imperfection we mean immobility of the factors of production, price rigidity, ignorance regarding market trends, static social structure, lack of coordination etc. Obviously, these market imperfection proved to be great obstacles in the way of productivity and economic development.

Economic development of the LDC's is restricted to a larger extent by the presence of three major constraints. Market Imperfection is one of the formidable obstacles in these countries. There are certain forces which are acting as major hindrances in the path of prosperity. Almost all the LDC's are suffering from market imperfection due to the following factors:

1. Factor Immobility,
2. Rigid Social Structure,
3. Imperfect Knowledge of the workers about market conditions,
4. Small number of entrepreneurial class,
5. Out moded methods of production,
6. Lack of specialization,
7. Lack of optimum use of economic resources. These factors are analyzed in sections 2.4 of this unit.

DECREASING COST :

Most of the private goods are subjected to increasing cost due to the operation of diseconomies of scale. There is inadequate investment of capital in production operation and as such, there are diseconomies of large scale production. Average cost of production rises along with the rise of out put. Private goods are associated with inadequate infrastructural facilities and hence average cost has a tendency to rise with the rise of production. Thus inadequate investment, inability

to eliminate the duplication cost, imitated market are responsible for the existence of decreasing cost. Unlike the public goods, no budgetary allocation is made on the part of private goods. Demand for and supply of these goods are not revealed through administrative setup and the budget.

The applicability of demand supply equation of the market system in private goods is

Shown in the following diagram No. 1

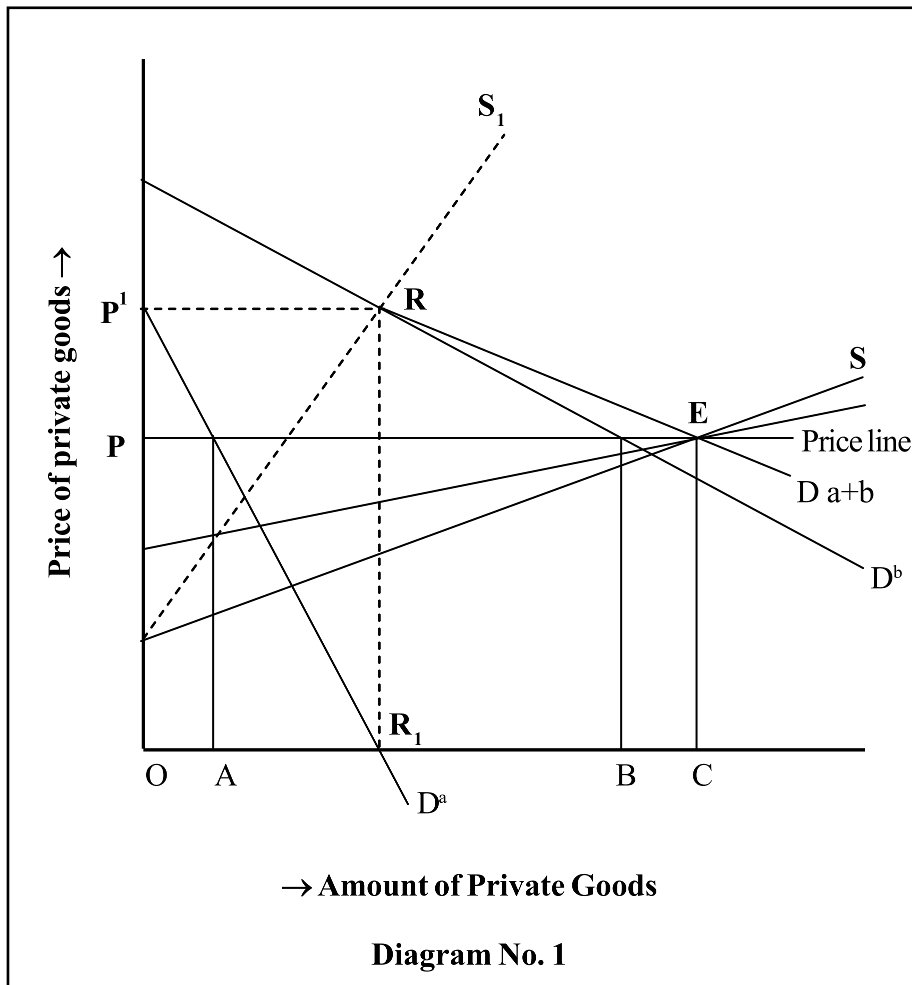

Diagram No. 1

In the diagram No-1 Da is the demand curve for individual A, Db is the demand curve B.

RDa + b is the aggregate demand schedule of A & B for private goods. S is the supply curve of private goods, A will consume OA output and B will consume OB output at price OP. Here demand for total output is OC. Where OA+OB=OC and OA=BC. Price of output=CE or OP. E is the point of equilibrium. S and aggregate demand curve Da+b intersect. Price is CE or OP. If supply S1 and aggregate demand curve Da+b meet supply curve at R, the price will be OP1. B will purchase ORl at this price OP. Ba + b is the horizontal addition of demand schedule of A&B. Aggregate demand curve starts from point R.

MARKET EXTERNALITIES :

Externalities refer to the economic effects which come from the use of goods to other parties for economic units. The economic effects of externalities may be termed as Spill-over -effects, neighbourhood effects or third party effects. These kind of effects is invisible to private goods.

Public goods or wants assume different forms. For e.g. social goods or wants and married goods or wants. Social goods have externalities and it distinguishes them from private goods and wants. Of course goods can be divided into two broader classifications. They are purely private goods and purely public goods. Externalities refer to the cost and benefits which private firm ignore in making it present value analysis.

Purely private goods can be indicated by Xj, Where j = I…...n and purely public goods by Xg where g= 1... .n. since purely private is divisible, it is consumed by different persons of the society under exclusion principle and hence total consumption can be estimated by aggregating the shares of

all individuals consuming the commodities. Thus pure private goods can be defined as,

$$Xj = \text{Summation of } Xj^{1}$$

$$I = I$$

Here Xj is total consumption of purely private goods and I is the individual of the community consisting of S number of individuals.

Positive externalities may occur in case of private goods like garden. On the whole, public goods are associated with externalities, but elements of externalities do not arise in case of private goods.

2.11 LETUS SUM UP :

Goods may be classified in to various classifications. Ex.-Public Goods, Private Goods, Merit Goods & Mixed Goods. Budgetary allocation is to be made for the production and distribution of the Public Goods the consumption of which is a must. While Private Goods are produced and distributed by the private sector for profit maximization. Both types of goods have there own characteristics.

Merit Goods like education, Medical Service, Public Health, Sanitation etc. are provided by the Government for the satisfaction of some selected section of people of the society. Budgetary provision is made to the production of these goods. Mixed Goods like Kerosene, Sugar, Wheat, Rice etc. are provided through the PDS at the subsidized prices. Mixed Goods are partly public goods and partly private goods.

Externalities refer to the cost and benefit which private firms ignore in making its net present value analysis. Credit

goes to Samuelson and Musgrave for the establishment of a relationship between the theory of public goods and externalities.

KEY WORDS:

Externality : It refers to the economic effect which originates from the production and utilization of public goods to other parties or economic units.

Social Goods : Goods which are provided for free of direct charges through budgetary provision and cost raised through taxation are known as Social Goods. For e.g. education, health facilities, roads, park etc.

SUGGESTED READINGS :

1. U. Hicks, Public Finance, 1964.
2. B.B. Bhattacharya, Public Expenditure, Inflation and growth, Oxford University Press, New Delhi.
3. Govt. Budgeting, 1956, John Coiley & Sons, New Delhi.
4. Economic policy and planning V.G. Mankar, Bombay, 1994.
5. H.L. Bhatia, 'Public Finance', 1993.

Check your progress : 2.1

1. What is market imperfection? Mention the salient factors which are responsible foe effecting for market imperfection. (Answer within fifty words)

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2. What is externality? Discuss its impact on the society.

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TERMINAL QUESTIONS:

1. Show the difference between merit goods and mixed goods. Do you think that a budgetary provision is needed for their production and distribution? Explain.
2. What is market imperfection? Explain the factors which are responsible for effecting market imperfection in developing countries.
3. What is externality? Discuss the impact of externality on the society of a country.
4. Write short notes:

   I. Mixed Goods, II. Private Goods, III. Decreasing Cost

HINTS TO CHECK YOUR PROGRESS EXERCISES:

1. Read section 2.9 on Market Imperfection and salient factors.
2. Read section 2.6 on externality and its impact.

BLOCK - II : TAXATION

UNIT- 1 : DISTRIBUTION OF TAX BURDEN, THEORIES OF TAXATION AND INCIDENCE :

STRUCTURE

1.0 Objectives

1.1 Introduction

1.2 Basic Concepts

1.2.1 Taxation and its Definition

1.2.2 Characteristics of Taxation

1.2.3 Characteristics of Good Taxation

1.2.4 Classification of taxation and the Merits and Demerits of Direct and Indirect Taxation.

1.2.5 Relative Superiority between Direct and Indirect Taxation

1.2.6 Role of Indirect Taxes in Developing Countries

1.3 Distribution of Tax Burden

1.4 The Benefits Received Approach and the Ability to Pay Approach

1.5 Critical Study of Traditional and Modern Theories of Taxation

1.6 Neo-Classical and Modern Concept of Incidence

1.6.1 Neo-Classical and Modern Theories of Incidence

1.7 Let us Sum up

1.0 OBJECTIVES :

After a systematic reading of this unit you should be able to—

1. Explain the distribution of tax burden to various sections of people of the society with the help of various approaches advanced by experts.
2. Differentiate the traditional, neoclassical and modern theories of taxation which are advanced for explaining the manner and extent of the distribution of tax burden.
3. Define incidence of taxation from the angles of prominent tax experts and Economists.
4. Analyze different concepts of incidence.

1.1 INTRODUCTION :

Taxation is one of the crucial tools in the hands of the modern welfare government to mobilize adequate financial resources to meet expenditure incurred on various expensive public goods and services. This compulsory contribution having no direct quid-pro-quo affects all, from top to bottom. In this unit, we shall look at different types of taxes and their comparative merits and demerits in terms of objectives of equity, efficiency and simplicity etc. We shall review the role played by different approaches or theories like ability to pay and benefit theory of taxation to distribute the tax burden to different section of people of the society. A background of the neoclassical and modern concepts of incidence of taxation is highlighted here.

1.2 BASIC CONCEPTS :

This section makes an analysis some key concept of taxation

1.2.1 Taxation: Taxation and its Definitions

It is a recognized fact that taxes are one of the most productive and prime sources of public revenue. These days, there is hardly any economy in the world which remain outside the orbit of taxation. Tax has been defined by different economists like Adam, Bastable, Plehn, Dalton, Taylor, Taussig etc. in different ways.

We shall take up only two definitions put forwarded by Hugh Dalton and C. Bastable.

"A tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the tax-payer in return." - Hugh Dalton.

"Tax is a compulsory contribution of the wealth of person or body of persons for the service of the public powers." - C. Bastable.

Tax is a regular, certain and elastic source of revenue on the part of both central and regional governments. Moreover, it is compulsory payment with legal support and therefore tax evasion and avoidance are illegal and subjected to punishment. Those who practice these sorts of malpractices are treated as antisocial. On the whole, it is one of the most important and effective fiscal tools which is used for the achievement of certain well defined aims and objectives of an economy viz., developing and developed economy.

1.2.2 Characteristics of Taxation :

From the above definitions and discussion we come to our conclusion that taxation direct and indirect, progressive, proportional, regressive and degressive taxes are having the following salient characteristics:

I. **It is a compulsory payment:** As stated earlier, tax is a compulsory contribution by citizens. These is no direct quid-pro-quo promised by the tax levying authority i.e. government for tax to the tax payer. Refusal of tax is an offence subject to payment of legal offence.

II. **Tax is a payment to the government:** Taxes are imposed only by the government or its authority upon the citizens for common welfare. A non tax payer is benefited from the service rendered by the government. Thus it is a public money which is to be spent by the government for the citizens.

III. **Elements of sacrifice:** Element of disutility or sacrifice is involved with the payment of a tax. Taxes are paid not for self interest but for common interest. For example, if income tax is imposed, it reduces the volume of income of the tax payers which leads to the curtailment of volume of consumption, saving and investment.

IV. **Welfare motive:** The sole aim of collection of tax is the generation of public welfare. It is not a payment for specific benefit and benefits of public expenditure may go to anyone irrespective of the tax to contributed to the government.

V. **No direct coordination between benefit and tax :** Another important characteristics of a tax is that there is no direct coordination between benefit received from

goods and services and tax. To quote Taussing, "the essence of a direct quid pro-quo between the tax payer and the authority."

VI. Tax is not the cost of benefit : Tax is not the cost of benefit conferred by the government on the public. Both benefit and taxes are independent of each other. Since benefit is ultimately a subjective thing, there is no scientific means of measuring it.

VII. Payment of tax is a personal liability : Payment of tax is a personal liability of an individual, firm etc. Taxes may be imposed on person, income, wealth, expenditure etc. but payment is to be made by the individual. Of course, there is no direct relationship between this liability and receipt from the government expenditure.

1.2.3 Characteristics of a Good Tax System :

Tax affects all, from top to bottom being a vital instrument in fostering the development of the economy. Thus it has far reaching consequences on the entire economy. The choice and selection of taxes assume crucial importance. It is observed that every tax imposes additional burden and creates sacrifice or disutility on the part of the tax payers. Thus it becomes essential that the burden as well as sacrifice of tax should be divided fairly. It must be levied on people with great care and rationality. To do so, the government is to follow certain code of conducts in the form of principles which are known as canons of taxation. A good tax system should possess the canons or maxims of taxation which are propounded by Adam Smith, the founder and father of economics and C.F. Bastable. A good tax system must observe the following canons as advocated by

Adam Smith in his famous book, "The Wealth of Nations," Book V :

1. Canon of equality
2. Canon of economy
3. Canon of certainty
4. Canon of convenience

Since the days of Smith, many writers including C.F. Bastable have advocated many more characteristics for a good tax system which are as follows:

1. **Canon of Productivity:** Since revenue realization is the primary objective of taxation, taxes should yield considerable amount of revenue for the expenses of the government.

   Moreover, tax should not discourage the productivity of the country both in the short and long run. To make the tax system more productive, multiple taxes are the must.

2. **Canon of Elasticity:** It implies that tax system should be elastic so that government may increase or decrease revenue according to its requirement. Direct taxes may be made elastic by introducing a scale of progression.

3. **Canon of Diversity:** According to Bastable, diversity should exist in the tax system of a country. There should be all kinds of taxation so that everybody may be called upon to contribute towards the government according to ability to pay. Multiple tax system can make the tax system more diversified.

4. **Canon of Simplicity:** A good tax system should be so simple that one can understand it easily. It will be feasible to lower down the mental burden of the tax payer.

5. **Canon of Flexibility:** Tax system should not be rigid rather it must be flexible to make it more productive. Flexible tax systems quickly adjust to the new circumstances. It reduces the financial trouble faced by the government.

6. **Canon of Expediency:** According to this Canon, tax should be based on certain well founded principles so that reaction of the tax payers towards such an imposition could be understood easily. Govt. should increase its tax-revenue by increasing the rates of existing taxes.

7. **Canon of Coordination:** According to this canon, there should be proper coordination among the three tier governments viz., Central, State and local bodies for mobilizing necessary revenue smoothly within their jurisdiction. This sort of attitude should be there among various tax administrative departments as well as boards.

Other canons of good tax system:

We have already explained the Smithian and Bastabal's canons of taxation which are recognized as characteristics of good tax system. Following are some other canons of good tax system.

1. Canon of neutrality.
2. Canon of programmes.
3. Canon of performance.
4. Canon of balanced
5. Canon of forcibility

From the above discussion, it is evident that no tax system any where in the world satisfies all the canons discussed above. But every government of both developing and developed countries should keep the above cited canons in view while devising their tax system to secure maximum social advantage.

1.2.4 Classification of Taxation and Merits and Demerits of Direct and Indirect Taxation :

Different economists have classified taxes from different angles. Some economists have classified it on the basis of forms, while others on the basis of nature, aims and methods of tax imposition. It is to be noted here that the most important and most widely used is the one between direct and indirect taxes of various forms. This classification is the most popular and common one.

Direct and indirect taxes have been defined by different experts and economists in different ways. These definitions show the differences between the two taxes. J.S. Mill, Mrs. U. Hicks, Hugh Dalton, D. Macro, Bastable are well known economists who are capable of defining and showing the differences between direct and indirect taxes. Besides these economists, other prominent economists who defined direct and indirect taxes are - P.E. Taylor, A.R. Prest, Anetonio De Viti De Marco etc. To understand this popular classification as well as differences, the concept of 'impact' and 'incidence' are used. Direct tax is that tax whose impact (immediate burden) and incidence (ultimate burden) falls on the same person while an indirect tax is that tax whose impact and incidence fall on different persons.

Merits and Demerits of Direct and Indirect Taxes:

Merits of direct taxes:

1. **Equitable:** Direct taxes are progressive and are based on the ability to pay principle. They are imposed on the rich section of people of the society.
2. **Economical:** As direct taxes are collected in lump-sum, the cost of collection is comparatively is low. No strenuous expenditure is required for its collection.
3. **Certainty:** The revenue flows from direct taxes is sure and certain. Tax payers know with certainty the actual amount of tax to be contributed to the Government.
4. **Educative value (create civic consciousness):** Direct taxes generate a filling of economic and civic consciousness in the minds of the tax payers. They keep a watch on the utilization of tax revenue.
5. **Elastic:** Direct taxes can be made more elastic. Amount and rates of these taxes can be raised or reduced according to requirements of the public authority.
6. **Productive:** Being progressive tax, income of the Government raises along with the rise in income and wealth of the tax payers.
7. **Reduce inequality:** Being progressive tax, rich people are subjected to high rates of taxation and the poor are exempted from direct tax obligation. It minimizes inequality of income and wealth.
8. **Absence of leakage:** There is no scope for any leakage in case of direct taxes as they are paid directly by the tax payers to the Government.

9. **Anti inflationary instrument:** ‘Direct taxes can act a bold and active anti inflationary fiscal measures. They can fight against inflation by mobilizing excess purchasing power of the people.

Demerits of Direct Taxes :

1. **Inconvenient :** It goes against the cannon of convenience. Tax payers are to maintain proper and elaborate accounts which are not and easy task from the part of illiterate and ignorant taxpayers.
2. **Unpopular:** Direct taxes are unpopular as the taxpayers have the knowledge that they are paying the sum directly. They pinch the taxpayer as their impact and incidence all the same person.
3. **Tax evasion (through mal practices):** There is greater possibility of evasion of direct taxes. It is due to Malpractices adopted by dishonest tax payers. Tax evasion leads to corruption.
4. **Narrowness of scope:** As scope of direct tax is narrow, it fails to raise the civic sense in all people of the society, Violates equity principle: Direct tax is incompatible with the policy of ability to pay. Some times rich people are to pay more taxes irrespectively of their ability to pay.
5. **Counterforce to honesty:** Direct taxes encourage dishonesty. Most people like to evade and avoid direct taxes by adopting malpractices.

Merits of Indirect Taxes :

A number of merits are associated with indirect taxes which are cited below:

1. **Indirect taxes are convenient:** Tax payers do not feel its burden which is involved in the payment of taxes. Taxpayers pay it in bits only at an interval of time.
2. **Difficult to evade:** The possibility of tax evasion is not found. The tax payers pay the small amount along with the payment of price of the tax commodities,
3. **Social value is inherent:** Indirect taxes are of social value as Government can restrict the consumption of harmful commodities like wine, drugs etc. by imposing heavy taxes on them.
4. **Equitable:** Indirect taxes can be made more equitable by imposing heavy taxes on luxury goods which are used by the rich class of the society.
5. **Educative value:** It can raise civic sense in the minds of the tax payers by touching heir hearts without any discrimination.
6. **Productive:** They can yield large revenue for public exchequer if imposed on necessary commodities.
7. **Helpful to production and investment:** It serves as one of the most power full tools in raising both production and investment in higher priority industries.
8. **Less unpopular:** Tax payers do not feel any burden in the payment of taxes. It is called a tax in the veil.

9. **Economical:** Indirect taxes are more economical than the direct taxes as they are easy to collect from all the consumers.
10. **Check on harmful consumption:** Consumption of harmful, intoxicants like wine, opium etc. can be checked easily by imposing heavy dose indirect taxes. Thus it serves a great social purpose.

Demerits of Indirect Taxes :

Indirect taxes are not an unmixed blessing. There are a number of Demerits, Most important demerits are cited below:

1. **It promotes socio-economic inequality:** Being the commodity tax, the majority of poor people are liable to pay relatively more. This is unjust and inequitable.
2. **It is uncertain:** They are extremely uncertain taxes. Government fails to estimate the income from indirect taxes accurately. It is due to the frequent fluctuation of demand for the tax commodity.
3. **It is inflationary in nature:** Indirect taxes lead to a sharp rise in prices, they prove to be inflationary. Every middleman tends to charge more than the tax and the price rises.
4. **It is regressive in character:** They are regressive in nature. They fall on all people indiscriminately irrespectively of their ability to pay.
5. **It fails to create civic consciousness:** They do not promote civic sense as they are collected in small amount through middleman and they do not fell its burden at all.

6. **It is uneconomical:** As they involve more cost of collection so they are more uneconomical. Moreover large expensive administrative staff is required to administer the taxes efficiently.
7. **It encourages dishonesty:** As the middlemen or the traders charges more prices than the actual amount of tax levied by the Government it amounts dishonesty.
8. **It discourages saving and investment:** They discourage saving of the tax payers, because the taxes are included in the price which reduces the volume of income. It lowers down the volume of investment and it retards the process of capital formation.
9. **No direct contact with the government:** Indirect taxes being taxes in the veil, lose direct link between the Government and the tax payers. They are collected through the middleman and traders and as such it has the least educative value in promoting civic consciousness.

1.2.5 Relative Superiority between Direct and Indirect Taxes :

The question now arises as to which tax is better or superior, direct or indirect? In fact, it is not an easy task to answer to this critical question. More can be said on both sides. Both taxes have their relative merits and demerits. In reality it is found that no country developing and underdeveloped and developed can do with one type only. Indirect taxes were advocated by the economists and tax experts in the 19th century, but in the 20th century, economists accorded more priority to direct taxes. There should be proper balanced

between the two taxes. The rich can be taxed directly, but pockets of the majority poor have to be tapped through various types of indirect taxes. To make the tax system more productive, both are urgently necessary. In developed countries, direct taxes receive greater attention from the government, while in LDCs, more emphasis is laid on indirect taxes. Of course, their relative importance depends upon a number of factors such as distribution of income, nature of economic set up and stage of economic development. It would be worth while to note here that some famous economists, Prime Ministers have favoured both the taxes due to their practical importance. Famous Italian economists Antonio de Viti de Marco has regarded these two taxes as complementary to each other. Gladstone, a great statesman as well as P.M. of U.K. said that these two types of taxes are "two attractive sisters between whom he was perfectly impartial." Thus the only way out is to impose both types of taxes by honest and intelligent team of tax administrative personnel.

1.2.6 Role of Indirect Taxation in Developing Countries:

In economic literature there has been a good deal of discussion as to which type of taxation is superior. The role played by both taxes viz., direct and indirect taxation in economic development of LDCs and developed countries can not be underestimated. Both types of taxation are treated as complementary to each other. But it is the indirect taxation which is of crucial importance for its indispensability in yielding necessary revenues for economic development and for the attainment of other fiscal objectives in developing countries. It is already discussed that the economists of the 19th century had

given more weightage on indirect taxes than on direct taxes. Gladstone, a great statesman as well as Prime Minister of U.K. said that both direct and indirect-taxes are "two attractive sisters between whom he was perfectly impartial. Similar treatment was shown by famous Italian economist A.De.V.de Marco too. Indirect taxes have a special role to play in socio-economic development of LDCs which are characterized by low level of income, low saving-investment, low productivity and low consumption. It is due to unfavourable infrastructures. Development of it requires huge financial investment. Private capital is not floated towards it which is associated with long gestation period. Thus it needs more public investment. To mobilize huge funds, large amount of tax revenue are to be raised by the government and it is the indirect tax which can provide ample revenues.

From the light of foregoing discussion it is clear that the role of direct tax is limited in LDCs where main thrust has been placed on indirect taxes which have wide coverage. Indirect tax should be so structured as to discourage consumption of non essential and luxury goods and to encourage the production of essential goods and services.

Indirect taxes can be made more equitable and productive than the direct taxes provided they are efficiently administered. These taxes can reduce effective demand by raising the prices of goods and services and ultimately it acts as an anti-inflationary measure in most of the developing countries. It ensures price stability, an important objective of tax policy. Moreover, its role can be analyzed from the angle of civic consciousness. The tax payers fell that they are regularly contributing lion share to the state exchequer. It is the most productive source of revenue as evasion of tax is practically impossible. It improves

distribution system by reducing income wealth inequalities which is one of the major objectives of modern government. Indirect taxes are also preferred in the developing countries as it does not conflict with the provision of the W.T.O. which is one of the three main pillars of world trade.

It would be worthwhile to note the views of Dr. RJ. Chelliah of India who puts the case of indirect tax, a tax in the veil, the LDCs. He is of the opinion that indirect taxes are directed to broaden the tax net minimize inequalities, check potential increase of consumption, provide protection to domestic infant and weak industries and to correct disequilibrium in the BOP. Government is to accord priority to minimize their ill effects to a larger extent and strengthen their good effects to the maximum. Of course, it depends upon the sincerity honesty, efficiency and integrity of the government as well as concerned authority.

1.3 DISTRIBUTION OF TAX BURDEN :

The most common method of financing the multiple government activities is by taking recourse to the fruitful device of taxation. In every country lion share of public revenue is mobilized through tax. But it is a recognized fact that every tax is an additional burden on the tax-payers. It creates pain and friction in the minds of the tax payers. The proper distribution of tax burden is one of the fundamental problems in public finance of modem democratic states. Thus it becomes essential that the burden of taxes should be distributed fairly among different sections of people of the society. To secure fair distribution of this burden is obviously an ethical question. We are to ascertain the indirect effects of both direct and indirect taxes.

If burden of taxation is not fairly distributed among various sections of people of the society, it may create great disorder in the society. The government must see to it that tax principles are designed in such a manner as to minimize its ill effects to a larger extract and strengthen the good effects to the maximum. The tax system should be based on equity and justice and every tax payer should bear tax burden according to his ability to pay. Burden of tax can be distributed among various classes of people by adopting different concepts of equal sacrifice, equal proportional sacrifice, equal marginal sacrifice and equal absolute sacrifice. These approaches have been advanced with a view to reducing tax burden and promoting welfare of the society. It would be worthwhile to note here that some modern economists of repute do not favour the equity concepts of equal proportional sacrifice and equal absolute sacrifice mainly because they fail to generate welfare of the society. But recent advancement of the equity theory accords priority to the minimization of aggregate sacrifice and maximization of welfare of the entire society. This shift of emphasis is found in the writings of the prominent writer economists like Prof. Pigou, Edgeworth, wagner and Dalton. Erik Lindahl's theory also tries to provide an answer to the question of allocation of tax burden among the tax payers which was not done by some of the important theories like the physiocratic theory, expediency theory. Socio-political theory etc.

1.4 BENEFIT AND ABILITY TO PAY APPROACHES:

Different approaches have been provided by different writers as well as economists with a view to allocate and distribute the tax burden to different sections of the society.

But we shall take up only two approaches which try to explain the methods of distribution of tax burden among the taxpayers. These approaches are as follows :

1. The Benefit -Received Approach :

This is an approach which links the tax liability to the government activities. It maintains that since government is providing goods and services for the good of the society, it should impose taxes for them. The burden of tax is to be distributed according to the benefit of services and goods provided to the tax payers. This benefit theory is popularly known as the Insurance Theory or the Theory of quid pro-quo. This theory was quite popular and acceptable with the thinkers of the 17th and the 18th centuries. They were the physiocrats, Hobbes, Locke, Rousseau, smith, M.C. Culloch, Senior. But it is to be noted that this benefit approach had only a scanty place in the writings of writer of the 19th century. Wick sell, Viti De macro advocated for the benefit approach.

There is a definite relation between the benefit of services rendered by the government and the contribution made by the beneficiaries. Accordingly those tax payers who receive more benefits from government services should be called upon to bear more tax burden and vice versa. Thus the collective amount of tax should not be more than the aggregate benefit received by the tax payers. This approach is based on the motion, “Do not take more than you give.”

This benefit approach or principle can be explained with the help of the following Diagram No-l

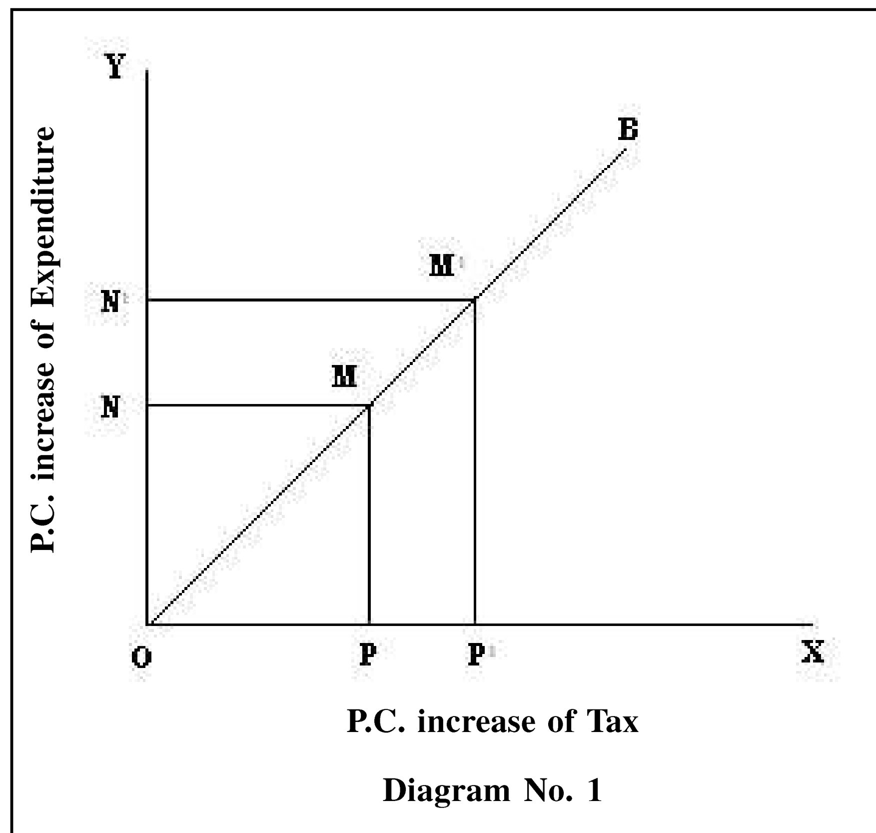

Diagram No. 1

In diagram No.1 OX stands for percentage increase of tax. OY stands for percentage increase of public expenditure; AB is tax benefit line which moves upward. OM is the volume of tax. ON is the benefit. When volume of tax rises from OM to OM′, benefit also rises from ON to ON′. It shows that higher the tax, higher is the benefit and vice versa.

Like other approaches advocated by different economists in different times for the distribution of tax burden and to solve the problems of equity in taxation, this benefit approach too is not free from criticisms. Benefit can not be measured scientifically, as it is the state of mind of the tax payers. It is quantitative rather than qualitative. Moreover this principle can not be applied to social security measures implemented by the government. If it is property followed, government welfare

activities are to be restricted to a larger extent. It will be a treat to welfare state which is outcome of the defects of ancient police state. It is to be noted here that the most formal formulation of the benefit theory was provided by Erik Lindahl in 1919 through his voluntary exchange model. LindaW's model is also not free from criticisms in the hands of Prof. P.A. Samuelson. It ignores the active role of private good and as such it is a partial explanation.

2. Ability to Pay Approach or Theory of Taxation :

Ability to pay principle or theory of taxation has been modified, restated and advocated by a number of economists like Jean Bodin, Jean Jaccub, Rosseau, Sismondi, J.S. Mill, Wagner, F. Roose, Prof. Western etc. The reformists as well as socialists considered ability to pay principle of taxation appraising base of reducing tax burden. The solution to the question of justice and equity in modern taxation depends upon the concept, 'Ability to Pay'. According to J.S. Mill, "Equality in taxation means equality in sacrifice." Prof. Western regarded ability to pay as an ideal ethical basis of taxation. According to this principle or theory, individual should be asked to pay taxes according to their ability to pay and accordingly, the rich having more ability to pay should contribute more taxes than the poor having less ability to pay. There are two concept of equity in taxation. Namely horizontal equity and vertical equity. According to the horizontal equity, equals should be treated equally i.e. person with the same ability to pay should bear same amount of tax burden. While according to vertical equity, unequal should be treated unequally.

There are two approaches used to explain tax payer's ability to pay. They are as follows:

1. Objective approach and
2. Subjective approach.

The objective approach explains the factors which are responsible for affecting tax payer's ability to pay. These factors are income, property, expenditure on consumption and size of the family. This objective approach is based on the Faculty Theory of Ability to Pay. It is to be remembered that different views have been provided by different economists like Henry Simons of the university of Chicago and Nicholas Kaldor of Cambridge, U.K. who advocated expenditure tax in lieu of income tax.

Some economists explained the ability to pay treating it as subjective concept. In this subjective approach, tax burden is measured in terms of sacrifice of utility made by the tax payers. There are three concepts of sacrifice which are cited below.

I. Principle of Equal Absolute Sacrifice:

Credit goes to J.S. Mill for presenting this concept first. According to this principle, money burden of taxation should be distributed among the tax payers in such a manner that every tax payer is called upon to make an equal sacrifice. It means what the rich should pay more in taxes in comparison to the poor. Cohen Stuert and Edgeworth supported this principle for the establishment of justice and equity in the society. But it is not free from criticisms. Sacrifice or disutility can not be measured accurately. Moreover, this technique

proposes regressive type of taxes which create inequality of income in the society.

II. Equal Proportional Sacrifice:

According to this principle, the burden of taxation on all citizens should not be uniform, but it should be in proportion to their income earned. It makes the tax system progressive as rich are to contribute more than the poor. It can be explained mathematically

$$\text{Rate of tax} = \frac{\text{Sacifice made by X}}{\text{Total income of X}}$$

$$= \frac{\text{Sacifice made by Y}}{\text{Total income of Y}}$$

Here X and Yare two individual tax payers.

III. Equal Marginal Sacrifice:

This principle was supported by a number of economists like Edgeworth, Pigou. Cannan, Dalton and Musgrave etc. According to this principle, government should impose taxation in such a manner that the aggregate sacrifice by all the tax payers should be the minimum. Thus element of progression is inherent here. This principle is called as the least aggregate sacrifice principle and Pigou looks upon it as "the ultimate principle of taxation." It is based on the principle of maximum happiness. To generate equality, the rich should be taxed and the poor should be offered bounties.

These three approaches of ability to pay principle can be mathematically expressed in the following way.

1. Equal Absolute Sacrifice:

$$[U(Y) - U(Y-T)]A = [U(Y)-(Y-T)]\,B$$

2. Equal Proportional Sacrifice:

$$\frac{[U(Y) - U(Y - T)]A}{U(Y)} = \frac{[U(Y) - (Y - T)]B}{U(Y)}$$

3. Equal Marginal Sacrifice:

$$\frac{dU(Y - T)A}{d(Y - T)} = \frac{dU(Y - T)B}{d(Y - T)}$$

Here Y=Income

T=Tax

U=Total utility

U(Y) =Total utility before tax

U(Y -T)=Total utility after tax

A & B are two individual tax payers.

These three concepts of ability to pay theory can be illustrated diagrammatically –

Diagram No. 2

Here, OX stands for income

OY stands for marginal utility.

CE is the total utility

CF is the marginal utility

OD & YC are amount of income required for subsistence

A has the income above the subsistence level equal to OG

B has OH

Total utility of A is IE

Marginal utility of A is GF

Total utility of B is JK

Marginal utility of B is HL

Now under equal absolute sacrifice -

A will pay WG amount of tax

B will pay SH amount of tax

Under equal proportional sacrifice -

A will pay VG amount of tax

B will pay TH amount of tax

Under equal marginal sacrifice -

A will pay VG amount of tax

B will pay VH amount of tax

Besides these principles, one more principle was advocated by some early socialist economists and radical writers of French Revolution. This principle is known as principle of social welfare and the writers are Sismondi, Hall,

Adolf Wagner. According to Adolf Wagner of Germany, progressive taxation should be adopted to achieve maximum welfare of the society.

Merits of ability to pay principles :

1. It satisfies the ideals of horizontal and vertical equity.
2. It secures social justice, an important objective of taxation.
3. It is morally sound.
4. It establishes justice and equity by reducing inequality of income and wealth.
5. It satisfies the criterion of good tax system.
6. It is more wider in outlook as this theory includes allocational and distributional problem.
7. It permits us to include the satisfaction of both merit goods and social goods.

Demerits :

1. This principle is vague. It has three different interpretations of equal sacrifice with different measures. Thus it creates a lot of problems.
2. There is no general agreement among the economists as to the merits of the three equity concepts.
3. Serious objection has been raised against the unrealistic assumption of cardinally measurement of utility of income. But utility and sacrifice can not be measured scientifically, as it is the state of mind.
4. This principle can not be extended to cover some indirect taxes like those on commodities and services.

5. Tax on property and wealth is regressive in nature, causing more burden to small property holders than big one.
6. Element of tax evasion is inherent which is morally unsound. Tax payer may become dishonest by concealing their real income and property.

In conclusion it may be said that multiple based taxes are preferable to single based ones. It is preferable from the view point of measure of ability to pay the taxes and less adverse economic effects.

1.5 CRITICALSTUDY OF TRADITIONAL AND MODERN THEORIES OF TAXATION :

Different writer-economists have put forward different theories in different times to distribute burden of taxation among the citizens. These theories can be classified in to two distinct groups For Example— 1. Traditional Theories, 2. Modern Theories.

Some of the important theories of these two schools are as follows -1.The Mercantilist Theory, 2. Physiocratic Theory, 3. The Expediency Theory, 4.Socio Political Theory, 5. Cost of Service Theory, 6. Benefit of Service Theory, 7. Ability to Pay Theory, 8. Equity Theory, 9. The Least Aggregate Sacrifice Theory.

Critical study on some of the above mentioned theories is analyzed below—

The MERCANTILISTS were of the opinion that Government should collect maximum amount of revenue by imposing multiple taxes with minimum resistance from the

public. Dalton prefers this theory. Even modern Government prefers multiple tax system to realize adequate amount of revenue. But this theory has lost its importance in modern welfare states as the burden of taxes may fall mainly on the majority poor, week and voiceless people. Later on Phoysiocrats developed this theory due to its pitfalls.

The PHOYSIOCRATIC THEORY is one of the earliest theories of taxation and it was based on the formulation that Government should impose taxation on net surplus. Tax should be imposed only on land or agriculture as it would yield net return. They advocated for single tax and vehemently opposed the idea of Mercantilist's Theory. Of course sound proposals for single tax system came from the economist's of the 17th, 18th and 19th centuries too. Among the advocates of single tax system were Issac Sherman, Henry Jorge etc.

The COST OF SERVICE THEORY, one of the oldest theories of taxation advocated by the traditional writer-economist maintain that Government should impose taxation in accordance with the cost of services rendered to the people. This theory has no place in modem tax system as it is difficult to determine the cot of all services rendered. So it is neither just nor desirable in modem welfare states.

The BENEFIT THEORY states that the burden of taxation should be in proportion to the benefit of services rendered by the Government. It was supported by Grotins, Pefend, Hobbes and the Physiocrates like Locke, Hume and Rousseau. This theory is a modified version of the Cost of Service Theory. Benefit Theory has laid more stress on the demand side while Cost of Service Theory on the supply side. This theory combines income and expenditure sides of the

budgets. This theory has been restated and modified by Bowen and Lindahl with their models.

ABILITY TO PAY THEORY is also as old as the Benefit Theory. It is recognized as the most universally accepted theory of taxation. According to this theory, every citizen should contribute taxation according to his ability to pay. Tax payer's .ability can be measured through income, wealth and property, expenditure and size of family which are known as objective approach of ability to pay. In the; subjective approach one can estimate the burden felt by the tax payers and each tax payer should render equal sacrifice which can be interpreted in three ways and they are—

1. Equal Absolute Sacrifice
2. Equal Proportional Sacrifice
3. Equal Marginal Sacrifice

This theory is called the ultimate theory of taxation. This theory has been supported by Edgeworth, Pigou, Canan and Delton.

Equity Theory is advocated by modem economists to reduce the tax burden. Equity means fairness in the distribution of tax burden. Two types of equity are there—

1. Horizontal Equity,
2. Vertical Equity

However modern economist like Paul Samuelson has criticized the concepts of Horizontal and Vertical Equity with the help of his "Optimum Allocation of Social and Private Wants".

Thus from the foregoing investigation and observation on the traditional and modem theories of taxation, it is observed that the development and the refinement of views have differed to some extant from economist to economist. There is the shift of emphasis only on the theories of taxation. All these theories aim at achieving justice and equity in taxation.

1.6 NEO-CLASSICAL AND MODERN CONCEPT OF INCIDENCE :

Before our real discussion we should know what the incidence of taxation is? Among the most important studies in public finance, the study of incidence of taxation is of great significance. Different economists of different periods define incidence of taxation in different ways. The economists who are associated with it are Hugh Dalton, Prof. Adam, Findlay Shirras, Musgrave, Mrs. Ursula Hicks, Prof. J.K. Metha, D. Dosser, Suligman, Edgeworth, Buckler, Mans field and Canard etc.

Traditionally incidence of a tax has come to mean the final or ultimate resting place of direct burden of tax payment. Incidence of taxation explains the question of who and in what proportion bears the final burden of taxation. Incidence of tax rests on the person who ultimately bears the money burden of the tax. It is observed that four types of burden are involved in incidence of tax. They are money burden and real burden, direct burden and indirect burden.

The goal of this study is to enquire about the class, section and groups of people who ultimately bear the burden of taxation. Therefore, it is urgently necessary to understand the socio-economic effects of particular taxes.

Different economists have classified incidence of taxation into a number of classifications. They are as follows:

1. Specific Incidence: When a tax is imposed without any change in the expenditure side of the government, the resulting incidence is called specific incidence.
2. Differential Incidence: When a tax is levied as a substitute for another tax, Musgrave called the resulting incidence differential incidence.
3. Balance Budget Incidence: When government increases its expenditure from the yield of the tax the resulting incidence is called balanced budget incidence.

Mrs. U. K. Hicks classified incidence into two classifications. They are as follows:

1. **Formal Incidence :** The direct money burden of a tax is called formal incidence. It is same as defined by Seligman and Dalton. It refers to the concept of incidence of taxation and it is a part and parcel of the theory of incidence.
2. **Effective Incidence :** Effective incidence is a part of the study of general effect of taxation. It refers to the broader effects of taxation. It enables us to say which type of tax is to be preferred or avoided for the larger interest of the society.
3. **Dynamic Incidence :** Douglas Dosser has introduced the concept of Dynamic Incidence of taxation. It is the total process of distribution for all the years after a change in tax. Dosser has introduced this concept with a view to show the differences between the static incidence and dynamic incidence of taxation.

4. **Static incidence :** Static incidence is nothing but the immediate distributional consequences of a change in tax.

Musgrave's concept, Hicks' concept and Dosser's concept are indirect new or modern concepts of incidence of taxation.

Superiority of modern concepts over the traditional and the neo-classical concepts :

The modern concept has been recognized as superior to the traditional one because of the following grounds.

1. There is no relationship between direct effect and indirect effects of incidence in the eyes of the traditional concept. But it has been nicely examined by the modern concepts through the distributional change in resource transfer.
2. Traditional concepts laid down more importance on money burden by ignoring the change in real income of individual. It ignores the influence of public expenditure which are taken into account in the modern concepts.
3. Traditional concept is concerned with loss but modern concepts consider the entire change in distribution including gain and loss of individual.
4. Traditional concept of incidence neglects the consequences of increased resource transfer to public use. But this aspect has been nicely examined by the modern concepts.

1.6.1 Neo Classical and Modern Theories of Incidence:

Different theories of incidence of taxation have been advanced by different economists of different schools. They are as follows :

1. The Concentration Theory:

The physiocrates of Franch were associated with the concentration theory. They suggested the levying of a single tax on the net income form land. They regarded agriculture alone was productive but other occupations were 'sterile'. Smith and Canard had criticized this theory on the ground that single tax would not be productive for modern welfare society.

2. The Diffusion Theory :

This theory was advanced by writers like Canard as well as Mansfield The diffusion theory asserted that all taxes are diffused among all the members of the society. The diffusion takes place in the entire economy by shifting and re-shifting of the taxes. This theory prefers indirect taxes to the direct ones.

This diffusion theory is subject to criticisms. Every tax can not be shifted. This theory is misleading as it assumes a state of perfect competition and mobility. But these are unrealistic assumptions.

Neo Classical Theory of Incidence :

The Neo-classical theory of Incidence is formulated by a number of neo-classical economists like A.C. Pigou, Marshall, Seligman. F.Y. Edgeworth etc. to explain the causes which are responsible in the determination of the magnitude of incidence of taxation. It is observed that incidence of tax

particularly commodity tax like sales tax, excise duty etc. depends upon a number of factors. Among the factors, the most important are elasticity of demand and supply of the taxed commodity, the cost conditions (Increasing cost, Decreasing cost and constant cost), market conditions (Competitive market, monopoly, oligopoly, duopoly etc.). Now we shall concentrate how an indirect tax is shifted under above cited conditions.

1. Elasticity of Demand and Supply :

Incidence of the tax falls on the producers or sellers provided demand for the commodity is elastic. On the other hand, if demand for the commodity taxed is inelastic, incidence is to be borne by the consumers or buyers.

In the case of elastic supply, incidence of the tax falls upon the consumers or buyers because of higher bargaining power of the producers or sellers, while incidence of the tax falls on the sellers or producers provided the supply of the taxed commodity is inelastic in character.

Naturally incidence of tax on necessary commodity falls on the consumers or buyers. While incidence on comfort and luxury falls on the sellers.

In the case of substitute goods with elastic demand, incidence of tax falls upon the sellers or traders.

2. Different Cost Conditions :

If the taxed commodity is produced under increasing return i.e. decreasing cost, incidence will be on the consumers. While a commodity produced under diminishing return i.e.

increasing cost, price will rise by less than the amount of tax and hence, incidence will be small on the buyers or consumers.

In case of constant return to scale or constant cost, incidence of tax will fall on the buyers or consumers.

3. Different Market Conditions :

In case of competition, if the tax is levied on the commodity, tax is shifted to the consumers or buyers. But if it is imposed on profit, incidence will fall on the producers or sellers.

In the case of monopoly, if tax is levied on commodity and the amount of tax is small, the monopolist does not like the shift the burden of taxation to the shoulders of the buyers. But if tax is heavy, the monopolist list shifts its burden to the buyers to earn more profits.

Under oligopoly market, if price of the taxed commodity is set by the firm who is also the price leader, the tax on the commodity is directly shifted to the buyers.

While under duopoly market where only two sellers or producers are there, one seller is the price leader and so burden of the tax is shifted to the consumers or buyers.

Modern Theory of Incidence of Taxation :

The traditional and neo-classical concepts of incidence have been restated and modified by a number of economists like Dalton, K. Wickshall, Musgrave, Hicks, Dosser etc. From the above discussion, general proposition that can be made is that incidence of a tax is divided between the buyers and the sellers in the ratio of the elasticity of demand and elasticity of the supply of the object taxed.

The modern theory of incidence of taxation was propounded by Hugh Dalton with the help of elasticity of demand for and supply of the commodity taxed. It has got the full support of the above cited modern economists. These economists believe that tax is a part of cost of production and it is paid as other agents of production paid. Thus tax is included in price of the commodity. Shifting of a tax takes through change in price. That is why it is said that price is the vehicle of tax. It is the product of forward shifting and backward shifting. According to modern writers including Dalton, incidence of a tax imposed on a commodity is "divided between the buyers and the sellers in the proportion of the elasticity of supply of the object taxed to the elasticity of demand for it." If elasticity of supply is equal to the elasticity of demand, incidence of tax will be equally divided between the buyers and the sellers in the proportion of the elasticity of supply of the object taxed to the elasticity of demand for it". If elasticity of supply is equal to the elasticity of demand, incidence of the tax will be equally divided between the buyers and the sellers.

Tax incidence may be represented thus

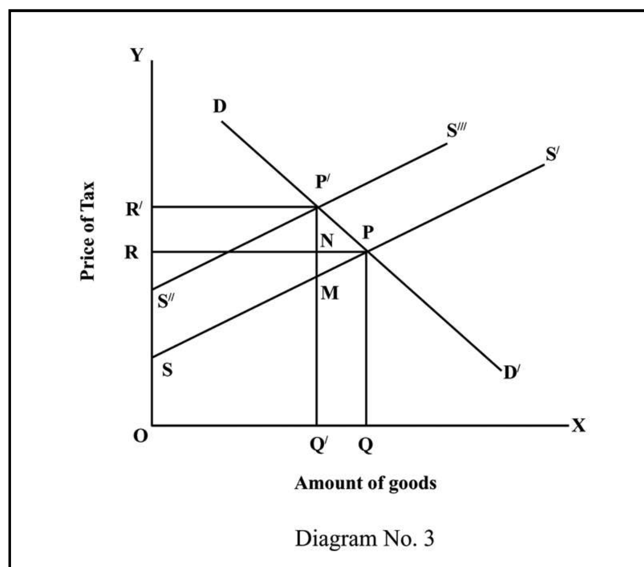

Diagram No. 3

In the Diagram No.3 DD' represents the demand curve and SS' represents the supply curve. OX represents the amount of taxed goods. PQ represents the price per unit and OQ i.e. PR is the amount of goods sold before the imposition of tax. Suppose a tax is imposed on a commodity to be realized from the sellers. The new supply curve is represented by $S''S''$, the price is $P'Q'$ and OQ' i.e. $P'R'$ is the amount of goods sold. Tax per unit is $P'M$.

Out of the tax $P'M$, $P'N$ will be borne by the buyers and MN will be borne by the sellers.

The geometrical proof of it is as follows:

$$Ed = \frac{QQ'}{QO} \quad \frac{P'N}{PQ}$$

$$Es = \frac{QQ'}{QO} \quad \frac{NM}{PQ}$$

$\frac{P'N}{NM}$ represents the ratio of incidence of tax.

1.7 LETUS SUM UP :

1. Taxation constitutes the most important source of revenue for the achievement of certain specific objectives like growth, economic stability etc. in developing and developed countries.
2. Distribution of tax burden is a difficult problem. Tax burden is distributed to different sections of the society according to different theories like Benefit Theory, ability to pay theory etc.

Economists have advanced two approaches to measure tax payer's ability to pay. They are:

1. Objective Approach
2. Subjective Approach. Income, property, consumption expenditure are included into the objective approach. While principle of equal proportionate sacrifice and principle of equal marginal sacrifice are under the jurisdiction of subjective approach.
3. Different economists define incidence of taxation in different ways. Incidence is the final or ultimate burden of taxation to be borne either by buyers or by the sellers.
4. According to Dalton, incidence of taxation is divided between the sellers and buyers according to their relative estimate of demand and supply. Modem concept of incidence comprises the following (1) specific incidence, (2) differential incidence, (3) formal incidence, (4) effective incidence, (5) budget incidence (6) dynamic incidence. These are the outcome of the modem theory of incidence.

KEY WORDS :

1. **Quid-pro-quo:** No direct return can be claimed by the tax payers from the government.
2. **Sine-qua-non:** Indispensable.
3. **Horizontal Equity:** Equal treatment for equal i.e. like people should be treated in a like manner.
4. **Vertical equity:** Unequal treatment to unequal i.e. unlike people should be treated in an unlike manner.

SUGGESTED READINGS :

1. 'Public Finance, Theory and Practice' A.R. Prest.
2. 'Public Finance' H. Dalton
3. 'Public Finance' Mrs. U. Hicks
4. 'Public Finance and Fiscal Policy' R.K. Choudhury
5. 'The Shifting and Incidence of Taxation', Seligman

CHECK YOUR PROGRESS EXERCISES:1.1

1. What are the factors which determine the ability to pay the taxation? Mention the factors only.

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2. Define incidence of taxation. Mention various types of incidence of taxation. (Mention the types only)

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TERMINAL QUESTIONS :

1. What is the Ability to Pay Theory of Taxation? Show the justification of Ability to Pay Theory of Taxation.
2. What are the Objective Approach and Subjective Approach to measure ability to pay taxation? Explain.
3. Incidence of tax imposed on a commodity is "divided between the buyers and the sellers in the proportion of the elasticity of supply of the object taxed to elasticity of demand for it". Discuss the statement with diagram.
4. Critically examine the modern concepts of incidence. Do you think that modern concepts are improvement over the Neoclassical concept of incidence?

HINTS TO CHECK YOUR PROGRESS EXERCISES

1. Income, Property, Expenditure, Size of family, Equal absolute sacrifice, Equal proportional sacrifice and Equal marginal sacrifice.
2. See 1.5 for definition of incidence of taxation and 1.5.1 for types of incidence of taxation.

UNIT – 2 : INCOME AND CONSUMPTION BASED TAXES :

STRUCTURE

2.0 Objectives

2.1 Introduction

2.2 Meaning of Income and Consumption Based Taxes

2.2.1 Distinction between Income Based Taxes and Consumption Based Taxes

2.3 Importance and Limitations of Income Based and Consumption Based Taxes

2.4 Let us Sum up

2.0 OBJECTIVES :

In this unit you get to know about the definitions, examples of both income based and consumption based taxes. After going through this unit you will be able to know:

1. Various definitions of economists of repute and examples of both income based and consumption based taxes.
2. Distinctions between the income based taxes and the consumption based taxes.
3. Socio- economic significances of income based and consumption based taxes on the economy of a country.
4. Various problems of both types of taxes.

2.1 INTRODUCTION :

Taxation is perhaps the most controversial element of Government policy adopted so far. Government being the guide, friend and philosopher of the citizens from cradle to grave, it wants to mobilize adequate amount of financial resources. One of the major sources of revenue is taxation the basis of which is different. Income based taxes (IBTs) and consumption based taxes (CBTs) are playing a significant role in generating much needed revenue in both developed and developing countries of the world. It is to be noted here that the Government faces certain formidable problems in imposing both types of taxes due to their lacunae.

2.2 MEANING OF INCOME AND CONSUMPTION BASED TAXES :

Income and consumption based taxes-meaning Taxes are imposed depending upon their bases in all the countries of the

world. Income based taxes are imposed depending upon their bases while same treatment is shown towards the consumption based taxes i.e. indirect / commodity taxes. The most important income based taxes are land revenue, agricultural income and wealth tax, property tax, corporate tax, death duty, gift tax, tax on interest, professional tax, stamp duty, house tax and jewelries etc. Consumption based taxes are - sales tax, VAT, excise duty, custom duty, purchase tax etc.

2.2.1 Distinction between Income Based Taxes and Consumption Based Taxes

A distinction has been made between the two types of taxes. They are as follows:

1. Income based taxes being the direct taxes were advocated by the writers and economists of the 19th century; while consumption based taxes are advocated by them during the 20th century.
2. Income based taxes have lesser coverage and as such they yield less revenue in most of the LDCs of the world. But the consumption based taxes have much more coverage and they fetch more revenue to the government of most of the developed countries.
3. Income based taxes are not liable to place the tax payers in worse position as they are levied on the basis of ability to pay; while consumption based taxes place the users or consumers in a worse position.
4. Income based taxes follows the principle of equity of sacrifice while consumption based taxes are not equitable 3. The surplus income which is taken away by income

as burden of it falls more heavily on the weaker sections of the society.

5. Income based taxes are directed to reduce the magnitude of inequality of income and wealth in the society. Consumption based taxes are responsible for widening the gap between the 'haves' and 'have nots'.

6. Income based taxes being the direct taxes create civic consciousness in the minds of the tax payers, but consumption based taxes fail to do so as they are the taxes in the veil (Dalton).

7. The root cause of tax erosion and tax avoidance is income based taxes. Income based tax payers are forced to practice mal-practices to evade the taxes. As tax erosion is not found in case of consumption based taxes, tax payers do not practice mal-practices which are morally unsound.

8. Income based taxes are not inflationary in nature while consumption based taxes are inflationary which is treated as curse coming from the leaps of thirty three cores Gods and Goddess.

9. Income based taxes are unpopular as it is directly paid by the tax payers. They create friction and pain in the minds of the tax payers. Consumption based taxes are popular as it is tax in the veil.

10. Income based taxes can not be shifted easily to other. Both impact and incidence fall on the same person. While incidence of consumption based taxes falls mostly on the consumers or buyers of the taxes commodity.

2.3 IMPORTANCE AND LIMITATIONS OF INCOME BASED AND CONSUMPTION BASED TAXES :

Taxation has far reaching consequences on the economy of both developing and developed countries. Income based taxes occupy the same place in the economy of developed country which consumption based taxes occupy in the economy of the LDCs. The income based taxes were advocated by the economists in the 20th century, while the economists accorded more priority to the consumption based taxes in the 19th century. It is to be pointed out that consumption based indirect taxes have a special role to play in the LDCs which are determined to achieve a fast rate of economic growth. On the other hand consumption based taxes have a wider coverage and bring adequate financial resources to the Govt. The percentage share of these indirect taxes in total tax revenue has been rising as days rolled by.

Similarly income based direct taxes also figure prominently by n the LDCs but they make a meager contribution to the budgets.

Importance of Income Based Taxes :

Importance of income based taxes are increasing due to the following reasons.

1. Income based taxes being direct tax, can reduce the wide gap between the 'haves' and 'have nots' and as such they can help, in achieving the ideals of egalitarian state.
2. They can check high marginal propensity to import of the rich and restrict the volume of conspicuous consumption.

based taxes can be utilized for rapid economic development of the country.

4. They can act as anti-inflationary measure provided the rich are heavily taxed. It stabilizes the price level.

5. It is a well recognized fact that income based taxes are more attractive due to peculiar characteristics like- productivity, equity, economy, certainty, civic consciousness, elasticity and absence of leakage etc. To Taylor, progressive income based taxes are superior to regressive CBTs.

Limitations of Income Based Taxes :

The limited role of income based direct taxes is due to the following reasons.

1. Income based direct taxes tend to be arbitrary. These are levied in the arbitrary manner by the Govt.

2. Imposition of income based taxes is difficult task particularly in primary producing countries. Here large portion of income/ produce is not exchanged for each. It creates a problem of assessment of income.

3. Possibility of tax evasion and avoidance is another formidable problem. Tax payers may practice mal- practices to evade the taxes and thus it makes the tax payers dishonest.

4. The coverage of income based taxes is narrow. Low income groups are normally exempted from payment of these taxes on the basis of ability to pay. Thus these

taxes are not productive on the part of the poor and backward countries.

5. The country may suffer economically due to lower level of saving and investment resulting in too heavy taxes.
6. Income tax returns have to be filled timely and properly with various sources of income. Tax payers are to maintain completed records which are inconvenient for the ignorant, illiterate tax-payers.
7. Tax administrative machinery is weak particularly in the LDCs. It leads to tax-evasion, avoidance and tax leakage.
8. Income based direct taxes are unpopular; because the tax payers have the perfect knowledge that they are paying the sum to the authority concerned. It creates some psychic pain to them.

Due to these limitations, income based taxes can not be regarded as a mass taxation in UDCs and LDCs. Its application is limited to a grater extent.

Importance of Consumption Based Taxes :

The socio-economic and political importance of consumption based indirect taxes have been realized by many economists and commissions like Italian economist Antonio de Viti de Marco, Chelliah, Prof, Prest, Gladstone, a great states man of the 19th century. Indirect Taxation Enquiry Commission etc. It is an admitted fact that income based direct taxes play an insignificant role in the LDCs of the world. It is mainly because of the absence of money economy, illiteracy among the tax payers, difficulty in maintaining proper records, political instability and inefficient tax administration.

Consumption based taxes are more suitable in LDCs than the income based direct taxes because of the following reasons.

Being indirect taxes, consumption based taxes are more productive and have a much wider coverage which bring adequate financial resources to the Govt. for development purposes. These taxes can be levied easily due to lesser per capital income of the people in these countries.

Moreover, these taxes are acting as an anti-inflationary weapon. They can reduce the price level by curbing unwarranted consumption. Its role in establishing justice and equity in the society is commendable. It can be done by imposing heavy taxes on the rich and essential goods consumed by the poor section of the society.

Consumption based taxes are more useful in the conservation of valuable foreign exchange resources for welfare purposes. By reducing the volume of import and protecting weak domestic industries, it can improve the position of the BOP of the country.

It helps in the diversion of the resources from non-essential goods to most essential goods. This sort of diversion is called beneficial diversion.

Consumption based taxes can be oriented towards raising employment opportunities by encouraging labour intensive technique of production. It performs social as well as economic services to the community in general and the 'have-nots' class in particular. It is equally convenient to both the tax-payers and the Govt. It is also only means of reaching the poor and it is paid in bits.

The importance of consumption based taxes in checking the consumption of harmful commodities like tobacco, liquor, drugs, cigarettes etc. can not be under estimated.

Consumption based taxes are comparatively less popular as it is a tax in the veil and it remains hidden behind the price. It is difficult to evade which is an antisocial or illegal act. It has immense importance for balanced regional development which is one of the ideals of an egalitarian society.

Consumption based indirect or commodity taxes can touch the hearts of all sections of people. Even the lower income groups of people can be made to contribute taxes by broadening the tax base. Thus it can be treated as a mass tax in the LDCs.

Limitations of Consumption Based Taxes :

Consumption based taxes are not unmixed blessing. The limitations of these taxes are as follows:

Being regressive in character, consumption based taxes are not equitable. It is obviously unfair as both the rich and the poor contribute the same amount in spite of having different ability to pay the taxation.

They are uneconomical as large administrative staff is required to administer such types of taxation.

They fail to create civic consciousness and tax payers become indifferent towards their responsibilities. Moreover they are incompatible with the policy of industrialization if raw materials are taxed.

These taxes are responsible in giving birth to inflation which is a curse to dowll trodden of the society.

To conclude, no value judgment can be made on the relative importance of income based taxes and consumption based taxes, as both are complementary to each other. Gladstone remarked that both taxes should be viewed as equally attractive sisters and therefore, Govt. should handle both the taxes properly to get the desired results. Both may be used as a part and parcel of comprehensive fiscal policy. To avoid cyclical fluctuation, both can be used as counter cyclical policy.

2.4 LET US SUM UP:

1. The bases of IBTs are incomes derived from various sources of the tax payers; while the bases of CBTs are consumption operation of goods and services.
2. IBTs are progressive direct taxes and CBTs are indirect or commodity taxes which are regressive in nature.
3. Being the direct tax IBTs are nqt popular while CBTs are more popular.
4. Both taxes have their far reaching consequences on the economy of both developed and LDCs of the world.
5. IBTs are not as productive as CBTs.
6. CBTs have wider coverage than the IBTs.

KEYWORDS :

Haves : Imply the reach or advantageous sections of the people of the society

Have nots : The poor, weak and voiceless disadvantageous sections of the people.

Labour Intensive Technique : Any process of production is termed 'labour intensive if the share of labour is proportionately more than the share of other factors of production. Small scale industry, Handicrafts and cottage industries are examples of labour intensive production.

SUGGESTED READINGS:

1. Dalton, 'Public Finance'
2. Prest, 'Public Finance in Under Developed Countries'
3. Tripathy, 'Public Finance in Under Developed Countries'

CHECK YOUR PROGRESS EXERCISES: 2.1

1. Show the differences between IBTs and CBTs. Give some examples of both types of taxes (within thirty words)

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2. Mention the limitations of IBTs and CBTs.

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TERMINAL QUESTIONS :

1. What are the income based taxes and consumption based taxes? Show the differences between income based taxes and consumption based taxes.
2. Explain the significances of income based taxes and consumption based taxes.
3. Analyze the limitations of income based and consumption based taxes.

HINTS TO CHECK YOUR PROGRESS EXERCISES:

1. See 2.2.1
2. See 2.3 on limitations of IBTs and CBTs.

UNIT - 3: INDIAN TAX SYSTEM

STRUCTURE

3.0 Objectives

3.1 Introduction

3.2 Salient Features and Defects of Indian Tax System

3.3 Recent Tax Reform Measures.

3.4 Role of Taxation in Economic Development

3.5 Let Us Sum up

3.0 OBJECTIVES :

After a systematic reading of this unit you should be able to :

1. Explain the characteristics of Indian tax system.
2. Highlight the pitfalls of Indian tax system.
3. Discuss the various tax reform measures recommended by the Chelliah Committee along with the Kelkar Committee and their inclusion in the successive budgets of India.
4. Analyze the major comparative role of direct and indirect taxation in economic development of both developed and LDCs of the world.

3.1 INTRODUCTION :

During the British rule, Indian tax system was unorganized, unregulated and unplanned. It was observed that no due attention was paid for making the tax system more uniformity as well as progressive. It was regressive in nature. But just after the attainment of independence, objectives like social welfare, social justice and economic development are included into Indian tax policy. Indian tax system like that of any other country has now developed in response to many influences - economic, political and social. Government wants to bring about a radical change in Indian tax structure by constituting a number of committee.

3.2 SALIENT FEATURES AND DEFECTS OF INDIAN TAX SYSTEM :

Features of Indian tax system :

The salient features of the Indian tax system are as follows :

1. Tax Structure :

Indian taxation is composed of two types' viz., direct tax and indirect tax. The contribution of direct taxes is meager and it is roughly 17 p.c. of total tax revenue; while lion share comes from indirect taxes. Its contribution is 83 p.c.

2. Predominance of indirect taxes:

Share of indirect taxes is large in comparison to direct ones. Now its contribution has been on the rise.

3. Higher incidence of taxation on urban areas as against the rural areas :

Incidence of taxation on rural area is small due to the predominance of agriculture and its allied activities which are exempted from the per-view of taxation. The wage earning urban people are liable to contribute more taxes to public exchequer. It creates regional economic imbalances in our country.

4. Complexity of tax laws:

Tax laws are highly complex and loopholes persist. Tax evasion and avoidance are regular features which are responsible for creating a parallel economy.

5. Lock of productivity and elasticity :

Large share of tax revenue is spent on unproductive operations like defence, civil administration, interest payment. Tax revenues are spent on political ground. Tax system can not be made more elastic and as such, it is not productive.

6. Reduction of inequality:

Indian tax system fails to remove the disparity of income and wealth of the people of the society. Rather, it has widen the gap between the rich and the poor by making the rich more richer and the poor more poorer.

7. Lack of co-ordination :

There is no close cooperation and co-ordination between two sets of government i.e. union and regional governments. Different taxes with different rates prevail.

8. Due place is not given to local finance:

The growth of revenue of local bodies are not at per with the growth of their activities and therefore, they are to relay more upon the central government to mobilize financial resources.

9. Rising trend in tax revenue:

The tax revenue in India has continuously been rising in absolute terms. The share of tax revenue to five year plans is also rising as days rolled by.

Defects of Indian Tax System :

Indian tax system suffers from the following drawbacks:

1. Unscientific :

Indian tax system fails to secure social justice, equity, mobilizing saving and discouraging undesirable investment. Thus it is inconsistent and unscientific.

2. Inflexible and inelastic:

This is another important drawback of Indian tax system. It depends mostly upon urban income and wealth and abandon agricultural income. It fails to strike a balance between direct and indirect taxes.

3. Traditional in nature:

Tax structure is conservative and traditional. More priority is accorded to the indirect taxation which is regressive in nature.

4. Unproductive:

The revenue coming from both direct and indirect taxes is inadequate to fulfill the growing needs of the public authority. As it is unproductive, Government is to take shelter to deficit financing which is inflationary in character.

5. Complex tax laws:

Indian tax system is not based on the canon of simplicity rather it is complicate. Complicated rules and regulations stand

as hurdle in the way of honest and illiterate tax payers. They provide more opportunities to unscrupulous elements.

6. Unbalanced tax system:

Indian tax system is said to be highly unbalanced. More wightage is given not on direct taxes but on indirect ones. It has violated the principle of horizontal equity.

7. Lack of coordination:

India has adopted federal system of finance under which both union and state Governments impose different taxes separately with different rates. Thus it 1lack of coordination between the two sets of Governments.

8. Large scale tax evasion:

Tax evasion and avoidance are the most serious defects of Indian tax system. Creation of black money generates parallel economy. It destabilizes the economy and corrupts the socio political setup of the country.

9. Huge tax arrear :

Large amount of tax is lying in arrear which proves inefficiency. Unrealistic tax assessment, administrative delay and lack of proper information are other major reasons for large scale tax arrear which is accumulating over the years.

10. Inefficient tax administration :

There is lack of coordination between various tax agencies. Indian tax system is poorly administered. There is an

absence of adequate and timely supervision and monitoring by tax authorities. It makes the tax system more uneconomical

3.3 RECENT TAX REFORM MEASURES :

Govt. of India constituted different committees in different times under the chairmanship of some prominent economists with a view to suggest ways for improving the tax structure in the country. 'Following were the committees:

1. Taxation Enquiry Commission - 1953-54
2. Kaldor's Proposals for Tax Reforms 1955-56
3. Bhoothalingam's Tax Reforms - 1968
4. Direct Taxes Enquiry Committee - 1970
5. Committee on Taxation of Agricultural Wealth and Income -1972
6. Indirect Tax Enquiry Committee – 1976
7. Chokshi Direct Taxation Committee – 1977
8. Chelliah Committee on Tax Reform 1991
9. Kelkar Committee (Task Force on Direct and Indirect Taxes) 2002

The Government of India is keen to bring about a radical change in entire tax structure along with the improvement in tax administrative machinery. Different committees are constituted in pursuance of government's commitment to make the tax system simple, credible, fairer and progressive. Utmost care has been taken to make the tax more simplified and rationalized. It would be worthwhile to note here that most of

Committee have been incorporated in different budgets of India. With a view to remove most of the anomalies inherent in the tax system and improve equity, incentive structure, introduction of VAT system to do way with the defects of present multi point sales tax.

Personal income tax has been restructured with lower rates, fewer slabs, higher exemption limit of Rs. 1,00,000, reduced saving linked tax exemption on the basis of the Kelkar Committee. Moreover, by eliminating the distinction between registered and non-registered firms and a flat rate of tax, the system of taxation of firms has been rationalized and simplified. Introduction of the presumptive tax is one of the tax reform measures to enlarge the tax net. Though the standard deduction has been abolished in the latest budget for 2006-07, tax exemption limit has been raised to Rs. 1,00,000 for savings on various schemes and surcharge has been lowered from 10 p.c. to 2 p.c. One ofthe core reform measures is the total abolition of dividend tax on company.

To boost up industrial activity and export trade, government wants to cheapen the imported inputs. Moreover, service tax net has been broaden and rates has been pegged up to 12 p.c. in the latest budget for 2006-07. The scheme of ‘Saral’, ‘Sahaja’ and ‘Samadhana’ is also an acceptable scheme to the illiterate and ignorant tax payers of our country. The yield from the direct taxes is expected to rise to Rs. 4,000 crore in the latest budget. It is directed to minimize the gap of the ‘haves’ and ‘have nots’.

A noticeable tax reform measure is that the yield from indirect taxes has been reduced to Rs. 2000 crore at present. Indirect tax reform measures, adopted and implemented in the

successive budgets are noticeable. One of the important tax reform measures is the complete exemption of both custom and excise duty on life saving drugs and defence related goods. VAT system makes the indirect tax system more friendly, transferent and neutral. 2005 is a remarkable date in the history of Indian tax system for the transition from sales tax system to VAT. It makes the tax system more productive which is the need of the hour.

Moreover, India is looking for the formation of simple and transparent tax laws to bring about a radical change in the law/ laws. The Central Board of Direct Taxes (CBDT) remarks, "the ideal tax structure would be one which is simple and easily administrable and where, tax exemptions are gradually phased out. Rewriting of incometax laws is the most important step in the on going economic reform".

3.4 ROLE OF TAXATION IN ECONOMIC DEVELOPMENT :

To accelerate the pace of economic development and stability of a country taxation can serve as a useful and bold instrument of fiscal policy. The dire necessity in the developing countries of the world is to achieve economic growth and development. It requires rise in real production, employment through increased saving and investment. To achieve this objective, volume of consumption is to be curtailed and resources are to be diverted from profit motivated private sector to public sector. The role played by both direct and indirect taxes, the twin sisters can not be underestimated. It is observed that the scope of direct taxes is drastically limited and more thrust is given on indirect taxes in the LDCs. But it is to be

the recommendations of the Chelliah Committee and Kelkar noted here that taxes are the most productive, elastic, flexible source of the revenue of governments central and regional.

Taxation has got both budgetary and non-budgetary objectives. The primary objective of taxation is revenue objective and as such government wants to mobilize adequate revenue from diversified taxation, which touches the hearts of all sections of people of the society. To regulate the economy, it is used as an active instrument by the government. Government can render help to the weak infant industries for their survival and growth. The role played by import duty, export bounties, import quota and import licenses in restricting the growth of foreign industries on the soil of the LDCs is commendable.

According to Seligenan, taxation is the oldest means of mobilizing revenue for the government to finance expensive and multiple activities. Taxation can provide necessary incentives to work, save and invest which are conductive to capital formation as well as economic development.

Tax on consumption of commodities is urgently necessary to promote volume of saving and investment particularly in the LDCs where propensity to consume is much more. Inequality of income and wealth which is inherent in the LDCs can be minimized to the desired extent by correcting maldistribution income and wealth through suitable tax policy. Inflation which is treated as a curse to the down trodden can be checked by means of direct and indirect taxes. Proper and well designed tax policy can check both inflation and deflation for attaining the objectives of economic stability and growth. Dr. R.G. Chelliah argues that taxation has to mobilize surplus income of the ‘haves’ class to channelise it to productive operation.

From the above discussion we may conclude that taxation has far reaching consequences on the economy of both developing and developed countries of the world.

3.5 LETUS SUM UP :

Taxation constitutes the most important source of revenue for the achievement of certain specific objectives like economic growth, economic stability, full employment, reduction of in equality of income and wealth etc.

Indian tax system possesses certain peculiar characteristics as well as defects.

The Chelliah Committee (1991) and the Kelkar Committee (2002) come in to being to recommended certain bold measures for the simplification, rationalization and modernization of Indian tax system. Most of the recommendations have been incorporated in the successive budgets of the country.

KEY WORDS :

Incidence of taxation- the final money burden of taxation.

SUGGESTED READINGS:

1. R.N.Bhargava, 'The Theory and Working of Union Finance in India'

2. N.Kaldor, 'Role of Taxation in Economic Development'

3. H.L.Bhatia, 'Public Finance'.(Fiscal Policy)

CHECK YOUR PROGRESS EXERCISES: 3.1

1. Mention the salient features of Indian tax system
2. Mention the defects of the Indian tax system.

TERMINAL QUESTIONS :

1. Discuss the salient features of Indian Tax System. What are the defects of Indian Tax System?
2. Explain the tax reform measures adopted by the government of India during the post economic reform policy.
3. Discuss the role played by taxation in economic development of developing country.

Short Notes :

1. Chelliah Committee (1991)
2. Kelkar Report(Task Force),2002

HINTS TO CHECK YOUR PROGRESS EXERCISES:

1. See 3.2 on salient features of Indian tax system.
2. See 3.2 on defects of Indian tax system.

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SELF LEARNING MATERIAL

ECONOMICS

COURSE : ECO - 104

PUBLIC ECONOMICS : THEORY AND PRACTICE

BLOCK - 3, 4 & 5

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ECONOMICS

COURSE : ECO - 104

PUBLIC ECONOMICS : THEORY AND PRACTICE

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ECONOMICS

COURSE : ECO - 104

PUBLIC ECONOMICS : THEORY AND PRACTICE

		Pages
Block – 3 :	Public Expenditure and Public Debt	1-40
Block – 4 :	Fiscal Policy and Federal Finance	41-69
Block – 5 :	Public Budget, Public Utilities and Public Enterprises	70-109

BLOCK – III PUBLIC EXPENDITURE AND PUBLIC DEBT

UNIT 1 : PUBLIC EXPENDITURE

STRUCTURE

1.0 Objectives

1.1 Introduction

1.2 Structure and Growth of Public Expenditure

1.3 Wagners Theory of Public Expenditure

1.4 Modern Theories of Public Expenditure

1.4.1 Eric Lindahl Theory

1.4.2 H.R. Bowen Theory

1.4.3 P.A. Samuelson Theory

1.5 Investment Criteria

1.6 Cost-Benefit Analysis

1.7 Shadow Pricing and External Cost and Benefit

1.8 Role of Public Expenditure in Economic Development

1.9 Let us Sum up

1.0 OBJECTIVES :

After reading this unit you should be able to—

1. Explain the various causes of the heavy growth of public expenditure and public debt depending upon the different theories put forwarded by leading economists.
2. Define what the project evaluation is? And to know the usefulness of cost benefit analysis particularly in LDCs.
3. Differentiate between shadow pricing and market price along with their implication.
4. Discuss the role of public expenditure in economic development of both developing and developed countries of the world.

1.1 INTRODUCTION :

Public Expenditure like public debt occupy prominent place in the study of public finance. It is important and effective fiscal tools which is being utilized for the attainment of certain well defined objectives. It has far reaching consequences on production as well as distribution of income wealth of the society as a whole. But it is a regret that the classical economists believed in the negation of this instrument of immense economic importance. Modern economists, on the other hand, have accorded more priority to the discussion of this the crucial weapons. The causes of the heavy growth of public expenditure have been nicely examined by a host of economists with the help of their laws and theories. In this unit, necessity of evaluation of projects particularly in the LDCs and causes of projects are analysed with the help of cost benefit analysis. The concept of shadow price plays a significant role in removing the defects of

market mechanism which stand as hurdle in the path of economic development of the LDCs.

1.2 STRUCTURE AND GROWTH OF PUBLIC EXPENDITURE

Structure of Public Expenditure

Public expenditure is one of the most important and effective fiscal weapons. It has got far reaching effect on production and distribution of wealth and income of the society. It is an admitted fact that the old, classical economists took little interest in the discussion of public expenditure. Their view on public expenditure was absolutely negative. As they were the ardent supporters of the 'Laissez Faire Policy'. Modern economists afford more reliance and they place more discussion of public expenditure in the theory of public finance.

A good number of economists of repute have classified public expenditure depending upon various bases. These classifications are cited below in a tabular from.

1. Expenditure on the basis of common benefit :

   Expenditure yielding benefit for a11-Expenditure on education, defence etc.

2. Expenditure creating benefit for certain people – poor relief, social security measures.

3. Special benefit to some but a benefit for all – expenditure on administration of justice.

4. Expenditure creating benefit for a particular group only— subsidy to particular industry.

5. Expenditure on the basis of revenue received—Expenditure giving full return-expenditure on post office.

   Expenditure without direct return of revenue - expenditure on poor relief.

   Expenditure with indirect return of revenue - expenditure on education.

   Expenditure with direct particular return - expenditure on subsidy.

6. Classification on the basis of function

   Protective function -Expenditure on police, defence etc.

   Development function - expenditure on roads, rail, education etc.

   Commercial function - bounties, industrial exhibition.

7. Compulsory expenditure - defence.

   Optional expenditure - expenditure on subsidy.

8. Dalton's classification:

   Grants - expenditure on social security measures.

   Purchase price - expenditure on salary, T.A. & D.A. etc.

9. Roacher's classification:

   Necessary expenditure - defence expenditure.

   Useful expenditure - expenditure on education, training and research etc.

   Ornamental expenditure— expenditure on parks, war etc.

10. Shirras Classification of Public Expenditure -on the basis of importance

    Secondary Expenditure - expenditure on education, health, agriculture etc.

    Primary Expenditure - defense, law and order

11. Pigou's Classification: Non-transferable.;. defense, law and order, education etc.

    Transferable -payment of public debt, subsidy etc.

12. Metha's classification:

    Constant expenditure - defense

    Variable expenditure -postal service

13. Modern classification: Modern classification Comprises two components. These are— functional and departmental.

    Functional Classification— expenditure on national security, international affairs, finance, labour, agriculture etc.

    Departmental classification– expenditure on departments of labour, defense, agriculture etc.

It can be said that none of the above classification of public expenditure appears to be perfect one. Each classification has got some shortcomings of its own. It is difficult to perceive of a classification free of defects.

Growth of Public Expenditure :

least attention to public expenditure bring influenced by the policy of 'Laissez Faire'. Traditional's approach was closely linked with the philosophy of balanced budget or sound finance. But the modern welfare government performs many more expensive welfare, development functions for promoting economic development of the economy besides the performance of the primary duties more efficiently. These are the reasons why modern government has to incur more expenditure during recent years. The causes of the growth of public expenditure have been nicely examined by different economists in different periods. We shall take up Wagner's theory of public expenditure and other modern theories put forwarded by Lindahl, Bowen and Samuelson in a phase manner.

1.3 WAGNER'S THEORY OF PUBLIC EXPENDITURE

Adolf Wagner, a note~ German fiscalist propounded on imperial "Law of the Increase of State Activities" in 1883. This law came into operation after surveying the public expenditure records of some advanced countries during the 19th century Wagner was of the view that modern governments had started assuming new function as a result of dynamic changes in nature and purposes of the state and they perform both old and new functions more efficiently and thoroughly. He advocated an approach in which highest priority was accorded to social and political objectives which are the deciding factors of unprecedented growth of public expenditure. According to Wagner, "Comprehensive Comparisons of different countries and different times show that among progressive people, with which we are concerned, an increase regularly takes place in the activity of both the central and local governments. This increase is

both extensive and intensive; the central and local governments constantly undertake new functions; while, they perform both old and new functions more efficiently and completely". Wagner divided the public expenditure into three categories and they are as follows:

1. Expenditure for security.
2. Expenditure on cultural and welfare.
3. Expenditure on production and distribution of public goods.

The staunch supporters of Wagner law are Prof. Niti, A.P. Peacock, J. Wiseman, Colin Clark etc.

Following are the factor responsible for the growth of public expenditure in modern times.

1. Continuous increase of social and welfare activities.
2. Rising population and population growth.
3. Rising price and inflation.
4. Growth of democratic institutions.
5. Civil administration.
6. Social security measures.
7. Full employment.
8. Economic development
9. Public sector.
10. Public debt servicing
11. Urbanization
12. Internal Security. .
13. Industrialization

14. War
15. International responsibility
16. Economic planning
17. Modernization of agriculture, education and research.

Wagerian increase in pubic expenditure in different periods is shown in the following Diagram No. 1

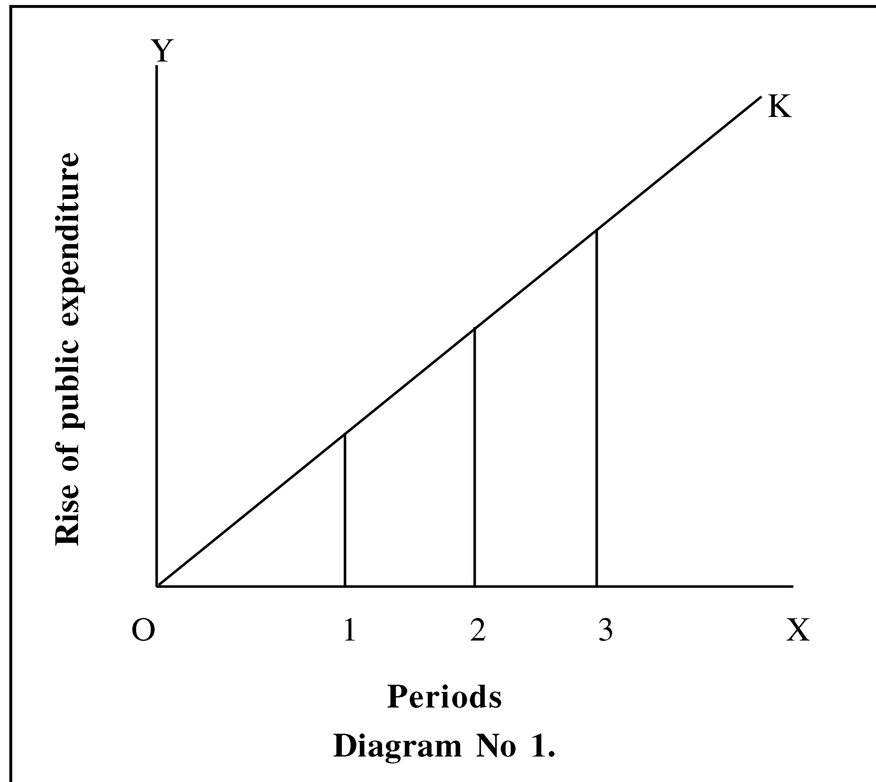

Diagram No 1.

Criticisms :

Wagner's theory is not free from criticisms. Wagner fails to establish a specific functional relationship between the rate of growth of economy and the growth of public expenditure. In the initial stage of economic development, public expenditure has a rising tendency while it has a declining tendency when the economy attains its maturity.

Wiseman-Peacock Theory (1890-1955), a modified theory for the explanation of the causes of the growth of public expenditure. But these two famous economists are of the opinion that public expenditure does not increase continuously due to the "displacement effect". According to Alan Tait Peacock, Public expenditure does not increase in a smooth continuous manner, but in jerk or step like fashion. Same treatment was shown by Colin Clark also.

Moreover, Buchanan and Tullock stated that Wagner's Theory shows discrepancy between growth of public expenditure and growth of out put.

The growing role of the state in the growing complexity of modern life has been discarded in Wagner's law.

Inspite of these criticisms leveled against this law, some economists including Beck Cyril Enwege (1950-60) stated that Wagner's law holds good even in developing countries of the world where rate of growth of public expenditure is much more than that of national income. Even J.M. Keynes, a noted economist accepted Wagers view and is of the opinion that increased public expenditure is the only way to fight against depression and unemployment.

1.4 MODERN THEORIES OF PUBLIC EXPENDITURE

A good number of modern and refined theories of public expenditure have been put forward by some economists of repute to analyze the causes of the growth of public expenditure in more commencing ways. Among these modern theories, discussion on Lindahl's theory, Bowen's theory and Samuelson's theory will be made.

1.4.1 ERIC LINDAHLTHEORY

Lindahl's Theory of public expenditure needs special mention. It is no denying fact that Lindahl has contributed an improved theory over Wagner's theory to analyze the scientific causes for the growth of public expenditure. It is recognized as one of the pure theories based on benefit principle. This theory is directly concerned with purely fiscal problem of providing for the satisfaction of public wants. It does not concern with the problem of just and equitable distribution of income.

We have already observed that there is close relation between public expenditure and taxation. It is the individual preference which determines the extent of public expenditure and taxation. Keeping this end in view, three decisions are to be made. They are as follows:

1. Determination of total amount of taxes as well as public expenditure.
2. Allocation of total amount of public expenditure among various social wants.
3. Allocation of total amount of taxes among various individuals.

To understand Lindahls' Model of Voluntary Exchange, let us suppose two individuals of a community along with only one type of social goods. A and B are two individuals who will use social goods. A and B receive different degrees of benefit from the social goods produced and provided for. Cost of providing it will have to be borne by both individual jointly. To get the benefit of joint products having joint cost, both A and B are to contribute taxation depending upon their share of purchases. Out of the two individual purchasers one will have to pay more if other contribute less due to his less

purchase of public goods. If this is done, the joint contribution covers the total cost of supplying social goods for which principle of divisibility and exclusion can not be followed. But it is to be noted here that if more than two commodities are taken along with many tax payers, the theoretical validity of this model will not be affected at all.

This theory can be treated as supply and demand theory of public expenditure as allocation of total cost of two joint products is done according to relative supply price based on demand for and supply of the two joint products.

Lindahl's theory is also not free from criticisms as it is based on certain unsound assumptions. The important criticisms are as follows:

1. It is a partial analysis; as private services have been discarded from its preview.
2. Lindahl has given top most priority only to the allocation of income aspect and discarded the role played by income distribution.
3. To Lindahl has consumers possess equal burgaining power and ability which are unrealistic and impracticable.

1.4.2 H.R.BOWEN THEORY

Credit goes to H.R. Bowen for the restatement, refinement and modification of Lindahl's theory of public expenditure. It is one of the pure theories of public expenditure based on benefit principle. This theory shows the characteristics of public goods and explains the distinct behaviour of consumers

of these goods in respect of their contribution for their enjoyment.

Social goods are consumed equally by all consumers irrespective of their contribution to the public authority. The users are not liable to contribute equal amount of taxation to meet its cost of production. It is due to the difference of degree of satisfaction. Each individual user of public goods is to pay an amount of tax equal to the marginal valuation of it. They will pay different amount of tax revenue for the use of same public goods. Thus the quantity of supply of social goods depends upon the equality of marginal cost and marginal utility derived by the users or beneficiaries.

1.4.3 P.A. SAMUELSON THEORY

Paul A. Samuelson, one of the critics of Lindahl's theory of public expenditure received award for the formulation of the most recent benefit theory of public expenditure. Application of market principle to the pricing of social goods is the starting point of Samuelson's theory of public expenditure. By discarding Lindahl's partial equilibriums approach, Samuelson has introduced an improved general equilibrium approach. He explains both the allocation and distribution aspects for optimal allocation of both public and private goods. It is already explained that public goods are supplied collectively and so budgetary allocation is required. While private goods are produced and supplied by private enterprises depending upon the revealed preference of the users in the market. Supply of public goods depends upon the desire of the members of the society.

It is to be noted here that the scope of general equilibrium analysis is wider than that of Lindahl's partial equilibrium analysis. The general equilibrium analysis brings both public and private goods into account. On the whole, Samuelson builds up an ideal theory which wants to determine optimum amount of public expenditure on both public and private goods. It is definitely an improved explanation over other theories of public expenditure.

1.5 INVESTMENT CRITERIA

Investment of resources posses a serious problem in all the LDCs of the world which are characterized by deficiency of capital, chronic poverty etc. Therefore, resources are to be utilized most efficiently and judiciously for rapid economic development. Good number of urgent projects may arise simultaneously in the economy which can not be undertaken for their completion. Thus selection of projects, sectors and techniques is complicated task due to inequality of income, chronic unemployment problem, large traditional backward sectors, inflation, imperfect capital market, production rigidity etc. Project evaluation is a necessary exercise. Thus different investment criteria are to be applied depending upon different objectives to be maximized over different periods of time. No single criterion can be prescribed for investment allocation. Careful judgment as well as thoughts are the need of the hour to select suitable criteria according to the changing circumstances of the society. Among the various criteria of project evaluation, cost benefit criterion is regarded the most suitable for both developed and developing countries.

Table No.-l

1.6 COST-BENEFIT ANALYSIS

Cost Benefit Analysis :

Credit goes to American Engineers for the development of the cost-benefit technique in economic planning. This analysis and technique are used in selecting the most desirable and urgent projects, sectors etc. under the plans. As public investment is limited in almost all the LDCs, economically, socially, politically feasible projects and sectors are to be chosen for their implementation.

According to some leading economists like Prof. I. M.D. Little, Mirrless and Hyman etc., this powerful micro planning technique is more beneficial to both the developed and the LDCs. After the allocation of plan investment between different sectors and projects, government and the planner will have to select the projects within the projects to which investment is directed. This selection of projects is entirely based on scientific evaluation. Selection or rejection of projects and investment depend upon the ratio of cost and benefit. Only the top projects whose benefit cost ratio are the highest, are to the included and the rest are to be excluded for their implementation. Lesser, cost involving and greater benefit yielding projects are selected under the plan which provide net social benefit. Selected projects should satisfy the national objectives to the maximum.

Cost Benefit Criteria :

There are four benefit cost criteria discussed by the US subcommittee on benefits and costs. These are:

1. B-C 2. B-C/1 3. $\frac{\Delta B}{\Delta C}$ 4. B/C

Here B stands for benefit

C stands for cost

1 stands for direct investment

Δ stands for investment

For determining the total annual return on a particular investment, the formula B-C/1 is used. If the private investment happens to be very large, then even high value of B-C/I may be less beneficial. Thus this criteria is not beneficial to achieve good results for the economy; while adoption of B-C criterion favours large projects only.

B/C criterion is regarded as best criterion. If B/C =1, the project is marginal because the benefits occurring from the project just cover the cost. If B/C<l, then benefits are less than the costs and so the project is rejected. The higher the benefit cost ratio, more profitable will be the project and these projects are selected.

Benefits and costs may be of various types. Benefit from project may be real, direct, indirect, tangible and intangible. Similarly cost may be real, nominal, primary, secondary, associated and project.

The best and effective criterion for project evaluation is B/C. The choice of the projects or sector with a fixed budget is shown in the following table No.-1

Table No.-l

Project	Cost C	Benefit B	Net Benefits B/C	B-C	B/C Ranking
I	400	800	400	2.0	2
II	290	350	60	1.2	5
III	160	208	150	1.3	4
IV	100	250	48	2.5	1
V	600	840	240	1.4	3
VI	250	250	0	1.0	6
VII	600	540	-60	0.9	7

Here the best choice is to include projects I, II, IV,V with the least cost but more benefits for the society.

1.7 SHADOW PRICING AND EXTERNAL COST AND BENEFIT :

The concept of shadow pricing has been defined by different economists like Jan Tinubergen, H. B. Shenery, K.S. Kretcher to overcome the problems created by market mechanism. This price is known as accounting price, social price or efficiency price. Shadow price is the fictitious price used for the purpose of economic calculation in a planned economy. It ensures optimum resource allocation which is not done by market mechanism. Market price does not reflect social benefit and social cost. Shadow prices are those which would bring about an equilibrium between demand and supply of a factor of production or a commodity. Shadow price may differ from the market price.

Sometimes market price of labour is higher than the shadow price.

Importance of shadow prices :

Cost benefit ratios for projects can be easily calculated on the basis of shadow prices. It is a crucial tool for selecting projects priorities and attaining optimal allocation of scarce resources for the attainment of most desired objectives. Shadow price can measure the actual value of output input of the projects.

Different types of shadow prices are there in cost benefit analysis on project evaluation. They are shadow labour cost, shadow wage, shadow foreign exchange rate, shadow cost of capital, shadow price output. They reveal the valuation that society attaches to the output input of the project undertaken.

With a view to evaluate a project with shadow price tool, we have to calculate the total benefit from a project and total cost incurred on it. It plays a dominant role in programming which implies optimal use of investment in production operation in LDCs.

Limitations of shadow price :

Inspite of a number of advantages of shadow price, it has certain practical difficulties in its smooth functioning. They are as follows :

1. Non availability of structural data.
2. It is timeless and static in nature and it neglects the reality i.e. dynamism.

3. It is absolutely indeterminate due to the impossibility of calculation of marginal productivity of labour.
4. Prof. Myrdal regards the concept of shadow price as unrealistic and useless tool for the LDCs with multi dimensional problems.

1.8 ROLE OF PUBLIC EXPENDITURE IN ECONOMIC DEVELOPMENT

The role of public expenditure in economic development of both developing and developed countries can not be underestimated. It is playing the most significant role in the attainment of development objectives. According to John Adler, there is close relation between public finance and economic growth. It possesses the same place in the study of public finance which production and distribution - consumption possess in the study of economics. The developed and the LDCs are having their respective problems.

Public expenditure has to play an active role in reducing regional socio-economic disparity, developing social overheads, creation of various types of infrastructures in developing countries. While in developed countries, role of public expenditure is abit different. Its role in maintaining smooth rate of economic growth with stability can not be underestimated. Thus stabilization and stimulation of socio-economic activities are the most crucial role of public expenditure. Its role in promoting saving, investment and capital formation is commendable. These are pre-requisites for accelerating the pace of economic development of a country.

Public expenditure in the shape of progressive subsidies can be helpful for accelerating the pace of economic growth.

Diversion of resources from developed regions can minimize economic disparity and thereby improves distribution system. Prof. A. Lewis has advanced his bold arguments infavour of reducing regional disparity through balanced economic development.

Public expenditure can be utilized as an anti-inflationary tool of fiscal policy of developed countries. it is a powerful and excellent tool for regulating and controlling inflation, deflation and economic depression. Of course other tools of fiscal policy are to be utilized simultaneously to this cause. Keynes are in favour of public expenditure as an anti depression tool. Public expenditure in the form of pump priming can fight against deficiency of effective demand through public works programmes and social security measures.

The role of public expenditure in the extraction and utilization of country's resources of immense economic significance is much more. Economic development greatly depends upon the proper and fuller utilization of these resources. It can act as a powerful promoter of economic growth and an active compensatory mechanism.

Public expenditure has a special role to be played in the developing countries of the world. It can promote economic development in several ways. It provides sound and effective means for building up economic and social overheads which are urgently necessary for economic development. In a developing economy public expenditure must play a very active role in promoting economic development while in developed economy, it looks towards the maintenance of economic stability. The role of public expenditure in the development of agriculture, industry and exploitation of forest resources and other natural resources

can not be underestimated. It is obviously beyond the capacity of individual who are economically unsound.

It is already discussed that for rapid economic development, capital formation is of crucial importance and most of the developing countries are suffering from capital deficiency. It is therefore, utmost necessity to achieve higher ratio of saving to national income and it can be achieved through planned public expenditure policy. Public expenditure is to be curtailed in a phased manner to curtail volume of consumption which can stimulate saving and investment for economic development.

Thus public expenditure has got far reaching effect on production, distribution and economic development of a country.

1.9 LET US SUM UP

1. Public expenditure occupies a prominent role in the achievement of socio-economic objectives like growth with stability, full employment etc.
2. Public expenditure has been classified into a number of classifications depending upon the basis of benefit and return received importance and functions etc.
3. Different theories have been advanced by the classical and modern economists to explain the causes of the growth of public expenditure.
4. Investment criterion is mainly based on cost-benefit analysis. Most urgent projects are included under the umbrella of investment of financial resources particularly in the LDCs due to paucity of financial resources.

5. Shadow pricing is known as ac~ounting pricing which ensures optimum allocation of resources. It is used to remove the defects of market price and market imperfections.

KEY WORDS :

1. **Pump Priming :** Large scale compensatory public expenditure incurred at a single stroke during economic depression is called pump priming.
2. **Shadow Price :** It is known as accounting price or social price or efficiency price. It removes the practical problems of market price or market mechanism which is inherent in developing countries.

SUGGESTED READINGS :

1. Samuelson, "The Pure Theory of Public Expenditure".

2. Dalton, "Public Finance".

3. J.K. Mehta, "Public Finance."

4. LM.D. Little, "Project Analysis in relation to planning in a mixed economy."

CHECK YOUR PROGRESS

EXERCISE : 1.1

1. Show the distinction between shadow price and market price (within forty words)

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....

....

2. Mention the major causes of the growth of public expenditure in modem times.

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TERMINAL QUESTIONS :

1. Public expenditure has a tendency to grow very fast in modem time. Explain briefly the factors which have caused this tendency.
2. Critically explain Wagner's 'Law of increasing state activities' with a diagrammatic representation.
3. Show the distinction between shadow price and market price. Discuss the relationship between shadow price and project evaluation.
4. Explain the role of public expenditure in economic development of developing and developed economies.

HINTS TO CHECK YOUR PROGRESS EXERCISES :

1. See 1.7 on growth of public expenditure.

2. See 1.3

UNIT – 2 : PUBLIC DEBT

STRUCTURE

2.0 Objectives

2.1 Introduction

2.2 Role of Public Debt

2.3 Burden of External Public Debt and Shifting of Debt Burden

2.3.1 Burden of Internal Public Debt and Shifting of Debt Burden

2.4 Principle of Debt Management

2.5 Repayment of Public Debt

2.6 Let us Sum up

2.0 OBJECTIVES

The objectives are—

1. Explain the fundamental differences between external and internal public debt and various principles of public debt management.
2. Assess the burden of both external and internal debt on the economy of a country.
3. Examine the differences between various types of burden of public debt of the economy.
4. Examine the different principles to be followed for debt management.
5. Analyze the role of various methods of debt redemption followed by different countries.

2.1 INTRODUCTION :

Like taxation and public expenditure, public debt can be used as an instrument of the government's economic policy. It is one of the effective sources of mobilization of resources which is used for the, achievement of some well defined aims and objectives of the economy. Modern economists have given more reliance upon this normal method of government finance along with other sources of public finance. It is used as a means of regulating the economy. It may be used to gain the long aspired goal of self reliance—

Public debt is of recent origin and was not heard prior to the 18th century. According to Bastable, it is the creation of the last two centuries. There is the phenomenal growth of

public debt in modern times. According to Gurely and Shaws, the mounting volume of public debt is a necessary feature of a strong and healthy structure of the economy.

Following are various types of public debt :

1. Voluntary Debt :

Usually public debts are voluntary in nature. When Government borrows money from the public, individuals and institutions by using securities, it is called voluntary public debt. Here no force is used rather people are requested to contribute to Government loan programs. It depends upon the ability, willingness and convenience of the subscribers.

2. Compulsory Debt :

At the time of national crisis like war, compulsory debt is incurred. Sometimes Government uses force for getting loan from individuals and institutions. Compulsory loans are uncommon in modern days.

3. Funded Debt :

The long term debt or deficit period debt is known as funded debt. Government makes an arrangement on the mode and time .of repayment of these dates. It is incurred for the creation of permanent assets.

4. Unfunded Debt :

The short term debt which is obtained to meet current requirements is called unfunded debt. Treasury bills are The role of public debt in stimulating social and economic

examples of unfunded debt. It is paid off within a year. Its rate of interest is lower than that of funded debt.

5. Internal Debt :

Internal Debt is contracted by the Government from the resident of the country. It simply involves transfer of resources from the bond holders to the Governments. According to Lener this debt is not burdensome. But M.C.Wright said that it is purely burdensome.

6. External Debt :

External debt is incurred by the Government from foreign individuals, institutions and Governments for the achievements of the objectives of fiscal policy. There is general opinion that external debt results in the impoverishment of the debtor country.

7. Productive Debt :

Public debt is said to be productive if the investment generates employment and income, which are utilized for the repayment of both principal amount and interest. Debt incurred for railway construction, irrigation schemes, power schemes etc. is called productive debt.

8. Unproductive or dead weight debt :

Unproductive debts are those debts which do not generate income and employment. According to Shirras,

Unproductive debt is debt weight debt. One example of unproductive debt is war debt.

9. Redeemable debt :

Public debts are mostly redeemable. When the Government promises to repay the debt along with interest at some future date. It is called redeemable debt. This debt may be of short period and long period. To make the payment, Government has to impose new taxes and setup sinking fund.

10. Irredeemable debt :

It is known as non-redeemable or perpetual debt. Irredeemable debt is that debt the principle of which is never returned by the Government except the payment of interest regularly. It is a permanent burden on the tax payers. For e.g. Irredeemable debt is British Consoles of 1750

2.2 ROLE OF PUBLIC DEBT

Public debt both internal and external plays a predominant role in the LDCs and developed countries of the world. It is a major instrument of resource mobilization. Tax revenue alone can not render the needful help in the mobilization of necessary resources and as such government is to take shelter to public debt. Its role in underdeveloped countries with market imperfections and rigidity can not be underestimated. The debt revenue can be profitably used for developing and exploiting country's resources. It may be used to gain the long aspired goal of 'self reliance'.

overheads like education, public health, research and training can not be underestimated. It can promote productivity and efficiency of the labour class. Public debt offers a sound economic base depending upon which country can prosper.

Lord Keynes also recognized its role n the development of other infrastructural facilities in the developing countries of the globe. Moreover, public debt is acting as an anti depression fiscal device. It is profitably utilized to fight against economic depression which is responsible for creating an atmosphere of gloom and frustration. Public debt is useful method to break the vicious circle of poverty and market imperfection which are inherent in most of the LDCs.

The role of public debt in fighting against very expensive war is much more. It helps the government to meet the requirement of war to a larger extent. This is why Prof. Shirras stated that it is baseless to say that expenditure on war is uncommenced.

Smooth functioning and healthy growth of the public enterprises depend upon the flow of more financial resources, the lion share of which is contributed by public debt. It is to be noted here that these public sector enterprises help in building sound economic foundation of the country.

Its role in arousing the spirit of universal brotherhood is much more. This spirit is treated as the pencca of economic development.

Thus it is evident from the above discussion that public debt may go a long way for economic development of both developing and developed countries. They have to seek both types of public debt in their initial and final stages of

development. No country can manage its affairs without public debt.

2.3 BURDEN OF PUBLIC DEBT AND SHIFTING OF DEBT BURDEN

Burden of External Public Debt and Shifting of Debt Burden :

It is observed by some eminent modern economists that external public debt is more burdensome than the internal debt or internal debt is better than the external debt. Question of burden arises out of shifting. Economist have advanced the following reasons in favour of their arguments.

1. When debts are incurred from foreign countries or international financial institutions, the debtor countries have to repay huge amount of money annually which pose heavy strain over its financial resources.
2. Sometimes it is found that external debt may posses a threat to economic and political independence of the debtor country. USA's occasional interference on India's economic affairs is an example of this type.
3. The debtor country may be directed by the creditor country by imposing certain unfavourable conditions regarding debt's use, mode of payment etc.
4. Public debt may be responsible in the creation of inflation which is regarded as a curse to the majority down trodden of the society. It is due to sudden rise of money supply without corresponding rise in goods and services.

5. Question of large scale exploitation of scarce but important resources of the debtor country is inherent. It may jeopardize the economy of the debtor country.

The burden of external public debt can be studied under the following heads :

Direct Money Burden :

In the case of external debt, the debtor country is to remit to the creditor country a huge amount of money every year by way of interest along with principal. It makes the debtor country more poorer richer and the creditor country more richer. It is the root cause of regional economic imbalances.

Indirect Money Burden :

Sometimes the amount of interest is paid not in terms of cash but in terms of kind, i.e. in terms of goods and services. It results in a rise of price level of goods and services within the country. This means a reduction of economic welfare of the community and this represents the indirect money burden.

Direct Real Burden :

Govt. may impose new taxes upon the people for the repayment of principal and payment of interest of the external debt. The burden of these taxes falls heavily on the majority poor than the rich section of the community. Economic welfare of the poorer section is reduced to a larger extent. It represents the direct real burden.

Indirect Real Burden :

Indirect real burden of external debt lies in the check to production of wealth, income and employment in the debtor country. Taxes imposed in order to raise funds for the repayment of debt may reduce people's ability and desire to work, save and invest, ultimately, productive capacity of the people declines to a larger extent and this represents the indirect real burden of external debt.

Some economists are of the opinion that external debt for development and productive purposes is not a burden but a profitable venture.

2.3.1 BURDEN OF INTERNAL PUBLIC DEBT AND SHIFTING OF DEBT BURDEN

There is hot discussion on the question of burden of an internally held public debt in economic literature. Some economists are of the opinion that internal public debt is burdensome and some are of the view that it is not burdensome for the country. According to the classical economists, both internal and external debt are burdensome as they were the ardent supporters of the 'Laissez Faire Policy'. But this view of the classical economists has been rejected by some modern economists like Keynes, Hansen, Lerner, Harris, Bowen, Buchanan, Davis, Musgrave etc. Lerner and his stanch supporters are of the opinion that internal public debt is not at all burdensome. According to Lerner, "Internal public debt imposes no burden on the community as a whole." It will not reduce the volume of financial resources of the country. Question of loss of economic resources does not arise. To Lerner, internal debt is not a burden on posterity and the nation can not

be 'bankrupt'. Only external debt impoverishes the nation. In case of internal debt, both the debtor and the creditor live within the same country and money will not go from one country to another. So, it is not burdensome.

It will be worthwhile to note here that Prof. M.C. Wright has challenged Lerner's opinion and remarked, "the statement that an internally held public debt imposes no economic burden on society is not entirely true. The burden has been enormously exaggerated, but it could be foolish to derry that it does not exist. Strains and frictions may develop through out the system."

We may discuss the burden of an internal debt under the following heads :

Direct Money Burden :

In the case of internal debt, there can be no question of any direct money burden or direct money benefit, as all payments are merely transfer payments within the four walls of the same country. Money will remain within the country.

Indirect Money Burden :

When government spends debt revenue on social and economic overheads, this results in the creation of demand for several goods and services. It raises the price level to a larger extent and as a consequence, the economic welfare of the poor section of the community is reduced. This represents indirect money burden of an internal debt.

Direct Real Burden :

Government pays the interest and repays the principal by imposing new taxes upon the people. Generally the tax payers are the poor people and the lenders are the rich people. Thus there is a transfer of wealth from the poorer to the richer people which creates gross in-equality of income and wealth. Hence, internal debt involves a direct burden.

Indirect Real Burden:

Internal debt involves an indirect burden arising from the check to production owing to the high taxation, required for meeting the debt charges and the curtailment of socially desirable expenditure. Moreover, it produces adverse effect on ability to work, save and invest of the people. On a consequence, productive capacity of the people declines to a larger extent.

From the above discussion it is clear that productive debt is burden less. While unproductive, dead weight debt is burdensome. If debt is taken with a motive for unproductive purpose, motive for making the government extravagant, motive of posing challenge to the economic -political freedom, it is burdensome. However, the burden of external debt is far greater than the burden of internal debt.

2.4 PRINCIPLE OF DEBT MANAGEMENT

Debt management is a method depending upon which the government can mobilize debt revenue and redeem it properly without harming the economy as a whole. It refers to the debt policy which is designed to attain at certain objectives and

of debt management policy are there and they are traditional and modern approach which are capable of advancing various objectives of debt management. Prof. P.E. Taylor and C.C. Abbot have identified the following principles of debt management.

1. Minimum Interest Cost of Servicing Public Debt :

It is observed that every government is interested in keeping the rate of interest at the minimum level so that debt obligation will be less burdensome for the entire economy. It will have less adverse effect on person's willingness to wok, save and invest. But this policy can not be followed for a long period when other objectives come into conflict with other objectives. Moreover, this low interest rate policy may have adverse effect and it may generate inflationary pressure.

2. Satisfaction of the Needs of the Investors :

Public debt is to be managed in such a manner that it must satisfy in needs and aspirations of investors who are less in number. Securities and terms and conditions must satisfy the investors. Govt. should offer favourable and attractive terms and conditions so that investor expresses their willingness to invest their money in such type of securities.

3. Funding the Short Term Debt into Long Term Debt :

The government should cast its eyes to convert its short term debt into long term debt with proper caution so that economic stability is not disturbed. To get the desired result,

rate of interest should not be raised to an exorbitant level in the long run which may adversely affect the rate and magnitude of private investors.

Cooperation Among Public Debt, Fiscal Policy and Monetary Policy :

A sound debt management policy is not possible without close cooperation from the central banking institutions. The government must ensure that the rate of interest does not rise to an exorbitant level. If timely cooperation is floated from fiscal and monetary authorities, it will be feasible to attain the twin objectives of growth with stability of the economy.

It would be worthwhile to note here that modern debt management policy is abit different from the traditional one. Modern government should look after economic stabilization during inflation and economic depression. During inflation, the maturity period of public debt should be raised while during economic depression, maturity period may be shorten to raise the volume of circulation of money to the desired extent.

Thus it can be said that a debt management policy is the best which can yield maximum social advantages with minimum sacrifice.

2.5 REPAYMENT OF PUBLIC DEBT

It is an accepted fact that where there is the question of public debt, there is the question of repayment. The sooner the debt is cleared, the better for the government. Various time bound methods may be used to repay its debt depending upon the circumstances of the country. These methods are analyzed below.

actual implementation of this policy. There are two approaches

1. Repudiation:

Repudiation of debt means the method of escaping from the burden of repayment of debt. It is nothing but the unilateral violation of previous contract made by the debtor and the creditor. The debtor country may follow this method under certain circumstances. The communist government of Soviet Russia adopted this method just after the collapse of the Tsar administration. The USA adopted it after the civil war. This method was adopted by a number of European Governments and Germany during and after the World War-I. But this method is immoral and dishonest and it may provoke realization from the strong creditor countries.

2. Conversion :

Under this method a high interest debt is converted into a low interest debt before its maturity. This method was first adopted by U.K. and she became successful by lowering down rate of interest to 3.5 p.c. from 5 p.c. in 1932. According to Keynes, "successful conversion is a fine art." It is an admitted fact that conversion is not a sound and effective method of debt redemption of public debt.

3. Sinking Fund :

Sinking fund is recognized as the most popular and systematic method of repayment of public debt. Credit goes to Huge Walpole who set up the sinking fund first in U.K. and as such he is known as the father of sinking fund. It is a separate fund constituted by the government out of the national income. Keeping this end in view, sinking fund was set up in India in 1924. It was constituted in 1979 in USA on the basis of

Alexander Hamilton's suggestion. Sinking fund is of two types and they are: Definite or Fixed and Indefinite or Movable.

It should be noted here that it is considered as a slow process of debt repayment. Moreover, there is a possibility of using the fund for other purposes during the periods of necessity. Surplus budget is one of the prerequisites for the creation of sinking fund.

4. Capital Levy :

It is a method utilized to repay the war debt, the magnitude of which is much more. According to Ricardo and Pigou, government should levy a tax on the rich capitalist propertied class of the society whose ability to pay the taxation is much more. It is to be paid not for all times to come but only for once and its rate is more than any other taxes. Besides Ricardo and Pigou, economists like Hobson, Edgewroth, Laurance and Dalton too advocated for capital levy for debt redemption.

The Chief opponents of capital levy were Shirras, Stamp, Pen and Hicks.

5. Surplus Budget :

Surplus Budget is the most important method of repayment of public debt. It is not a permanent phenomenon but occasional one. Surplus budget is quite unthinkable during war and for the LDCs.

6. New Taxation :

Levy of new taxes to mobilize revenue and to payoff old debt is another method of debt redemption. This method has certain limitations. Economic inequality gets further accentuated besides enhancing sacrifice of tax payers.

7. Other methods :

Besides the above cited methods of debt redemption, many more methods are in operation. They are: terminal Annuity, Surplus balance of payment, compulsory reduction of rate of interest, refunding, serial bond redemption and buying up loan from the market.

Of course some of the methods are extreme ones, such as repudiation and some are morally unsound and practically impracticable.

2.6 LETUS SUM UP:

1. Burden is involved in both internal and external debt. However, burden of external debt is far grater than that of internal debt. Debt burden is classified into four classifications -Direct money burden, indirect money burden, direct real burden and indirect real burden.
2. Different principles of public debt management are advanced by some leading economists like Taylor, C.C. Abbot etc. These principles are:- (1) Minimum cost of servicing public debt. (2) Satisfaction of the needs of the investors. (3) Funding short-term debt. (4) Cooperation among public debt, fiscal policy and monetary policy (5) Proper adjustment of maturity.

3. Debt redemption is an obligation on the part of the debtor country. Various debt repayment methods are adopted in different periods. They are - repudiation, conversion, sinking fund, capital levy, surplus budget, compulsory reduction of rate of interest, terminal annuities, refunding, surplus balance of payment, serial bond redemption and buying up loan in the market.

KEY WORDS :

Repudiation : It is the unilateral violation of terms and conditions on paying off public debt.

Capital Levy : Tax levied on the rich capitalist propertied class of a society whose ability to pay the tax is much more is called capital levy. Generally it is used to repay the war debt.

SUGGESTED READINGS :

1. Taylor, "The Economics of Public Finance".

2. R.K. Lekhi, "Public Finance".

3. R.N. Tripathy, "Public Finance in underdeveloped countries," 1967.

4. C.S. Shoup, "Public Finance."

CHECK YOUR PROGRESS

EXERCISES: 2.1

1. Mention the salient methods of repayment of public debt.

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2. Cite the debt management principles adopted by the Government of a country.

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TERMINAL QUESTIONS :

1. Discuss the burden of internal public debt and external public debt. Show the distinction between money burden and real burden of public debt.
2. "An internal public debt imposes no burden on the community." Discuss the statement.
3. Explain the various principles of public debt management policies with their limitations.
4. Discuss the various methods of repayment of public debt with criticisms.

HINTS TO CHECK YOUR PROGRESS EXERCISES:

1. See 2.5 on the repayment of public debt.
2. See 2.4 on principles of debt management.

BLOCK - IV FISCAL POLICY AND FEDERAL FINANCE

UNIT 1 : FISCAL POLICY

STRUCTURE

1.0 Objectives

1.1 Introduction

1.2 Role and Objectives of Fiscal Policy in Both Developing and Developed Countries.

1.3 Distinction between Fiscal and Revenue Deficit

1.3.1 Adverse Consequences of Fiscal and Revenue Deficit

1.4 Balanced Budget Multiplier and its Implications

1.5 Let us Sum up

1.0 OBJECTIVES

After going through this unit you would be able to—

1. Explain what the fiscal policy is? Highlight the role and objectives of fiscal policy both in the LDCs and developed countries.
2. Differentiate fiscal deficit and revenue deficit and their adverse consequences on the economy.
3. Effects of fiscal instruments on the economy of a country,
4. Define balanced budget multiplier and its effects on an economy.

1.1 INTRODUCTION

Fiscal policy deals quite directly with the matter which immediately influences the consumption and investment expenditure and hence income, employment and output of the economy of a country. It plays a dynamic role in both developing and developed countries, However, the prime objective of fiscal policy of developing countries is the attainment of rapid economic development while it is originated to the necessities of maintaining full employment and economic stability against cyclical depression. Full employment can be achieved through the avoidance of inflation and deflation. The role played by six fiscal instruments like taxing and spending, borrowing and lending, buying and selling in the achievement of economic growth and full employment in developing countries is commendable. Fiscal deficit and revenue deficit are the products of government failure in the mobilization of necessary public expenditure and unrestricted indulgence in deficit financing on the economy.

1.2 ROLE AND OBJECTIVES OF FISCAL POLICY IN BOTH DEVELOPING AND DEVELOPED COUNTRIES :

Role and objectives of fiscal policy in developing countries:

Fiscal policy in a developing country differs from that in developed one both in regard to its role and objectives. In a developing country, government has to play an increasing role in accelerating the pace of economic development. This policy has a dynamic role to play in the promotion of rapid economic development in these countries. We can pin-point the major role and objectives of fiscal policy in developing country. They are –

1. Acceleration of capital formation which is sine-qua-non of economic development.
2. Mobilization of financial resources for public sector in general and private sector in particular.
3. Maintenance of economic stability.
4. Removal of inequality of income and wealth.
5. Optimum allocation of resources for economic growth.
6. Encouraging investment.

Now we shall take up the following objectives of fiscal policy:

1. Attainment of full employment :

According to Prof. A.P. Lerner and Keynes, significance of full employment is much more in developing as well as developed countries. Contra-cyclical fiscal policy occupies the central place for maintaining full employment without economic disturbance. Keynes favoured public works programmes for

the generation of more gainful employment in the economy. It promotes security, progress, dignity, weakness non functional discrimination, protects democratic society against fascism and communism, may prevent war and revive the spirit of liberation. If fiscal policy fails to create full employment, it may try to avoid unemployment and underemployment. A planned investment can step up the volume of output, income and employment in the country. Rational allocation of resources is necessary and resources are to be diverted from low priority line of production to high priority ones. This can be done by the policy of tax-holi day, tax rebate, tax exemption, progressive subsidy etc. Public expenditure in the form of pump priming, compensatory spending can promote volume of employment.

2. Economic Growth :

The primary aim of fiscal policy is to accelerate the pace of economic growth. To achieve high rate of economic growth, economic stability is called for. Fiscal instruments like taxation, public expenditure, public debt, deficit fmancing are to be utilized judiciously to raise consumption, production, employment and income. According to Mrs. Hicks, fiscal policy must aim at the attainment of the twin objectives of growth with stability. A successful employment policy provides a congemal atmosphere of economic growth. Achievement of economic growth which is a dire necessity for developing country is possible only through increased investment.

3. Stabilization Objective :

It is observed that most of the developing countries are characterized by inflationary pressure of prices. To ease such a

situation, a combination of all the fiscal weapons may help in removing unjustified price differentials and correcting imbalance of demand and supply. The instability caused by international fluctuations can be corrected by tariff policy to a greater extent. In the boom period, import duty should be imposed on consumer goods and luxury imports are called for to curb the use for additional purchasing power. While during the periods of recession and depression, government should undertake public works programmes through deficit financing. To get rid of international cyclical fluctuation, a contra-cyclical measure (deficit budget during depression and surplus budget during inflation) is urgently necessary. Moreover, other disturbing forces can be met with compensatory taxation, public expenditure, pump-priming, public debt and debt management. Thus an anti-inflationary fiscal policy has an important role to curb inflation which disturbs the entire economy and retards economic development of developing countries.

From the above discussion, it is quite clear that the objectives of fiscal policy in a developing economy has to be different from developed countries in their outlook. The developing countries have to meet some extra-ordinary fiscal situations which are uncommon in developed countries. It requires an appropriate mix of fiscal and monetary policy to attain fruitful results.

Role of Fiscal Policy in developed country :

It is already stated that the role of fiscal tools and objectives of fiscal policy in developing countries are different from those of developed ones.

There are two salient objectives of fiscal policy in developed country namely, (I) to achieve and maintain full employment in the economy and (2) to achieve accelerated economic growth with stability through the avoidance of inflation and deflation which are unjust and inexpedient according to Keynes. Fiscal policy has been developed with reference to developed country and it is originated to the necessity of maintaining full employment and stability against cyclical depression. We shall discuss these objectives below in a tabular form:

1. Full employment :

A carefully conceived and scientifically utilized fiscal policy and its instruments can provide more employments opportunities to the unemployed and underemployed youths of the country. The usefulness of fiscal policy to achieve the micro objectives of full employment and stability has come into prominence ever since it was used to counter unemployment during the great depression of 1930's public expenditure on social and economic overheads public sector enterprises all render their helping hands to generate employment opportunities. Policy of tax holiday, subsidy to install industries particularly in rural as well as backward regions help to generate more employment. Keynes recommended public works programmes to reduce the magnitude of unemployment during depression. Moreover, he advocated government compensatory spending to step up employment opportunity in different sectors of the economy.

2. Economic growth :

A high rate of economic growth with economic stability is the third important objective of fiscal policy. The fiscal instruments should be utilized to encourage production, distribution, consumption of goods and services. Supply side economists advocated tax incentives to encourage production. With a view to improve the efficiency of technical progress and there by economic growth, heavy investment is made on research, innovation and other multiple development activities. Most profound support to this policy was given by Prof. Hicks. To her, it can do a lot to economic growth. In the process of economic growth, role of public debt and its management is much more. Budget framing is also an important tool of economic growth.

A successful employment policy provides a congenial atmosphere of economic growth.

3. Stabilization :

It is a general important objective of fiscal policy for all countries of the world. Fiscal policy must aim at avoiding deflation, "depression and inflation. But mild inflation is recommended for stepping up capital formation and investment. Increasing public expenditure is bound to raise purchasing power in the hands of the people. Fiscal incentives in the form of tax concession, tax exemption, and tax holiday to newly installed industries, subsidies to encourage production of essential goods will help to raise production. Fiscal policy can be used to achieve external economic stability. Fluctuation in international trade can create instability in national income. During inflation, heavy import duty on import of luxury goods

and consumer goods can be levied. Progressive public expenditure and deficit budget can play an important role in fighting against depression; while surplus budged is a virtue during inflation. These days, fiscal policy is the keystone of economic stabilization. The government can meet both inflationary and deflationary challenge. It has a crucial role in fighting the forces of economic destabilization.

Thus full employment, Economic growth and stabilization are the three goals of fiscal policy. But on certain occasions, these goals may come into conflict with each other. Government tries to bring about coordination among these objects as best as it can. On the whole, the concept of fiscal policy has attracted the attention of the economists, statesmen due to its healthy impact on the entire economy.

1.3 DISTINCTION BETWEEN FISCAL AND REVENUE DEFICIT :

Fiscal deficit is the summation of government receipts, loan recoveries and other borrowing receipts minus plan and non-plan expenditures. It includes the amount of borrowing plus budgetary deficit. Fiscal deficit equals to aggregate expenditure minus aggregate tax and non-tax revenue receipts and recoveries of loan. In other words, fiscal deficit is the total expenditure minus revenue receipts plus recoveries plus sale of public assets. Fiscal deficit may be called gross total deficit.

Revenue deficit refers to the excess of revenue expenditure over the revenue receipts. Thus revenue deficit is equal to total revenue expenditure minus total revenue receipts. The real measure of government obligations given by fiscal deficit and not by budgetary deficit or revenue deficit.

Following table shows the trend of fiscal and revenue deficit of the government of India.

TABLE No. l

Trend of fiscal and revenue deficit since 1980-81 to 2006 07

Fiscal deficit	Percentage	Revenue Deficit	Percentage
2000-2001	5.7	2000-2001	4.1
2001-2002	6.2	2001-2002	4.4
2002-2003	5.9	2002-2003	4.4
2003-2004	4.8	2003-2004	3.6
2004-2005	4.4	2004-2005	2.5
2005-2006	4.3	2005-2006	N.A.
2006-2007	3.8	2006-2007	N.A.

Source: Economic Survey, Govt. of India 2004-05.

The magnitude of fiscal deficit during 1980-81 to 1990-91 rose by 4.9 times while revenue deficit has also been showing an increasing trend. It rose by 8.6 times during the same period i.e. 1980-81 to 1990-91. The amount of revenue deficit during 1990 91 to 2004-05 rose by 3.6 times from Rs. l,8562 crore to Rs.99,860 crore in 2004-05. Its proportion to GDP has declined from 3.3 P.C. to 2.5 P.C. from 1990-91 to 2004~05.The centre's revenue shot up to RS.78.210 crore in the first four months of 2006. The revenue deficit was 1.93 p.c. of the GDP during 2006 07 though it was budgeted at 2.1 P.C. Fiscal deficit was Rs.86.404 crore till July 2006 which was 58.17 P.C. of the budget estimation ofRs.l,48,686 crare for 2006-2007 according to the latest monthly figure released by Comptroller General of Accounts.

Fiscal deficit in the first four months of this financial year amounted to 2.2 p.c. of the GDP. The government had budget fiscal deficit at 3.8% of the GDP for 2006-2007.

1.3.1 ADVERSE CONSEQUENCES OF FISCAL AND REVENUE DEFICIT :

Adverse consequences of fiscal and revenue deficit :

1. Accumulation of more public debt :

Fiscal and revenue deficit are responsible for the accumulation of more public debt. This debt is having both real and money burden. Mounting public debt is causing a matter of great worry for the Government, general public and the economist The habit of resorting to public debt encourages non plan, non productive and inflationary public expenditure. External debt results in the drain of wealth out of the country.

2. Burden of debt servicing is severe :

Interest payment on the current and accumulated past loans keeps on rising in most of the LDCs. There is enormous rise in the cost of servicing the huge public debt. The expenditure on interest payment and repayment of past loan is non-development unproductive expenditure. Non-development expenditure is the expenditure on audit, collection of tax, currency, police, external affairs, pension and defense etc.

3. Inflationary pressure is mounting :

Accumulated fiscal and revenue deficit over the years have been responsible for growing non developmental expenditure and add to the inflationary pressure which is a

curse to the majority poor section of the society. There is inequity in debt increase in the price of the essential goods cause's great sufferings to the poor and weak and interest payments are received by the rich making them rich, increasing a gulf between the rich and poor.

4. There is adverse effect on development expenditure :

Since the total expenditure has to be kept within limits to check inflation, the axe falls on the development expenditure, particularly because non plan non developmental expenditure is politically motivated and, therefore, can not be reduced without risk to the Government. Besides the rising defense expenditure, civil expenditure and expenditure on subsidies, the increase interest payments due to the accumulated public debt is a major cause of growing non plan non developmental expenditure which takes a large slice of the total expenditure, restricting the scope to raise the developmental expenditure specially on capital formation.

So, from the above discussion we can conclude that revenue deficit and fiscal deficit have various effects on economic life, production, distribution, level of economic activity and employment.

1.4 BALANCED BUDGET MULTIPLIER AND ITS IMPLICATIONS :

Balanced Budget Multiplier is one of three alternative expansionary policies to be used to attain full employment in an economy. Here budget is balanced with equal public expenditure and tax revenue without deficit. Multiplier is defined as the

ratio of net increase in national income to initial rise of government expenditure. The case of multiplier which is just like a wave in the river. Giving rise to a number of waves, multiplies the money injected into the economy. Symbolically,

$$\text{Budget Multiplier} = \frac{\Delta Y}{\Delta G}$$

Here ΔY = indicates net chance of national income(NI)

ΔG= indicates initial change in government expenditure.

The Balanced Budget Multiplier. Theory maintains that any increase in government expenditure even though fully adjusted by tax revenue, would lead to an equivalent increase in national income. According to Balanced Budget Multiplier, an expansion (contraction) of the budgetary expenditure, even though fully balanced by increased (decreased) taxation would be expansionary (contractionary) in effect. This implies that a depression can be remedied even by increasing taxation provided public expenditure is also increased correspondingly. Similarly loan can be remedied by a reduction in taxation provided public expenditure is also reduced by the same or larger amount.

Multiplier model is of different types and they are as follows :

1. Multiplier model with fixed investment.
2. Multiplier model with variable investment.
3. Money multiplier with fiscal sector.

Multiplier value of balanced budget may be unity, more than unity and less than unity. Balanced budget needs not always be expansionary and it may also be contractionary.

Sometimes multiplier is negative, zero or positive. Propensity to import reduces the value of the multiplier. Net multiplier effect of the budget depends on marginal propensity to import. One point is to be noted here that a balanced budget is not expected to be neutral in terms of its effect on income and employment. The actual value of the multiplier depends on the value of marginal propensity to consume and other relevant factors. When we apply the multiplier principle in underdeveloped country, value of the multiplier will be much higher. Marginal Propensity to consume in the UDCs is high while it is low in advanced countries of the world.

1.5 LET US SUM UP :

1. Fiscal policy deals which matters which immediately influence consumption and investment and hence, income, out-put and employment in the economy.
2. Prime fiscal instruments are taxation, public expenditure, public debt, budget and public works programmes. "Taxing and spending, borrowing and lending, buying and selling", constitute the six fiscal instruments of the government.
3. Balanced budget multiplier is one of the three alternative expansionary policies to be used to attain full-employment in an economy. According to J. Have1mo, change in tax is equal to change in government expenditure is equal to change in income which is the essence of the theory of balanced budget multiplier in the form of equation.

minus plan and non-plan expenditure. While revenue deficit is the excess of revenue expenditure over the revenue receipts of a country.

5. Fiscal deficit and revenue deficit are covered partly through borrowing and partly through the RBI credit to the government of India.

KEY WORDS :

Disposable income :

After a good part of Personal income is paid to the government in the form of Personal taxes, what remains of Personal income is called disposable income. Disposable income, therefore = personable income - personal taxes. The incomethat is spent on living is called disposable income.

Multiplier :

Multiplier is defined as the ratio of net increase in national income to initial rise in government expenditure. It can be compared with a weave of river, giving rise to a number of waves multiplies the money injected into the economy.

Public works :

It is one of the most significant anti-depression device of fiscal policy. Public works are durable goods produced by the government .They are roads, rail-tracks, school, Parks, Buildings, hospitals etc.

SUGGESTED READINGS :

1. R.N. Tripathy, "Public Finance in underdeveloped Countries".

2. A. Hansen, "Fiscal Policy and Business Cycle".

3. U.K. Hicks, "Public Finance".

4. R.K. Choudhury, "Public Finance and Fiscal Policy."

CHECK YOUR PROGRESS EXERCISES : 1.1

1. Mention six fiscal instruments.

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2. Differentiate fiscal deficit and revenue deficit (answer within twenty words only)

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TERMINAL QUESTIONS :

1. Explain the role and objectives of fiscal policy in developing and developed economics.

2. "Changes in taxes and expenditure that aim at the short-run goals of full employment and price level stability

4. Fiscal deficit is the summation of government revenue receipts, loan receipts and other borrowing receipts are usually called fiscal policy." Discuss the term fiscal policy in the, light of above statement.

3. "Taxing and spending, borrowing and lending buying and selling constitute the six fiscal instruments of the government". Discuss the role played by these six instruments in the achievement of economic growth and full employment in developing country.

4. Differentiate fiscal deficit and revenue deficit with their magnitude in Indian budget. Show their adverse consequences on the Indian Economy.

5. Define what the Balanced Budget Multiplier is? Discuss its implication as an instrument of fiscal policy.

HINTS TO CHECK YOUR PROGRESS EXERCISES :

1. Taxing and Spending, Borrowing and Landing, Buying and Selling are the prime fiscal instruments

2. See Pera 1 of 1.4 or See Pera 1 & 2 of 1.4

UNIT 2 : FISCALFINANCE

STRUCTURE

2.0 Objectives

2.1 Introduction

2.2 Fiscal Federalism

2.3 Principles and Policies of Federal Government

2.4 Methods of Resource Transfer in a Federation

2.5 Let us Sum up

2.0 OBJECTIVES

After going through this unit you would be able to—

1. Explain the various principles to be adopted for the distribution of resources between the two layers of government in federation.
2. Highlight the methods of resource transfer from the federal government to the state governments.
3. Analyze the growing problems face by the union and the state government.
4. Explain the various principles to be adopted for the distribution of financial resources between the central and the state government.

2.1 INTRODUCTION

There are many countries of the world which have a federal form of government along with federal finance. A federation is an association of two or more states. There is a clear demarcation of the sources of revenue between the centre and the regional government. The financial arrangements between the two sets of governments are a matter of great importance. The center and the states have separate powers of spending and taxing. But there is the constitutional provision in the matter of incurring and raising revenues from different sources.

But complete financial autonomy has never been realized in practice any where. Certain adjustments are necessary for meeting the expanding requirements of financial resources. In most federation large transfers of financial resources from the centers to the state governments become an economic necessity.

Adjustment of financial resources is being done by adopting certain methods and they are as follows-Tax Sharing, Grants in Aid, Loan, State Contribution and Surcharge on Taxes.

2.2 FISCAL FEDERALISM

We are all familiar with federation and federalism.

The multilevel decentralized fiscal system of a federation is called fiscal federalism. It studies the issues relating to the ways in which revenues of the country is shared between various layers of government. Dr R. N. Bhargava rightly comments, "the term federal finance refers to the finance of the federal as well as the state government and the relationship between the two". Here the areas of raising revenues and expenditure have been well defined and demarketed. There is both independence and interdependence of different layers of the governments. The federal structure of government is found in USA, Canada, Australia, Switzerland, India, Pakistan, Malayasia, West Indies, Nigeria etc.

There is the problem of imbalance in financial resources which is responsible for creating conflict between the two sets of governments. Thus there is an urgent need for adjustment and re allocation of resources in the light of changing circumstances.

2.3 PRINCIPLES AND POLICIES OF FEDERAL GOVERNMENT :

None can deny the fact that there are no uniform principles which determine the allocation of functions among the component governments and there can not be any uniform basis for the efficient division of financial resources for the

same. However, economists like Seligman, Paul Studensky, Mrs. Hicks, I.M. Buchanan, R.N. Bhargava, B.P. Adarkar, B.R. Misra etc. suggested the following general principles for the satisfactory working of federal finance.

1. Efficiency :

Some functions are assigned to the federal or union government and some to the state or regional governments depending upon their efficiency, honesty, sincerity. According to Prof. Seligman, two factors determine the effectiveness of various taxes, namely, the nature of tax and the character of administration. Income tax, wealth tax etc. may be expected to be efficiently administered by the federal government while land revenue or land tax, sales tax etc. by the state government. Proper allocation of revenue would improve administrative efficiency.

2. Economy :

According to this principle, cost of administration should be minimum so that revenue can be utilized for the uplift of the mass people. Overlapping in fiscal programmes and tax evasion should be avoided Economy is one of the important criteria of efficiency in any system of public finance.

3. Adequacy :

States should have adequate financial resources to discharge their multiple expensive functions more efficiently. To make the principle more productive or adequate, it must be elastic as well as flexible. This principle was supported by Dr. R.N. Bhargava too.

4. Principle of Uniformity :

Uniformity implies that the system of taxation and pattern of public expenditure should be uniform in the regional governments. The regional governments should be treated uniformly by the federal government. It would be compatible with the canon of justice and equity.

5. Integration and Co-ordination :

The entire financial system of a federation should be well-integrated and coordinated to have desired result. Proper utilization of resources are made possible by coordinated, integrated inter-governmental fiscal policies.

6. Desired Effects :

Tax sources should be divided in such a manner that government is capable of realizing them very nicely. To maintain equilibrium in the B.O.P, the central government should levy custom duty and house tax should be imposed by the local governments to get the desired result.

7. Suitability :

A tax may have wider or narrower jurisdiction and accordingly tax with wider jurisdiction should be left with the union or federal government and tax with narrower jurisdiction will be suitable either to regional or state governments. Say for example, income tax with its wider-base should belong to union government while, estate tax with its narrower base should belong to local governments.

While reviewing the principles of federal finance. Mrs. U.K. Hicks advanced the following principles:

1. Yield stability :

The local tax should have a stable base. Without stability, it is not possible to make expenditure plans or borrowing programs. Thus, "the first necessity for a local tax is, therefore, for one that will help subordinate Governments to keep there finances on an even keel, in other words for a tax whose yield is reasonably stable in times good and bad".

2. Localized source :

A local tax is that its base should be localized within the jurisdiction of the tax authority. Unless the source is localized, the local authority can not have proper control over their budget. Property tax is a good example of local tax.

3. Local utilization :

It is a good local tax which can be reserved for local use only. "Basically the purpose of this is to ensure local autonomy; but on other grounds also it is vary desirable to avoid overlapping tax rights between national and regional Governments. When revenue needs are urgent, the major Government must necessarily override the interests of the regional authority, and this leads to much friction, as well as to confusion in local budgets. In both Canada and Australia there was much heartburning on this account between 1939 and 1945.

Some other economists have realized the importance of the following principles of federal finance.

1. Principle of Transfer of Resources :

All states are not equal as to resources and socio economic development. Some states are economically very strong and some are weak. It is essential that the federation should pay special attention to the financial needs of the weak or poor states. It is done by providing specific grants to these states. In order to reduce the existing interstate disparity, the Government should transfer the resources from relatively more developed areas to the relatively less developed areas. This is beneficial diversion. Dr. B.R. Misra is in favour of this principle.

2. Principle of Economic Regulation :

According to this principle, federation timely regulation and supervision are essential for the regulation of financial control. Certain rules and regulations are framed by the federal Government and these are to be followed by the state Governments. It requires federation supervision.

3. Principle of Accountability :

The states or regional Governments in a federation are accountable" to the federal Government in respect of their expenditure. It controls the extent of misuse of Government revenue and ensures their efficient use. This helps to control unwise and arbitrary spending of public money. In India, the constitution entrusts the parliament with the responsibility of prescribing powers and functions of the audit department.

From the above discussion it is evident that the pursuit of proper tax-expenditure policy requires that these principles should be observed.

2.4 METHODS OF RESOURCE TRANSFER IN A FEDERATION :

Needless to say that there is a big gap between the needs and resources of various state governments and local governments in a federation. To meet the deficit of expenditure, sources of income have been divided by the federal government depending upon certain methods. Following are the methods of inter governmental financial transfer which are in operation.

1. Tax-sharing :

Under this method, certain taxes are levied by the central government and the same are collected but the proceeds are shared between the two layers of the federal set-up on the basis of the following criteria.

(a) Fixed population basis, (b) Equal basis and (c) Unproportional basis.

In Indian federation, certain percentage of the yield of income tax and central excise duty are distributed among the state governments on the basis of the recommendations of Finance Commission. This method has some merits of its own. It helps the states to remove some amount of resource gap. It establishes healthy relationship between the union government and state governments. It is better not to spread the tax-sharing scheme to too many taxes.

2. Grants-in-Aid :

It is one of the most crucial methods of devolution of financial resources in a federation. The method of grants-in-aid is known as the "Principle of Compensation." It can serve

many useful purposes in a federal set up. Grants are basically meant to meet the additional "needs" of the state governments. During depression, some state governments may be required to provide relief grants against famine, droughts, flood etc. without taxing the citizens. It is also provided to reduce regional disparity. In India, grants are covered under Articles 273,275, 278 and 282 of the constitution.

Grants may be of various types. They are as follows:

i. Plan grants :

Plan oriented grant are determined by the Planning Commission. It is granted to the states under Article 275 (I) of the constitution of India to bridge the gape of revenue and expenditure of the country.

ii. Non-Plan Grants :

Non Plan Grants are determined by the Finance Commission. These are provided to control and coordinate welfare activities and other development programmes.

iii. Ad-hoc Grants :

The center may provide ad-hoc grants to the states for special purposes. For e.g. grants for relief measures during food, draught, famine etc. are ad-hoc grants. Of course it is temporary measure.

iv. Conditional and Unconditional Grants :

Conditional Grants are made for certain specific purposes and so it is used as selective or categorical grants. Government has to use such funds only for the purposes for which they are allocated. These grants are provided on the basis of expenditure needs each state. For e.g. education, irrigation grants are conditional grants.

Unconditional Grants are given mostly to bridge the gap between revenue and expenditure of the poor states. These are made on the basis of per capita income, poverty of the states. Such grants are also known as equalizing grants or block grants.

v. Matching Grants :

One variety of conditional grant is matching grants. It is available to the states on the condition that the latter much contribute a specific percentage of the cost of the project. If the state Governments fail to spend the conditional amount for the specific purposes, matching grants will not be available.

vi. Specific Purpose Grants :

States may be given specific purpose grant for the development of some special and selective projects like communication facilities. It is recommended by the Finance Commission of our country. These type of grant is also called ad-hoc grants or selective grants.

vii. Discretionary Grants :

These grants are sanctioned for any purpose. In India Article 282 of the constitution empowers the Governments (Union and States) to provide such grants, not withstanding the existing distribution of financial resources and Finance Commission is not authorized to deal with these grants.

Grants-in-aid are not statutory and therefore, not compulsory.

3. Loan :

Loan has a special place in federal set-up. It is provided for meeting the financial requirement of the projects of

immense economic significance. It is also provided for meeting the needs of financial resources during natural calamity or short-fall in expected tax receipts. A loan becomes a kind of investment loan provided it is paid back out of the earnings of the projects for which loan is incurred. Generally rate of interest on such loan is lower than the prevailing market rate of interests. It makes the state governments more economical in its spending.

From the above discussion it is quite clear that non single adjustment mechanism would be helpful in all circumstances. Thus financial adjustment should be based on realism as well as objectivity and it should be need based.

2.5 LET US SUM UP :

1. The multi-level decentralized fiscal system is called fiscal federalism. Federal finance means the finance of the federal as well as state governments and the relation between the two.
2. There are certain criteria or principles of dividing financial resources between the union and state governments and these principles are -Principle of Efficiency, Principle of Economy, Principle of Desired Effects, Principle of Uniformity, Principle of Adequacy, Principle of Integration and Co-ordination, Principle of Suitability etc.
3. Fiscal imbalances which are inherent in a federation have been sought to be solved by the transfer of resources from the central to the regional governments through tax-sharing, grants-in-aid and loan. Resources are distributed on the basis of the recommendations of Finance Commission.

KEY WORDS :

Grants in aid : It is one of the crucial methods of the devolution of financial resources in a federation.

Fiscal Federalism : The multilevel decentralized fiscal system of a federation is called fiscal federalism.

Principle of compensation : The method of grants in aid is known as principle of compensation.

SUGGESTED READINGS :

1. R.K. Lekhi, "Public Finance."

2. H.L. Bhatia, "Public Finance".

3. R. Canvery, "Public Finance".

4. B.P. Taygi, "Public Finance."

5. R.A. Musgrave, "Public Finance in Theory and Practice".

6. Dr. B. Misra, "Economics of Public Finance."

CHECK YOUR PROGRESS EXERCISES : 2.1

1. What is fiscal federalism? Site the general principles of the devolution of financial resources between the central government and the state government in a federation.

2. Mention the methods of devolution of financial resources in a federation.

TERMINAL QUESTIONS :

1. What is fiscal federalism? Explain the general principles of devolution of financial resources between the central government and state governments in a federation.
2. Explain the mechanisms used to restore balance between different layers of government in a federation.
3. Critically examine the problems offederal finance with special reference to Indian federation.
4. Write short notes:

   a. Horizontal fiscal imbalance.

   b. Grants-in-Aid.

   c. Fiscal Deficit.

HINTS TO CHECK YOUR PROGRESS EXERCISES :

1. See Para I of 2.1 and 2.3
2. See 2.4

BLOCK V : PUBLIC BUDGET, PUBLIC UTILITIES AND PUBLIC ENTERPRISES

UNIT 1: PUBLIC BUDGET

STRUCTURE

1.0 Objectives

1.1 Introduction

1.2 Types of Public Budget

1.3 Economic Classification of Budget

1.4 Functional Classification of Budget

1.5 Zero Based Budgeting

1.6 Programme Budgeting

1.7 Performance Budgeting

1.8 Budget as an Instrument of Economic Policy

1.9 Let us Sum up

1.0 OBJECTIVES

After reading this unit you should be able to—

1. Define the concept of budget depending upon various approaches and its types.
2. Explain budget as an instrument of economic policy.
3. Highlight the significance of budget in the attainment of economic growth with stability.
4. Point out the advantages and limitations of Zero-Based Budgeting.

1.1 INTRODUCTION

Budget is a financial blue print of a country for a specified period of time. It is a statement of expected revenue and propose expenditure of a country for a given period. It is treated as a sine-qua -non for planned economic development as well as stability of a country. It is an instrument of economic policy, a pivot of financial administration and occupies and important place in modern economy.

Various types of budget prevent the arbitrary spending as well as misuse of govt. funds by eliminating undesirable programmes. It is necessary to take shelter to zero-based Budgeting primarily to justify the financial requirement of each department ministry so as to select the best alternative. It can bring about desired changes in the economic condition of a country.

1.2 TYPES OF PUBLIC BUDGET

Budget, an effective and prominent instrument of fiscal policy is of different types or kinds. The various types of budget are presented below.

1. Executive and Legislative Budget

The executive budget is prepared by the executive branch of the government. It establishes direct relation between the chief executive and the budget department. This type of budget is in operation in many countries like the U.S.A., U.K. India etc. It is believed that an executive budget is superior to legislative budget due to a number of grounds.

On the Contrary, the legislative budget is prepared as well as adopted by legislature directly through the varied committees.

2. Revenue and Capital Budget :

It is customary to distinguish between 'revenue budget' and 'capital budget'. Revenue budget is related with the current financial transaction of a government while capital budget refers to the transaction of capital nature. In revenue budget all current expenses are met through taxation while all capital expenses are met through borrowing. Capital account receipts include market loan, borrowing from RBI (India) through the sale of treasury bills, loan from foreign govt., institutions, repayment of loan by state Govt. to the Central Govt. In India, investment outlays are included under both revenue and capital budget.

3. Incremental Budget :

In the incremental budget, past levels of expenditure are taken as given and only new addition to or reduction from the fast outlay are examined.

4. Zero-based-Budget :

Zero-based Budgeting is a revolutionary concept as well as novel management tool for planning. It was first introduced in a formalized manner in USA's department of agriculture. In India, its first application was in the department of science and technology in 1983. Here Zero is taken as a base and future activities are decided according to the present situation. The names of famous economists like Musgrave, Peter A. Phyrr and Hilton Young are associated with this type of budget. The budget is considered as a whole and a fresh i.e. from zero base. According to Musgrave, "The idea of zero base budgeting is to consider the budget as a whole, rather to examine incremental changes only."

5. Modern Classification of Public Budget:

Modern economists try to classify budget into a number of classifications. To make the budget worthwhile, modern approach of economic and functional classification has come up Government expenditure and mode of financing should be presented in economicallyand functionally significant categories.

1.3 ECONOMIC CLASSIFICATION OF BUDGET :

of the budget. It provides information on the generation of savings, investment, consumption etc. form different budgetary items. This classification wants to categorize Govt. expenditure and receipts into different classes of economic significance. It categories public expenditure into two classes. Viz., current and capital expenditure. Current expenditure is divided into three classes and it is again sub-divided into four classes.

Similarly capital expenditure is divided into five classes, viz., gross capital formation, capital transfer, investment in shares, loan and advances and repayment of public debt. It provides crucial information of the impact on the whole of the economy besides the detailed financial assets and liabilities of the government.

The need for introducing an economic classification of budget was realized by Dr. M.H. Gopal of India. For the first time in 1957-58the Ministry of Finance, government of India adopted the economic classification of the budget. The economic classification is presented in six accounts. It covers Central Govt. transactions and departmental commercial undertakings.

1.4 FUNCTIONAL CLASSIFICATION OF BUDGET :

The need for functional classification of budget arises for depicting a better picture of Govt. expenditure. The UN says, “It Classifies public expenditure by specific governmental function such as defence, health, execution, promotion of agriculture, etc. “The word function means a ‘purpose’. It cover only the expenditure and not the receipts of the Govt. Here the main items of Govt. expenditure are grouped in terms of broad objectives. It tries to reclassify the functions under two

categories (i) Departmental (civil service and economic service) and (ii) Non-developmental (general service and unallocative).The U N Bureau of Economic Affairs, New York, in its “Annual for economic and functional classification of government transactions” 1959, groups expenditure under five heads viz., General Services, Community Services, Social Services, Economic Services and Unallocable Services. But the functional classification of Indian budget has been allocated under four heads (1) General Services, (2) Social Services (3) Economic Services, and (4) Unallocable Services.

(1) General Services :

General Services cover both civil and defence expenditure, general administration, tax collection, police, currency, conduct of external relation and provision against natural calamities.

(2) Social Services :

Social Services include social amenities like education, medical and public health, housing, rural water supply, nutrition programmes, social security etc. Expenditure on social services is included under the category of development expenditure.

(3) Economic Services :

These services promote economic activities and are divided in to agriculture, industry, transport and communication, fuel, power, forest, minerals and multi purpose projects. Expenditure on education services are under the jurisdiction of development expenditure.

Classification of Govt. expenditure and receipts in terms of economic categories will be called economic classification

(4) Unallocable Services :

Interest payments, pensions, food subsidies, statutory grants to the states, special loans, aid to foreign country are unallocable services. Expenditure incurred on these head is called non development expenditure.

Ministry of Finance, Govt. of India is adopting functional classification since 1967-68. Therefore, it is re-named as economic- functional classification of budget. The cost benefit notion shapes this classification.

The economic functional classification is undoubtedly an index for measuring the magnitude of Govt. activities and it plays a pivot role in fiscal policies. But is not free from certain limitations. It reflects only one end of the picture and it does not tell us how the budget is indirectly helping the economy. It lacks scientific break up in aggregate. It fails to show the exact-impact of certain kinds of expenditure.

1.5 ZERO BASED BUDGETING :

Different economists like Prof. R.A. Musgrare, Peter A. Phyrr, the father of Zero-Based Budgeting etc. defined ZBB in different ways. According to Prof. Musgrave, "The idea of Zero-based-budgeting is to consider the budget as a whole, rather to examine increamental changes only." Peter A. Phyrr defined, "Zero-based budgeting is an operating planning and budgeting process which requires each manager to justify his or her entire budget request in details from scratch (hence zero-base) and shifts the burden of proof to each manager to justify why any money should be spend at all as well as how the job can be done better."

It is a revolutionary concept as well as a novel management tool for planning. This budget is considered as a whole and a fresh, i.e, from zero base. In Z.B.B. no section of business is supposed to be essential and it has to prove its worthwhileness. Each Department, Ministry is required to justify its budget request from the bottom up.

Objectives of Z.B.B :

1. To provide justification of the projects as a whole in the light of the objects set for the budget and priorities of the society. It requires each manager to justify a fresh request in detail from the scratch.
2. To consider the budget as a whole rather to examine incremental changes to get maximum economic return.
3. To analyze, evaluate and justify annually all the financial requirement of the budget unit. It means the evaluation and prioritization of all programmes at various levels efforts. Each department ministry is required to justify its budget request from the bottom up, evaluating alternative programme packages and ranking programmes to select the best alternative and allocate resources accordingly.
4. To request from various agencies for funds on the basis of cost benefits as well as cost effectiveness of each agency.
5. To eliminate time consuming exercise of the traditional budgeting by fresh evaluation and prioritization of all programme.
6. To bring the spending agencies under the umbrella of scrutiny and the accountability and to act as a constant

policy for the appropriate planning period. "It is a forward

reminder of necessity of utmost efficiency in expenditure and in resource allocation programme.

Merits :

1. Zero Based Budgeting forces the manager to critically examine the activities and projects to raise cost effectiveness. It raises the sprit of cost consciousness and cause administrator to evaluate in detail the cost effectiveness.
2. It places all the projects in competition. It ensures better management of funds and helps in reducing budget deficit.
3. It develops and promotes a professional and cost reduction orientation spirit among the managers.
4. Zero Based Budgeting encourages the grass root participating in the process of budgeting. It provides coherence between planning and budgeting. It expands executive participation at all levels of the management.
5. It provides the better information and subsequently better management of funds. Moreover it stimulates and redirects resources from the less productive operation to more productive one.

Demerits :

1. The mountain of paper works and allocation of time for the budget preparation have made ZBB a costly proposition. It requires tremendous paper work and detailed analyses.

2. Financial benefits might be inflated by the managers due to wrong calculation and misguidance of the managers.
3. It is not compatible with big and growing organizations which called for very efficient manager but it is lagging behind in most of the LDC's.
4. Computation of cost benefit for the projects is difficult task. On the part of inefficient and dishonest managers.
5. It involves a lot of time and cost operation is high enough which goes against the LDC's.
6. The multiple levels of decision making, lengthy, delayed procedures, poorly developed methods of communication, availability of out dated and unreliable data and some other organizational deficiencies pose serious problems in the successful execution of the ZBB.

It would be worth while to note that Z.B.B. was first tried to introduce by Jimmy Carter in 1973 when he was the Governor of Georgia in the USA. It was introduced in a formulized ways in the department of agriculture of USA. In India its first application was in the department of science and technology in the year 1983. Several states of India like Maharastra, Andhra Pradesh ,Assam attempted to introduce in the department of police and P.W.D. in the a meaningful ways. Introduction of the Z.B.B. in various departments and ministries of India is the need of the hour.

1.6 PROGRAMME BUDGETING

Programme Budgeting is essentially a long-term 'rolling planning system under which budget is an allocative process between competing claims, and the budget itself a statement of

looking budget. According to Games Cutt, "Programe budgeting is a set of procedures designed to improve the basis for policy decision and to secure a more effective and efficient allocation of scarce resources in the public sector, the out put of which does not generally command market price". President Johnson described Programme budgeting as a very new and very revolutionary system. Programme budgeting system was introduced in the US Defence Department during 1961-62. The Second Hoover Commission in the USA introduced the term "Programme Classification" to establish a proper relation between objectives of Public Economic policy and the resources used by the Govt. It covers both the decision to spend a particular set of resource for a particular purpose or laying down the sequence of steps for executing the project along with expenditure of resources involved at each stage. When budgeting covers both the above mentioned aspects, it may be termed Performance and Programme Budgeting System (PPBS). Technically both types of budget are similar but identical. Under the programme budget classification, the budget would frame a programme structure to attain a particular objective. As for example, removal of illiteracy is a general objective and expenditure is incurred to the illiteracy removal programmes which can be treated as specific programmes. In programme budgeting, the main emphasis is on a budget classification in which functions, programmes and their subdivisions are established for each agency.

Advantages of Programme Budgeting :

This budgeting system has many advantages of its credit. They are as follows :

1. Proper assessment of achievement.
2. It is reliable and scientific guide for both executive and legislature. It is a good guide for rigid and complicated decision making.
3. It provides knowledge of economic policies.
4. It helps in future programming.

Limitations :

1. Programme budgeting fails to define the priorities and objectives of value judgement.
2. It is incapable of providing enough scope of innovations in budgetary techniques.
3. It makes the administration complicated.
4. It does not provide accurate information of the measurement of actual cost and benefit of various projects. Thus it fails to provide correct solution for all fiscal problems.

1.7 PERFORMANCE BUDGETING :

The First Hoover Commission (1949) coined the term. Performance Budgeting in the USA. It recommended the adoption of budget based on functions, programmes and activities. It was first applied in US Department of Defence. It concerns with the objectives aimed at by the Govt. rather than with the out-lay incurred on several projects. According to Burkhed, performance budgeting is one which presents the purposes and objectives for which functions are requested, cost for programmes proposed for achieving these objectives. U.S.

Bureau of Budget define, "A performance is one which presents the purpose and objectives for which funds are required, the cost of the programmes proposed for achieving those objectives and quantitative data measuring the accomplishment and work performed under each programmes". A Buck recommended performance budget which was based upon Economic Functional Classification of Budget. In India, The Administrative Reforms Commission's study Team on Financial Administration has recommended the implementation of performance budget. It is suggested even by The Estimate Committee in its 20th report.

Under programme budgeting system, the over all budget is divided into functions and then subdivided into programme and activity, funds allocated for doing specific quantity of works.

Objectives :

1. To coordinate the physical and financial aspect of every programme.
2. To make possible more effective audit.
3. To enable the legislature better understanding and better review of the budget.
4. Improvement of the formulation of the budget.
5. Increasing the accountability of the management control over financial operation.
6. Clear presentation of purposes and objectives for which funds are demanded.
7. Corelate annual budgets and development plans.

Limitations of programme budgeting :

1. Performance budgeting is not a substitute for conventional budgeting rather it is a supplementary to it.
2. It does not help qualitative evaluation.
3. It centralizes decision making in Govt.

Ultimate objectives of many services are not clearly definable. Actual costs are not ascertainable. Estimation of cost and benefits in areas like defence, foreign policy is not easy task.

1.8 BUDGET AS AN INSTRUMENT OF ECONOMIC POLICY :

Budget is defined as one of the important instruments of economic policy of both developed and developing countries of the world. It provides a positive contribution to economic goals. In developed countries, the main purpose of the budget is to act as an anti-cyclical fiscal policy. During the periods of depression and unemployment, deficit budget is famed, while during the periods of boom and inflation, surplus budget is a virtue. Thus the role played by these two types of budget in regaining economic stability is commendable. It serves as an important device to achieve economic development which requires adequate funds. It requires budgetary provision. Moreover, to provide public goods, budgetary allocation of funds is made in every country due to the failure of private sector. Budget promotes and sustains economic growth which require adequate investment, saving, capital formation and consumption. This specific purpose is served by the economic classification of the budget. This classification is useful in providing scientific and detailed information of government transaction.

Prof. D.T. Lakhawala remarked budget as an instrument of economic policy. All new taxes and expenditure policies are included under the budget. It regulates and guides the course of the economy in right direction.

According to V.P. Singh, Ex. P.M, MP. & F.M. of India, budget is a sign of moderation, computerization and. dynamism. It acts as a revenue raising device, incentive to economic activities, human capital formation, proper allocation of resources, diversion of resources from less useful to more useful production, building of economic overheads, raises income and employment, balanced development, removal of unemployment, cure inflation- deflation, removal of poverty and inequality, check to misuse of public funds.

The economic, social and political progress of a country depends upon the success of the budget which is an effective means of enforcing fiscal policy. F. Shirras apply remarked, “The budget is undoubtedly the pivot of the administration and without a budget based on sound principles, financial disorder with all its attendant consequences take place as surely as night follows day.” Similarly Dalton remarked, “We now think of the budget as a powerful instrument for achieving certain aims - (i) full employment, (ii) high level of investment, and (iii) a better distribution.”

Budget serves as a powerful tool of coordination between the executive and legislature. It is the heart of administrative management and an exhaustive plan of public finance of the Govt. The legislature of a country is able to exercise control over the executive and formulate policies for welfare of the country through the budget.

There is no doubt that budgetary policy must be sound, keeping in view the needs and requirements of the economy. It can bring about desired changes in the economy.

1.9 LET US SUM UP

1. Budget acts as an effective instrument of economic policy of both developed and developing countries. It is the heart of administrative management.
2. Various types of budget are in operation and they are (a) Balanced budget, (b) Deficit budget, (c) Performance budget, (d) Progranune budget, (e) Zero-based budget (f) Revenue and Capital budget, (g) Conventional and Administrative budget, h) Executive and Legislative budget, (i) Full Employment budget, (j) Plan and non-plan budget, (k) Development and non-development budget etc.
3. Modem classification of budget- (a) Economic classification, (b) Functional classification, (c) Programme and performance classification.
4. Revenue budget is a tax finance while capital budget is loan finance.
5. Zero-based budgeting is a new technique for the preparation of the budget. It considers the budget as a whole and a fresh.

KEY WORDS :

1. Break-even-point :

The equilibrium point established by the quantity of total expenditure and total revenue is called break-even-point. The

public utilities and Enterprises can earn profit just after crossing this point.

2. Zero Based Budgeting :

The idea of ZBB is to consider the budget as a whole, rather to examine incremental changes only. The budget is considered as a whole an a fresh i.e., from Zero Based

SUGGESTED READINGS :

1. A. Smithies, “The Balanced Budget”.

2. A.R. Prest, “Public Finance in underdeveloped countries”.

3. C.E. Bastable, “Public Finance”.

4. Lekhi, “Public Finance”.

CHECK YOUR PROGRESS EXERCISES: 1.1

1. Write the main objectives of Zero Based Budgeting (ZBB)

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2. Mention only five advantages of Programme Budgeting System.

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TERMINAL QUESTIONS :

1. Explain the differences between economic and functional classification of budget. Discuss the importance of this classification.
2. To what extent budget is an instrument of economic policy? Discuss.
3. Zero-Base-Budgeting is an effective instrument of fiscal control." Discuss.
4. "Zero-Base-Budgeting is an improvement over the traditional budgeting". Do you agree?
5. What is programme budgeting? State the conditions for its success.

HINTS TO CHECK YOUR PROGRESS EXERCISES :

1. See 1.5
2. See 1.6

UNIT 2 : PUBLIC UTILITIES AND PUBLIC ENTERPRISES

STRUCTURE

2.0 Objectives

2.1 Introduction.

2.2 Rights, Duties and Characteristics of Public Utilities

2.3 Characteristics of Public Utilities

2.4 Pricing of Public Utilities and its Distinction from the Pricing of the Public Enterprises

2.5 Distinction between Public Utilities and Public Enterprises

2.6 Let us Sum up

2.0 OBJECTIVES

After going through this unit, you should be able to—

1. State the meaning and role played by public enterprises and public utilities.
2. Explain the rights and duties of public utilities along with their characteristics.
3. Highlight the pricing policies of public utilities with their criticisms.
4. Differentiate between public enterprises and public utilities.

2.1 INTRODUCTION

The government is committed to socio-economic responsibilities for solving multiple problems faced by the country. Public enterprises and public utilities occupy a significant place to achieve planned growth in both the LDCs and developed countries. To get rid of vicious circle of poverty and accelerate the pace of economic development, rapid growth of capital accumulation is called for. Public sector provides enough funds required for economic welfare of the mass people which can not be done by private sector. Public sector enterprises must help the private sector as the best guide in achieving balanced growth in an economy. Thus price policy framed by public sector enterprises should satisfy the needs and aspirations of the people of the country. As they are guided by a variety of considerations, price policy can not be uniform for all public enterprises.

The concept of public enterprises has been defined by different economists from different angles. Following are some of the important definitions of public enterprises.

According to S.S. Khera, "By public enterprises is meant the industrial, commercial and economic activities carried on by the central government or by state government or jointly by the central government and a state government."

According to N.N. Mallya, "Public enterprises are autonomous or semi-autonomous corporations and companies established, owned and controlled by the state and engaged in industrial and commercial activities."

According to Hansen, "Public enterprises means state ownership and operation of industrial, agricultural, financial and commercial undertakings."

The concept of public utilities has been defined by some economists in different ways. They are as follows:

In the words of R.G. Hawtry, "Public utilities refer to services in which a tendency to a local monopoly necessitates the intervention of a public authority to defened the interest of the consumer."

According to G. Roper, "Public utility is any undertaking that meets the needs or inconvenience of a considerable section of public and that places the undertaking in position justifying the imposition of control in return for monopolistic or other special privileges."

The role of public enterprises/ utilities has become to be regarded as vitally important in recent years. They are regarded as important vehicle to achieve socio-economic objectives. These are grown in number and in geographical area. Investment

in this sector has phenomenally increased now. In developing countries, they have to play a commending role in deciding the extent and direction of economic development. The role played by public sector enterprises in providing merit and social goods can not be underestimated. They can provide major source of external economies to other important industries and services.

Public enterprises try to avoid monopolies and excessive competition in important sectors like electricity supply, city transport, water supply etc. The role played by public sector enterprises in breaking the vicious circle of poverty through planned investment is much more. It can earn profit which can be invested and re-invested for the healthy growth of industrial sector.

They can serve as a tool in redistribution of income and wealth by charging lower prices for product services. Govt. can start export-oriented industries with a view to mobilize valuable foreign exchanges. The reasons for which this sector has been assigned a crucial role in an economy are as follows:

1. Development of infrastructure.
2. Capital formation.
3. Strong industrial base.
4. Export Promotion.
5. Proper and fuller utilization of resources.
6. Economic welfare.
7. Equitable distribution of social product.
8. Removal of regional disparity, enhance employment opportunity, raise state revenue, economic justice, self

reliance, agricultural development and prevention of monopolistic exploitation.

From the above discussion, we can conclude that public enterprises utilities can act as complement to private sector and try to remove the lacuna in economic development of a country. They provide the commanding heights to control the economy in the larger interest of welfare and development.

2.2 RIGHTS AND DUTIES OF PUBLIC UTILITIES

Rights and duties of public utilities vary from country to country depending upon the nature of the economy. Practical needs, political ideology, social and economic philosophy etc. Public utilities are expected to provide regular as well as efficient services to the public at reasonable rates. Certain rights or privileges have been entrusted to the public utilities with a view to maintain regular as well as efficient services. These are as follows :

1. Competition in public utilities is not allowed. The entry into public utility is determined by an act of parliament or state legislature.
2. They have the right to use public property when necessity arises. For example water supply company may dig roads to lay down pipes. Similarly electricity department may cut trees for the construction of its line.
3. They are allowed to charge reasonable rates for the services rendered to the people. Moreover, a fair rate of return is also allowed to them.

4. Public utilities have the rights of 'eminent domain', depending upon which they can acquire public property on payment of compensation.
5. They are allowed to act as a model for the private enterprises in order to remove the lacuna in economic development.

Following are the duties to be performed by the public utilities:

1. Public utilities are to provide valuable essential services to each and everybody without showing discrimination. The examples of essential services are water, power, transport and communication, electricity, irrigation, flood control, drainage works, banking, insurance etc. These are provided by the natural monopolist with Government regulation.
2. Public utilities are to maximize public welfare rather than profit. Being the guide, friend and the philosopher Government is to maximize welfare of the people of the society by producing and distributing utility services at lower prices. It is done by charging lower prices to the weaker section of the society.
3. Utilities have a duty to provide adequate services to all at reasonable rates. They have a duty to provide adequate consumption goods and services at reasonable price without discrimination to the consumers. For e.g. water supply, gas, electricity etc. are provided for round the clock.
4. Essential services are to be supplied as and when required. Certain rules and regulations are framed with a view to standardize the use of public utilities. They

have a duty cater to basic wants or essential services of the people of the society. To maintain standard or quality of the product to be supplied to the users framing of necessary rules and regulation is the need of the hour.

5. Safest equipments are to be utilized to supply the public utility services. It is essential to provide safety metures in relation to supply of some service product. For e.g. electricity, water supply, gas supply organizations etc. are highly risk- prone. Thus it is a Government that has to ultimately assumes the responsibility for both quality of service and for safety measures.

2.3 CHARACTERISTICS OF PUBLIC UTILITIES

Public utilities are distinct class of industries which supply indispensable limited services under monopoly condition with little government regulation of price, profits and service quality. Public utilities have certain distinct characteristics of their own. These sectors are different from others in regard to the motive of the product-services and conditions of the products. Following are the characteristics of public utilities.

1. Service Products :

Public utility industries mostly deal in essential services, the celebrated examples of which are water-gas supply, electricity supply, transport and communication etc.

According to R.G. Hawtrey, public utilities refer to services which cater to basic needs of the people of the society. Here transport and communication are obviously services

which are material by nature. But gas, water, electricity are regarded as service products.

2. Lack of Storability:

Public utility services can not be stored for a long period of time as storage is a costly affair. Production varies along with the variation of demand for the services. As for example transport and communication, electricity etc. can not be stored at all.

3. Persistent demand :

Public utility services are demanded persistently almost round the clock i.e. all the 24 hours (day and night). For e.g. water, gas, electricity, telephone service etc. are required all the 24 hours.

4. Uniform quality :

The services provided have to be of uniform quality. Say for example, electricity is to be supplied at a uniform voltage, water and gas have to be provided at a same pressure within a given locality. There are no possibilities of variations of quality for different customers.

5. Non-transferability :

It is difficult to transfer the demand for the service from one seller to another seller. Because, the industry is natural monopoly. The buyer can not satisfied his demand for the service supplied by other industries. He can not buy it from

another industry. For e.g. gas and electricity are not supplied by the substitute companies.

6. Exclusive franchise :

They are given the exclusive franchise by the Government to protect the uneconomic composition of like service. The Government has appointed rates and price tribunals like the Railway Rates Tribunal in India and England. Government must bring such public utility services within the ambit of its own operation for the greater interest of the community as a whole.

7. Price discrimination :

Public utilities rates are clear examples of price discrimination. Different rates for larger and smaller users of power, gas are in existence. The principle of what the traffic will bear is the dominant principle of it. The different rats for larger and smaller users of power, gas for domestic and industrial consumption of power, for lighting and power in domestic consumption of electricity, for transport and railways of goods of different values are all examples of discrimination by public utilities.

8. Consumption goods :

They provide consumption goods at reasonable rates for the larger interest of the users. For e.g. water supply, transport and communication facilities, electricity and gas services are consumption goods.

9. Low annual turn-over :

Public utility services yield meager revenue as compared to investment of capital. They provide essential services at the cost of heavy investment. Some public utility firms follow the policy of' no profit and no loss' which lead to lower out put. For e.g. post and telegraph department of India.

10. Decreasing cost :

Production of public utility services is subject to decreasing cost. It is due to the existence of both external and internal economies of scale and investment of larger capital. Along with the rise in scale of out put, are unit cost declines. When heavy loss is incurred Government subsidies are called for.

Other characteristics :

(i) It requires Govt. subsidy.

(ii) Efficiency in management.

(iii) Out put is regulated by the Govt.

(iv) Demand for services is inelastic.

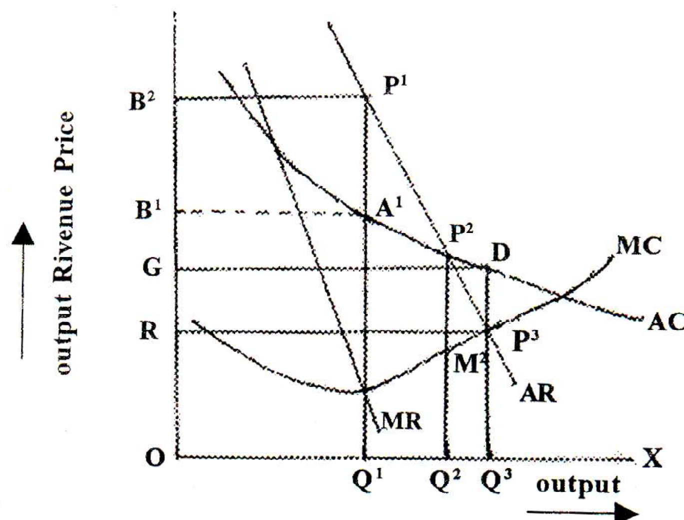
2.4 PRICING OF PUBLIC UTILITIES AND ITS DISTINCTION FROM THE PRICING OF THE PUBLIC ENTERPRISES

There is no uniformity in the pricing policies followed by public utility enterprises because different utility enterprises have to play different roles in the economy. A number of principles have been advanced by different economists in different times. They are as follows.

1. Marginal Cost Pricing Principle :

The names of different famous economists are directly associated with the marginal cost pricing principle. According to this principle, price of the commodity service should be fixed on the basis of the marginal cost of production in order to ensure an optimum allocation of resources resulting in an optimum out put and maximum utilization of the factors of production. This principle advocates that P = MC. Prof. Hoteling suggested this principle for public utilities like Railways in 1938. This pricing principle is applicable to all public enterprises and utilities in a socialist economy. This view was advanced by Prof. A.P. Lerner and Prof. Meade. This principle explains how prices are determined in both public utility and public enterprises. This principle is followed in Bharat Heavy Electronics, Heavy Engineering and Electricity Generation. This principle is considered to be the most efficient principle of both public utility and public enterprises. This principle of marginal cost of production was known as "Hotelling-Lerner" rule.

Marginal Cost Pricing Principle can be explained with the help of Diagrame No. 1



In Diagram No. 1 pricing is fixed at Q3P3 where demand curve intersects the MC curve. Here it is seen that out put produced (QQ3) is largest as compared to other rules of price fixation. Average cost of out put OQ3 greater than marginal cost. Thus, total cost of OQ3 level of out put is OQ3DG and total revenue obtained is OQ3P3R. In this case, GDRP3 of cost remained uncovered by the revenue receipts. This is a deficit, it follows that there is decreasing cost. On the contrary, in case of increasing cost conditions, MC>AC, there would be a surplus when Price =MC.

Limitations of Marginal Cost Principle :

1. As revenue consideration is of secondary importance on part of public utility concern, thus management becomes inefficient. Inefficient management leads to heavy loss and economies scale disappear. So, increasing cost condition appears in the long run.
2. Marshallian concept of time element is neglected in the determination of rates or price. In the initial stage of development, public utility may charge very low price, but in long secular period, price may go up.
3. It is important to note that such efficient pricing to obtain optimum resource allocation is conditioned by the presence of perfect competition. But in reality there is no perfect competition. Marginal cost pricing policy is faced with some practical difficulties which remain unsolved. Heavy loss is incurred if it is covered by either by taxation of any kind or by public debt. It leads to general discontentment and increased inequality in the society.

4. Calculation of detailed marginal cost of each item of multiple commodities or joint cost is costly and complicated affairs. It is due to the lumpiness of the projects and the dearth of expertise. Men of ability an integrity are less attracted in the public utility services.
5. It fails to achieve maximum utilization of out put due to heavy underutilized and unutilized capacity. Thus it goes against the motives of public utility undertakings.

2. Principle of no-profit and non loss :

Credit goes to Prof. Lewis and William Robson for their active support to this principle. According to Lewis, public utility enterprises should follow two norms (I) They should make neither loss nor profit after meeting all expenses. (ii) Prices for services should correspond to relative costs. The main aim of this principle is to eliminate loss and profit by the adjustment of price of out-put and services provided by the public utility industry. It acts as an anti-inflationary and anti-deflationary measure. This principle was supported by a host of economists like A. Henderson, I.M.D. Little, J.M. Durbin etc.

Limitations :

1. According to Hansen, making profit by public utility industry is desirable and a necessity. This is not relevant in the LDCs. This principle is inconsistent with the planned economy.
2. Prof. Robson was of the opinion that, profit earned by public utility industries should be invested and re invested for the healthy growth of the enterprises and

it would improve the efficiency and quality of the products.

3. In the long run, profits earned by public utility industries enable them to raise wage rates, reduce price and better condition of employment.

Principle of making profit :

This principle was supported by a number of economists like Prof. Hansen, Dr. V.K.R.V. Rao, Prof. Galbraith, S.S. Khera, etc. Indian Planning Commission advocated for this principle for the attainment of twin objectives (i) economic growth, (ii) economic stability. Public utility enterprises earn profit for mobilizing investment surplus and profit is considered as yardstick of efficiency. Principle of making profit has been accepted by the Indian Taxation Enquiry Commission. Policy of making profit rests on the arguments (i) expansion of public sector, (2) inadequacy of resources for investment in LDCS, (3) improvement of quality of public sector (4) to measure efficiency of public utility and enterprises. This pricing policy is relevant in USSR and in a number of Latin American and Middle Eastern Countries. Even capitalist countries like U.K., U.S.A. France, Japan, Germany etc., 90 P.C. of revenue was mobilized from the profit of the public utility and public enterprises.

It is to be noted here that principle of making profit is not applicable to each and every public enterprises. Some public utility services are to be exempted from the preview of making profit as they are mostly guided by welfare motive.

Principle of Average Cost of Production :

According to some economists including Prof. Taylor, average cost pricing principle is the best solution to tackle

the problem of abnormal profitability of public utility. The industry will not earn excess profit except the normal one while price is fixed at average cost. This principle is followed by Indian post and Telegraph. Many reasons are given in support of this principle. The public enterprises should provide optimum volume of out put cheaply. Consumers pay the entire cost of the product. There is less chance of exploitation. Moreover, it provides more autonomy to the enterprises.

But this principle suffers from certain short comings. The welfare economists have opposed it on the ground that it is incompatible with the policy of efficiency as well as optimality. Calculation of average cost is abit difficult task. On the whole, average cost of price policy is not regarded an ideal policy of public utility as it may hide the inefficiency of the same.

Other Pricing Policies :

We may add a few other pricing policies of public utilities and enterprises. They are as follows :

l. Cost-plus pricing :

The main objective of this pricing principle is to recover the entire cost and returned on investment. This is used in public enterprises like Indian telephone industry.

2. Discriminatory pricing :

This principle is commonly used in some of the multi-product and multi-service concerns. For e.g. Railways, Indian Airlines.

3. Import-based pricing :

Import base pricing is followed in those public industries which have no domestic competition and whose production cast are higher than the price of similar imported product.

4. Externally determined pricing :

In some areas, the price of public enterprises are externally determined. Price of some essential commodities are controlled directly by the Government. Typical examples of such price fixation are the prices of steel, fertilizers etc.

5. Cost of Service Principle :

The Cost of Service Principle is the true competitive principle of pricing and brings about the most equitable rates. For e.g. railway service is more costly to supply in the hilly regions than in plains and that explain the difference in rates. Higher fairs are paid for travel in air conditions than in ordinary coaches.

6. Value of service principle :

The principle commonly applicable is the value of the service principle. Each class of customers is charged a price that it is able to pay according to its demand for the service. Demand for service depends upon the elasticity of demand for the service product.

7. Administered price policy :

A large number of commodity prices are controlled or regulated directly or indirectly by the Government. The administered prices not only covered those goods and services

and their' production, but also those connected with public distribution system (PDS). A host of factors enter in to this sense. They are supply position, price of import, the administered prices and lot of other variables. It is the administered price which can control inflation. Good numbers of commodities are administered to secure proper supply of the commodities with strict vigil of the Government. In India as many as 55 items are administered by the Government or Government authorities. Items carrying a weight of 11% in Wholesale Price Index (WIP) are fully administered. Some items are called 'core items' and rest are termed intermediate goods and some final goods like iron, steel, coal, drugs and medicines, paper, news print etc. Moreover, items under dual pricing are partially administered by the Government. Out of 360 items entering into WIP, 305 items are not subject to Government price administration.

It is to be noted here that there is the element of revision of administered price. Question of rise of budgetary deficit or subsidies arises if price is kept unchanged. If the administered price is revised upwards, there is the occurrence of inflation with various impacts on the economy. Inflation leads to cost escalation, reduction of plan expenditure, retarded economic growth rate and increased money supply. Of course, part of the problems can be solved by the major Government policy decision.

There are two considerations which guide public utilities in the fixation of rates / prices. The utility can reduce the cost per unit by producing large quantity. It may charge low price from certain categories of customer to raise total demand for services. Thus promotional aspect is an important one in public utility pricing. Social aspect is taken into account by it in fixing

price for the services rendered. Thus, utilities base their price policy on price discrimination.

2.5. DISTINCTION BETWEEN PUBLIC UTILITIES AND PUBLIC ENTERPRISES

One can easily distinguish public utilities from public enterprises. The distinction between the two is shown below :

1. Public utilities are run with little Govt. intervention and they are indispensable but limited services. The celebrated examples of these services are supply of gas, water, electricity, transport etc. Thus, these are distinct class of industries which supply urgently necessary services under monopoly condition.

   Public enterprises are owned as well as operated by Govt. or Govt. authority. They provide both goods and services like defence, nuclear energy, electricity, gas, coal, transport etc.

2. Public utilities have not become an important source of fund of Govt. Their main motive is the generation of welfare of the customers. Question of reinvestment of fund does not arise.

   But public sector enterprises have become an important source of funds for economic development. As they run their business to earn profit.

3. Services supplied by public utilities is non-transferable. The buyers can not buy railway service from another company if he is not satisfied with the services rendered. Service-out put provided by public enterprises can be transferred.

nature and these principles are adopted to achieve certain economic objectives.

4. In case of public utilities, initial investment is small with low return. Public enterprises require large initial investment of capital but return is distinct.

5. Sustained demand is one of the most important characteristics of public utilities. It is demanded for almost round the clock.

   Demand for and supply of goods and services of public enterprises are not continuous. They are purchased according to their requirements.

6. Quality of public utility services should be uniform for all consumers.

   Goods or services provided by public enterprises may be of varied quality. For example, iron and steel manufactured and supplied by iron and steel industry may be of different quality.

7. There is no direct and proportionate relation between the changes in demand and changes in price of public utility services. Their demand is inelastic.

   In case of public enterprises demand for goods produced changes along with the income of the consumers. Thus demand is elastic in nature.

8. Scope of public utility services is limited and sizeable services have been brought under the umbrella of public utility industries.

   Number of public sector enterprises is expanding as days rolled by. They have come to be regarded as an important vehicle to achieve socio-economic objectives.

9. Public utilities are not asked to adopt discriminating price policy for the greater interest of the consumers.

Various regulations exist to control price, profit, accounts and service of public utility industries.

Public enterprises may be asked to adopt discriminatory price policy in favour of the poor section of the society and for avoiding concentration of economic power in fewer hands.

10. Some public utility organizations are operated by local governments like municipalities, municipal corporations etc. They own and operate some industries like water supply, gas supply, urban transport etc.

    On the other hand, public enterprises are wholly or partly owned and operated by the Govt. or Govt. authorities. Govt. exercises over-riding powers over the public enterprises.

2.6 LET US SUM UP

1. Being a natural monopoly, price discrimination is visible in case of public utility industries.
2. Public utilities are distinct class of industries which supply indispensable services with little govt. regulation of price, profit and service quality.
3. Large capital out-lays; long gestation period and low rate of return are inherent in public enterprises.
4. Enterprises which are owned and controlled by public authorities, whose out-put is marketed, are termed as public enterprises.
5. The pricing principles followed in public utilities and public enterprises have been varied and diverse in

KEY WORDS :

1. Price discrimination :

It refers to the charging of different prices to different groups of industrial for the same goods or services.

2. Public utilities :

It refers to the company or enterprise which has been the supplier of some essential goods or services and is, in consequences, subject to some form of Govt. control.

3. Unallocable services :

It covers pension, interest payment, food subsidies. Grants-in-aid, special loan and aid to foreign countries. Budgetary allocation is made on these services.

SUGGESTED READINGS :

1. K.K. Khanna, "Management of Public Sector Enterprises In India."
2. H.L. Bhatia, "Public Finance".
3. Andlay & Sundharam, "Public Economics and Public Finance".
4. R.K. Choudhury, "Public Finance and Fiscal Policy".

CHECK YOUR PROGRESS EXERCISES : 2.1

1. Cite only five rights of public utilities.

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2. State the main pricing policies of public utilities and public enterprises.

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TERMINAL QUESTIONS :

1. Define public utilities. Explain the rights and duties of public utilities.
2. Critically examine the pricing policies of public utilities and public enterprises.
3. Distinguish between public utilities and public enterprises.
4. Explain the major characteristics of public utilities.

HINTS TO CHECK YOUR PROGRESS EXERCISES :

1. See 2.2 on rights of public utilities.
2. See 2.4 and answer.

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