B.A. PART-II
(SEMESTER-III)

ECONOMICS
MACRO ECONOMICS AND PUBLIC FINANCE

Unit 2

Department of Distance Education
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LESSON NO. :

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AN INTRODUCTION TO PUBLIC FINANCE

1. Meaning of public Finance
2. Definitions of Public Finance
3. Nature and Scope of Public Finance
4. Importance of Public Finance
5. Distinction between Public Finance and Private Finance.

1. Meaning of Public Finance:

Public Finance deals with the financial matters of the state. Every government has to perform manifold functions for the welfare of the community which the individual can not or does not perform properly. In short, raising of funds for the necessary expenditure constitutes the subject of public finance. Modern economists do not simply include the revenue and expenditure but also have given equal significance to the effects of fiscal operations so as to enlarge the scope of public finance to a great extent. Hence fiscal problems and fiscal policies are integral parts of public finance. The fiscal operations and fiscal policies have effects upon the national production and income, the national standard of living, distribution of wealth and income, the money markets etc. which in turn effect the economic life of the nation. Therefore, every individual of the country is concerned with the methods of public finance.

2. Definitions of Public Finance:

The economists have defined public finance variously emphasising one or the other aspects of the subject. Public finance is related to the financing of the State activities, and a narrow definition of public finance would try to say that public finance is a subject which discusses the financial operations of the fiscal or public treasury. Early writers of the subject defined public finance in such a narrow manner, though this is not the case now.

There was no unanimity among classical economists on the scope and subject matter of public finance. Adam Smith in his book "Wealth of Nations", gave precedence to expenditure where as Ricardo and J.S. Mill concentrated much more on revenue. As far as the neoclassical economists are concerned, they gave very little significance to the discussion of public finance. However it was Bastable who first made an attempt to make a systematic study of public finance and he defined "Public finance deals with expenditure and income of public authorities of the State and their mutual relation as also with the financial administration and control." Dalton has defined public finance as "It is concerned with income and expenditure of public authorities and with the adjustment of one to another." Obviously, this definition of public finance deals with, adjustment of income and expenditure of the Central Government, State Government, Municipalities, Corporations and other such administrative units. Dr Macro defines "The economics of public finance studies the productive activities of the state which are directed towards the satisfaction of collectives wants."

Philips E. Taylor says "Public Finance deals with the finances of the public as an organised group under the institution of government. It thus deals only with the finances of the government include the raising and disbursement of government funds. Public finance is concerned with operation of the fiscal or public treasury. Hence, to the degree that it is a science, it is the fiscal science; its policies are fiscal policies, its problems are fiscal problems." Similarly Carl C. Plehm says that the term public finance, has come by accepted usage, to be confined to a study of funds raised by governments to meet the costs of governments.

Thus, public finance was concerned to explain that, how public authorities have collected revenue; how can they make expenditure and how revenue-expenditure process was administered; it was not concerned that how revenue and expenditure process of the government is affecting or will affect the economic and social aspects of the economy. Thus the scope of public finance can be said to be narrow and the science of public finance can be regarded only as a positive science.

It continued to influence the ideas of the economists and government policies for more than a century and naturally caused an immeasurable loss to the world. It was with the publication of the major works of Keynes on economics, which revolutionised the economic theory and practice that the classical theory came to be discarded. His general theory furnishes sound foundation for formulation of a fiscal policy for achieving certain socio-economic goals which arise out of some socio-economic problems. It looked to the state to create the condition of full employment, bringing about distributional justice and securing stability and growth. This is reflected in the latter editions of Prof. Pigou and Dr. Dalton's books. Thus Rolph and Break hold, "It may be defined as the discovery and the appraisal of the effects of government financial policies." Thus the appraisal of the results achieved involves value judgement. Thus, the scope of public finance in modern times have been broadened and the study of public finance can also be regarded as normative science.

For instance, Richard A. Musgrave has rightly noticed, "The complex problem that centre around the revenue expenditure process of government is referred to traditionally as public finance........". In other words, "the subject matter of public finance is logically, though not solely concerned with the financial aspects of the business of government." In the same manner, Prof. B.P. Herber says, "The government budgetary practices taxing and spending.......". Again, Prof. C.S. Shop refers that, "the discipline of public finance describes and analyses government services, subsidies and welfare payments and methods by which the expenditures to these ends are covered through taxation, borrowing, foreign aid and the creation of new money. Public finance deals with a resource allocating system that makes little use of the pricing mechanism through considerable use of money. But not even money employed in one branch of public finance, the free supply of government service. And money but no pricing is involved in the distribution of subsidies and welfare payments. On the other hand, both money and pricing are utilised when the government engages labour or other factor services or purchases goods and services produced by firms. "From the above discussion it can be pointed out that there are four methods of raising resources of public authorities: (1) taxation (2) borrowing (3) foreign aid and (4) creation of new money or resort to deficit financing. And government expenditure is incurred in providing services or the satisfaction of social wants free or otherwise, making welfare payments, purchase of factor services and purchase of goods and services produced by others.

Above definitions of public finance point out that the scope of public finance has been enlarged. Modern economics do not simply include the revenue and expenditure but also have given equal significance to the effects of fiscal operations so as to enlarge the scope of public finance to greater extent. Besides value can also be exercised in the sphere of taxation, borrowing deficit finance and public expenditure. Hence it can be analysed that the scope of public finance is continuously widening and public finance is positive as well as normative science.

3. Nature and Scope of Public Finance:

By now, we have learnt that the science of public finance deals with the finances of the state. But in public finance, we do not study only the activities of the state as the want satisfying activities. We study the financial implications and other aspects of such activities also. As we know that the state has to perform manifold functions and for the performance of these functions funds are needed. So the scope of public finance is the study of collection of these funds and their allocation to various branches of activities which are regarded as the duties of the state. So the nature and scope of public finance is discussed under two heads : (a) The functions of the State, and (b) Subject matter of public finance.

(a) The Functions of the State:

Although ancient philosophers like Plato explicitly declared that, "the Government should organise both economic and non-economic activities." Classical economists like Adam Smith advocated the principle of laissez faire and wished to restrict the scope of government functions and therefore government expenditure and taxation. The role of the government was not to interfere with the working of the market forces but to limit its own activities to the barest minimum necessary.

Thus for Adam Smith, Government had three duties of great importance - national defence, maintenance of internal security, and establishment and maintenance of certain essential public institutions which private persons would always find unprofitable. Accordingly, the activities of the state were to be tolerated only as a necessary evil and were to be kept to the minimum possible scale.

Despite the popularity of classical philosophy, the scope of government activity increased with the growth of civilization and complexities of urban lives. Adolph Wagner's famous law of the increase of state activities clearly demonstrates growing variety of responsibilities being shouldered by the governments. But the confidence of economic thinkers and political leaders was completely shaken by the sad experiences of the Great Depression. That is why the concept of the state and its functions has gradually changed especially after thirties.

Keynes and his followers openly stressed that through the fiscal activities of the state, it was possible to increase employment opportunities and to maintain it at a high level.

With the passage of time, the idea of welfare state has gained importance. Such a view of the state has, however, extended its functions. It has to make provisions for medical facilities, education, poor relief and sanitation and various other services of public utility, so as to increase the welfare of the community as a whole.

The rise of modern states has been accompanied by an increase in the number of state functions and consequently the scope and importance of public finance. However, in general, the following services are provided by the government in a modern state:

1. Security, both external and internal;
2. Justice, or the settlement of disputes;
3. To control and regularise the economic enterprise;
4. The social and cultural welfare of the people;
5. The regulation of moral standards;
6. To make proper utilisation of natural resources;
7. The control of communication and transportation for the promotion of the unity of state;
8. The administration of the government financial system, expenditure, revenue and fiscal control;
9. Proper administration;
10. Support of public officials; and
11. Religion and religious rights.

The following are the main functions of modern state:-

1. Protective Functions: These functions include provision of security from external aggression and maintenance of law and order in the country. Every government keeps army and police force for this purpose. It also establishes courts which decide cases of warring parties and deal out justice to the people. This is a primary function of the State. Unless a country is properly protected, no productive activity can be carried on.

2. Administrative Functions: The administrative functions relate to the carrying out of the routine work of a government. Every government has to establish or maintain various departments in order to give good administration to the people.

3. Social Functions: The government also undertakes the responsibility or providing relief to the poor, the sick and the unemployed. Social insurance, including health and unemployment insurance and granting of old-age pensions are now considered very essential functions of modern government. Besides these, the modern governments provide public parks, libraries, education, medical aid and decent living facilities. These functions help in the development of human resources of the nation.

4. Economic and Commercial Functions: In economics we are mostly concerned with these functions. They include measures for facilitating the establishment, regulation and control of business units. The main economic functions of the State are the following:

(i) Optimum Utilisation of National Resources: The governments of today also undertake responsibility of making the best use of the country's resources, human as well as material. The resources are scarce and they can be put to alternative uses while the wants are unlimited. So there should be no wastage and no misdirection of the scarce resources. In the planned economies, this function is performed by the planning authority.

(ii) Economic Stability: The government has also to ensure smooth running of economic life and activity. So it strives to eliminate economic fluctuations. If their effects are not mitigated, producers suffer heavy losses during depression. This results in poverty and mass unemployment. When the country is faced with such a situation the government spends large amounts of money and launches various projects such as building of roads, digging. of canals etc. Thus it strives to give the nation economic stability and makes it get rid of the evil effects of cyclical fluctuations.

(iii) Economic Equality: Modern governments also endeavour to reduce inequalities of income and property existing between different classes of a community. Public finance can be very helpful in this respect. The people with higher levels of income are taxed heavily and the money so collected is spent for the benefit of the poor people. Thus an effort is made to reduce the gap. The government can influence and regulate economic and social life of the people through its fiscal policy. Taxes are used for more equitable distribution of wealth and they are instrumental in checking concentration of wealth and income. Thus taxation can be very helpful in reducing economic inequalities in the country.

(iv) Provision of Social Security: All modern States have introduced far reaching and ambitious social security schemes such as old age pension, provident fund and insurance against unexpected contingencies of life. In developed countries every citizen is assured of financial aid for meeting the various contingencies of life, free medical aid including maternity benefits, free education, suitable employment, old age pension etc. It is clear that government has to spend large amounts of money for providing these facilities to their people. Only a government can undertake such social security measures.

(v) Accelerating Economic Development: The main concern of the governments of the under-developed countries is to accelerate the rate of economic development. They have given top priority to this function. These governments strive to develop means of transport and communications, irrigation, credit and banking facilities etc. In other words, the government has to build infra-structure in the economy. With the availability of these facilites, the rate of growth is accelerated in the country. But these facilities can be provided only by government as they involve large expenditure. The government of India has spent crores of rupees on the developmental schemes for roads, railways, electricity etc. In all under-developed countries, the government has given top priority to economic development. This, in fact, is now the chief function of a modern State. Even in developed countries, the government are assisting further development in order to raise living standards of the people still higher. These are some of the functions for which a government has to incur expenditure and raise revenue. That is why Public Finance has assumed so much importance now a days.

Thus the functions of the government are increased day by day. In order to perform these functions the expenditure of the government is also increasing. So it has to increase its revenue to meet the expenditure. The rapid increase in the functions and the duties of the government has also added to the importance of public finance.

The effects of fiscal operations on economic life:

In order to finance public expenditure, various fiscal methods are available at the disposal of the public authorities. They are:

(i) Taxation, surplus of public enterprises, fees, fines etc.
(ii) Borrowing from the public,
(iii) Borrowing from the central and commercial banks,
(iv) Borrowing from external sources,
(v) Withdrawls from money balances.

Economic analysis indicates that operations of public finance have a close bearing on investment and consumption. These can, therefore, be successfully used to control aggregate demand and stabilise economy. During depression period, the third, fourth, and fifth methods may be largely relied upon because of their greatest demand expansionary potency. Whereas first method i.e. taxation tends to be perverse, as it is likely to depress the levels of income and employment by reducing private consumption and investment. Further, the scope of second method is limited by the low levels of income and savings. This will stimulate the process of employment and income generation in the private sector.

In under-developed countries the last two methods may be used for financing developmental public outlays to extent of the volume of additional liquidity required to match growth in real national income. Thus the expansionary finance tends to be compatible with economic stability. Similarly, the first two methods can also be used for financing public sector investment and directing private investment towards desirable lines of production. Thus, the three important fiscal means by which resources can be raised for the public exchequer are; taxation, borrowing from the public and credit creation. These means must be used in harmonious combination so as to produce the best over all effects on the economic life of the people in terms of economic progress and social welfare.

(b) Subject Matter of Public Finance:

Public Finance looks into the financial problems and policies of the government at different levels and also studies the inter-governmental financial relations. Thus the subject matter of public finance may be classified as under:-

1 Public Revenue
2 Public Expenditure
3 Public Debt
4 Financial Administration
5 Economic Stabilisation, Growth and Distributive Justice
6 Federal Finance.

1 Public Revenue: Public Revenue concentrates on the study of the several sources from which the state might derive its income. It deals with the methods of raising funds, principles of taxation and other related problems.

2 Public Expenditure: This part of the public finance deals with the study of principles and problems relating to the expenditure of the government.

3 Public Debt: Public Debt has assumed the role of an important instrument for regulating the working of the economy. This part of the public finance studies the reasons for which the loan is raised, the sources of the loan, the method in which it raised, the interest and the method of repayment. Thus, it examines the problems related to raising and repayment of loans.

4 Financial Administration: Financial Administration relates to the public budget, passing, implementation, auditing and similar other matters.

5 Economic Stabilisation, Growth and Distributive Justice: These aspects of the economic policy of the government, now-a-days, have assumed a great significance in the discussion of public finance theory.

6 Federal Finance: The issues like division of functions and resources between centre and states; problem related to inter-governmental financial flows and financial imbalances, and then re-allocation of functions and resources on the criteria of changing efficiency, uniformity and economy of state service have assumed a significant place in the study of public finance.

4. Importance of Public Finance:

The functions of government have increased extensively and intensively. It is obvious that for the performance of these functions, money is needed. The government levies new taxes and raises rates of old taxes for the collection of required funds. The strength of a nation is reflected in its budget. The extent of state activity and its efficiency are primarily dependent upon the funds raised by it. Here lies the importance of public finance.

But one thing must be noted that Public finance is no longer considered as a mere tool of raising the state revenues. It is now regarded as a powerful instrument for the attainment of social and economic objectives. For example, governments of today want that every citizen should be free from the pangs of hunger and poverty. So all governments have launched various social security schemes. Thus, public finance has become a powerful instrument of social justice and social welfare. It affects the entire economy.

It is also employed by modern governments to bridge, as far as possible the gulf between the rich and the poor. An equitable system of public finance would tax the rich and spend the proceeds for supplying such services as benefit to the poor primarily. This is one of the important aspects of finance.

Public finance is not only a means of achieving economic and social justice, but of regulating economic activity. It can be used to retard or stimulate economic activity as and when desired by the government.

The effect of taxation is felt not merely when revenues are raised, but also when they are spent. Taxes and subsidies are the means by which consumption and production in the country are affected.

Public finance operations affect a series of transfers of purchasing powers. One aim underlying all these transfers is the attainment of maximum social advantage. Since the main objective of economics is to promote human welfare, the importance of public finance is, indeed, very great.

In a developing economy, the State must play a very active role in promoting economic development and the public finance is the instrument that State must use. In an under-developed country, the vast and varied natural resources have yet to be fully exploited, technical know-how is lacking, means of transport and communication are under-developed and irrigation and power resources are also to be developed. No individual can accomplish these tasks as this is beyond his capacity. Only the State can do it. Moreover, the rate of saving in these countries is very low. So the State has to step in to promote capital formation. The State must control and regulate economic activity and this is done through public finance which is very effective in a democratic country. The government levies taxes on those articles the consumption of which it wants to curtail.

Thus, it can increase saving and curtail consumption through heavy taxation on consumption goods. Similarly the State can give incentives in the form of tax concessions and subsidies for the production of those commodities the supply of which it wants to increase. Taxation can also be used to raise resources for economic development. As Nurkse says, "Public Finance assumes a new significance in the face of the problem of capital formation in under-developed countries." Public Finance can be instrumental in diverting resources from less important channels to more important channels. Hence it has a vital role to play in the economic development of a developing economy.

5. Distinction between Public Finance and Private Finance:

We can understand the meaning of public finance in a better way, if we know the differences between public finance and private finance. Some of the differences are given below:

(i) An individual adjusts his expenditure to his income. In other words, he has to live only using his income. If his income increases he can increase his expenditure. If his income decreases, he must curtail his expenditure, otherwise he will be in trouble.

But this is not the case with the government. The government first prepares estimate of expenditure and then devises ways and means to raise the required funds. The governments, unlike the individual, adjust its income expenditure.

(ii) For the public authorities, the unit of time for the budget is one year whereas for an individual, there is no specific time. He do not balance his budget by a particular date or during a given period.

(iii) It is considered beneficial for an individual to save something. Surplus budgeting is a virtue for individuals. But it is not essential for government to adjust always their expenditure less than their income. Sometimes they are required to spend more than their incomes in the interest of the country. They are to spend money for war or for the purpose of economic development or to curb depression in the economy.

(iv) Secrecy surrounds private finance. But publicity, on the other hand, is essence of public finance. Government budgets are published and the widest publicity is given to them. Publicity strengthens public credit.

(v) An individual cannot make any big change in his income and expenditure. He can increase his expenditure easily, but cannot decrease it. Similarly he cannot increase his expenditure easily, but cannot decrease it. Similarly he cannot increase his income so easily. But governments are in much better position to make fundamental changes in the schemes of public income and public expenditure. Planning started in India in 1950-51. There is a lot of difference between the budget of previous period and the budget of the current year. There has been manifold increase.

(vi) An individual can obtain only an external loan. There can be no internal loan for an individual. How can he raise an internal loan from himself.

But governments can raise internal as well as external loans, as the need arises.

(vii) Governments can incur expenditure by resorting to deficit financing. But this is beyond the reach of an individual. If he does this, he is put behind the bars.

(viii) In the matter of making provision for the future, a government is much more liberal and far-sighted than an individual. Human life is uncertain and that is why individuals discount the future at a very heavy rate. So they are anxious to reap quick returns. But the statesman is a trustee for future generations also. Governments therefore launch those projects which has long gestation periods and involve large expenditure.

LESSON NO. 2.1 A **AUTHOR: DR. HARVINDER KAUR**

PRINCIPLES OF PUBLIC FINANCE AND PUBLIC EXPENDITURE

1. Introduction:

Every economy is faced with the perpetual problem of scarcity. In a solution adopted to solve it, the state gets an important role (a) of undertaking various economic activities directly and (b) of regulating the activities of the private sector. The exact role of the state differs from one type of economy to another. Adam Smith enunciated the philosophy of the virtues of market mechanism and laissez faire. His assumption led him to the conclusion that all economic activities should be undertaken by private sector only with the following exceptions: (a) maintenance of the state itself; (b) creation and maintenance of social overheads; (c) protection of the society against internal disorder and external aggression; and (d) projects which require huge investments and which the private sector is not in a position to meet. parallel to the classical philosophy, we have Wagner's law of increasing state activities and Wiseman-Peacock hypothesis according to which the public expenditure must keep on increasing with the passage of time. These theories project an expanding role for public finance.

PRINCIPLES OF PUBLIC FINANCE AND PUBLIC EXPENDITURE

This lesson is divided into two sections. Section-I deals with the Principle of Public Finance and Section-II deals with the Principle of Public Expenditure.

2. Rationale of Public Finance:

The followers of the classical school itself realized the imperfections of market mechanism and inadequacy of laissez faire. Lack of distributive justice, a divergence between social and private costs and benefits, and general instability in income and employment levels became widely known. These and othe limitations of market mechanism (like distorted investment, production and consumption patterns) led the thinkers and theoreticians to advocate an increasing role for the state in the form of public undertakings, through various budgetary policies, through expanding budgetary operations, and through regulation of the private sector. Those concerned about the ill effects of market mechanism on the health and efficiency of labour advocated more of welfare activities on the part of the state. Economists like Marshall and Pigou noted the divergence between social and private costs and benefits. They wanted the state to rectify these defects. Musgrave added that the state must ensure adequate supply and consumption of merit goods.

Keynes put his arguments for state intervention in terms of a need for remedying the inherent tendency for a shortage of effective demand. His ideas were further refined to accommodate the concept of balanced budget multiplier. Lerner's advocacy of functional finance, Gurley and Shaw's analysis of the role of financial structure of an economy in its health and prosperity, and Redcliffe committee's analysis of the role of public debt via the liquidity, effect have paved the way for a full fledged intervention by the state in economic affairs of the country. The state activities are now expected to have an all-pervasive role. In reality also, its financial operations form a major portion of the total flows; its taxation expenditure and public debt instruments are being continuously refined to tackle the complexities of a modern economy.

Some broad objectives of government intervention are as follows:-

(i) The first objective is to ensure optimum resource-allocation. We limit ourselves only to the productive resources here. Resources are optimally allocated if (a) income distribution is optimum so that the demand pattern generated reflects the needs and preferences of the society, and (b) there are no market imperfections. Optimality can also be expressed in 'marginal conditions'. Both these conditions are unrealistic, and need for government intervention arises. Instruments of intervention can be many, including direct regulation, tax measures and use of public expenditure including subsidies. Use of such measures alters the relative attractiveness of different investments, and relative prices of different inputs. This accordingly affects resource allocation. Direct government investment is itself a main force in resource allocation.

(ii) The second objective is to ensure efficient use of resources, that is avoiding their wastage including unemployment. Such an unemployment may be open or disguised and wastage may be due to imperfections of the market, supply gaps and like. Government intervention should ensure that the relative prices of factors are altered to bring them in harmony with their relative availabilities, supply gaps are filled and bottlenecks are removed.

(iii) Income and wealth inequalities are a common feature of market economies and their removal becomes of the main objectives of government intervention. These inequalities bring in inequalities of opportunities also. Arguments against reduction of inequalities can be put forth in terms of non-measurability of utility and income enjoying capacities of individuals. But these arguments do not stand in the way of realties where object poverty and wide inequalities prevail. Moreover, income enjoying capacity is a fluid concept. Government intervention is required to strike at root causes of these inequalities by ensuring fuller employment, by a check on price rise and through progressive taxation. However, one should not hope that fiscal measures alone can ever succeed in tackling this problem, they can at best be a help in overall policy of removing inequalities.

(iv) Another objective of government intervention is to tackle the problem of economic instability. In a market economy, demand and supply flows seldom match, either at aggregate level or at micro level. Therefore, government intervention is needed (a) to bring in an overall conformity between demand and supply, and (b) to bring about a similar conformity for individual goods and services.

Modern states are the welfare states whose main objective is to ensure maximum social welfare for the people. The government budgetary and debt policies have become the indispensable tool which virtually not only influence the public life, but also effect the welfare of the people to a greater extent. In other words, public finance plays a key role in the determination of national income, employment, out put, prices and other parameters in the economy. Public finance must have some criterion to be designed for its operation which may lead to achieve the maximum social welfare. This guiding principle has been technically called the principle of maximum social advantage.

3. Principle of Public Finance-Principle of Maximum Social Advantage:

The principle of maximum social advantage was not approached in a proper way by the older writers on public finance. They made unrealistic assumptions resulting in faulty conclusions. Adam Smith and his followers said that 'every tax is an evil and every public expenditure is unproductive'. This version is faulty which has been severely criticised by various economists.

Prof. Dalton and Prof. Pigou are too prominent economists who formulate the fundamental principle of public finance. According to them, the Principle of Public Finance or the Principle of Maximum Social and Net Advantage govern both operations of public finance i.e. revenue and expenditure simultaneously to maximise the economic welfare of the society as a whole. The principle says that public authority should collect revenue and spend the money to maximise the welfare of the people as a whole. Taxes impose a burden, expenditure relieves social burden. Expenditure thus yields utility that goes to counteract the disutility caused by taxes. That relationship between revenue and expenditure is best which enables the state to maximise the surplus of utility over disutility. But it should be remembered that as more units of money in the form of taxes are raised from the people, the burden of sacrifice per unit will go on increasing as the utility of money to the people will go on increasing. On the other hand, the benefit occurring to the masses from the successive units of money spent on their welfare will go on decreasing because on the law of diminishing marginal utility. This will mean that with every additional unit of tax raised the burden of sacrifice will go on increasing and the amount of benefit will go on decreasing. Thus a point will be just equal to sacrifice imposed in raising that unit of revenue. Here the state should stop, as at this point the marginal sacrifice is equal to the marginal benefit. This is the optimum limit of the state in public finance activity.

This can also be illustrated with the help of a diagram-I, SS is the sacrifice curve and BB is the benefit curve. Both the curves meet at the point P. OP' shows the limit of state's public finance activities.
To conclude, for making maximum net social advantage, the financial operations should be carried up to the point where marginal utility of public expenditure is equal to the marginal disutility of public revenue.

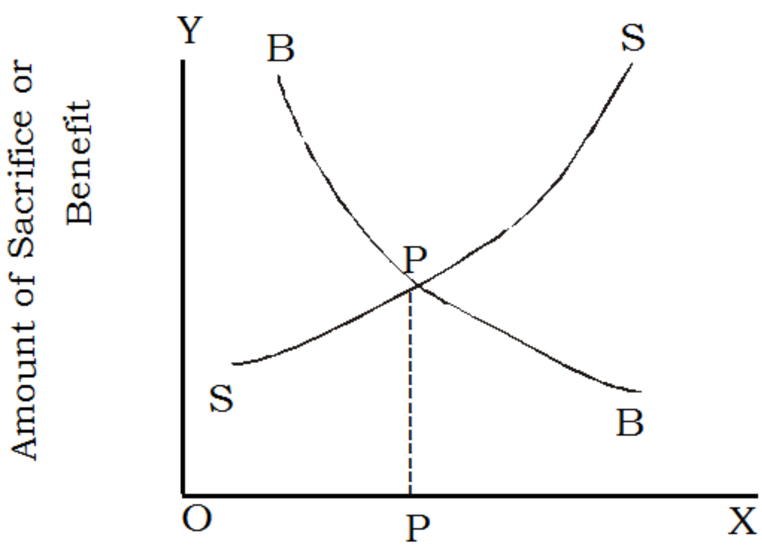

Diagram - I

Principle of Equi-Marginal Utility

According to Prof. A.C. Pigou the resources should be allocated among different uses that expenditure should be incurred in different uses in such a form that the marginal utility obtained from each different use is the same. The burden of taxation should be so divided among different sources that the marginal sacrifice on each source is the same. This is the principle of equi-marginal utility or maximum satisfaction as applied to public finance.

Methods to get Maximum Social Advantages

The state authority can take the help of three fundamental principles of public operations. Public expenditure should be carried on up to that level where benefit derived from last unit of money spent by state is equal to the sacrifice imposed in raising the unit of revenue. The taxes should be distributed in a manner that the marginal utility of money paid in taxation is equal to all tax-payers and the resources of state must be distributed on different heads of expenditure so that the marginal return of satisfaction from each of them is same.

Practical difficulties

It is very difficult for the state to balance the marginal disutility of taxation with the marginal utility of expenditure. Utility and disutility are not easily measurable. The disutility of taxation is a composite quantity. The more a man is taxed the greater is his loss of utility. Second taxes reduce people's consumption or their savings. They mostly decrease their consumption. Such a decrease generally reduces their efficiency and their productivity falls in the long run. Just as it is difficult to measure the disutility of taxation, so also it is difficult to calculate the benefit from the expenditure of public revenue. The benefit that people get directly by having some commodities that the state supplies. The benefit that comes from the increased efficiency of the people and benefits of a more equitable distribution of wealth that public expenditure brings about. So the advantage of public expenditure is broken up into several parts.

In spite of some limitations, the Principle of Maximum Social Advantage does provide a broad framework of judging measures of public finance.

Self check exercise

Q.1. Explain principle of Maximum social advantage.

Q.2. Define Public finance.

4. The Principle of Public Expenditure:

The Principle of public expenditure is concerned with finding out that fundamental rule which should govern the public expenditure policy of the state.

The state exists for the welfare of the people. So the state should see to it that no particular individual is specially benefitted by its expenditure policy, but the maximum benefit accrues to the aggregate of its people. In view of this, Prof. Pigou and others talk of Maximum aggregate benefit as the correct principle of Public Finance. Prof. Adarkar while agreeing with the view that the state the exists for the welfare of the people and it should aim at maximising benefit to the masses, objects to the technique to considering the principle of expenditure and the principle of taxation separately. He feels that both sides of the science of Public Finance are so closely interrelated that we cannot think of the one without at the same time thinking of the other.

To understand that principle it is necessary to make a distinction between (a) the planning of public expenditure and (b) the spending of public funds.

It is necessary for the state to have some idea of how much money would be needed for the discharge of the duties that it has taken upon itself. This stage can be called planning stage, the state to think of expenditure and revenue together. Once the budget has been passed the various items on which the money has to be spent are also determined. Revenue would decide how far to go in the matter of expenditure or where to stop. But the order in which the various items of expenditure would be taken up does not depend upon the volume of public revenue. We should say that public expenditure should be so planned that maximum possible aggregate benefit is secured from whatever amount of money is spent. To the extent to which it is not possible to make this presupposition, it is not possible also to have an independent principle of public expenditure.

4.1 Canons of Public Expenditure

It is indeed doubtful if any simple set of rules can be adequate guide for the complicated patterns of expenditure of modern governments. However, a study of such rules does give us an insight into some of the problem involved in public expenditure. Finally Shirras in his book "The Science of Public Finance," has given the following four canons of public expenditure:

1. The Canon of Benefit

According to the Canon of Benefit, public expenditure should be incurred, or regulating on various items, in such a way as to secure the maximum social benefit. It is attained "when the public utility of the marginal expenditure in each case is equal". Thus according to the canon of benefit, the State should push expenditures in different directions upto that level which equalises the marginal benefit in each case. Hence the canon of benefit may also be called the principle of equi-marginal social utility. Indeed there may be many practical difficulties in following this principle in actual practice. But as a theoretical rule, it is a true principle of public expenditure. While describing the canon of benefit, Findlay Shirras says, "public expenditure should be permitted for the benefit of a particular person or section of the community unless (a) the amount of expenditure involved is small, (b) a claim for the amount could be enforced in a court of law, and (c) the expenditure is in pursuance of a recognised policy or custom."

There has been some controversy about the statement given above. So far as an item (a) is concerned, the word 'small' is a relative term. It is not clear whether by 'small' Shirras means a small amount or a small percentage of the total amount. Moreover, it does not clearly follow as to why even a small amount of expenditure should be incurred on a person or section of persons. As far as the item (b) is concerned, it refers to the obligatory expenditure which the State must incur. This expenditure, therefore, occupies a high priority and confers a relatively greater social benefit. Concerning item (c) it may be said that Shirras seems to believe that expenditure sanctioned by custom and prevailing practice is justified. This is also not self-explanatory. Only when an expenditure confers relatively greater social benefits then it is justified.

2. The Canon of Economy

According to this canon, public expenditure should be incurred in such a way as to minimise the wastage of public money. The resources of every economy are relatively scarce. Hence no wastage should be allowed. The process of public expenditure should not involve use of resources more than what are just necessary. Shirras clearly seems to attach a narrow meaning to 'economy' as he talks of avoiding the 'extravagance and corruption." Actually the word 'economy' has a broader meaning. Even if a government avoids all wastage in a particular expenditure the expenditure would be uneconomic if the benefit derived from it is less than the benefit that would have been derived if this money had been spent on some other project. Indeed as governmental activity increases in coverage and quality, it is difficult to judge the extent and type of wasteful expenditure. One form of wastage of public expenditure is the delay that often occurs in formulating the plans of public expenditure, their sanction and their execution. Some benefits are generally lost due to the delay. At least, when prices are rising, the public authorities have to pay more for the same benefits. These days in quite a few cases, public authorities use cost-benefits approach to determine the worthwhileness of projects. According to this approach, social costs and social benefits are estimated and accordingly the project is assessed. Indeed, the technique of cost-benefit analysis cannot be applied to all the items of public expenditure. There are certain items of expenditure which are contractual in nature e.g. interest on public borrowing. The authorities are under legal obligation to incur these and hence the question of economy in their case does not arise.

3. The Canon of Sanction

The canon of sanction suggests that no expenditure must be incurred without proper sanction by the duly authorised body. This sanction is important for the enforcement of the canon of economy and for the prevention of unwise and reckless spending. If the canon of sanction is observed, the responsibility for each item of expenditure can be fixed upon some specific official. In modern times, the principle of sanction takes a very elaborate form. The government must seek the sanction of the legislature before it spends any money. Within The government, each department, must seek the sanction of the Finance Ministry for its different expenditure. Within a department, every section must get the sanction from the head of the department, of the financial controller. Indeed, a very rigid adherence to this canon is likely to involve delays but that has to be accepted if we want to ensure economy and honesty. In modern democratic governments, there is an elaborate system of sanction, checks, controls and auditing.

It may be noted that in connection with the canon of sanction, Shirras also says that "loans should be spent only on those objects for which money may be so borrowed." This is in accordance with the orthodox view that current expenditure should be financed from revenue while capital expenditure may be financed from loans; which could be gradually repaid. This is not considered to be a sound view now. According to the modern fiscal theorists, whether a government should borrow or tax will depend upon the state of the economy. It the economy is faced with an inflationary situation, the government has to make attempt to reduce the level of demand. In this situation, the government may even finance capital expenditure out of taxes. In a situation of depression and unemployment, on the other hand, the government has to rise the level of demand in the economy. Hence it may raise loans to meet its expenditure and thus activise the idle saving to the individuals. Not only this, government may even cut taxes to stimulate the level of private demand.

4. The Canon of Surplus

The canon of surplus says that the governments should avoid deficits in their budgets and should aim at surpluses. This canon also implies that the normal routine expenditure of the government should be invariably met from current revenues and borrowing should be avoided to meet such expenditure. In other words, the governments should not spend more money than they receive just as an individual should not spend more money than he earns.

It may be pointed out that the canon of surplus no longer finds favour with the modern fiscal theorists. These days the regulatory role of fiscal policy is given great importance and therefore, the choice of a surplus or a deficit budgetary policy is left to be decided by the merits of the case. During a period of depression and unemployment, the government, is justified in having a deficit budget and thus raise the level of demand. Indeed, in the opposite situation of inflation, a surplus budget is helpful in removing some of the excessive purchasing power from the hand of the people.

Self check exercise

Q.1. Describe canons of public expenditure.

Q.2. Differenciate between canon of surplus and canon of sanction.

5. Canons of Public Expenditure in India

The four canons of public expenditure discussed above are equally valid for all countries and India is no exception. As noted already, public expenditure in one of the most significant instruments of economic policy. In view of its powerful effects on the economy misguided public expenditure can do a great deal of harm to the nation. For example, there are many economists in India who believed that the prevailing inflationary situation in the country is partly the result of increasing volume of unproductive government expenditure. In fact, the basic problem of the underdeveloped countries like India is to come out of economic stagnation and start the process of economic development. Public expenditure has been found to be the chief and efficacious means of doing this. These countries, therefore, have to take utmost care to have a judicious expenditure policy. They should have a comprehensive, public expenditure programme so that they are able to raise agricultural and industrial production and productivity. Indeed, as a result of huge spending on developmental activities there is bound to be an increase in expenditure on administration. There is a great need to keep this expenditure at the minimum possible level so that more and more funds are available for developmental purposes. With a view to derive maximum benefits from public expenditure, it is essential that it should be incurred with efficiency and economy. All wastes should be avoided and bribery, corruption and nepotism should be eradicated. This will also ensure people's confidence in the public authorities and would reduce their tax resistance.

6 Summary

In this lesson we have discussed principle of public finance and public expenditure.

The state exists for the welfare of the people. So the state should see to it that no particular individual is specially benefitted by its expenditure policy, but the maximum benefit accrues to the aggregate of its people. To understand that principle it is necessary to make a distinction between (a) the planning of public expenditure and (b) the spending of public funds.

It is necessary for the state to have some idea of how much money would be needed for the discharge of the duties that it has taken upon itself. This stage can be called planning stage, the state to think of expenditure and revenue together. Once the budget has been passed the various items on which the money has to be spent are also determined. Revenue would decide how far to go in the matter of expenditure or where to stop. But the order in which the various items of expenditure would be taken up does not depend upon the volume of public revenue. We should say that public expenditure should be so planned that maximum possible aggregate benefit is secured from whatever amount of money is spent. To the extent to which it is not possible to make this presupposition, it is not possible also to have an independent Principle of public expenditure.

7. Short answer type questions

Q.1. Define public finance.

Q.2. Explain canons of Economy and canon of sanction.

Q.3. What is the Principle of public expenditure ?

Q.4. What is the Principle of maximum social advantage ?

8. Long answer type questions

Q.1. Explain principle of Maximum social advantage.

Q.2. Define Public finance and describe objectives of government intervention.

Q.3. Describe canons of public expenditure.

Q.4. Differenciate between canon of surplus and canon of sanction.

9. Recommended Books

1.	Huge Dalton	:	Principles of Public Finance
2.	Richard A. Musgrave	:	Theory of Public Finance
3.	H.L. Bhatia	:	Public Finance
4.	B.P. Tyagi	:	Public Finance
5.	A.R. Prest	:	Public Finance
6.	R.A. Musgrave and	:	Public Finance in Theory and P.B. Musgrave Practice
7.	R.J. Chelliah	:	"Trends in Taxation in Developing Countries." IMF Staff Papers, July 1971. An excerpt re-printed in G.M. Meier (ed.) Leading Issues in Economic Development (1976)
8.	C.S. Shoup	:	Public Finance
9.	P.E. Taylor	:	The Economic of Public Finance
10.	Findlay Shirras	:	Science of Public Finance.

LESSON NO. 2.2 **AUTHOR : DR. ABDUL WAHID**

PUBLIC EXPENDITURE

I. Introduction

II. Comparison between Public Expenditure and Private Expenditure.

III. Significance of Public Expenditure.

IV. Theories Explaining Growth of Public Expenditure.

V. Causes of Increase in Public Expenditure.

VI. Public Expenditure.

I. Introduction

Public expenditure is a compound word which is composed of 'public' and ‘expenditure’. The word ‘public’ is used here to signify the state or the Government. ‘Public Expenditure’, this means the expenditure incurred by public as an organised body under the institution of the Government. Simply put, public expenditure means expenditure incurred by Government-it can be Central, State and Local. The expenditures are incurred for achieving various social and economic ends.

Public expenditure is one of the important aspects of Public Finance. In a sense it is more important than the revenue aspect. This is because actually it is government expenditure which gives rise to need for taxation and public borrowing. Not withstanding this fact, however, the theory of public expenditure is even today not so developed as the theory of taxation. This is so because traditionally, under the influence of the philosophy of laissez faire and a belief in the efficacy of price mechanism the theory of public expenditure received relatively less attention. According to the laissez faire thinking, the state had to perform only limited and set functions, such as defence against external aggression and maintenance of internal law and order. It had to perform only these functions and therefore the Government had to seek the necessary revenue only. A theory of public expenditure was, therefore, believed to be less essential. The chief problem was thus to know the best way in which the required revenues could be raised. This led to rapid development of theory of taxation. The theory of public expenditure, on the other hand, remained unexplored. This was the position almost till after the first quarter of the present century. Later, however, with the advent and development of welfare economics, the role of the State in economic life was clearly recognised. The fiscal operations of the Government came to be assigned key role and the theory of public expenditure received increased attention, this tendency was intensified partly by larger interest of economists in problems such as economic development, planning and distributive justice and partly by the widening range of government activities. Consequently, the theory of public expenditure got a stimulus and numerous studies in the theory of public expenditure have been initiated.

II. Comparison between Public Expenditure and Private Expenditure

It is customary to compare public expenditure with private expenditure. The latter may be defined as the expenditure incurred by private individual economic units as distinguished from public authorities.

With regard to the similarities between public expenditure and private expenditure. It may be said that neither public authorities nor private economic units would like to spend without corresponding returns, and thus waste the resource. Given the objectives to be realized, both will attempt to achieve these with the minimum possible expenditure. If in actual practice, there is any shortfall on this account that must be attributed to inefficiency, lack of foresight, uncertainty and similar other factors. Another important point of similarity between public expenditure and private expenditure is that both are flexible in nature - privtate economic units as well as public authorities take a collective view of the income and expenditure and the possibility of adjustment between the two. Moreover, each case there can be more than one ways of raising additional income.

However, while private expenditure and public expenditure are similar in their overall nature, there are also glaring dissimilarities between the two. The chief dissimilarities lies in the objective with which the expenditures are made. In the case of an individual economic unit it is the exchange relationship which determines the pattern and volume of expenditure. A private consumer, for example, would try to equate the marginal utility of the goods or services purchased with the disutility of expenditure to be incurred. Similarly, a private firm will compare the private marginal returns from a particular expenditure with the amount to be spent. But public authorities cannot always adopt commercial attitude towards their expenditure plans. They have to consider the social benefits of their expenditure schemes. Now, in most of the cases, these social benefits are vague and not measurable. The government has, therefore, to impute social valuation to these benefits with a view to judge if these expenditure schemes are worth while. Yet another dissimilarity between public expenditure and private expenditure concerns the time horizons of the public authorities and the private economic units. An individual has only a limit to horizon and thus plans the future only within foreseeable limit. The government, on the other hand, have to take a very long time view. They have to plan for future generations as well. Hence they may incur heavy expenditures in such a way that they run into a sort of permanent deficit. Private economic units simply cannot do so.

III. Significance of Public Expenditure

In a modern capitalist economy, public expenditure is one of the most important instrument of economic policy. Public expenditure can be used as an engine of economic development, as a stick to regulate the economy and as a means of promoting distributive justice. The significant of public expenditure may be discussed:-

Public expenditure increases the level of national income and employment. When public expenditure is made, it immediately increases the income of the recipients. But as a result of the multiplier effect the total increase in national income is much more than the initial amount of public expenditure. Increased income and employment lead to higher level of consumption and also larger volume of savings. This helps to sustain larger investment plans.

Public expenditure on industry and agriculture helps to increase the industrial and agricultural output of a nation. Public Expenditure on economic and social overheads assists the productive process in the economy. The construction of roads, railways and other means of communication facilitates trade and commerce and the enhances production. Government expenditure on defence against external aggression and on the maintenance of law and order within the country ensures that the people are able to carry on productive pursuits undisturbed. Public expenditure on education, health and medical facilities ensures that the labour force is more efficient and heal their and thus has greater productivity.

Public expenditure is an important instrument of maintaining economic stability in the economy. This is so because in modern economies government expenditure constitutes one of the most important elements of total demand. Hence variations in public expenditure have proved to be an effective means of regulating the flow of expenditures in the economy. Thus during periods of inflation, when total demand is more than the total value of available goods and services; measured in current prices, government expenditures towards the value of output measured in current rather than rising prices. This would help in fighting inflation. On the other hand, during periods of depression and unemployment, when aggregate demand is less than the total value of goods and services available, government expenditurescan be increased so as to adjust the aggregate expenditures upward to the value of output produced at full employment. The use of public expenditure to fight fluctuations in prices, income etc. is called compensatory spending i.e. spending with a view to compensate for the excesses and deficiencies of aggregate demand.

The significance of public expenditure also arises from the fact that it is an important instrument of promoting distributed justice. To achieve this objective, government may undertake special schemes of public expenditure, which particularly benefit the proper sections of society. Government expenditure on poor relief, unemployment compensation, old-age pension and other social security measures may also be of great help, public expenditure can also be used directly for the upliftment of backward sections of classes by giving them scholarships, medical aid, subsidised housing and other essential goods and services.

In under-developed countries like India public expenditure has assumed all the more significance. In these countries, for various reasons, particularly the low ratio of savings to national income governments have been virtually forced to pay an active role in generating and promoting economic development. In these countries there are indeed large investment opportunity but not only capital is lacking but the private enterprise is also shy. The construction of railways, irrigation works, multipurpose projects and modern steel plants are beyond the resources available to the private enterprises. These projects also involve long gestation periods for which the private enterprises cannot wait. Thus government alone have the finance and the patience to undertake these projects. Moreover in the under-developed countries there exist certain backward or depressed areas. Only public expenditure can help to bring prosperity to these areas and thus promote regional balance in the country.

IV. Theories Explaining Growth of Public Expenditure

There has been persistent and continuous increase in public expenditure in every country of the world. This tendency was, in fact, first noticed in the 19th century but it has become definite and pronounced in the 20th century. In United States of America for example, in the year 1975, the expenditure of the Federal Government alone $924.6 billion which constitute about 28% of the national income. India is also no exception. Total expenditure of the Government of India rose from 2,560 crores in 1960-61 to Rs. 1,41,873 crores in 1993-94. Total expenditure of the Central Government in 1995-96 rose by 14.7% to Rs. 191618 crores from Rs. 166998 crores in 1994-95. Total expenditure of Government of India as a proportion of GNP rose from mere 5.93% in 1950-51 to 7% in 1975-76 and to 17.5% in 1994-95. However, as ratio of GDP, the total expenditure declined from 17.5% in 1994-95 to 17.4% in 1995-96. The expenditure on revenue account increased by 312 times between 1950-51 and 1993-94. There are at least two well-known theories that explain the rapid growth of public expenditure almost all over the world. One of these is associated with Wagner's name and other with Wiseman and Peacock. Let us briefly examine these theories:

1. Wagner's Law of Increasing State Activities:

   Adolph Wagner, a German economist of the latter part of 19th century, Presented his famous "Law of Increase of State Activities" in the following words:-

   "Comprehensive comparisons of different countries and different time show that, among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both the Central and the local governments. This increase is both extensive as well as intensive: the central and local governments constantly undertake new functions, while they perform both old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a more satisfactory fashion, are satisfied by the Central and Local Governments.

According to Wagner, there are inherent tendencies for the activities of the different layers of government to increase both intensively and extensively. In fact, the data about government expenditures in all the countries does demonstrate a persistent and pronounced increase to justify the elevation of Wagner's statements as a 'Law'. F.S., Nitti, after a careful study of expenditure in various countries, supported Wagner's thesis and concluded with empirical evidence that not only Germany but government in all the countries and of all the types-centralized and decentralized, large and small, war like and peaceful-showed essential similar tendencies towards marked increase in their expenditures.

Wagner emphasizes that there has been both intensive as well as extensive increases in government functions. Intensive increase means 'expansion in the traditional functions of the government. Thus defence has become more complex and expensive in nature and administrative set up has increased its intensity and coverage. There has also been extensive increases in government functions. It has to expand its activities in the field of various welfare measures such as providing social security and attempting redistribution of income and wealth.

We must indeed note that Wagner's Law is applicable to only progressive states i.e., those in which the government was interested in expanding the public sector of the economy and undertake various activities for the general benefit. Moreover, Wanger was not concerned with the mechanism of increase in public expenditure. Since his study is based simply on historical experience, the precise qualitative relationship between change in public expenditure and the time taken has not been put in any functional manner. In other words, the fact that over a period of time public expenditure has been increasing, could not be used to predict to that extent to which they public expenditure would actually change in future.

2. Wiseman Peacock Hypothesis

The Second important theory that seeks to explain the growth of public expenditure as been put forth by Wiseman and Peacock in their study of public expenditure in the U.K. for the period 1890-1955. The essence of this theory is that the public expenditure, though it does grow over a period of time, does not increase in a smooth manner but in jerks or step like fashion. The argument is that at some particular time a social or other "disturbance takes place and necessitates and increase in Government expenditure which the prevailing or existing public revenue cannot meet". There takes place what has been called "displacement effect". The government and the people cry to find a solution of the problem and agree to form the older level of expenditure and taxation to a new and higher level. People attain a new level of 'tax tolerance'. The public expenditure and taxation get stabilized at a new level till another disturbance occurs to cause a displacement effect. Since each major disturbance leads to the government assuming a larger proportion of the total economic activity, the next result is the concentration effect.

The Wiseman Peacock hypothesis appears quite convincing. In fact the British data are consistent with this finding. But it must not be forgotten that the two authors have actually emphasized the recurrence of abnormal situations which leads to sharp increase in public expenditures and revenues. The data from most of the other countries show only a constant and regular increments in public expenditures.

V. Causes of Increase in Public Expenditure:

The various causes of increase in public expenditure all over the world may be put as follows:

(i) Wars:

The most important single factor in pushing public expenditure upward has been the preparation for wars. The constant international tensions arising from super-power rivalry have almost forced countries to be heavily armed all the time. This involves huge costs. Besides, the progress of the military, the progress of sciences has been very rapid so that the rate of obsolescence of thewar machines is very high. Moreover, defence expenditure includes not only expenditures on men and materials during the wars but also pensions to war veterans and interest on war debt.

(ii) The Emergence of Welfare State:

Till 19th century, the State was basically a state primarily interested in the protection against the external aggression and maintenance of internal law and order. But a modern state is a Welfare State whose main function is to promote social, economic and political well-being of its citizens, As a result of this there is a fundamental change in the nature of the State, the modern governments have to perform a larger number and variety of functions with a view to change the content of the social and economic life of the citizens. The special welfare activities such as old age pensions, sickness and accidents benefits, unemployment relief, free or cheap medical aid, subsidised food and housing involve large expenses. Incidentally the increasing functions of the State have also led to the creation of large bureaucratic and administrative machineries which also involve huge volume of public expenditure.

(iii) Democratic Institutions:

A modern state involves large number of democratic institutions. It has to incur expenses on elections, legislature and cabinets. It has also to maintain diplomatic and consular relations with all other countries. Moreover, most of the modern states are members of international organisation such as United Nations

Organisation, International Monetary Fund and the World Bank etc. This also involves huge expenditure.

(iv) Role of Economic Planning:

In almost all the countries the state government has adopted the planning in one form or the other to accelerate the pace of economic growth. This has substantially increased the expenditure.

(v) Growth of Population and Rise of Towns:

An important factor that has led to increase in public expenditure has been the rapid growth of population and the increased concentration of the people in the towns. Naturally when population increases government expenditure on essential services must increase. For example, there will be more children to educate and more old persons to care for. The continuous process of urbanisation also imposes additional responsibilities on the government and leads to larger expenditures on services such as protection of life and property, transportation, public health, sanitation, play-grounds, organised recreations, etc.

(vi) Collective Satisfaction of Wants:

Many wants which were formerly satisfied through private expenditure are now satisfied collectively through government expenditure. Thus services like city transport, water supply and lighting prove inconvenient or uneconomical when provided on private or competitive basis. With a view to avoid duplication and wastage an also to reap the economies of large scale production, the satisfaction of these wants has been taken up by public bodies.

(vii) Socialisation of Industries:

Another factor responsible for the increased public expenditure has been the policy of nationalisation followed by most governments in recent times. The payment of compensation and the setting up and running of large scale establishments involve large expenses.

(viii) Economic Fluctuations:

As already noted public expenditure has been found to be a very useful tool of fighting cyclical fluctuation in income, employment and other economic variables. Consequently whenever a decline in employment takes place, Government expenditure on public works and other projects is increased with a view to provide employment to those who are unemployed and also to raise the level of business activity in the country.

(ix) Promotion of Economic Development:

In the under-developed countries of the world, the governments have been virtually forced to play an active role in starting the process of economic development. This requires large expenditures not only on the provision of infrastructure such as power, transport and communication but also on directly undertaking industrial enterprises and helping production in the private sector.

VI. Public Expenditure in India:

Like all other countries, in India also there has a continuous upward trend of public expenditure. This tendency has been marked since independence and particularly since 1950-51 when we started with the process of economic planning. The following Table clearly indicates the rapid expansion in public expenditure in India.

	I 1951-56	II 1961-66	III 1961-66	3 annual 1966-69	IV 1969-74	V 1974-79	VI 1980-84	VII 1985-90	VIII 1992-97
1.Agriculture and allied sector	15	12	12	17	15	12	14	14	14.7
2. Irrigation and Power	30	19	22	24	27	29	39	36	34.11
3. Industries	5	24	23	25	20	24	15	13	10.8
4. Transport and Communication	26	27	25	19	20	18	17	17	21.8
5. Social Service	24	18	18	15	18	17	15	20	18.6
6. Total Expenditure	100	100	100	100	100	100	100	100	100
7. Real Expenditure (Rs. Crore)	1,960	4,672	8,577	6,625	15,779	39,469	10,467	22,1435	---
8. Total Plan	2,400	4,800	7,500	6,625	15,902	39,350	97,500	1,80,000	4,34,100

Source : Economic 1993-94, 1995-96.
Surveys

The Data given above clearly indicate that the expenditures incurred by Government of India have grown 113 times from Ist to VII Plan. The same is true for the expenditure of the State Government. Total expenditure of union government in 1999-2000 was Rs. 3,03,738 crores. Actually quite a few factors which have already been noted as causes of increase in public expenditure all over the world have been in operation in our country have been in operation in our country also. As is well known, India was under foreign rule till 1947. The foreign Government naturally did not undertake any comprehensive programme of economic and social reconstruction. Consequently, the government expenditures were not very large. With the advent of the independence many factors operated to increase the government expenditures in the country. The establishment of an independent democratic state involved various expenditures. The administrative services had to be strengthened. The constitution of India also laid the basis of a welfare state. This led to expand social responsibilities of the Government. The introduction of economic planning led to increasingly large expenditures on various development projects at the Central as well as the State levels. The Chinese aggression in 1962 and three Indo-Pak conflicts of 1948, 1965 and 1971 led to a substantial increase in defence expenditures. In 1980-1981, the defence expenditure was Rs. 3604 crores. This had gone up to Rs. 18,835 crore during 1995-96 and to Rs. 35873 croes in 1999-2000. Subsidies had shot up from Rs. 1851 crores in 1980-81 to Rs. 25692 crores in 1999-2000. The defence expenditure further increased to Rs. 42597 crores in 2003-04. The increasing prices have also led to higher costs of administration, defence etc. As a result of all these factors, there has been a steady upward trend in public expenditure in India.

Long answer type questions:

1. Discuss briefly the causes of the growth of Public activities.
2. Explain in detail theories of increasing state activities.
3. Discuss the significance of Public Expenditure in a modern economy.

Short answer type questions:

(i) Compare Public Expenditure and Private Expenditure.

(ii) What is significant of Public Expenditure?

(iii) What is Public Expenditure?

(iv) Explain Wagner's Law of Increasing State Activities.

(v) Explain Wiseman Peacock Hypothesis.

LESSON NO. 2.3 **AUTHOR : DR. HARVINDER KAUR**

CLASSIFICATION OF TAXES

2.3.1 Introduction

Taxes constitutes significant part of public revenue in modern public finance. A tax is a compulsory contribution imposed by a public authority. There is no direct quid pro-quo between the tax-payers and public authority. In other words the tax-payers cannot claim reciprocal benefits against the taxes paid. The tax-payers do get many benefits from the government but no tax-payers has a right to claim any benefit. From the public expenditure may go to any one irrespective of the taxes paid. Anyhow, taxes have been classified in various ways on different basis such as the form, nature, essence and method of taxation.

2.3.2 Kinds of Taxes

Following are the different kinds of taxes:

1. On the basis of form:
   - (a) Direct taxes
   - (b) Indirect taxes
2. On the basis of nature:
   - (a) Income tax
   - (b) Expenditure Tax
   - (c) Property tax
   - (d) Taxes on commodities and services
3. On the basis of essence:

(a) Ad valorem tax
(b) Specific tax

4. On the basis of method:
(a) Proportional tax
(b) Progressive tax
(c) Regressive tax

1. Direct and Indirect Taxes:

A common classical adopted in taxation is direct and indirect taxes, but different authors have defined direct and indirect taxes in different ways. According to one notion, the distinction between direct and indirect taxes lies in the difference in relationship between the taxing authority and the tax-payer.

Direct taxes are taxes on income, the taxing authority assesses the liability directly on each tax payer, whether a person or a business, according to their specific circumstances. They then pay the tax directly to the authority.

Indirect taxes are taxes on consumption, liability to the tax is determined by the tax payers themselves, since it depends on what and how much they buy. The assessment in the first instance may be on the manufacturer or distributor but the tax is finally paid by the consumer. The method of tax payment is, however, indirect since it is the supplier who hands the money over the taxing authority. In other words, the impact and the incidence of a direct tax are on the same person, while the impact and incidence of indirect are on different persons. Prof. Shirras distinguished the direct and indirect taxes as those levied immediately on property and income of person and those are paid by the consumers to the state directly are called direct taxes. On the other hand, those taxes which affect the income and property of people through their consumption may be called indirect taxes.

In the group of direct taxes thus income tax, wealth tax, property tax, estate duties, capital gains tax, capital levy may be included. While commodity taxes or sales tax, excise duties etc. may be grouped as indirect taxes.

2.3.3 Merits and Demerits of Direct and Indirect Taxes:

Direct taxation has a number of advantages:

1. The important direct taxes i.e. taxes on income and property, can be made conform to the principle of ability-to-pay as they can be graduated at progressive rates.
2. Direct taxes are certain in the sense that the tax payers are individually identifiable and the rates of tax, allowance and the time of payment are pre-determined and known to them.
3. Direct taxes can be regarded as convenient if these are levied on pay-as-you-earn basis, since the tax payment coincides with the receipt of an income.
4. The incidence of tax cannot be shifted by the person on whom the tax is assessed. The taxing authorities can, therefore, establish that on whom the tax burden falls.

5. Direct taxes are also elastic i.e. the government's revenue can be increased simply by raising the rates of taxation.
6. Direct taxes reduce income but leave the decision on how to allocate the after tax income saved and spent on consumption are not distorted by taxation.
7. Finally, direct taxes are supposed to have an educative effect. The tax-payer is conscious that he provides funds to the governments, and is interested in seeing that they are properly utilised. Thus he is likely to be more mindful about his rights and responsibilities as a citizen of the state.

Conversely, the demerits of direct taxation include the following:

1. Direct taxes have an adverse effect on the will to work and save.
2. Direct taxes are often inconvenient because numerous accounting and other formalities have to be observed. Sometimes, the tax-payers have to pay a large amount of taxation in lump sum. Because, the payment of these taxes in lump sum is not as convenient to the tax-payer as the frequent payment of small amounts of indirect taxes.
3. Direct taxes are expensive to collect, as each tax-payer has to be directly contacted by the revenue authorities.
4. There is always a possibility of tax evasion in case of direct taxes.
5. Direct taxes have a psychological effect. Tax payers are more conscious of direct than of indirect taxes. They can legally reduce their liability only by reducing their income. The resistance of direct taxes can manifest itself in a variety of ways: encouraging the black money, a preference for leisure over work, a vote at the next election against a government that had become unpopular by levying direct taxes.

The Merits of Indirect Taxes are:

1. They are convenient to pay than the direct taxes, as these are paid in small amounts and at intervals instead of in one lump sum.
2. A consumer as little scope of evading indirect taxes on consumption since they are included in the price of goods and services.
3. Indirect taxes are psychologically less painful to pay since the satisfaction derived from the consumption compensates to some extent for the sacrifice of paying tax. The burden of an indirect tax is less felt as it is hidden in the price of the commodity.
4. Indirect taxes can be more progressive in nature if the luxurious commodities are heavily taxed and the essential commodities are exempted from tax.

The Demerits of Indirect Taxes are:

1. Indirect taxes are regressive, as relatively, a larger burden is imposed on the poor.
2. Indirect taxes lead inflationary forces. Direct taxes take away a part of the purchasing power of the tax payers and that has the effect of reducing demand. Indirect taxes begin by adding to the sale price of the taxed goods without touching the purchasing power. So the result is that in their case inflationary forces fed through higher prices, higher costs and wages and again higher prices.

3. Indirect taxes discourage savings, as the cost of living is raised by them.
4. Indirect taxes cannot be elastic unless they are imposed on articles of common consumption.
5. Indirect taxes lose direct link between the tax-payers and the public authority.

2.3.4 Comparison between Direct and Indirect Taxes:

Direct and indirect taxes can be compared on the basis of welfare, administrative and distributive aspects.

Welfare Aspect: Miss Joseph Hicks and others have maintained the superiority of direct taxes over indirect ones from the point of view of welfare aspect. The tax-payers have to undergo lesser amount of satisfaction in the case of direct taxes. On welfare grounds, therefore, direct taxes are supposed to be superior.

Administrative Aspect: From the point of view of administrative cost, efficiency and productivity, indirect taxes are better than the direct taxes. It is maintained that in under-developed countries owing to general poverty of the masses, direct taxes cannot cover many people and hence cannot yield large amount of tax revenue to the Government. Indirect taxes are equally levied on every person, their collection is convenient in small amounts and their cost of collection is constant over time.

Distributive Aspect: Direct and indirect taxes can be compared on the basis of distributive aspect. Direct taxes are regarded as superior to indirect taxes in reducing inequalities. But indirect taxes can be made progressive by levying them on luxuries and items of conspicuous consumption.

Broadly speaking, indirect taxes, and direct taxes are complementary to each other. Every tax system has both direct and indirect taxes.

Self check exercise

(Q1) What is a tax?

(Q2) Distinguish between a tax, fee and price.

(Q3) Distinguish between direct tax and indirect tax.

2.3.5 Different taxes and their advantages

1(a) Income Tax:

Income tax is the most important tax of all taxes and with the application of progressive rate schedule, provision of an exemption limit and incorporation of a number of incentive provision; it can be made not only to satisfy all the canons of a sound tax system but may also go a long way in realising variety of socio-economic objectives set out by the economic system. Due to all these factors, taxes on income have assumed increasing importance in the structure of direct taxation.

Income taxes are either universal or partial. Partial income taxes may be uniform, quasi scheduler, or scheduler. In the universal income tax, everyone at least files a return. This is the mass income tax initiated during World War II. The universal income tax also happens to be uniform, in the sense that a single (progressive) rate schedule is employed.

The partial income tax allows personal exemptions so high relative to the medium household income that only a minority of households pay the tax. Almost all wage payments and most salary payments are exempted. The tax is virtually on property income, including income from human capital and on economic rent. If a single progressive rate scale is used, it is a uniform partial income. If differing rate schedules apply to different types of income. It is a scheduler partial income tax.

Scheduler rates are commonly supplemented by a progressive rate scale applicable to the tex-payer's total income from all sources. If the progressive rate scale is heavy and if the scheduler rates are low and proportional, not far from uniform, then the tax is only a quasi-scheduler income tax.

Advantages of Income tax: Income tax conforms to the principle of ability-to-pay. For the same reason it is also a powerful instrument for reducing inequalities in the distribution of wealth. Its incidence can be located, as the maintenance of economic stability, both in periods of boom and depression. a tax on income, like any other taxes, it does not compel the tax payee to reduce is expenditure in any particular direction.

The main drawback of the income tax is that it reduces the incentive to save and invest more than other taxes, if it is very sharply progressive. This danger cannot be over-emphasised.

(b) Expenditure Tax

The expenditure tax means, as the very name implies, a tax upon a person's total spending minus any deductions allowed by the law.

A progressive rate on a household's total consumption expenditure can be either a supplement to the income tax or a substitute for it. As a supplement, it is imposed on a wealthy few, chiefly to penalise consumption that is demand extravagant, or to reach indirectly to that income obtained in forms that escape the income tax, notably capital gains. In this form the expenditure tax yields an insignificant amount of revenue.

As a substitute for the income tax including tax or a corporation income tax, the expenditure tax becomes either a mass expenditure tax or a uniform but partial expenditure tax. No experience is available for either of these two types.

Personal expenditure tax is considered as one of the indices of ability to pay and therefore, a suitable base of determining the tax liability. In underdeveloped countries it claims its worthwhileness by providing an encouragement to savings and investment. The consumption expenditure can be computed simply by subtracting from income the households increase in net worth. In practice, however, this would be a formidable task. A more feasible procedure would be to determine the tax-payer's annual consumption in accordance with the following schedule (a) Bank balance at the beginning of the year; (b) minus net investment (costs of assets purchased minus proceeds from assets sold);

(c) minus bank balance at the end of year; and (d) consumption expenditure during the year.

But an expenditure tax would pose difficult problems. It would be crucial that there will be a complete recording of cash balance at the outset. Otherwise, tax-free consumption might be financed later by withdrawing such balance. Inclusion of imputed consumption e.g. housing and home grown food might be needed to obtain a meaningful tax base, especially at the lower end of the scale, so that computation problems cannot be overlooked as readily as it is under the income tax. Borrowing must be accounted for. A more serious difficulty would arise in drawing a line between consumption and investment.

Another objection to the expenditure tax is that its administration is likely to be very difficult. Assesses would have to maintain complicated accounts, whatever system of assessment may be adopted. Evasion of tax may also be difficult to check.

India and Sri Lanka have experimented with a general expenditure tax but India's experience with regard to revenue potentialities of this fiscal instrument was not at all encouraging. It led to a large scale evasion and avoidance of taxation and it was considered to be a vexatious instrument of taxation. It has a chequered history in the Indian Fiscal System. It was abolished with effect from the beginning of the financial year 1962-63, but was reimposed with effect from 1964-65, and was again abolished with effect from 1966-67.

In conclusion, it may be said that theoretically there is a good deal to be said in favour of the tax from the point of view of both equity and incentives, but the practical difficulties in its imposition are considerable.

(c) Taxes on Capital or Property:

For tax purposes, capital means all forms of marketable wealth. It consists of the stock at any moment of (a) physical goods including real property (i.e. land and building) and moveable property, e.g. furniture, jewellery etc; (b) securities, including government bonds; and (c) money. Capital taxes have great importance. As a criterion of a person's ability-to-pay, income is probably a better measure than ownership of property. Property or capital taxes can also be valuable instruments for bringing about a more equal distribution of wealth by levelling down fortunes.

Arguments against taxes on capital are mainly on economic and political grounds. In a complex economic system such taxes are difficult and expensive to assess and to collect. At a time of inflation the taxes are likely to become unfair. In so far as they discourage savings capital taxes reduce the supply of capital to industry. Their adverse economic consequences cannot be ignored.

The main capital or property taxes are capital transfer tax, capital levy and wealth tax:

(i) Capital Transfer Tax:

As the name implies it is a tax on the transfer of capital. The tax is in the nature of the death duty when the transfer is the result of legacy and is treated as gift tax when the capital is transferred during the donor's life. Capital transfer taxes are levied on the basis of the two estate and the inheritance principles.

(ii) Capital Levy:

A Capital levy establishes a heavy tax liability according to property ownership as of one date. Tax payment is normally spread out over a decade or two. Any particular property owner's total liability will usually be so large that he could not possibly meet it even by restricting his purchase of resources for the year to year. Imposed on a once for all basis, such levies have been used by various governments in emergency situations such as war time or post adjustment.

The main argument in favour of capital levy is that it would mean a considerable reduction in the volume of public debt and consequent reduction in the burden of taxation.

(iii) Wealth Tax

Wealth tax can contribute a major part to the tax system as it has not disincentive in its effects as the income tax and it is and effective means of reducing inequalities of distribution. It is an important State Tax in the USA. In India it was introduced in 1957.

This is a tax on the ownership of wealth as distinct from a tax on its transfer. It can be in the form of an annual tax or of a once for all tax such as the wealth tax imposed in Poland in 1975. The nature of wealth taxes also differs depending upon the way that a government intends that the tax liability would be met. These are: An additive wealth tax and A substitutive wealth tax. An additive wealth tax is one that can only be paid by sale of some assets. A substitute wealth tax is fixed at such a level that a tax payer has a choice of paying it out of capital or out of annual income.

(d) Taxes on Commodities and Services:

Indirect taxes are taxes on consumption of commodities. The main categories of various taxes on commodities are customs and excise taxes, purchase or sales taxes and value added taxes. Commodity taxes may be one of the useful instruments for regulating consumption e.g. taxes on injurious commodities.

(i) Customs and Excise Taxes:

Customs are taxes levied on internationality traded goods. They may be export duties on goods going out of the country or import duties on goods coming into the country. Custom duties are regarded revenue earning duties if the primary objective is to raise revenue. Protective duties: If they are used to protect home industries from foreign competition in home markets by making imported goods more expensive. Preferential duties: If they are intended to favour particular countries so as to encourage trade between them or to create special relationship, as, for example, between members of the British Common Wealth or the European Economic Community. Different rates of duty are then charged depending on the area of origin of the imports.

Excise taxes are revenue duties on home produced goods that are imposed to match custom duties on imported goods.

(ii) Purchase or Sales Tax:

The Sales tax is levied upon and collected by the government from the seller, while a purchase tax is levied upon the collected from the purchaser. A general sales tax, however is imposed on the sale of all commodities except those which may be specially exempted by the government. Sales taxes have this advantage over income tax that they would catch persons who are able to avoid income taxes. They also tend to catch expenditure out of accumulated wealth and out of capital gains which may be effectively taxed in underdeveloped countries through other forms of taxation. Sales taxes discriminate against consumption and in favour of savings because they reduce the ability to spend by taking money away from consumers and they lessen the incentive to spend since tax liability can be reduced by saving more and spending less.

The General Sales Tax may take several forms:

(a) Turn-over Tax (b) Manufacture's Sales Tax (c) Wholesaler's Sales Tax (d) Retail Sales Tax.

(a) Turn-over Tax: Under the turn-over tax, a product is taxes repeatedly as it moves through the stages of production and distribution. As a result, the tax base is a multiple of G.N.P. and high yields can be obtained at very low rates. General sales tax refers to the turn-over tax. And a turn-over tax refers to the multi-point sales tax.

(b) Manufacturer's Sales Tax: A single stage tax is imposed at only one point of sales. It is imposed at the point of sale by the producer. Manufacturer's Sales Tax is levied on the basis of two principles: the Origin Principle and the Destination Principle. Taxation at the manufacturing level as per the origin principle permits inclusion of exported goods which are consumed abroad and excludes imported goods which are produced abroad. Taxation at the retail stage as per the destination principle does the opposite.

(c) **Wholesaler's Sales Tax:** A wholesaler's tax is a modified form of manufactures sales tax. A manufacturer can by-pass a wholesaler, a wholesaler cannot by-pass a manufacturer.

(d) **Retail Sales Tax:** The retail sales tax is a single stage tax. In the retail sales tax only those dealers are taxed who are retailers i.e. who sell to the ultimate consumer.

The retail sales tax is well-suited to the destination principle. All imports other than by ultimate users can be allowed to enter free of any import tax; the imported goods will be fully taxed as they pass from the domestic retailer to the domestic user.

(iii) **Values Added Taxes:** Value added taxes are levied on both goods and services and are general turn-over taxes on consumption. They are imposed throughout. the European Economic Community (EEC). This is a tax imposed on the value of that part of a firm adds to the goods and services that if part of a firm adds to the goods and services that it purchase from other firms. The product is then sold at a higher value than the value of the purchased goods and services. The Indirect Taxation Enquiry Committee, which is popularly known as L.K. Jha committee (1976) defines Value Added Tax as "Value added Tax (VAT) in its comprehensive form is a tax on all goods and services (except export and government services). Its special characteristic being that it falls on the Value added at each stage from the stage of production to retail stage."

The value is thus the difference between the costs of materials etc. purchased from other forms on the one hand and its own sales proceeds on the other, at each stage in the chain of transactions i.e. manufacture, wholesale, retail etc. This difference is that base of the value added tax. There are three important varieties of value added tax:

(i) **Gross National Product (GNP) Type:** The effective base of the tax is the GNP of the country. At each stage, the tax base would thus be equal to sum of depreciation, wages, interest, profit and rent.

(ii) **Income Type:** In this case, the tax base is sales minus materials minus depreciation for each firm. The aggregate tax base would be net national product.

(iii) **Consumption Type:** The consumption type differs from that of the income type so that while the latter permits the firm to deduct depreciation, the former permits it to deduct gross investment i.e. purchase of capital goods.

While computing the tax base which constituted the primary tax in administering any tax system, capital outlays are exempted under the net income type VAT, only depreciation is allowed for deduction under the net type of VAT and no capital outlays not even depreciation provision are exempted under the gross product of VAT.

Comparison of VAT and Sales Tax

Sales tax or a multi-stage turn-over tax or a cascade tax is levied every time the commodity changes hands, on the price at which the transaction takes place. As against this, VAT is assessed only on the incremental value added at each stage to the commodity since the last taxable transaction. Thus it is a tax, the total of which remains the same no matter how many transactions take place during the process of production. As compared with the sales tax VAT, (an ad Valorem, comprehensive, single-point, uniform sale tax), is a far better tax. In developing countries as a complete substitute for a sales tax, a value added tax has following advantages:

(i) Administrative advantage
(ii) Promotion to economic growth
(iii) Instrument of planning
(iv) Promotion of economic efficiency, and
(v) Healthy effect on exports.

(i) The value added taxation offers the advantage of administrative simplicity as compared with other general taxes for which it may be substituted. Even the most comprehensive value added tax would involve a much smaller number of tax payers than the personal income tax and as a result its administrative and compliance costs are less than those of a persons income tax.

(ii) A consumption type of value added tax would be more favourable to economic growth as compared to either a retail sales tax or a general turn over tax because the latter also taxes investment goods, which are exempted under the former.

(iii) Another advantage is that of lesser tax evasion. This happens because records of sales, purchase and tax payments have to be kept at each stage of the transactions and therefore cross checking of information and records is possible.

(iv) If the value added taxes were introduced incomplete substitution of a retail sales tax, it would provide a definite incentive to exports. This is because under a value added tax all home sales would be liable to his tax while experts would escape. This would help the developing countries in increasing their export earnings, thus easing the pressure on their balance of payments and contribution to the acceleration of their rate of growth.

(v) The VAT will constitute a dynamic part of the tax system. The VAT is the most obvious choice for a tax to vary in response to short-run economic fluctuations. It can be raised or lowered as the situation demands more quickly and easily than many other taxes. Thus the VAT can constitute an important instrument of development finance and economic stabilisation in developing countries.

While the VAT has some advantages, there are some difficulties too. VAT is not an easy system to adopt, especially in an under-developed economy. It is a complication system and needs an efficient and honest government machinery to do the cross checking and link up various production activities and the resulting tax liability of each firm.

2. Specific and Ad-valorem Taxes

According to the method of assessment taxes on commodities may be classified into two types: specific and ad-valorem.

(a) **Specific taxes:** Specific tax are based on specific qualities or attributes of goods. These are generally assessed on the weight, number of volume or the commodity taxed e.g. specific excise duty may be levied on the cloth in the length units and tax on the sugar is based according to the units of weight. The tax on television is to be based on size.

Specific taxes are easy to calculate and administer.

(b) **Ad-valorem taxes:** Taxes which are levied entirely on the basis of money value of the goods are called ad-valorem taxes. Several imported article are taxed in term of value and they have nothing *to* do with the size, length and weight of the commodity.

The ad-valorem taxes are equitable in incidence as they are based upon the value of article so that canon of ability-to-pay is fulfilled.

Specific taxes are aggressive in character as the same specific tax is levied on different types of goods, so it puts more burden on poor section than on the rich. Thus, from equity point of view, ad-valorem taxes are preferred to specific taxes.

5. Discuss merits and demerits of direct and indirect taxes.
6. How are tax systems classified with reference to the relationship between tax and tax base? Which one of them is superior? Why?
7. Make a case for progressive tax system.
8. Discuss the role of indirect taxes in a developing country like India. Why do such countries rely heavily on direct taxes.

3. Proportional Progressive and Regressive Taxation:

A tax may be proportional, progressive or regressive according to the relationship between its rate structure and the income, wealth or economic power of the payer.

(a) **Proportional taxes:** A Proportional tax is one in which the rate of tax remains the same though the tax base changes. In this system all incomes are taxed at a uniform rate of taxation. If income is doubled, the tax amount is also doubled. It is illustrated with the help of following table 1:

TABLE 1

Tax base	Rate of Income Net Income	Amount of Income (Rs.) (Rs.)	Tax (%)	Tax Payable
1000	10	100	900	
2000	10	200	1800	
3000	10	300	2700	

The above table clearly indicates that if the gross income of individual is double then the net income after paying the tax is also double. Following diagram also explains similar position of proportional tax rates:

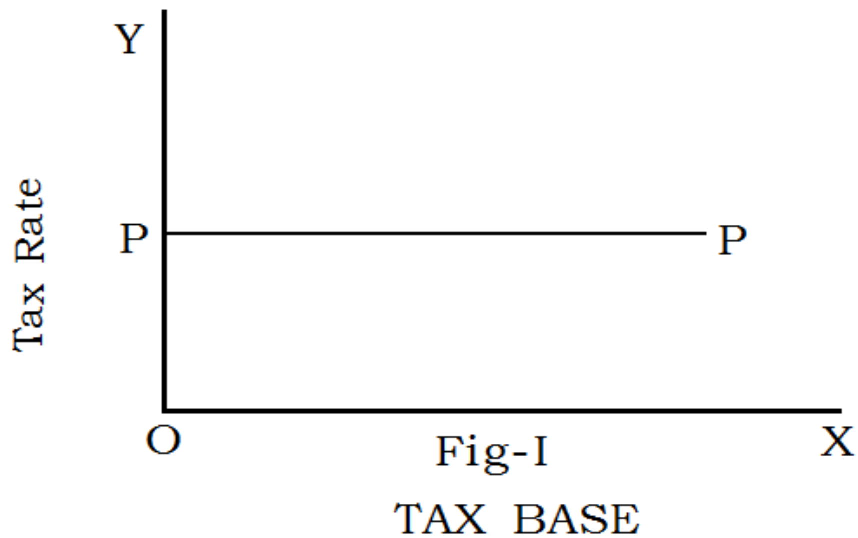

Fig-I

In Fig. 1 tax rate OP remains constant without affecting the tax base.
This tax system does not bring any socio-economic structural change in the society because all the tax payers pay at constant tax rate. This system does not reduce the inequalities of income and wealth but widens the gap between the rich and the poor.

(b) **Progressive taxes:** A tax called progressive when with increasing income the tax liability not only increase in absolute terms but also as a proportion of the income. It can be shown with the help of a table and diagram.

TABLE 2

Taxable Income of Individual (Rs.)	Rate of Tax (%)	Amount of Tax Payable (Rs.)	Net Income after payment
5000	10	500	4500
15000	20	3000	12000
25000	30	7500	17500

It is clear from Table 2 that with the increase in income tax rate will also increase accordingly.

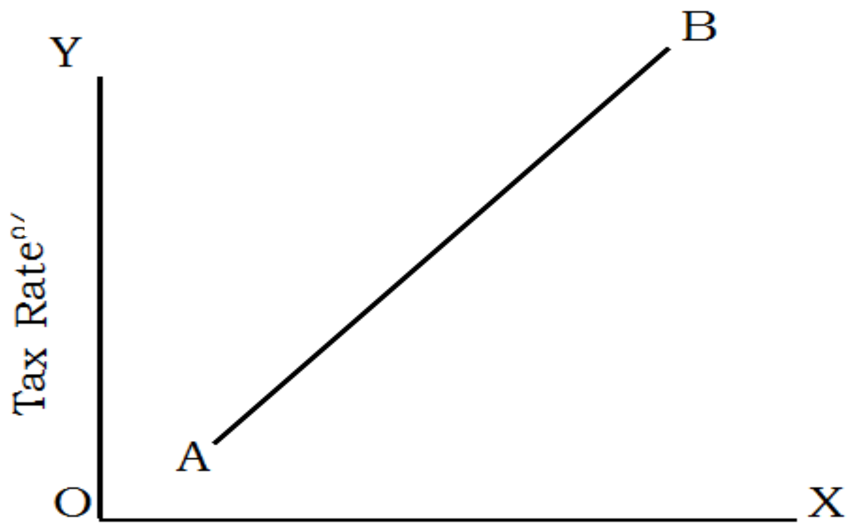

fig.-2

In the fig. 2 AB line shows the progressive rate of taxation. At every individual income there is a different tax rate.

The progressive tax on income affects the process of economic growth by modifying these propensities the incentive of propensity to work to save and to invest. As regards the incentive to work, it is affected by a rise in marginal rate of income tax through the operations of the substitution and income effects. These effects reduce the net income of the tax payer and this operates in such a way as to make him economise in leisure and work more. In order to analyse the affects of high rates of tax income and profits on the quantity of capital and the rate of investment, it becomes necessary to take into account the behaviour of saving, the behaviour of inducement to invest, and the behaviour of enterprise and risk-taking. To the extent that high marginal rate of income taxation discriminated against saving and in favour of consumption, the volume of investible resources available to the private sector may fall leading to an adverse effect on the rate of investment in this sector. Besides a high tax on business profits may reduce the investible resources available to the private sector may fall leading to an adverse affect on th rate of investment in this sector. Besides a high tax on business profits may reduce the investible resources of the industries to the extent that it tends to reduce their retained profits and as a result, the effect on corporate investment may be adverse.

The progressive tax system is equitable and just a powerful tool for reducing inequality. This system is quite elastic because the state can change the rate of taxation for any particular time for collection of more funds. The main disadvantage of progressive tax system is that it retards capital formation.

(c) Regressive taxes ;

When the rate of tax decreases as the tax base increase the taxes are called regressive taxes. Regressive taxation is against the objective of welfare state and in modern times no government likes to adopt such tax policy. The system of regressive taxation can be represented with the help of a table and a diagram.

TABLE 3

Taxable Income (Rs.)	Rate of Income Tax (%)	Amount of Tax Payable (Rs.)	Net after the Payment of Tax (Rs.)
5000	15	750	4250
15000	10	1500	13500
25000	7	1750	23250

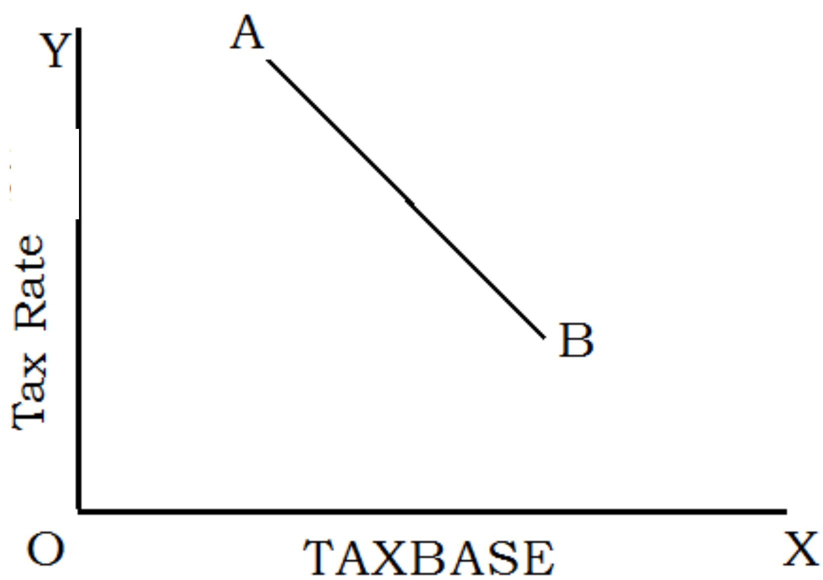

Diagram - 3

The table and diagram 3 show that as the ratio of income is increased, the (v) What is a tax?
burden of tax is falling more and more upon poor than on the rich. Thus regressive tax system is unjust and inequitable.

Degressive taxes: Another term "degressive taxation" is used to distinguished between certain forms of progressive rates. Degressive progression occurs when there is declining degree of progressive as the tax base increases.

Which tax system is most suitable?

Now, the question arises that which tax system is most suitable to the present democratic set up especially in the developing countries. Progressive tax is superior to the proportional and regressive taxes due to its productivity promotion of stability with growth and optimum social allocation of resources. Therefore, in the modern democratic set-up, progressive with proportion taxation is considered an alternative which can bring about equity in the distribution of tax burden.

Self check exercise

(Q1) Distinguish between progressive tax an regressive tax.
(Q2) Superiority of direct taxation over indirect taxation.
(Q3) What are specific and ad-valorem taxes?

2.3.6 Summary

In this lesson we have discussed taxes, kinds of taxes, merits and demerits of direct and indirect taxes, comparison between direct and indirect taxes and advantages of taxes. Direct taxes are taxes on income, the taxing authority assesses the liability directly on each tax payer, whether a person or a business, according to their specific circumstances. They then pay the tax directly to the authority. Indirect taxes are taxes on consumption, liability to the tax is determined by the tax payers themselves, since it depends on what and how much they buy. The assessment in the first instance may be on the manufacturer or distributor but the tax is finally paid by the consumer. The method of tax payment is, however, indirect since it is the supplier who hands the money over the taxing authority. In other words, the impact and the incidence of a direct tax are on the same person, while the impact and incidence of indirect are on different persons.

2.3.7 Short answer type questions

Q.1. What is tax ?

Q.2. Distinguish between tax, fee and price.

Q.3. Distinguish between progressive and regressive taxes.

Q.4. What are spscific and ad-valorem taxes ?

2.3.8 Long answer type questions

Q.1. Discuss merits and demerits of direct and indirect taxes.

Q.2. How are tax systems classified with reference to the relationship between tax and tax base? Which one of them is superior? Why?

Q.3. Make a case for progressive tax system.

Q.4. Discuss the role of indirect taxes in a developing country like India. Why do such countries rely heavily on direct taxes.

2.3.9 Recommended books

1.	Huge Dalton	:	Principles of Public Finance
2.	Richard A. Musgrave	:	Theory of Public Finance
3.	H.L. Bhatia	:	Public Finance
4.	B.P. Tyagi	:	Public Finance
5.	A.R. Prest	:	Public Finance
6.	R.A. Musgrave and	:	Public Finance in Theory and P.B. Musgrave Practice
7.	R.J. Chelliah	:	"Trends in Taxation in Developing Countries." IMF Staff Papers, July 1971. An excerpt re-printed in G.M. Meier (ed.) Leading Issues in Economic Development (1976)
8.	C.S. Shoup	:	Public Finance
9.	P.E. Taylor	:	The Economic of Public Finance
10.	Findlay Shirras		Science of Public Finance.

LESSON NO. 2.4

CANONS OF TAXATION

2.4.1 Introduction:

A tax is a compulsory levy and has no quid-pro-quo. It is not a price paid by the tax-payer for any definite good or service supplied by the government. A tax payer is not entitled to pay benefit on account of the said tax. A pure tax, therefore, is not the same thing as a fee or a rate. A fee or a rate (such as water rate) is related to the use of a given service though the payment may have no relation to the value or cost or benefit of the said service. In other words, the said payment is likely to have an element of price in it, as also an element of tax. A fine is also a compulsory payment; but it is not a general levy like tax. It is imposed to induce fined individual, to follow certain social and other lines of behaviour.

It is possible that the authorities in selling a good to the public at a price may be mixing an element of tax in it. The authorities may compel the public to choose the consumption of a certain service (such as street lighting) and then charges in excess of the legitimate price. We may also consider another source of public revenue with an element of compulsion in it, namely, the profits from paper currency and mintage. The actual cost of creating currency is much less than its face value. However, profits from currency and coinage is not like usual profits from other public undertakings. The public faces an element of compulsion in the sense that it has no option but to use the currency. In the same manner, it is a possibility that the authorities may be able to compel the capital market to subscribe to public loans at rate of interest lower than the market ones. Having understood the nature of a tax and seen that tax element may be present in so-called non-tax revenue also, we may say a word about the role and objectives of taxation. It should be remembered that taxation, to be ideal, is excepted to conform to certain objective of the society. Thus in the days of Adam Smith when the main task of economic development and capital formation was in private hands, taxation was judged on the basis of its coming in the way of free market mechanism. An ideal tax system was believed to be the one which caused minimum possible disturbance to the working of the economy. The canons of taxation provided by Adam Smith were based on the same principle. However, these days, it is recognized that taxation has more relevant role to play. In a modern economy, it must contribute towards maintenance of economic stability, towards reduction of income and wealth inequalities, and towards capital formation. In an underdeveloped country taxation is expected to help in removing regional disparities, to help executing development plans to correct balance of trade disequilibrium.

In absolute terms, the contribution of taxation to the total of public revenue has been increasing. It has been possible to do so through a steady extension of coverage and a revision of rates. At the same time economic expansion itself has contributed to this trend. Quite a few are closely to the level of economic activities. Thus as economic expansion takes place, revenue from income tax goes up more than proportionately because income tax is normally progressive in rates and people keep on moving into higher income slabs as economy expands. This trend is further strengthened if (and this is generally so) there is an inflationary pressure on prices. In India, we have witnessed this phenomenon over the last four decades. Almost ever year, the budgeted estimates of revenue from income tax have been exceeded by actual realization. This tendency is much stronger in the case of indirect taxation. We notice that revenue from excise duties has been rising very fast; in the cast of Central Government budget, its contribution has always been the highest. Similarly, the state has been experiencing a rapid increase in sales tax collections. It may be noted that in India, there has been and additional reason for indirect tax revenue to increase so fast. The central Government, having raised the rates of direct taxes to abnormal heights, found that it could no longer rely on direct taxes for an expanded coverage or for higher rates. On the other hand, indirect taxes offered unlimited scope in this direction. As a result, the Government has to come to levy indirect taxes on inputs and capital goods also, resulting in cost-cascading effects. The States, for reasons of their own, found it better not to use their powers to tax agricultural incomes, or enhance land revenue. They have also mainly on indirect taxes, mainly sales tax and excise duties.

Indirect taxes it may be pointed out, are considered more burdensome than direct taxes. We need not go into proof or otherwise of this contention. Suffice it to say that indirect taxes alter the relative prices of taxed goods and services and thereby distort resource allocation and also consumption. Further, indirect taxation is generally expected to increase income inequalities. Though we can draw models of indirect taxation in which luxuries are taxed and necessities are left out, yet in practice, it is mainly the necessities that get taxed for reasons of revenue. As a result, indirect taxes become regressive in character, i.e. their burden falls more on the poorer sections of the society.

2.4.2 Objectives of lesson

In this lesson we will study about :

I. Canon of Taxation

II. Features of a good tax system

2.4.3. CANONS OF TAXATION

Taxes are imposed according to certain principles. Adam Smith had laid down four canons of taxation which are still considered to be the foundation of all discussion on principles of taxation. These four canons are as under:-

(i) Canon of Equality or Equity

This is the most important canon of taxation. It lays the moral foundation of the tax system. According to this canon every citizen should pay taxes according to his ability to pay. It does not mean that every citizen or tax-payer should pay the same sum. Nor does it mean that every tax-payer should pay at the same rate. What this canon really means is, the equality of sacrifice. There will be equality of sacrifice only if the amount of tax to be paid is in proportion to the respective abilities of the tax-payers and, as the income increases the rate of tax also increase. It needs to be emphasized again that all the tax-payers should pay at the same rate. It neither implies that all the tax-payer should pay the same amount nor that they should pay at the same rate. In fact, according to this canon every one should be called upon to pay tax according to his ability to do so. Only a progressive tax will be in conformity with this canon.

(ii) Canon of Certainty

This means that the tax which each individual has to pay should be certain and not arbitrary. The tax payer should know how much he is to pay, how this amount is calculated, when and where the tax is to be paid. Absence of certainty about a tax leads to corruption. According to Adam Smith inequality of taxes is not as bad as uncertainty. Most of the economists consider this canon as the most fundamental canon. This is so because all attempts at equality will prove illusory without the taxes being certain. According to this canon there should be no element of arbitrariness in a tax. The tax-payer should be able to calculate the amount that he is called upon to pay. That is why tax proposals contained in a budget are given wide publicity, the passing of a budget is a guarantee of certainly.

It is often said that an old tax is no tax. This is so because every thing about an old tax is certain and well known and people have already made necessary adjustments. It, therefore, causes least disturbance in the economic arrangements ofthe tax-payer.

Certainty is not only useful from the point of view of the tax-payer as well as from that of the government. It enables the government to estimate the proceeds of the various taxes and the time when they are expected to flow in. As a result of this the government can chalk out its financial programs with greater certainty.

(iii) Canon of Convenience

This is another fundamental canon of taxation. According to this canon the convenience of the tax-payer should be kept in view while deciding the amount of tax and the manner and time of its payment. Thus, for example, and revenue is collected after the harvest because it is convenient for the land revenue is collected after the harvest because it is convenient for the farmers to make payment at that time. Indirect taxes are normally convenient to pay. The consumer pays them when he makes purchases for which he chooses his own time. Besides the tax is concealed in the price of a commodity and is paid when the consumer buys that commodity.

(iv) Canon of Economy

A tax is economical if the cost of collection as compared to the amount of the tax collected is less. If, on the other hand, the salaries of the staff engaged for collecting a tax take away a major part of the tax revenue, the tax is certainly uneconomical.

There is still another implication of this canon. A tax would certainly infringe the canon of economy if it retards the development of trade and industry. If the rate of income tax is unduly raised, it would adversely affect saving and accumulation of capital. As a consequence of this the productive capacity of a community will be impaired. This would be obviously uneconomical.

A tax is economical if it does not hamper the prosperity of country. Subsequently, other economists have added some canons of their own. Some of these are described below:

(v) Fiscal Adequacy of Productivity

It is necessary that the nature of taxes should be such that the tax proceeds are adequate to cover government expenditure and the government does not run into a deficit. To achieve this end, both direct and indirect taxes should be imposed and their rates should be such that financial stability is achieved. However, while levying the taxes, care should be taken that they do not adversely affect the productive capacity of the country.

(vi) Elasticity

The taxes should be elastic so that in emergency the government is in a position to augment its financial resources. If the tax system is elastic, the government can raise additional funds for economic development either by raising the tax rate or by imposing new taxes.

(vii) Simplicity

It is essential that the tax system should be simple and understandable to the people. If a tax system is complicated a great power will pass in to the hands of the tax collectors. This is bound to lead to corruption and oppression.

(viii) Diversity

This is another important principle of taxation. This requires that there should be a large variety of taxes so that, if due to certain economic causes, tax revenue from some of the taxes goes down, the other taxes bring in sufficient revenue. This will save the government from financial difficulties.

The tax system should be so planned that there are neither too few nor too many taxes. Besides, there should be an admixture of direct and indirect taxes so that all citizens are made to contribute to the exchequer in proportion to their capacity.

(ix) Compatability with Social and Economic Objectives:

The tax system should be compatible with the social and economic objectives that a community has placed before itself. These objectives normally comprise achievements of economic stability and full employment, equality of incomes and wealth and economic growth. Modern government attach great importance to this principle. Taxes these days constitute an important part of fiscal policy which is being increasingly used for checking inflation and for helping the economic development.

The most urgent need of developing countries is to accelerate economic development. Since most of the resource needed for development are to be raised through taxes, tax system is of a great importance. The tax policy should be such as strengthens incentives to saving and investment. The tax revenue in these countries is not meant only to meet day-to-day government expenditure. It is also used to augment the rate of investment. The tax system should be such as makes every citizen contribute it share to the resources for economic development. The aim should be to create an economic surplus for accelerating economic development. To achieve this end, it has to be ensured that increase in income leads to increase in saving and tax revenue and that burden of development is equitable shared by various sections of the people.

2.4.4. Characteristics of a Good Tax System?

An answer to this question will be found in what has already been written about the canon of taxation. A good tax system should conform to these canons. It is however, neither possible nor necessary that every tax should be in conformity with each of the canons. What is needed is that the tax system as a whole should be in conformity with these principles. To achieve this end the tax system should have following feature:

(i) Each person is made to contribute according to his capacity to do so.

(ii) The tax that each individual is to pay should be certain.

(iii) Convenience of the tax-payer should be kept in view.

(iv) The collection of taxes should not cost much and the tax systems should not have an adverse effect on the productive capacity of the country.

(v) The tax system should be so diversified that it brings an adequate revenue.

(vi) The tax system should be elastic.

(vii) The tax system as a whole should be progressive.

(viii) It should be simple so that it does not lead corruption.

(ix) It should be compatible with social and economic objectives of the community and it should help in economic development of country.

According to Kaldor a good tax system is that which is based on equity, which has no adverse economic effect and which is efficiently administered. From the point of view of equity it is essential that the tax system should not unduly advance economic interest of one section of society at the cost of those of another section. Again the tax system should not adversely affect the initiative of the entrepreneurs, the productive capacity of the country and the rate of savings and investment. The tax system should be efficiently administered to that the scope for tax evasion is eliminated.

Mrs. Hicks emphasized three principles of a good tax system. These are:

(i) Tax revenue should be adequate to finance public services;

(ii) People should be taxed according to their ability to pay; and

(iii) Taxes should be universal. This means that the tax system should not discriminate in any manner between citizens in the same financial position.

We can, therefore, say that a tax system is good if:

(i) There is an equitable distribution of tax burden;

(ii) Tax revenue is adequate:

(iii) The convenience and interest of tax-payers are kept in view; and

(iv) The tax system is flexible.

Self check exercise

Q.1. What are the Characteristics of a Good Tax System?

Q.2. Explain the canons of certainty, convenience and equity.

2.4.4 PROBLEM OF EQUITY IN TAXATION

We have already discussed the canon of equity or equality of the tax system. This is the basis canon. It requires that the burden of taxes should fall on those who can fully bear it. It is equitable that the people in the same economic position should be treated in the same way for the purpose of taxation.

In order to make a tax system equitable several principles have been suggested. We examine some of them below:

(2.4.4.1) Cost of Service Principle: It is said that the tax system would be equitable and just if people are charged taxes according to the cost of service rendered to them by the State. But there is no way of determining the cost of service of armed force and police to an individual. Hence even though it appear that this principle will provide a just basis for imposition of taxes, its application is difficult. In view of this we cannot base tax proposals on this principle. In fact, in case of most taxes, there is no direct quid pro-quo to the tax payer.

(2.4.4.2) Benefit Theory: Like the cost of service principle, benefit theory is also not much of practical use. We know that most of the public expenditure is for common benefits and therefore, it is very difficult to calculate as to how much benefit has accrued to a particular individual. There are few cases where benefit to an individual can be calculate, e.g. old age pensions, but even in such cases the theory is not applicable. We simply cannot ask the old age pensions. Taxes are in fact levied for common purpose and not for benefit of an individual.

(2.4.4.3) Ability to pay Theory: This is the most plausible theory of equity in taxation. It requires that every tax-payer should be made to contribute according to his ability to pay. The acceptance of this principle, however, will not solve our difficulties. The question that immediately arises is: What is the measure of a man's ability to pay?

To lay down a criterion for man's ability to pay, we can proceed on two lines: subjective and objective. According to the subjective approach, we have to take into consideration the sacrifice made by the tax-payer consequent form payments of taxes. On this point three distinct views have been advanced:

(i) The principle of equal absolute sacrifice.
(ii) The principle of proportional sacrifice.
(iii) The principle of marginal sacrifice.

According to the principle of equal sacrifice the money burden of taxes is to be so distributed as to impose equal real burden on the individual tax-payer. This would mean proportional taxation.

According to the principle of proportional sacrifice the real burden on individual tax payer is not be equal but proportional either to their income or to economic welfare that they derive from that. Those who can make a greater sacrifice should be asked to pay more. This would mean progressive taxation.

The principle of minimum sacrifice takes into consideration the body of tax-payer in the aggregate and not individually. According to this principle the total real burden on the community should be as small as possible. Since the marginal utility of money is less to the rich than to the poor, the aggregate sacrifice will be minimum only if the tax revenue from the people in the higher income brackets.

These principles of taxation have little practical importance because they are related to sacrifice which is subjective and therefore, difficult to measure. An objective method will be more useful to measure the taxable capacity. Expenditure and income can serve as very useful indicator of taxable capacity but even they will not enable us to make an exact estimate of taxable capacity. In spite of its limitations pointed out above, income is being used as the basis for assessment of taxable capacity.

In brief, we can say that tax system as a whole should be equitable and it should be able to promote trade and industry in the country.

2.4.5 Summary

In this lesson we have studied about canons of taxation and characteristics of a good tax system. A good tax system should conform to these canons of equity, certainty, convenience, economy, simplicity and productivity etc.. It is however, neither possible nor necessary that every tax should be in conformity with each of the canons. What is needed is that the tax system as a whole should be in conformity with these principles.

2.4.6 Short answer type questions

Q.1. What is a tax ?

Q.2. Write short notes on

(i) Canon of productivity

(ii) Canon of economy

(iii) Canon of elasticity

2.4.7 Long answer type questions

Q.1. Discuss the various Canons of Taxation. Are they conflicting? Explain.

Q.2. What, according to you, is an ideal tax system for India?

Q.3. What is a good tax system? Explain in detail.

2.4.8 Recommended books

1. Huge Dalton : Principles of Public Finance
2. Richard A. Musgrave : Theory of Public Finance
3. H.L. Bhatia : Public Finance
4. B.P. Tyagi : Public Finance
5. A.R. Prest : Public Finance
6. R.A. Musgrave and : Public Finance in Theory and P.B. Musgrave Practice
7. R.J. Chelliah : "Trends in Taxation in Developing Countries." IMF Staff Papers, July 1971. An excerpt re-printed in G.M. Meier (ed.) Leading Issues in Economic Development (1976)
8. C.S. Shoup : Public Finance
9. P.E. Taylor : The Economic of Public Finance
10. Findlay Shirras : Science of Public Finance.

LESSON NO. 2.5

BURDEN OF PUBLIC DEBT

I. INTRODUCTION: Public debt, has assumed a significant role in modern times. In recent years, Government's expenditure has been increasing faster than their ability to raise resources. It is so because now their activities are not so restricted as only to maintain law and order and protect the country against external aggression. Therefore, when expenditure exceeds revenue, there is a deficit in the budget of the government. This deficit can be bridged either by raising revenue from taxation or by borrowing from the public or by depreciating the value of money in the hands of the people. So far as taxation is concerned, both in development and the developing countries, there are certain limits beyond which taxation can not be raised without adverse effects on the levels of investment and production and consequently on the rate of economic growth. Further, the method of deficit financing by the creation of new money may be inevitable under certain conditions. But after a certain level, it leads to inflation and other evils. Moreover, it taxes the rich and the poor alike which is not desirable for the welfare of the community.

Therefore, the most appropriate method, preferred by all the states alike in mobilising their financial resources is the method of debt finance.

II. MEANING: Public debt is not fundamentally different from taxation. It may be defined as kind of deferred tax through which public enjoys the advantages of the public expenditure much before it is met out of the current revenue. It refers to those obligations of the states as a borrower and private investor of capital where state promises to pay the lender the amount borrowed with interest after a given period of time. It excludes inter-state borrowings within the country, unpaid salaries of public officials and pensions to be paid on retirement.

There have been different views regarding public debt. In the opinion of Hume and Adam Smith, debt was a cause in leading a nation towards disaster. A Government should normally meet all of its expenditure out of its current revenue and if really necessary. Then only under certain exceptional circumstances, a government could be justified could be justified in raising some resources through loans.

Harlod M. Groves mentions that on account of certain favourable conditions such as the appearance of money and credit economy, development of industry and trade, security of the creditors, etc. public borrowing has emerged as an important institution. Besides, in the developing countries it is used not only for meeting the huge wasteful war expenditure or for recovering the deficiency of effective demand but also for combating inflation generated in the process of growth. Thus, it ensures growth with stability.

Now-a-days public debt is regarded as income of the state. It is also a method through which the government may finance public services without reducing the real wealth of individuals.

III. JUSTIFICATION OF PUBLIC DEBT: Borrowing by the government has been increasing year after year and the public debt of a country has been mounting as a result of that. The increase in public debt has been mainly due to the failure of a government to live within its means on account of heavy demands for public expenditure both under ordinary as well as extra ordinary circumstances. The growing complexity of war and other unexpected emergencies increased the sphere of government's activity, in order to meet these increased expenses the government have leaned towards public borrowing.

Public debt is necessary to finace such projects which promise a return which is sufficient enough for meeting the debt charges, the payment of interest on the borrowed funds and the repayment of the capital installments. Even that classicals, who disliked public borrowing, were liberal enough to sanction public debt for purposes of revenue yielding activities only. Besides, building up the economic infrastructure, (Such as canals and other irrigation works, railways, roads and bridges or installation of power plants, etc.) Which is the base for economic development, requires more than what the government procures through taxes.

Public debt acts as balancing wheel that controls the tempo of the business cycle. In periods of depression, when aggregate demand is not enough to accelerate the level of production and employment, compensatory fiscal policy suggests an increase in the public expenditure on public work, etc. after taking idle savings from the hands of the people to create effective demand and to promote economic recovery. Public debt helps to combat inflation because in this situation effective demand is more than available supply of goods and services and consequently the government is able to transfer extra purchasing power from the hands of the people.

The price spiral, enlargement of administrative services, increase in wages and dearness allowances, enhanced expenditures on defence and development of financial organisations are some of the factors that contribute to the pressing necessity for public borrowing. There are certain other understandable offshoots of the political aspect of the economy which have increased the proportion of borrowing. Some of these are: financial mismanagement, wasteful expenditure, political corruption and virtual refusal by public officials to formulate and execute appropriate tax programmes. The government, as a result, has to meet the consequent loss through borrowing.

The borrowing of the modern governments, specially in the developing countries, have increased due to governments' reinforced active participation in the economic development of their economies. On the one hand, the limited availability of funds for investment from the private sector and on the other, the need for increasing the role of capital formation for development purposes, have led the government to expand resources through loans both internal and external. If the government tries to finance all its expenditure through taxation, the burden on the present generation will be unduly heavy. In order to avoid it, the government undertakes investment funded through loans.

In other words, public debt is necessary (a) to meet temporary deficit when the income of the government and of the country has declined owing to slackness in the economy, (b) to meet the situation when expenditure has increased enormously and can not be met out of current revenue as, for example, in times of war or an economics crisis, (c) to achieve equity over time and (d) to change the volume or pattern of expenditure/ saving/ in the interest of economic stability, or for achieving full employment.

IV. TYPES AND BURDEN OF PUBLIC DEBT: Public debt can be Internal or External.

(a) Internal debts: When the public loan is subscribed entirely by the people of the country and the repayment is done in home currency. It is called internal debt. The government used this money to make payments to the government employees, contractors and other people from whom it buys goods and services. In this matter money is transferred from some sections to others in the community. There is no money burden of such debt.

But there is direct real burden of such a debt, i.e. sacrifice or hardship on the part of the community, depending upon the nature of such transfers of wealth. Public debt will be considered useful or beneficial if the wealth gets more evenly distributed. If it results in an uneven distribution of wealth, i.e. making the rich richer at the expense of the poor, then it imposes a real burden.

Let us now make an analytical study of the nature of such transfers. The government has to levy taxes to pay the interest and principal of the debt. The bondholders receive what the tax payers pay. Usually the bond -holders are rich people. But the tax burden is not exclusively borne by the rich. In actual practice the tax burden is borne both by the rich and the poor. Thus it results in a net loss of economic welfare.

The burden of public debt becomes more acute due to the fact that wealth is transferred from the young to the old and thus from the more active members of society to the comparatively less active members. This is not because the creditors of the government and the bond-holders, etc., are usually of old age. The internal debt has adverse effects both on the production and on the distribution of wealth. This is the direct real burden of internal debt.

Internal debt also results in an indirect real burden, because it might check production if the desire and ability to save are curtailed. This is likely to happen if the repayments of debt involves very heavy taxation.

(b) External Debt: External debt is that debt which is borrowed by the foreign country. When the loan is raised, wealth is transferred from the lending to the borrowing country. The converse is true when the loans have to be repaid. The direct money burden on the community is measured by the amount of the interest and principal paid by the debtor country to the lender country.

In order to know the direct real burden (loss of economics welfare) we shall have to see the proportion in which the rich and the poor contribute towards the payments of interest and the principal. The Governments levies taxes to raise the requisite amount. If the incidence of the tax is on the rich, the direct real burden is less. But if the incidence is more on the poor, the direct real burden will also be more. The foreign creditor gets a control over our goods and services on account of the payment that we make to him. But he buys goods and services our country with that money. Had there been no external loan, these goods and services would have been enjoyed by our people. To this extent economic welfare is reduced. This is the direct real burden.

Foreign debt also causes a check to the production of wealth in the country. This is its indirect burden. Taxes imposed by the government for the repayment of foreign debts may reduce the willingness and ability to work and to save. The debt payment by the Government will also reduce the public expenditure in the directions which might have provided a stimulus to production.

It may, however, be mentioned that international payments are made by exporting goods and this provides a stimulus to further production. The production isstimulated only in a particular direction. There is no general increase in production and employment. Because the factors of production are limited, if they are used in the export goods industries, they may have to be withdrawn from other industries.

2. Market Borrowings and Non-Market Borrowings

Borrowings are done by different agencies of State (e.g. municipal, local boards). Their public loans take the different forms are given on the next page:

(a) Market borrowings: i.e. , Sales to the public of government bonds (long terms loans) and treasury bills (short-term loans) in the capital market.

(b) Non-market borrowings: i.e. issue to the public of debt which is not negotiable and which is not bought and sold in the capital market e.g., issue of national savings certificates and plan bonds and accepting deposits in the post offices.

3. Voluntary Borrowings and compulsory Borrowings

(a) Voluntary loans: Loans may be voluntary, forced or compulsory. Most of the public loans are voluntary. But if the Government is not able to raise sufficient funds through voluntary loans, it may have to resort to forced loans.

(b) Compulsory borrowing represents a compromise between taxation and borrowing. It is compulsory like a tax but it is repaid with interest like a loan.

Compulsory loans have a special significance when the country is faced with an inflationary situation and they are much superior to voluntary public loans. Whereas voluntary public loans provide to the public with bonds which can be easily encashed, compulsory loans reduce the liquidy of the funds. Besides, the cost of the public debt, can be reduced by paying a lower rate of interest on the compulsory loan. But it is not desirable to rely continuously on compulsory loans because it arouses dissatisfaction in the public. Greater reliance should be placed on voluntary borrowing programmes.

V. DEBT REDEMPTION

Repayment of debt is essential if national credit is to be maintained. If the debts mare repaid, it becomes easier to raise loans later in times of emergency. The following are the methods adopted for debt repayment.

(i) Utilization of surplus revenue: Briefly speaking a revenue surplus is the excess of Government receipts over expenditure. This excess or surplus may be used to repay public debt. But this method is not of much significance in the modern time because budget deficits rather than budget surpluses are more common.

(ii) Purchase of Government bonds: The Government may buy back its own stock in the market, thus doing away with the obligation to that extent.

(iii) Terminable annuities: When a certain permanent debt is to be repaid completely, it may be done in the form of a payment of a certain fixed amount for a number of years. Such annual payments are called annuities.

(iv) Conversion: Conversion means exchange of new debt for the old debt. This method is used for reducing the burden of the public debt. The Government may have borrowed when the rate of interest was high. Now if the rate of interest falls, the Government can convert the old loans into new ones.

(v) Sinking Fund: It is the most important method. A certain amount is kept aside every year out of the current revenues for the repayment of debts and this accumulates, of compound interest so that it may equal the amount of public debt by the time of its maturing. Thus a fund is created which is called the Sinking Fund.

There are certain revolutionary proposals also for the redemption of public debt, some of them are:

(a) Debt repudiation: e.g., a Government may refuse to honour the obligations of the previous Government.

(b) Compulsory reduction of interest: But this method is not likely to be adopted by civilised government who normally would like to honour the contract made earlier.

(c) Excessive taxation of higher incomes: Although debts can be paid off by taxing the higher incomes steeply, yet sometimes excessive taxation may have adverse effect on trade and industry.

(d) Capital levy: The government may retire its public debt by levying a heavy additional levy too only once or at the most justice. This special heavy tax to repay public debts is generally called a capital levy as it is assessed on the value of capital held by the people.

VI. ROLE OF PUBLIC DEBT IN A DEVELOPING ECONOMY

A developing economy must exploit all possible financial resources in order to raise sufficient funds for its development plans. It has to utilise revenue surplus, get external aid, raise the level of taxation and, in addition to this, resort to public borrowing.

Public borrowing has one great advantage over taxation. Whereas taxation beyond a certain limit adversely affects economic activity, there is no such risk in public borrowing. It has no dis-incentive effect and therefore no adverse repercussions on economic activity, because it is mainly of a voluntary nature and then there is also an expectation of return and repayment.

According to expert opinion, taxation should cover at least current expenditure on normal government services and borrowing should be utilised to finance public expenditure which results in the creation of capital assets. In that case growing public debt will become self-liquidating and its burden on the economy will not be felt. But there is a limit to public borrowing and additional taxation has to be used as an instrument to finance development plans.

The classical economists did not approve of public borrowing. They were of the view that the use of resources by the government was not so productive as by the private people. Besides, it was thought inadvisable to levy taxes to pay off interest on loans because it deprived the economy of cash and capital. But the classical reasoning was based on the assumption of full employment, inelasticity of money supply and unporductiveness of public expenditure. These assumptions are no longer valid.

Public debt promotes economics development in the following ways; Public debt incurred for financing productive investment generates additional productive capacity in the economy. It is used as an instrument to moibilse resources which, in an underdeveloped economy, might have been hoarded or invested in jewellery or real estate. Thus, in an under developed economy, public borrowing can become, (if carefully managed and properly operated) a powerful instrument of economic development.

Besides, growing public debt provides people with opportunities to cover their savings into safe and stable assets which will yield income.

Public debt is also helpful towards economic development in another manner. The growth and composition of public debt provide the monetary authorities with assets which can be manipulated to execute a monetary policy considered desirable for economic development. Thus a growing public debt in a developing economy has become a powerful tool of economic development.

VIII. PUBLIC DEBT IN INDIA

After going through the role of public debt in an under developed economy. We shall now give a brief account of the extent and growth of public debt in India. In recent times public debt has shown an upward trend all over the world and India has been no exception.

The rate of increase in public debt was significant in the first fifty years of the present century. But it has shown a tremendous growth during the planning period. In 1950-51, at the commencement of economic planning, the total net liabilities of the Government of India amounted to Rs. 2, 865 crores. Since then it has risen progressively to Rs. 3, 150 crores at the end of the first plan, Rs. 6, 544 crores at the end of second plan. Total liabilities of the Government of India as a result of public borrowing was estimated of the order of Rs. 3, 14, 558 crores at the end of 1990-91 and Rs. 8,75,926 crore in 1995-96. Thus the nominal value of total liabilities increase 189 times between 1950-51 to 1994-95. The total internal public debt of India has increased 1,350 times i.e. from Rs. 2,022 crores in 1950-51 to Rs. 154003 crores in 1990-91 and to Rs. 8, 19,960 crores in 1998-99 further increased to 1021739 crores in 2002-03. The total external public debt of India has increased from Rs. 32 crores in 1950-51 to Rs. 31525 crores in 1990-91 and in 2002-03 it increased to 68520 crores.

The main causes of the increase of public debt in India have been the following:

(a) Increase in defence expenditure, which has gone up from Rs. 164. 13 crores in 1950-51 or Rs. 2, 497 crores in 1975-76 i.e., more than 15 times. It has gone up to Rs. 6, 076 crores on 1984-85, Rs. 8,730 crores in 1986-87, 16,426 crores in 1994-95 and Rs. 45694 crore in 1999-2000 and Rs 58, 587 crores in 2000-2001.

(b) Increase in Development and Social Expenditure. This had increased from only Rs. 48 crores in 1950-51 to Rs. 16, 900 crores in 1986-87. It has increased to 18, 223 crores on social services alone in 1994-95 and Rs. 72, 750 crore in 1997-98.

(c) Increase in Debt service has also been adding to the public debt in India. The debt charges had increased from Rs. 32.4 crores in 1950-51 to Rs. 758 crores in 1985-86. It amounted to Rs. 1159 crores in 1994-95 and to Rs. 3320 crore in 2002-03.

The other causes responsible for this phenomenal increase are the causes which have increased public expenditure, e.g., soaring prices, multiplication of administrative posts, increase in salaries and dearness allowances etc.

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DEFICIT FINANCING: OBJECTIVES AND LIMITATIONS

I. INTRODUCTION: Today, deficit financing has emerged as an important tool of financing the government expenditure. The government first outlines its expenditure according to the heads and objectives of the national policy and then attempts to locate sources of funds to meet this estimated expenditure. The main sources of revenue are tax estimated receipts during a year, the gap between the two is to be filled by what is called estimated receipt during a year, the gap between the two is to be filled by what is called "Deficit financing". Deficit financing is related to public borrowings but it is not the same thing as public borrowings. The term has been differently use in the advanced countries of west and the developing countries like India.

II. DEFICIT FINANCING IN DEVELOPED COUNTRIES: In developed countries, deficit financing is a wider term. It covers not only borrowings but also financing expenditure from printing of additional currency and drawing down of cash balances. In other words, deficit financing takes place even when a budget gap is covered by loans. In fact, any expenditure of the government beyond its current income is known as deficit financing. The financing of all public expenditure in excess of public revenue in current account is deficit financing.

III. DEFICIT FINANCING IN DEVELOPING COUNTRIES LIKE INDIA:

In India, the term has been defined in different manner. According to the Indian planning Commission, "the term deficit financing is used to denote the direct addition to gross national expenditures through budget deficits, whether the deficits government spending in excess of the revenue it receives in the shape of taxed, earning of state enterprises, loans from the public, deposits, funds and other miscellaneous sources. The government may cover either by running down its accumulated balances or by borrowing from the banking systems mainly from the Central Bank of country and thus creating new currency". It thus refers to the financing of the deficit in the budget through the creation of new currency by the Reserve Bank of India. The government transfers its securities to the Reserve Bank, on the strength of these securities the bank is empowered to issue more currency note which are put on circulation by making increase payments on behalf of the government. This process implies of course, creation of new money.

IV. BUDGETARY DEFICIT, FISCAL DEFICIT AND REVENUE DEFICIT:

These terms need clarification so these are defined and discussed below:

(I) Budgetary Deficit: Budgetary deficit or deficit financing in the traditional sense refers to deficit incurred to fill up the gap between the total expenditure (on both revenue account and capital account) and total receipts (both revenue and capital account).

Budgetary deficit=Aggregate expenditure-Aggregate receipts.

The budgetary deficit is financed through credit from the Reserve Bank of India and the balances of the government of India with RBI. It leads to increase in the money supply which in turn leads to secondary expansion of credit through the banking sector and has an inflationary inflationary impact on the economy.

(ii) Revenue Deficit: Revenue deficit refers to the excess of revenue expenditure over the revenue receipts.

Revenue deficit = Total revenue expenditure - Total revenue receipts.

Revenue expenditure is covered partly through the RBI credit to the government and party through borrowings. Borrowings do not add to the money supply, but create interest burden for posterity; and increase in the aggregate expenditure has and inflationary impact unless that is sufficient increase in the supply of wage goods.

(iii) Fiscal Deficit: Fiscal deficit includes the amount of borrowings plus budgetary deficit.

Fiscal deficit = Aggregate expenditure-aggregate tax and non-tax revenue receipts and recoveries of loans.

Fiscal deficit = Borrowings + budgetary deficit.

Fiscal deficit is covered partly through borrowings and partly through RBI credit to the government. Borrowings used for non-plan expenditure have inflationary impact due to the aggregate expenditure not accompanied by a compensating increase in the supply of wage goods.

V. TECHNIQUES OF DEFICIT FINANCING: There are mainly three techniques of deficit financing. They are as follows:

(i) Borrowing from Central Bank i.e. creation of new money.

(ii) The running down of accumulated cash balances. It implies to withdrawal of cash balances by the government from the Central Bank to finance budgetary deficits i.e. increasing the supply of money.

(iii) Issue of New Currency i.e. printing of more notes and putting in circulation.

VI. OBJECTIVES OF DEFICIT FINANCING:

1. In advanced countries like the USA and UK, deficit financing is used to maintain full employment even though they are capitalistic. The conditions of unemployment can be removed to a great extent by increasing the effective demand. The government should resort to a policy of public works, such as digging of canals and wells, construction of railways, bridges etc. by deficit spending through creation of additional money. There is a multiplying effect increasing both employment and income. Deficit spending in an economy during the period of depression, thus create effective demand, and employment in the economy increases.

2. In developing countries, there are many problems to be handled, such as unemployment due to low capital formation, poverty due to low level of income and its vicious circle etc.

- For rapid development, the government has to spend big amount on development projects, huge investments in heavy industries, and constructions of social overheads to create the infrastructural facilities, such as transportation means of communication, power, water supply etc. Whether the developing countries accepts the strategy of balanced growth as unbalanced growth, it cannot avoid such expenditure to remove deficiency of capital. In such a situation, it has to meet a large gap between its expenditure and income through deficit financing.

- Deficit financing can mobilise surplus, idle and unutilised resources of the country. The mobilisation of resources such as local raw material, capital and labour skills, becomes possible because of deficit financing.

-Under developed countries suffer from market imperfections. The major contribution in these countries comes from agriculture. It is necessary to increase the percentage contribution of the industrial sector in the national income stream of such countries. Besides, the government has to remove structural rigidities. These requirements add to the government expenditure which can not be met from inadequate public receipts. Hence the need for deficit financing is justified.

-Deficit financing can diverse undersirable and unproductive sources into the channels of desirable and productive channels of the country.

VII. LIMITATIONS OF DEFICIT FINANCING: Deficit financing to an extent, may be justified for stimulating rapid economic development and for providing infrastructural facilities by creating socials overhead capital but an unlimited deficit tends to create tremendous harms than good due to its inflationary impact.

Since the new money create is spent on projects with a long gestation period the supply of wage goods falls shorts of the large demand created by the new money in the hands of the people. This generates inflationary pressure in the economy mild inflation does help in economic development in two ways: (i) it creates forced savings and (ii) it stimulated private investment, because the profitability of investment rises.

However, deficit financing on a very large scale as that in India, leads to a runaway inflation which instead of leading to economic growth may hamper it and act as and obstacle to development.

Deficit financing widens inequalities of income. The professionals, traders and manufacturers benefit immensely from the falling value of money, the salaried people and wage earner (fixed income groups) suffer much from rising prices.

Deficit financing leads to undersirable changes in the pattern of production. The demand for luxuries and speculative transaction increase and resources are diverted from production of essential goods to production of luxuries, and speculative activities. Which is harmful to economic development.

Inflationary pressures resulting from deficit financing have an adverse effect on balance of payment position. Export become costly and can not face competitions in the world market. Imports are encouraged due to heavy demand for capital goods and technology imports. Balance of payments shows a large continuous deficit.

Initial deficit financing necessitates further deficit financing. The economy virtually caught in a "deficit financing trap".

It is clear from the foregoing discussion that deficit financing beyond the reasonable limits results in the problems of inflation, adverse balance of payments situation, inequality of income etc. Which have their own adverse effects on the economy. But it does not mean that the technique of deficit financing should not be adopted. In fact this technique must be adopted within a safe limits. Now question arises what is the safest limit to control the deficit financing. There is not any definite formula for determining the safest limit. It depends upon some important factors like what are the requirement of the economy, the power of tolerance of the people regarding rise in prices etc.

It is necessary to undertake quick yielding projects along with big, heavy industrial schemes. The available supply of consumer goods and other essential goods have to be rationally distributed. Non-developmental expenditure should be curtailed.

Increase in money supply due to deficit financing should be utilised for productive purposes alone.

VIII. DEFICIT FINANCING IN INDIA: In Indian context, deficit financing refers to only that expenditure which is in excess of current revenue and non-bankborrowings. Borrowing from the public are excluded from the measurement of the extent of deficits. The deficit gap between the expenditure and income is met by the following sources.

(a) Withdrawal of cash balance by the government.
(b) Borrowing from the Reserve Bank of India.
(c) Borrowing from Commercial Banks.
(d) Issue of new currency by the Central Government.

The Central government of India covers its budgetary deficit by selling treasury bills to The Reserve Bank of India and by drawing upon its accumulated cash balances account

(ii) ways and means advances and overdrafts from the Reserve Bank of India. Table-I shows plan wise deficit financing.

Table 1

Deficit Financing in India's Five Year Plans

Rs. in Crores

Items	I Plan	II Plan	III Plan	IV Plan	V Plan	VI Plan	VII Plan	VIII Plan
A. Total Plan Out lay	1,960	4,600	8,577	16,160	39,303	1,10,821	2,26,638	4,34,100
B. Aggregate domestic resources (Tax revenue, surpluses from public enterprises and public borrowings)	1,438	2,562	5,021	12,013	32,115	86,608	1,67,385	3,85,400
C. External Assistance	189	1,090	2,423	2,087	5,834	8,529	20,708	28,700
D. Deficit Financing (A+B+C)	333	948	1,133	2,060	1,354	15,684	38,545	20,000

Source: (i) RBI Reports on Currency and Finance.
(ii) Government of India, Plan Document.

Since the beginning of the First Five Year plan, the government has been using this source of money finance as there is a continuous increase in the public outlay. During the course of First Five Year Plan the total outlay was to the extent of Rs. 1960 crores which a gap of Rs. 333 crores was filled by deficit financing. There was a fair measure of price stability due to favourable monsoons and high industrial output. The Indian Government, it appears, through the deficit financing was not dangerous. Deficit financing of large and unjustifiable magnitude of Rs. 948 crores was responsible for a high rise in prices. Prices increased by 35 per cent during the plan period. In third plan deficit was Rs. 11.33 crores. Money supply increased by more than 60 per cent. The whole sale price index increased by 32 per cent. Prices of consumer goods soared, there was price-wages-cost price spiral in the economy during fourth plan. The main causes were 1971 war with Pakistan (Bangladesh) expenditure on refugees from Bangladesh, natural calamities, continuous increase in non-developmental expenditure etc. During fifth plan deficit financing reduced to Rs. 1,354 crores due to many favourable factors like favourable factors like favourable climate conditions, relaxations of controls, improvement in agricultural technology, etc. However, the overall increase in the whole sale price was 33 per cent.

Despite the heavy use of deficit financing in sixth plan Rs. 15,684 crores and substantial increase in the money supply (70.4 per cent), the wholesale price index rose by 13.5 per cent. Again production was satisfactory and national income rose by 5.2 per cent over the plan period. Actual deficit incurred during seventh plan amounted to Rs. 38,545 crores. The rate of inflation was 10 percent annum. In the eighth plan also target crossed in two years.

Deficit financing has become a matter of habit with the government. Every plan document of the planning commission of India contains a caution and calls for limiting deficit financing, inspite of such warnings, the government has been resorting to higher and higher deficit financing. Unless the non-development expenditure is seriously curtailed, tax evasion checked and black money unearthed, there is no hope to keep the amount of deficit financing with in safe limits.

LESSON NO. 2.7 **AUTHOR: DR. HARVINDER KAUR**

IMPACT AND INCIDENCE OF TAXES

A tax being a compulsory payment without any special benefit for the tax-payer naturally imposes a burden on the person who pays it. But a person who pays a tax may not actually bear the burden of that tax. He might make an attempt to shift this burden on to others. It will, therefore, be very interesting and instructive to find out as to who bears the burden of various taxes levied by the State. This lesson not only deals with the various concepts that helps us in this matter but also examines how certain taxes imposed on one section of the community are actually borne by the other. The scheme of the lesson is as under:

I. Meaning of incidence.
2. Distinction between impact, incidence and shifting.
3. Incidence and effects;
4. Demand and supply theory of shifting.
5. A brief reference to the new concepts of incidence; and
6. Importance of the study of incidence.

We shall now proceed to discuss these points in some detail in order to arrive at a clear understanding of the various concepts.

1. MEANING OF INCIDENCE:

By incidence of a tax we mean the final resting place of a tax. Taxes are not always borne by the people who pay it in the first instance. Sometimes they are transferred on to some other people. The incidence is, therefore, on the person who ultimately bears the burden of the tax. A conventional definition of incidence given by Prof. Dalton is, "To every shilling of revenue raised, there corresponds a shifting of direct money or incidence falling upon some one." According to him the problem of incidence is to discover the person who ultimately pays this one shilling.

2. IMPACT, INCIDENCE AND SHIFTING:

The impact of the tax is the immediate money burden and it is on the person who finally bears the tax. For instance, if an excise duty is imposed on sugar, it may be paid by the sugar manufacturer in the first instance. But this duty will be added to the price of sugar sold in the market and through a process of transfers, the consumer will ultimately be bearing the burden of this duty. Hence the 'impact' is on the sugar manufacture, but the 'incidence' is on the consumer. The incidence of a tax, therefore, refers to the ultimate money burden of the tax.

The term incidence should be distinguished from shifting. Shifting refers to the process of passing on the burden of a tax from the person who pays it in first instance and shift to that one who pays it finally. It is through shifting only that the incidence of the tax is finally determined. The process of shifting may be slow or may not be fully effective in the sense that the person who is intended to bear it may not entirely do so'. Further, shifting may be forward or backward. Thus a producer may shift it forward to the purchase of this product or backward by paying lower prices to the suppliers of raw material, labour, capital etc. Shifting should not be confused with evasion. Evasion is to avoid payment. In evasion there is no question of shifting the tax to somebody else, it is not paid at all.

The impact or the immediate money burden and the incidence or the ultimate money burden may be on one and the same person as in the case of income tax. Such a tax is then known as direct tax. But if the impact is on one person and the incidence is on another, the tax is known as an indirect tax.

3. INCIDENCE AND EFFECTS OF A TAX:

The 'incidence' of tax must be distinguished from the 'effects' of a tax. The imposition of a tax results in many other effects which are quite different from the problem of incidence. As we have already seen, in the case of the imposition of excise duty on sugar, the incidence is on the consumer. But this may have many effects of far-reaching consequence to the industry. The imposition of this duty may be a disincentive to the expansion of the industry because it will curtail the profits of the manufacturers. Producers might reduce wages and this may lead to the flight of labour. Readjustment of the family budgets may effect the demand for certain other goods also. It may reduce the consumption of sugar and consumers of sugar may also start looking for its substitute. All these expected consequences fall under the effects of taxation which, is a much wider problem than that of determining incidence of taxes.

4. THE DEMAND AND THE SUPPLY THEORY OF SHIFTING:

"The demand and the supply theory" known as the modern theory is the most acceptable approach in explaining the incidence of a tax. The application of this theory of tax 'shifting or incidence determination is the work of writers like Seligman, Edgeworth and Dalton. The modern theory regards the tax takes place through the change in price. Hence, shifting of tax take place through the change in price. As person would try to pass on the tax to another by raising the price of the taxed commodity. Therefore, shifting is common in commodity taxation. If taxes have no effect on prices, they are usually not shifted. Hence shifting forward or backward is not possible where there is no price transaction.

Obviously, shifting and incidence of taxes depend upon the process of pricing. But the prices are determined by the forces of Demand and supply. Hence, shifting of tax incidence depends upon the behaviour of buyers and sellers. Therefore, to understand the nature of tax incidence depends upon the behaviour of buyers and sellers. Therefore, to understand the nature of tax shifting as well as to determine the incidence of a tax, the factors which affect the condition of demand and supply should be analysed.

However, the most important factors which affect the conditions of demand and supply are the elasticity of demand, elasticity of supply and the laws of returns. Besides it should also be noted that the final shifting of taxes is conditioned by the relative strength of the various tendencies of work facilitating and preventing tax shifting.

Analysis of Elasticity of Demand and Elasticity of Supply

According to Prof. Dalton there are two general propositions with regard to taxes on particular commodities or service:

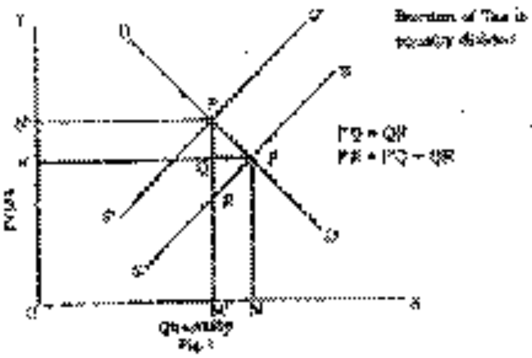
(1) The first is that, other things being equal, the more elastic the demand for the object of taxation, the more will be incidence of the tax upon the seller. If the demand of the commodity is perfectly elastic, the entire tax burden will be upon the seller, because an increase in the price due to tax will make the demand of the commodity zero. If the demand for the commodity is perfectly inelastic, the entire tax burden will be passed on to buyers, because an increase in price due to tax will affect the demand. When demand is relatively elastic, a greater part of the tax burden will be upon the seller and vice-versa.

(ii) The second proposition is that, other things being equal, the more elastic the supply of the commodity, the more will be the incidence of tax upon the buyer. And the less seller. If the supply of the commodity, the greater will be the incidence of the tax upon the seller. If the supply of the commodity is perfectly elastic, the entire tax burden is shifted to the buyers. With the imposition of the tax, the cost of production will rise and thus the price will rise, which may affect the demand of commodity and bring loss to the seller. Therefore, the seller would curtail the supply of the commodity, increase its price by the full amount of the tax and will shift the entire burden will be wholly on the seller. If the supply is more elastic, a greater part of the tax burden will be upon the buyer and vice-versa.

In the words of Prof. Dalton, we may conclude, "The sellers in short, try to put the incidence on the buyers by reducing supply, the buyers try to put it on the sellers by reducing demand. The relative ability of the two groups to achieve their aims, with the minimum loss to themselves, determines the results."

The above conclusions have been combined by Prof. Dalton to form a general proportion of the theory of Incidence of Taxation as the "direct money burden of a tax imposed on any commodity is divided between the buyers and sellers in the proportion of the elasticity of supply (Es) of the taxed commodity to the elasticity of demand (Ed) for it."

The above mentioned general principal of the incidence of the taxation has been explained with the help of Fig.1:



In the above diagram DD is the demand curve and SS is the supply curve for a particularly commodity or service. PM is the price per unit before the imposition of the tax and NP or OM is the amount sold per unit of time before the imposition of tax. Now a tax equal to P'R has been imposed on the commodity and is collected from the sellers. Now S'S' is the new supply curve after the imposition of the tax. P'M' is the new price after the imposition of tax and N'P' is the New quantity sold of the commodity after the imposition of the tax and P'R' is the tax per unit.

Thus, the price rise by P'Q and the sales fall by PQ due to the imposition of the tax. The incidence of the tax. P'R is divided between buyers and sellers. The buyers bear P'Q' and sellers bear QR. Thus P'R = P'Q+ QR.

Now we can prove that the incidence of tax is divided between buyers and sellers in the ratio of the elasticity of demand as follows:

$$\text{Elasticity of Demand: Ed} = \frac{\text{Proportionate change in demand}}{\text{Proportionate change in price}}$$

This can be expressed in mathematical terms as:

$$Ed = \frac{\frac{\Delta Q}{Q}}{\frac{\Delta P}{P}} = \frac{\Delta Q}{Q} \times \frac{P}{\Delta P} = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

(here Q stands for quantity demanded or supplied and P stands for price)

Now the elasticity of demand :

$$Ed = \frac{MM'}{OM} \div \frac{P'Q}{PM} = \frac{M'M}{OM} \times \frac{PM}{P'Q}$$

Similarly the elasticity of supply

$$Es = \frac{MM'}{OM} \div \frac{QR}{PM} = \frac{MM'}{OM} \times \frac{PM}{QR}$$

$$\frac{Es}{Ed} = \frac{MM'}{OM} \times \frac{PM}{QR} \div \frac{MM'}{OM} \times \frac{PM}{P'Q}$$

$$= \frac{MM'}{OM} \times \frac{PM}{QR} \times \frac{OM}{MM'} \times \frac{P'Q}{PM}$$

$$= \frac{P'Q}{QR}$$

Thus P'Q is incidence on buyer and QR on seller.

The above result holds good, even if the same taxes were collected from the buyers instead of the sellers, the only difference would be that, instead of a rise in the supply curve, there would be fall in the demand curve.

From the foregoing explanation of the general principle of the incidence of taxation, the following conclusions can be drawn.

(a) If the Ed=Es, the burden of taxation is equally divided between the buyers and sellers and the price of commodity will rise by half the amount of the tax. This is possible when both the supply and the demand curves have similar slopes as has been shown in Fig 1. In this figure the burden of tax=P'R=P'Q+QR, but P'Q=QR.

(b) When the degree of elasticity of supply is greater than of elasticity of demand i.e. Es>Ed., the burden of tax will be upon the buyers in higher proportion than upon the sellers, and the rise in price will be more than 50 per cent of the amount of tax per unit. This can be explained with the help of figure 2 as shown below:

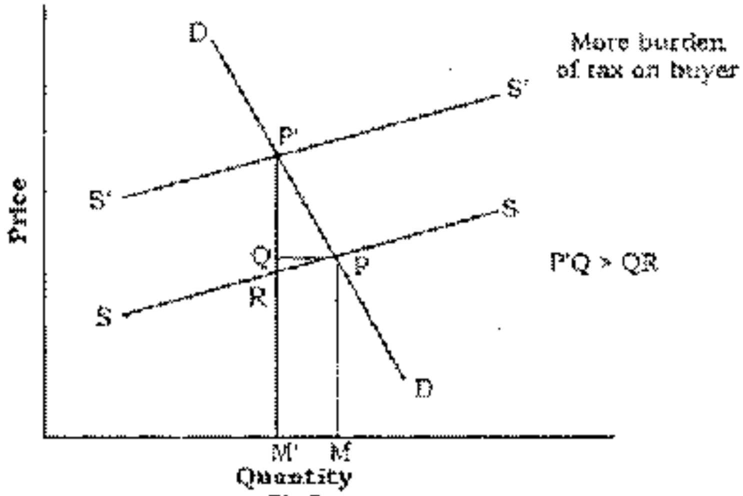


Fig.2

In figure 2 the demand and the supply curves indicate that the supply is more elastic than demand. PM is the price before the imposition of the tax. P'M' is the price after the imposition of tax. P'R' is the amount of the tax and P'R' =P'Q +QR. But since P'Q>QR, the burden of the tax falls more on the buyers than on the seller.

(c) When the degree of elasticity of supply is less than elasticity of demand i.e., Es<Ed., the burden of the tax falling on the sellers if higher than that falling on the buyers, as the rise in price of the taxed commodity will be less than 50 percent of tax per unit. This can also be explained with the help of figure 3 as shown on the next page:

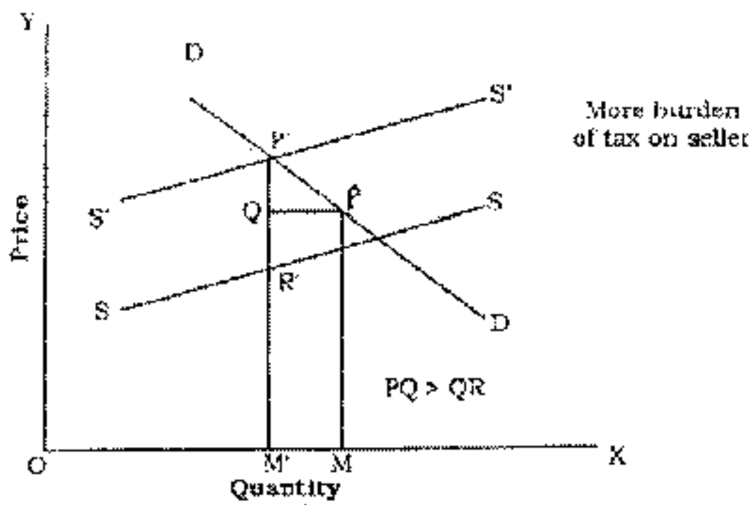


Fig.3

In figure 3 the demand and supply curves indicate that the supply is less elastic than the demand. PM is the price before the imposition of the tax, and the P'M' is the price after the imposition of tax.P'R' is the amount of the tax and P'R' =P'Q+QR but P'Q which shows rise in price is less than QR. Hence, the burden of the tax falls more on the sellers than on the buyers.

CRITICISM OF DEMAND AND THE SUPPLY THEORY

"The demand and the supply" as explained above does not satisfy the test of criticism.

(1) This theory is based on the demand and supply curves. But a tax is only one of many factors that will affect the supply or demand of a commodity. The new supply curve may be completely different from the one that is assumed in the above illustration, because as a result of the imposition of the tax many other factors may change, affecting the supply price of the commodity. Similarly, the demand curve may also change. The tax is bound to result in a reduction incomes and therefore, will change the demand curves for many other products. The tax may be only a small factor as compared to other influences determining the shape of the demand and supply curves.

(2) It is a partial theory since it takes into consideration only the receipt side of the budget and ignores the effects of public expenditure. A true incidence theory must deal with the net budget incidence i.e. tax burden minus expenditure benefits. Most of the modern researches while dealing with the incidence of taxation have also considered the expenditure benefits.

(3) Dalton has defined tax incidence as the 'direct money burden' of a tax. It is pointed out that while the term 'money burden' may be precise, the qualifying word 'direct' is too ambiguous and scientific precision. Let us suppose that a tax is levied and collect from the manufactures of sugar. We have first to consider the demand and supply curves of the wholesale dealers, the retail dealers and other intermediaries and finally be consumers. Where are we to stop in these series of exchanges and say that incidence can travels thus far and no further. If it is said that we should carry the analysis up to the consumers, the difficulty is that there is no person who is only a consumer and not a producer. The consumer of sugar may be a producer or syrups or the tax on sugar may be shifted by him to the producer of wheat and he may shift the tax to the consumers of wheat and thus there is no end to these series of transfers. Thus, R.N. Bhargava rightly points out that "incidence of taxation is indeterminate not because adequate information is not available, but because even in theory it can not be isolated."

5. A BRIEF REFERENCE TO THE NEW CONCEPT OF INCIDENCE

In the light of the above difficulties, certain modern economists like Ursula Hicks, Musgrave and others, following Swedish economist, Particularly Wicksell have given a new interpretation of incidence. To these writers incidence means changes in the distribution of income which arise as a result of changes in taxation and public expenditure (i.e., changes in budgetary policy). It is pointed out that whenever budgetary policy is changed, three important effects come into existence; (a) effects on production, (b) transfer of resources from public to the government and vice versa, (c) effects on the distribution of income as between people. The term incidence is used to designate the third type of effects; i.e., distributional changes which may arise due to changes in both revenue and expenditure of public authorities, while the traditional concept completely ignored the role of public expenditure.

6. IMPORTANCE OF INCIDENCE

We shall now proceed to discuss the importance of the study of incidence. In any tax system, the study of incidence is extremely important. Unless the incidence of a tax is traced, it is very difficult to find out whether the tax system is equitable or not and whether or not a tax has been levied according to the paying capacity of the tax payer. If the tax system is to satisfy Adam Smith's first canon of taxation, i.e., the canon of equality, the study of incidence becomes absolutely essential. When the Government levies a tax, in some cases, it is intended to be borne by the person on whom it is imposed, while in others it is intended to be shifted. But in actual practice, on account of the operation of economic process, the shifting may not take place at all or it may be only partially effected. It is also likely that the tax may be shifted on to wrong people. Under such circumstances there will be a great deal of injustice and hardship.

Thus, if public finance is to serve as an instrument of social justice, the study of incidence assumes great importance. The Government must make a careful study and pursue an appropriate policy to remove the unjust tax burden. If the rich people are taxed, the incidence must also be only on the rich so that the objective of taxation is achieved. Hence we must examine the incidence of each tax and see that it has a rich home to rest in to ensure that the tax system operates justifibly.

LESSON NO. 2.8

TAXABLE CAPACITY

2.8.1 Introduction

How to determine the capacity of community to pay taxes and what is the maximum amount that a government can raise taxes? This is what we propose to study in this lesson. The concept of taxable capacity is difficult to define precisely. Findlay Shiras identified two variants of the concepts; (a) Absolute taxable capacity (b) Relative taxable capacity. A distinction is made between the absolute taxable capacity and the relative taxable capacity. The absolute taxable capacity means the amount that a community can pay in the form of taxes without producing adverse effects. The relative taxable capacity means the respective contribution that two communities should make towards a common expenditure. Thus under a sound system of taxation rich should be made to pay more than the poor.

2.8.2 TAXABLE CAPACITY: MEANING AND ITS VARIANTS

What is the meaning of taxable capacity and what are the factors on which it depends?
Taxable capacity means the maximum capacity of a particular community to pay taxes. According to Taxation Enquiry Commission of India. "Taxable capacity of different sections of the community may be said to refer to the degree of taxation, broadly speaking beyond which productive effort and efficiency as a whole begin to suffer."
Findlay Shiras identified two variants of the concepts; (a) Absolute taxable capacity (b) Relative taxable capacity. A distinction is made between the absolute taxable capacity and the relative taxable capacity. The absolute taxable capacity means the amount that a community can pay in the form of taxes without producing adverse effects. The relative taxable capacity means the respective contribution that two communities should make towards a common expenditure.In regard to absolute taxable capacity, there are two extreme views. These are:

(a) How much a community can pay as taxes without a feeling of hardship.

(b) How much can be collected from a community in the form of taxes without taking into consideration that hardship to the tax payer.

If we go by the first views, the taxable capacity of a nation will be almost nil. This is so because, whatever the rate of taxation, it would certainly cause some hardship. In terms of the second view the absolute taxable capacity is almost limitless.

According to Sir Josiah stamp. "Taxable capacity is the margin of total production over total consumption of the amount required to sustain the population at subsistence level."

Findlay shirraz, however, defines taxable capacity as "the maximum amount, which the citizens of a country can contribute towards the expenses of public authorities without having to undergo any unbearable strain. Briefly, taxable capacity is the limit of squeezability." Thus according to Shirraz, the limit of taxable capacity is reached when the total national product stops increasing or begins to decrease or the income begins to fall. If the burden of taxation is such that it acts as a distinctive to hard work or leaves little with the entrepreneurs to meet the cost of depreciation, the limit of taxable capacity is aid to have been reached. Whereas absolute taxable capacity refers to whatever could be taken away be the state after allowing for the bearest of subsistence to the citizens, the relative taxable capacity means the capacity of a community (or of a section of this community) to pay taxes as compared to that of the other. Two different communities, therefore, will contribute towards a common expense according to their relative capacity. But how to measure this relative capacity to pay taxes? The relative taxable capacity of a community depends upon its national income, the pattern of income distribution, size of population, rate of growth of population and that of income, standard of living, administrative efficiency and the purpose of collection of taxes.

Out of these two concepts, the concepts of relative taxable capacity is of more practical use. This is so because whereas it is difficult to measure absolute taxable capacity, it is easy to compare the taxable capacity of two different sections of a society.

Self check exercise

Q.1. Define taxable capacity.

Q.2. Describe the types of taxable capacity.

2.8.3 DETERMINANTS OF TAXABLE CAPACITY

The determinants of taxable capacity should be obvious from the foregoing discussion: More important among the determinants of taxable capacity are:

(i) **The level of (real) Per Capita Income:** A common opinion is that the greater the per capita income, the higher the tolerable limit of the ratio of taxation to income.

(II) **The Distribution of Income:** Other things beings equal, taxation potential would be greater for a country with a more skewed income (and wealth) distribution than for a country with a less skewed distribution. Since most underdeveloped countries show markedly greater relative inequality than the developed, taxation potential in the former should be relatively greater on this count.

(iii) **The Relative Importance of Different Kinds of Economic Activity:** The most important factor here related to the relative shift between the conventionally taxable and non-taxable activities. Important, therefore, in this respect are the following: size of the non-monetized sector, the extent of subsistence farming, the degree of openness of the economy, etc.

(iv) **The Size of Employing Establishments:** The administration of an income tax and taxes in general is difficult where employment is in small establishments and where self-employment is widespread.

(v) **Form of Taxation:** Not only is the tax-structure relevant here, also relevant is the tax rate-structure. For instance, it is observed that high tax rations are associated with the use of progressive taxes, a partial explanation for which may be that the political attractions of progressive taxes have outweighed, its economic disadvantage (in terms of the impact on incentives etc.) especially in democracies the use of direct taxes at sleepily graduated rates on the affluent few may be necessary to win acceptance of acceptance of heavy taxes on the masses.

(vi) **Form of Government Expenditure:** This will affect taxable capacity in so far as specific form of government expenditure can affect productive capacity, incentives to save, willingness to work and the tax burden in general.

(vii) **Innovation and Administration:** Readiness to accept tax innovation, if not carried to extremes, can help push up tax limit. Several important innovations have helped to increase the tax limit since the end of world war II. Among these were the development of broad-based sales taxes, particularly value added taxes; the reduction of the threshold of income tax coverage made possible by with holding tax at source and by modern data processing system; and the convention of many excise and custom duties from specify to ad-valorem bases. Such innovation apart from the adaptation of the tax-payers to comply can also increase the revenue potential by minimizing tax evasion and compliance costs.

(viii) **Tax Rates in other Countries:** Tax rates in other countries also influence the tax limit by affecting opinions about what is bearable. The possibility that domestic capital will flow abroad to countries with lower taxes and that foreign capital will be discouraged from entering a high-tax country.

The section may be concluded with the observation that limits are neither static nor universal. They are determined with respect to time and a country in accordance with the country's situation vis-a-vis tax limits are highly important for policy making. A country that has exceeded the safe limit of taxation must cut government expenditures, however unpleasant as that may be. A country that has not reached its tax limit has more options.

Self check exercise

Q.1. What are the determinants of taxable capacity ?

Q.2. Write a short note on innovation and administration and taxable capacity.

2.8.4 TAXABLE CAPACITY IN INDIA

We have the following evidence, on tax ratios.

Tax Revenue as percentage of GDP*

Year	(Percentage) (at Current market Prices)
1950-51	4.32
1960-61	5.52
1970-71	11.43
1980-81	11.69
1990-91	10.75
1999-2000	14.5
2005-06	110.4

Source: Economic Survey, 2005-06

*Before transferring state's share in central taxes

Commenting on the above figures, Jha Committee (1978) observed: Comparing the tax ratios for India with other countries, we find that as against a tax ratio of about 16 per cent for India, it ranged from about 25 to 30 percent for advanced countries like the USA, UK and Denmark. This may suggest that our tax effort is low in comparison with that in the advanced countries. One cannot, however, ignore the fact that even a lower tax ratio of 16 to 17 percent can mean a much higher burden in a country where per capital income is below Rs. 1000 a year, than even a high ratio of 25 to 30 percent in countries having per capital incomes reckoned in terms of thousands of rupees............[1]

On account of paucity of data, the Committee regretted that it is less easy to compare India's tax efforts with that to the other developing countries. However, considering that per capita income in India is one of the lowest even among the developing countries. India's tax effort cannot be said too be to low by international standards.[2]

After independence there are many factors which indicate that the taxable capacity of the country has increased, and the country has not reached to the limit of taxable capacity.

The most important feature of the Indian tax system is the heavy reliance on indirect taxes, whose share in total tax revenue was 64 percent in 1950-51 and about 80 percent in recent years. This represents a serious constraint on our tax potential. The most immediate reason for the extremely limited role of direct taxes is the poverty of the exemption limit. And the exemption limit; if lowered, would not only fail to take adequate care of the subsistence needs of a family; it would also raise the administrative costs of tax collection to prohibitive heights.

Thus the most immediate need (in view of raising the taxable capacity) is that of diversifying the tax structure in favour of the direct taxes. This, however, may not be immediately possible given the constrains of backwardness. Nevertheless, areas may still be identified where improvements are possible.

1. Report of the Indirect Taxation Committee, Part-II, Jan. 1978. p. 11
2. op. cit, p.11

2.8.5 Summary

In this lesson we have studied about taxable capacity its meaning, types and determinants and taxable capacity in India. With economic development, the taxable capacity of the Indian fiscal system will gradually register an increase. However, in the meantime, it may be given a substantial fillip by reforming the tax system on the lines suggested above.

2.8.6 Short answer type questions

(x) Explain the concept of taxable capacity.
- (i) What are the causes of low taxable capacity in India?
- (ii) Differentiate relative and absolute taxable capacity.
- (iii) What is the significance of taxable capacity?
- (iv) Differentiate shifting and evasion of tax.

2.8.7 Long answer type questions

1. Discuss the concept of taxable capacity with a view to identify its determinants.
2. Define taxable capacity. Has India reached her taxable capacity ?

2.8.8 Recommended books

1.	H.L.Bhatia	:	Public Finance
2.	Hugh Dalton	:	Public Finance
3.	P.E. Taylor	:	Economics of Public Finance
4.	A.C. Pigou	:	Public Finance
5.	V.C. Mankar	:	Public Finance
6.	R.K. Lekhi	:	Public Finance
7.	B.P. Tyagi	:	Public Finance

SUGGESTED QUESTIONS FOR YOUR PRACTICE

1. What is public debt? Describe the money burden and real burden of public debt.
2. Describe the forms of public debt and suggest the methods to repay it.
3. Under which circumstances and for what purposes are the public loans justified?
4. Why is public debt incurred? Describe the methods of its redemption.
5. Discuss the role of public debt in a developing economy like that of India.
6. What is deficit financing? Give its objectives.
7. Define deficit financing? Why has the Government of India adopted deficit financing on a large scale?
8. What are the evil consequences of huge deficit financing?
9. Distinguish between (a) Impact (b) Shifting and (c) Incidence of a tax. Illustrate Your answer with suitable examples.
10. Explain in detail the Demand and the Supply theory of shifting.
11. Critically examine the demand and the supply theory of shifting.
12. Define the term incidence of taxation.

Write short answers of the following questions:

(i) Distinguish internal and external debt.
(ii) Differentiate voluntary and forced debt.
(iii) Distinguish productive and unproductive debt.

(iv) Define deficit financing.
(v) Differentiate fiscal deficit and budgetary deficit.
(vi) What are techniques of deficit financing?
(vii) Define incidence of a tax.
(viii) What is the new concept of incidence of taxation?
(ix) What is the importance of incidence of taxation?