Directorate of Distance and Continuing Education

Manonmaniam Sundaranar University

Tirunelveli – 627 012, Tamil Nadu.

B.A. ECONOMICS

(Third Year)

Fiscal Economics

(JMEC52)

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Semester	Course	Title of the Course	Course Code	Credits
V	Core - X	Fiscal Economics	JMEC52	4

SYLLABUS

Unit I: Introduction

Fiscal Economics: Nature, Scope, Objectives and Instruments – Major Fiscal Functions – Market Failure: Public Goods and Private Goods, Externalities, Efficiency Versus Equity – Principles of Functional Finance.

Unit II: Theories of Fiscal Economics and Policy

Principle of Maximum Social Advantage – The Benefit Approach – The Ability-to-Pay Approach – Equal Sacrifice Principle – Fiscal Policy and its Instruments.

Unit III: Budget and Taxation

Role of Government in a Modern Economy – Public Budget: Types and Structure – Taxation – Features of a Good Tax System – Direct and Indirect Taxes – Concept of Impact – Incidence and Shifting of Taxation – Elasticity and Determination of Tax Burden – Optimal Taxation.

Unit IV: Public Expenditure and Debt

Public Expenditure: Cannon and Classification – Wagner's Law of Public Expenditure – Public Debt: Meaning and Types, Burden of Public Debt – Principles of Public Debt Management – Deficit Financing.

Unit V: Indian Public Finance

Budget of the Government of India (Previous Financial Year) – Sources of Public Receipts (Tax and Non-Tax, GST and its Impacts) – Components of Public Expenditure – Sources of Public Borrowing and Debt Liabilities – Deficits – Appraisal of FRBM Act 2004 – Fiscal Federalism: Centre and State Relations – Recommendations of Last 3 Finance Commissions.

TEXTBOOKS

1. Bhatia H.L., (2012), Public Finance, Vikas Publications.

2. Tyagi B. P and H.P. Singh (2018) "Public Finance" Jai Prakash Nath & Co, Meerut.

3. Dr. S.K. Singh, "Public Finance in Theory and Practice", S Chand Publishing, 2008.

4. Lekhi, "Public Finance", Kalyani Publishers, 2015.

5. Richard. A. Musgrave & Peggy B. Musgrave, "Public Finance in Theory and Practices", McGraw Hill International Edition, New York, 2006.

Unit I: Introduction

Fiscal Economics: Nature, Scope, Objectives and Instruments – Major Fiscal Functions – Market Failure: Public Goods and Private Goods, Externalities, Efficiency Versus Equity – Principles of Functional Finance.

Nature of Fiscal Economics

Fiscal Economics is a **branch of public economics** that studies how government activities particularly **taxation, expenditure, borrowing, and budgeting** which affect the overall economy. Its nature reflects both **theoretical** and **practical** aspects of how public finance shapes economic growth, stability, and social welfare.

1. Normative and Positive Nature

Positive aspect: Fiscal economics examines *what is*—how government spending, taxation, and borrowing actually work in the real world.

Example: How does an increase in government expenditure affect GDP or inflation?

Normative aspect: It also explores *what ought to be*—how fiscal policy should be designed to achieve desirable outcomes such as equity, growth, or stability.

Example: Should governments impose higher taxes on the rich to reduce inequality?

Thus, fiscal economics combines **empirical observation** with **value-based judgment**.

2. Policy-Oriented Nature

Fiscal economics is **policy-driven**. It provides the **theoretical foundation** for **fiscal policy**—the use of government spending and taxation to influence the economy.

Governments rely on fiscal economics to:

- Manage **economic cycles** (control inflation and recession)
- Promote **economic growth**
- Reduce **unemployment**
- Ensure **equitable income distribution**

Hence, it has a **practical, applied nature**, directly connected to governance and economic planning.

3. Interdisciplinary Nature

Fiscal economics doesn't exist in isolation. It draws upon several fields:

- ✓ **Economics** (especially macroeconomics and public finance)
- ✓ **Political science** (because fiscal decisions reflect political priorities)
- ✓ **Sociology** (since fiscal policy affects social welfare)
- ✓ **Statistics and econometrics** (to analyse data for policy formulation)

This interdisciplinary nature helps fiscal economics understand **complex socio-economic realities**.

4. Welfare-Oriented Nature

A central aim of fiscal economics is **maximizing social welfare**. Government's fiscal actions—taxes, subsidies, and social expenditures—are designed to: Reduce poverty and inequality, Provide public goods (like education, healthcare, infrastructure) and Correct market failures

Thus, fiscal economics is not only about raising and spending money, but about **enhancing human welfare** through equitable resource allocation.

5. Dynamic Nature

Fiscal economics is **dynamic**, not static. Economic conditions, demographic trends, technology, and global trade constantly change—so fiscal policies must adapt.

Example: The fiscal response to the COVID-19 pandemic (stimulus packages, health spending) reflects the **adaptive** nature of fiscal economics.

Hence, it evolves with changing **economic priorities and challenges**.

6. Balancing Micro and Macro Perspectives

Fiscal economics bridges **microeconomics** and **macroeconomics**: At the **micro level**, it studies how taxes or subsidies affect individual and business decisions and at the **macro level**, it examines aggregate impacts on employment, output, inflation, and growth.

This dual perspective allows fiscal economics to connect **individual behaviour** with **national economic outcomes**.

7. Ethical and Institutional Nature

Fiscal economics involves **moral and institutional considerations**:

- ✓ Ethical: How fair are taxes? Are fiscal benefits distributed justly?

- ✓ Institutional: What are the roles of Parliament, Finance Ministry, and Audit bodies in fiscal decisions?

Hence, fiscal economics also studies **governance structures** and **accountability** in public finance.

8. Global and Developmental Nature

In the modern era, fiscal economics is **global in scope**. It examines:

- ➢ How international trade and capital flows influence national budgets.
- ➢ How fiscal discipline and debt management affect global credit ratings.
- ➢ How developing nations use fiscal tools to achieve **sustainable development**.

Thus, fiscal economics is crucial for both **domestic development** and **international economic stability**.

Scope of Fiscal Economics

The **scope of Fiscal Economics** refers to the **range of subjects, issues, and activities** that this field covers. In other words, it explains *what fiscal economics studies and deals with* — the various functions of the government related to **raising revenue, spending money, borrowing funds, and managing the overall economy**.

Fiscal economics is not limited to accounting for income and expenditure; rather, it examines how these fiscal operations **influence economic growth, stability, and social welfare**.

1. Public Revenue (Government Income)

This part of fiscal economics studies **how the government earns money** to finance its activities. It includes:

- ✓ **Tax revenue**: Income tax, GST, customs, excise duties, etc.
- ✓ **Non-tax revenue**: Fees, fines, interest, dividends from public enterprises, etc.

Fiscal economics analyses:

- ➢ The **sources and structure** of government revenue.
- ➢ The **effects of taxation** on individuals and businesses (e.g., how taxes affect consumption, savings, and investment).
- ➢ The **principles of taxation** (justice, equity, efficiency, convenience).

Example: How a rise in income tax influences people's spending habits or savings.

2. Public Expenditure (Government Spending)

This deals with **how and where the government spends its money**. Fiscal economics studies:

- Types of expenditure: capital and revenue expenditure.
- Allocation of funds to defence, health, education, infrastructure, etc.
- **Effects of public expenditure** on production, employment, income distribution, and economic welfare.
- **Efficiency and control** in government spending.

Example: How investment in education increases human capital and productivity.

3. Public Debt (Government Borrowing)

When government revenue is not enough to meet expenses, it borrows money. Fiscal economics studies:

- ✓ **Sources of public debt** (internal and external loans).
- ✓ **Management of public debt** (repayment, interest burden).
- ✓ **Impact of borrowing** on inflation, private investment, and future generations.
- ✓ The issue of **deficit financing** and debt sustainability.

Example: How excessive borrowing can lead to inflation or debt crisis.

4. Fiscal Policy

This is the **core area** of fiscal economics. It refers to the **use of taxation, expenditure, and borrowing** by the government to **achieve macroeconomic goals** such as: Economic stability, Full employment, Economic growth, Control of inflation and deflation, Reduction of inequality.

Fiscal economics studies **how fiscal policy works**, its instruments, limitations, and coordination with **monetary policy**.

Example: During a recession, government increases spending to boost demand (expansionary fiscal policy).

5. Budgetary Process

The **budget** is the government's **financial statement** of expected revenue and expenditure for a year. Fiscal economics examines:

i. The **preparation and presentation** of the budget.

ii. The **budgetary principles** (unity, universality, annuality, etc.).

iii. **Budgetary control** and **deficit management**.

iv. **Fiscal transparency** and **accountability**.

Example: The Union Budget of India outlines fiscal priorities for economic growth.

6. Fiscal Federalism

In federal countries like India, fiscal economics also covers the **division of financial powers** between different levels of government — central, state, and local. It studies:

- ✓ **Tax-sharing arrangements** and **grants-in-aid**.
- ✓ **Centre–State financial relations**.
- ✓ Role of **Finance Commissions** and **decentralized fiscal management**.

Example: How GST is shared between the central and state governments.

7. Effects on Economic and Social Objectives

Fiscal economics studies the **impact of fiscal operations** on broader goals like:

- **Economic growth** – through investment and infrastructure.
- **Employment generation** – through public works and subsidies.
- **Equitable distribution of income** – through progressive taxes and welfare schemes.
- **Price stability** – through fiscal control of demand and supply.
- **Social welfare** – through spending on education, health, and poverty reduction.

Example: Fiscal policy as a tool to reduce inequality through higher taxes on the rich and welfare spending for the poor.

Objectives of Fiscal Economics

The major **objectives of fiscal economics** can be grouped into **economic**, **social**, and **developmental** goals.

1. Economic Stability

One of the primary aims is to **stabilize the economy** by controlling inflation and deflation.

- During **inflation**, fiscal measures such as reducing expenditure or increasing taxes help to control demand.
- During **deflation or recession**, the government increases expenditure and reduces taxes to boost demand.

Fiscal policy thus acts as a **stabilization tool** that smooths economic fluctuations.

Example: During a slowdown, the government launches infrastructure projects to generate employment and increase income.

2. Economic Growth

Fiscal economics seeks to **promote sustainable economic growth** by influencing investment and productivity.

- Public spending on infrastructure, education, and research enhances growth potential.
- Tax incentives and subsidies encourage private investment.

The objective is to raise the **national income and living standards** over time.

Example: Government investment in highways, digital connectivity, and renewable energy boosts long-term growth.

3. Full Employment

Another key goal is to achieve **full employment** (maximum utilization of labour and resources).

- Expansionary fiscal policies—like higher public expenditure or lower taxes—stimulate demand and create jobs.
- Fiscal economics studies how to use budgetary measures to reduce **unemployment** and underemployment.

Example: Employment guarantee schemes (like MGNREGA in India) are fiscal tools for job creation.

4. Economic Equity (Social Justice)

Fiscal economics aims at **reducing income and wealth inequalities** in society.

- Progressive taxation ensures that the rich pay a larger share of taxes.
- Welfare expenditure supports vulnerable groups—like the poor, elderly, or unemployed.

The goal is to achieve **fair distribution of income** and promote **social welfare**.

Example: Subsidized food, education, and healthcare programs improve living conditions for the poor.

5. Resource Allocation and Efficiency

Fiscal economics guides the **efficient allocation of resources** between the public and private sectors.

- Some goods (like roads, defence, and sanitation) are better provided by the government (public goods).
- Taxes and subsidies can correct **market failures** and ensure that resources are used efficiently.

Example: Tax incentives for renewable energy encourage eco-friendly investment.

6. Price Stability

Fiscal measures help in maintaining **stable prices**.

- Excess demand causes inflation, which can be reduced by cutting government expenditure or raising taxes.
- During deflation, the opposite measures help to revive demand.

The aim is to avoid both **runaway inflation** and **prolonged deflation.**

7. Balanced Regional Development

Fiscal economics also seeks **regional balance** by encouraging development in backward areas.

- Government grants, subsidies, and infrastructure spending are directed toward lagging regions.

Example: Establishing industrial corridors or special economic zones in underdeveloped areas.

8. Fiscal Discipline and Debt Management

Another important goal is to maintain **financial stability** by avoiding excessive deficits and unsustainable debt.

- Fiscal economics studies how to balance **revenue and expenditure** responsibly.

Example: The Fiscal Responsibility and Budget Management (FRBM) Act in India aims to ensure fiscal discipline.

Instruments of Fiscal Economics

The **instruments** (or tools) are the **methods used by the government** to achieve the above objectives. There are three major instruments:

1.Taxation

Taxation is the process through which the government collects money from individuals and businesses to finance public spending.

Functions in Fiscal Economics

- Raises revenue for government expenditure.
- Controls inflation (by reducing disposable income).
- Redistributes income (through progressive taxes).
- Influences investment decisions (via tax incentives or disincentives).

Types:

- **Direct taxes:** Income tax, wealth tax, corporate tax.
- **Indirect taxes:** GST, excise duty, customs duty.

Example: High luxury taxes reduce consumption of non-essential goods and promote savings.

2. Public Expenditure

Public expenditure refers to the spending by the government on goods, services, and infrastructure to promote economic welfare.

Functions in Fiscal Economics:

- Creates employment and increases aggregate demand.
- Develops infrastructure and human capital.
- Supports welfare schemes (education, health, poverty relief).
- Promotes balanced regional and sectoral growth.

Example: Government spending on rural roads, housing, or healthcare increases productivity and welfare.

3. Public Borrowing (Public Debt)

When revenue is insufficient, the government borrows from domestic or international sources to meet its expenditure.

Functions in Fiscal Economics:

- Finances developmental projects.
- Helps in deficit management.
- Stimulates the economy during recessions (through deficit spending).

- Needs careful management to avoid excessive debt burden.

Example: Borrowing to fund infrastructure or emergency relief programs.

4. Budgetary Policy (Supplementary Instrument)

The **budget** serves as a comprehensive tool combining taxation, expenditure, and borrowing decisions.

Fiscal economics uses the budget to:

- Control deficits or surpluses.
- Plan resource allocation.
- Achieve fiscal balance and accountability.

Example: Union Budget sets annual fiscal priorities to balance growth and stability.

Major Fiscal Functions

The **major fiscal functions** refer to the **core responsibilities of the government** in managing the economy through its fiscal operations — **taxation, expenditure, borrowing, and budgeting**.

In other words, fiscal functions describe *what the government does through its financial activities* to achieve economic efficiency, stability, and welfare.

These functions were first clearly defined by **Richard A. Musgrave**, a leading public finance economist, who identified **three major fiscal functions**:

1. Allocation Function
2. Distribution Function
3. Stabilization Function

1. Allocation Function

The allocation function refers to the government's role in ensuring that resources are used efficiently in the production of goods and services — especially between the public and private sectors. It is needed because:

- The **market mechanism** alone cannot efficiently provide certain goods and services — known as **public goods** — like defence, street lighting, law and order, or sanitation.
- These goods are **non-excludable** (everyone benefits) and **non-rivalrous** (one person's use doesn't reduce another's).

Hence, private firms have no incentive to produce them, leading to **market failure.**

Government's Role:

The government **allocates resources** for producing public goods and correcting market imbalances. It may also use **taxes and subsidies** to influence private production and consumption.

Examples:

- ✓ Government spending on roads, bridges, defence, and education.
- ✓ Subsidies on renewable energy to encourage green production.

Objective:

- To achieve **efficient allocation of resources** so that both public and private goods are optimally produced for society's welfare.

2. Distribution Function

The **distribution function** deals with how **income and wealth** are distributed among individuals in society. Fiscal economics recognizes that free markets often lead to **inequalities**, concentrating wealth in the hands of a few.

Government's Role:

- Through **progressive taxation**, the government collects more from the rich.
- Through **public expenditure**, it provides benefits and welfare to the poor.
- It also introduces **transfer payments** like pensions, scholarships, and unemployment benefits.

Objective:

- To promote **social justice** and **equity** in income distribution.
- To ensure that everyone has access to basic needs — education, healthcare, housing, and employment opportunities.

Examples:

- Higher income tax for wealthy individuals.
- Free education, subsidized healthcare, or food security programs for the poor.
- Welfare schemes like MGNREGA or old-age pensions.

3. Stabilization Function

The **stabilization function** relates to maintaining **economic stability** — controlling inflation, unemployment, and ensuring steady growth. It is needed because:

- The capitalist economy is subject to **business cycles** — periods of boom and recession.
- During inflation, prices rise sharply; during depression, unemployment and idle capacity increase.

Government's Role:

Uses **fiscal policy** (taxation, expenditure, borrowing) to influence aggregate demand.

- ✓ During **recession:** Increase public spending, reduce taxes inorder to raise demand.
- ✓ During **inflation:** Reduce spending, increase taxes inorder to control demand.

Ensures **macroeconomic stability**, steady growth, and full employment.

Examples:

- ✓ Stimulus packages during an economic slowdown.
- ✓ Fiscal tightening to control excessive inflation.

Objective:

- To achieve **stable prices**, **high employment**, and **sustained economic growth.**

4. Developmental Function (Modern Addition)

Some economists also add a **fourth function**, especially in developing countries like India:

Fiscal policy is also used to **promote economic development**, build infrastructure, and raise living standards is called as the developmental function.

Examples:

- Investment in agriculture, industries, and education.
- Fiscal incentives for start-ups or rural development.

Market Failure

Market failure occurs when the **free market** — that is, when goods and services are produced and exchanged through voluntary transactions between buyers and sellers — **fails to allocate resources efficiently** or **fails to produce socially desirable outcomes.**

In other words, **market failure** means that the market mechanism (demand and supply) does **not lead to maximum social welfare.** As a result, the government often has to **intervene** through fiscal and regulatory measures to correct these failures.

Formal Definition

"Market failure is a situation in which the market, left on its own, fails to allocate resources efficiently or equitably, leading to a loss of economic and social welfare."

Understanding the Concept

In a perfectly competitive market:

- Prices reflect all costs and benefits.
- Producers supply goods efficiently.
- Consumers get what they want at fair prices.

However, in the real world, markets are imperfect — they may produce **too much of harmful goods** (like pollution) or **too little of beneficial goods** (like education). These inefficiencies create a gap between **private interest** and **social interest** — and that's where *market failure* happens.

Major Causes / Types of Market Failure

1. Public Goods

Nature:

Public goods are **non-excludable** (no one can be prevented from using them) and **non-rivalrous** (one person's use doesn't reduce availability for others).

Problem:

Because firms cannot charge people directly for their use, **no private producer** is willing to supply them — leading to **underproduction or absence** of such goods.

Examples:

National defence, street lighting, public parks, etc,

Government Role:

Fiscal economics steps in — government **produces or funds** these goods through **taxation and public expenditure.**

2. Externalities

Nature:

Externalities occur when **private activities have spillover effects** (positive or negative) on others that are **not reflected in market prices.**

Types:

Negative externalities: When an action imposes costs on others. Example: Pollution from a factory harm nearby residents.

Positive externalities: When an action provides benefits to others. Example: Education or vaccination improves society's wellbeing.

Problem:

Because these effects are **not included in the market price**, there is **overproduction of harmful goods** and **underproduction of beneficial goods.**

Government Role:

- ✓ Taxing negative externalities (e.g., pollution tax)
- ✓ Subsidizing positive externalities (e.g., education grants, health programs)

3. Monopoly and Imperfect Competition

Nature:

When a single firm (or few firms) dominates the market, it can **restrict output** and **charge higher prices**, leading to **inefficiency and welfare loss.**

Problem: Monopolies act in **self-interest**, not social interest.

Examples: A railway company or electricity board as a sole supplier.

Government Role:

- ✓ **Regulation** to prevent abuse of market power.
- ✓ **Public ownership** of natural monopolies (like water, electricity).
- ✓ **Antitrust laws** to ensure competition.

4. Information Asymmetry

Nature:

Market transactions require **full and accurate information**. If one party (buyer or seller) has **more or better information** than the other, it leads to **inefficient decisions.**

Examples:

- ✓ Sellers may hide defects in products.
- ✓ Insurance buyers may conceal health risks.

Problem:

Bad products or risks drive out good ones — a phenomenon known as **adverse selection**.

Government Role:

Mandating **disclosure norms**, **consumer protection laws**, and **quality standards.**

5. Inequality in Income and Wealth

Nature:

Markets reward efficiency and productivity, but not fairness. Over time, this can lead to **concentration of wealth** and **social inequality.**

Problem:

Extreme inequality reduces social welfare and economic stability.

Government Role:

Redistribution through **progressive taxation** and **welfare spending.**

6. Macroeconomic Instability

Nature:

Markets can experience cycles of **boom and recession**, leading to unemployment or inflation.

Problem:

The market cannot automatically maintain full employment or stable prices.

Government Role:

Use of **fiscal policy** (spending and taxation) to stabilize the economy.

Public Goods and Private Goods

Every economy produces goods and services to satisfy human wants.
These goods can broadly be divided into **Private Goods** and **Public Goods**, depending on **how they are consumed** and **who pays for them**.

The distinction mainly arises due to the **nature of consumption** — whether it is **exclusive** or **shared** among people.

1. Private Goods

Private goods are those which are owned and consumed by individuals. Their consumption by one person reduces the amount available to others, and non-payers can be excluded from using them.

Key Features

Feature	**Explanation**
Excludability	People who do not pay can be excluded from using the good. (Example: You can be denied entry to a movie without a ticket.)
Rivalry in Consumption	One person's consumption reduces the amount available for others. (Example: If you eat a slice of pizza, no one else can eat it.)

Rejectability	Individuals can decide whether or not to buy the good.
Provided by	Mostly produced and distributed by the **private sector**, based on profit motive.
Market Price Exists	Price is determined by the forces of demand and supply.

Examples

- ✓ Food, clothing, houses, mobile phones, cars, etc.
- ✓ Services like private education, private healthcare, etc.

Economic Implication

Private goods are **efficiently allocated by the market**, since people pay according to their willingness and ability to pay.

2. Public Goods

Public goods are those provided by the government because they are non-excludable and non-rivalrous — meaning, no one can be excluded from using them, and one person's use doesn't reduce availability for others.

Key Features

Feature	**Explanation**
Non-excludability	No individual can be prevented from enjoying the benefits of the good once it is provided. (Example: Everyone benefits from streetlights, whether they pay or not.)
Non-rivalry in Consumption	One person's use does not reduce availability for others. (Example: One person's enjoyment of national defense doesn't reduce its protection for others.)
No Market Price	Cannot be sold individually; hence the market fails to provide them efficiently.
Provided by	Government, financed through taxation.
Free Rider Problem	Individuals may benefit without paying for it, leading to under-provision if left to private markets.

Examples

National defence, Street lighting, public parks, Flood control systems, Police and fire services, Air quality, clean environment.

Economic Implication

Since markets fail to supply these goods (due to the **free rider problem**), the **government intervenes** through **fiscal policy** — collecting taxes and providing these goods to ensure social welfare.

3. Public vs Private Goods – Comparison Table

Basis	**Public Goods**	**Private Goods**
Excludability	Not possible to exclude anyone	Possible to exclude non-payers
Rivalry	Non-rivalrous	Rivalrous
Provider	Government	Private individuals/firms
Pricing	No market price	Market price exists
Example	Defence, streetlights, law & order	Food, cars, clothes
Efficiency	Market fails to provide efficiently	Market allocates efficiently
Free Rider Problem	Yes	No

4. Related Concepts

Quasi-Public Goods (or Merit Goods):

Goods that have features of both public and private goods — e.g., **education, healthcare**, **public transport**. These are partly excludable and partly rivalrous. The government provides them because they generate **positive externalities** (benefits to society).

Externalities

An **externality** occurs when the actions of one person, firm, or group **affect the welfare of others**, but these effects are **not reflected in market prices**.

In other words —An **externality** is a **side effect** (positive or negative) of an economic activity that affects **third parties** who are **not directly involved** in the activity.

Key Idea

Markets usually work well when **private costs = social costs** and **private benefits = social benefits**. But when externalities exist, this equality breaks down:

- **Private cost or benefit:** The cost or benefit felt by the individual or firm directly involved in the transaction.
- **Social cost or benefit:** The total cost or benefit to society as a whole (private + external effects).

Hence,

Social Cost = Private Cost + External.

Social Benefit = Private Benefit + External Benefit.

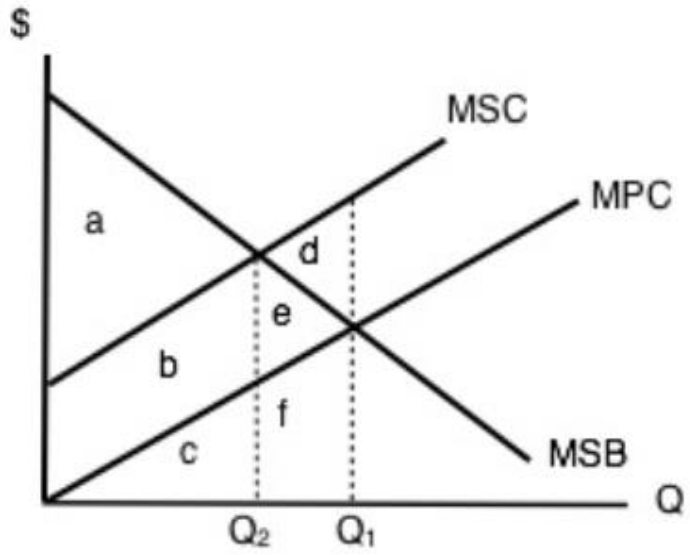
1. Negative Externalities (External Costs)

When an economic activity **imposes a cost** on others who are not part of that activity. The **producer's private cost** is **less than** the **social cost**, leading to **overproduction** or **overconsumption**.

Examples

- **Pollution** from factories: affects health, air, and water quality of nearby residents.
- **Noise** from airports or vehicles.
- **Deforestation** by companies causes climate damage to society.
- **Cigarette smoking** harms passive smokers.

Diagrammatically



The **Marginal Social Cost (MSC)** curve lies **above** the **Marginal Private Cost (MPC)** curve. The difference shows the **external cost** borne by society.

Government's Role

To **correct** negative externalities, the government may:

- Impose **taxes** (Pigouvian tax) equal to the external cost,
- Enforce **regulations** or **pollution control standards**,
- Promote **clean technology**.

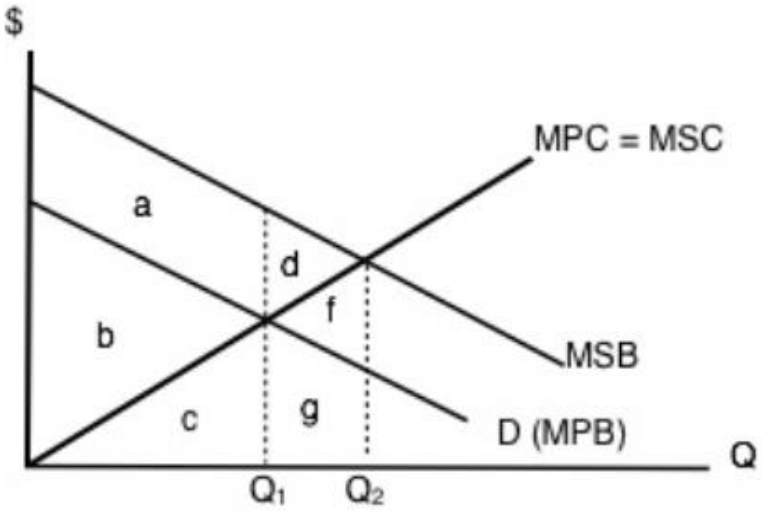
2. Positive Externalities (External Benefits)

When an economic activity **benefits others** who are not involved in the transaction. The **social benefit** is **greater** than the **private benefit**, leading to **underproduction** or **underconsumption** in the market.

Examples

- **Education:** Makes individuals more productive and also benefits society through innovation and civic behaviour.
- **Vaccination:** Protects both the person vaccinated and others by reducing disease spread.
- **Research and Development (R&D):** Benefits other firms and industries through shared knowledge.
- **Tree planting:** Improves air quality for all.

Diagrammatically



The **Marginal Social Benefit (MSB)** curve lies **above** the **Marginal Private Benefit (MPB)** curve. The difference represents the **external benefit** enjoyed by society.

Government's Role

To **encourage** positive externalities, the government may:

- ✓ Provide **subsidies**, **tax reductions**, or **free services**,
- ✓ Invest in **public education**, **healthcare**, and **infrastructure**,
- ✓ Support **R&D** and **innovation programs**.

3. Types of Externalities

Basis	Type	Example
From Production	Negative	Industrial pollution
	Positive	A firm trains workers who later benefit other firms
From Consumption	Negative	Smoking in public
	Positive	Getting vaccinated
Between Producers	Negative	Factory's waste harms a nearby fishery
	Positive	Tech company's innovation benefits others
Between Consumers	Negative	Loud music
	Positive	Home garden beautifies neighbourhood

4. Relation to Market Failure

Externalities cause market failure because prices do not reflect the true social cost or benefit of goods. Hence, markets overproduce harmful goods (negative externalities) and underproduce beneficial goods (positive externalities). This justifies government intervention — through taxes, subsidies, or regulations — to achieve social efficiency.

Efficiency Versus Equity

Efficiency

In economics, **efficiency** refers to the **optimal use of resources** so that **total output or welfare is maximized** — no one can be made better off without making someone else worse off. This condition is called **Pareto Efficiency**.

Efficiency → Focuses on "how large the pie is."

It is achieved when:

- Goods and services are produced at the lowest cost,

- Resources are allocated according to consumer preferences, and
- The economy operates on its **production possibility frontier (PPF)**.

Equity

Equity means **fairness or justice** in the distribution of income and wealth among individuals or groups in society.

Equity → Focuses on "how the pie is shared."

It does not mean equality (everyone gets the same) but **fairness**, where people receive rewards according to their effort, need, or contribution.

The Core Trade-Off

There is often a **tension (trade-off)** between **efficiency** and **equity**, because policies that improve one may reduce the other.

Focus	**Efficiency-Oriented Policy**	**Equity-Oriented Policy**
Goal	Maximize total output and growth	Distribute income more fairly
Typical Policies	Free markets, lower taxes, minimal government interference	Progressive taxes, welfare spending, subsidies
Effect on Economy	Encourages production and innovation	Reduces inequality but may discourage work or investment

How Fiscal Economics Balances Both

Fiscal economics studies **how government revenue and expenditure policies** can **balance** these two objectives.

1. Efficiency Aspect

Fiscal policies aim to:

- ✓ Ensure **productive efficiency**: using taxation and expenditure to encourage investment, employment, and innovation.
- ✓ Minimize **waste and distortion** in resource allocation (for example, avoid taxes that discourage production).
- ✓ Promote **economic growth** through infrastructure and education.

2. Equity Aspect

Fiscal policies aim to:

- ✓ Achieve **distributive justice** through **progressive taxation** — higher taxes on the rich, lower on the poor.
- ✓ Provide **social security**, **healthcare**, **education**, and **welfare schemes** to support the disadvantaged.
- ✓ Reduce **income and wealth inequalities**.

The Trade-Off Explained

When the government **redistributes income** (through taxes and subsidies):

It improves **equity** — society becomes fairer. But it may reduce **efficiency**, because:

- ✓ High taxes can reduce incentive to work or invest.
- ✓ Subsidies can encourage dependency or waste.

On the other hand, if the government **focuses only on efficiency**: The economy grows faster, but the **gap between rich and poor widens**, causing social tension.

Hence, **Fiscal Economics** seeks a **balanced approach** — ensuring that redistribution does not hurt efficiency too much, and efficiency does not ignore equity.

Example

Imagine two countries:

Country A	**Country B**
Has high growth but wide income inequality	Has moderate growth but low inequality
Policies favour free market	Policies favour welfare and redistribution
Efficient but not equitable	Equitable but less efficient

Fiscal economists try to find a **middle path** — policies that promote both **growth and fairness**, like:

- Progressive taxation with investment incentives,
- Education and skill subsidies (which promote both productivity and equity).

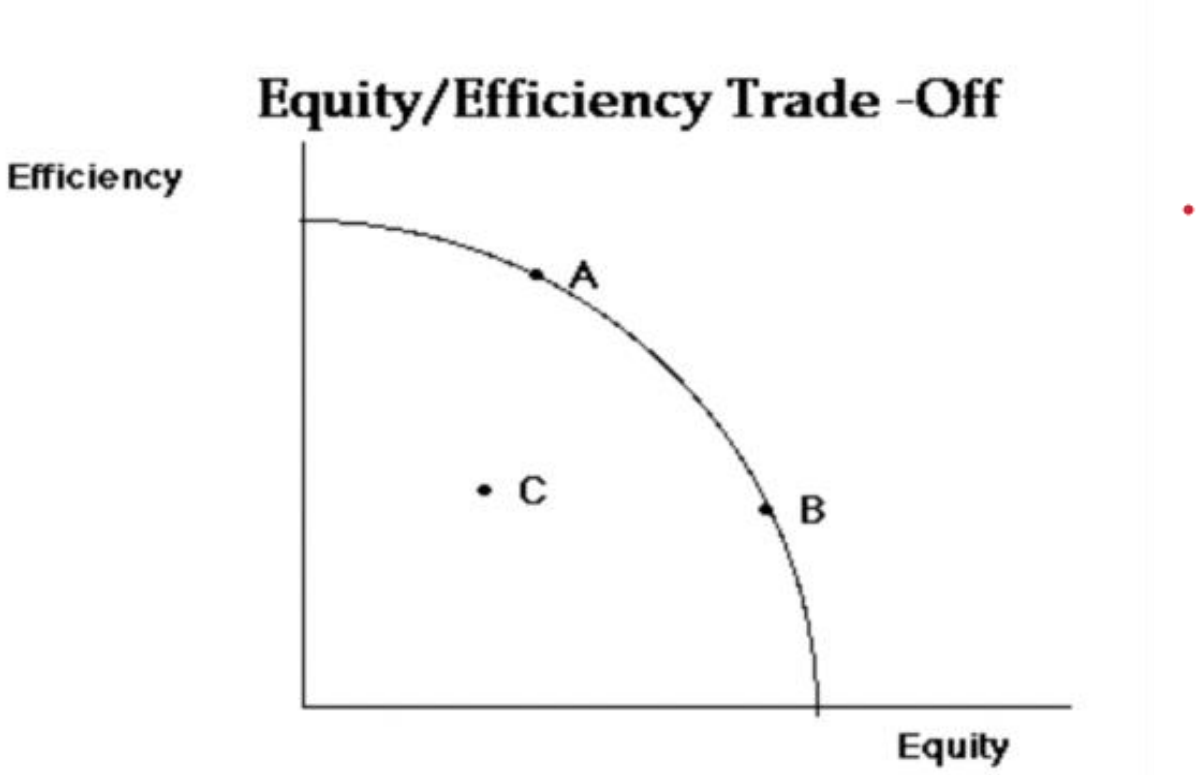
3 Types of Equity

Type	**Meaning**	**Example**
Horizontal Equity	People with similar ability to pay should pay similar taxes.	Two persons earning ₹50,000 should pay the same tax.
Vertical Equity	People with higher income should pay higher taxes.	Progressive income tax.

Intergenerational Equity	Fairness between present and future generations.	Avoiding excessive public debt that burdens future citizens.

In the diagram, on the Y-axis we assumed it as **Efficiency (total output)** and on the X-axis we assume it as **Equity (fairness)** An increase in one often decreases the other — forming a **trade-off curve** called the **Equity-Efficiency Frontier**.

The government's job is to choose the **optimal point** where **society's welfare** (both efficiency and equity) is maximized.



Principles of Functional Finance

Functional Finance is the idea that **government's fiscal policy (spending, taxation, and borrowing)** should be judged **only by its economic effects on the economy — not by traditional rules** like balancing the budget.

In other words:

- The **function** (purpose) of fiscal policy is more important than its **form** (whether there is a deficit or surplus).
- The **goal** is to ensure **full employment, price stability, and economic growth**, not merely to avoid debt.

So, Lerner's question was:

"Does this policy help the economy function better?"

If yes then the government should adopt it, even if it means running a deficit.

3. Core Principles of Functional Finance

Abba Lerner summarized the **principles of functional finance** in three main rules:

Principle 1: The Government Should Maintain Full Employment and Price Stability

The **government should adjust its spending and taxation** to maintain **aggregate demand** at a level that ensures **full employment** and **stable prices**.

- ✓ If **demand is low** (recession) then the government should **increase spending** or **reduce taxes**.
- ✓ If **demand is excessive** (inflation) then the government should **reduce spending** or **increase taxes**.

Example:

During a slowdown, the government may increase public works programs or cut income taxes to boost employment.

During inflation, it may raise taxes or reduce subsidies to curb excess demand.

The budget need not be balanced — a **deficit** during recession or a **surplus** during boom is acceptable if it stabilizes the economy.

Principle 2: The Government Should Manage Public Debt Functionally

The **government should borrow** only if it is necessary to **control interest rates**, **influence liquidity**, or **stabilize the economy** — not because it "needs" money like a household.

The government can create money or issue bonds to maintain stability.

If interest rates are too high then the government should buy bonds (increase money supply).

If interest rates are too low then the government should sell bonds (reduce money supply).

Thus, borrowing is a tool for **monetary control**, not for funding deficits.

Principle 3: The Government Should Print or Retire Money as Needed

If government spending exceeds taxes, it can **create new money** (deficit financing) until the economy reaches full employment.

Once full employment is achieved, further money creation can cause inflation. Then, the government should **reduce spending** or **raise taxes**.

This shows that money creation is **not inherently bad** — it's a **functional tool** to stabilize output and employment.

4. Comparison: Sound Finance vs Functional Finance

Aspect	Sound Finance (Classical View)	Functional Finance (Lerner's View)
Budget Rule	Balanced budget	Flexible budget (deficit/surplus as needed)
Government Role	Passive, minimal	Active, stabilizing role
Borrowing	Avoid borrowing	Borrow to stabilize economy
Deficit Financing	Dangerous and inflationary	Useful tool for full employment
Objective	Fiscal discipline	Economic stability and welfare
Guiding Principle	Financial prudence	Functional effectiveness

5. Tools of Functional Finance

Fiscal instruments are used *functionally* to achieve macroeconomic goals:

- **Taxation policy** used to control inflation or stimulate demand.
- **Public expenditure** used to generate employment and output.
- **Public debt management** used to influence interest rates and liquidity.
- **Deficit financing** used to stimulate production when idle resources exist.

7. Criticisms of Functional Finance

Criticism	Explanation
Inflationary risk	Continuous deficit spending may cause inflation.
Political misuse	Governments may use it for populist reasons, leading to overspending.
Neglect of long-term debt	Over-reliance on borrowing can raise debt-servicing costs.
Crowding out	Large public spending may crowd out private investment if not managed carefully.

Unit II: Theories of Fiscal Economics and Policy

Principle of Maximum Social Advantage – The Benefit Approach – The Ability-to-Pay Approach – Equal Sacrifice Principle – Fiscal Policy and its Instruments.

Principle of Maximum Social Advantage

The **Principle of Maximum Social Advantage** is one of the **core theories of fiscal economics**, developed by **Hugh Dalton**, a British economist. It explains **how government spending and taxation** should be managed to achieve **maximum welfare (social advantage)** for the society.

1. Meaning of the Principle

The **Principle of Maximum Social Advantage** states that the **fiscal operations** of the government — particularly **taxation** (revenue collection) and **public expenditure** (government spending) — should be carried out in such a way that they lead to **maximum net social benefit** or **maximum social welfare**.

In other words, the government should **collect and spend money** in such a manner that the **total happiness (satisfaction) of society is maximized**.

2. Core Idea

Every tax collected **reduces the purchasing power** (and satisfaction) of the taxpayer. Every rupee spent by the government on public welfare **increases satisfaction** in society.

Hence, there are **two effects:**

- **Disutility (loss of satisfaction)** from **taxation**
- **Utility (gain of satisfaction)** from **public expenditure**

The **government must balance these two** — it should **not tax too heavily** (causing suffering), nor **spend too little** (failing to improve welfare).

3. The Marginal Approach (Dalton's Analysis)

Dalton used the concept of **marginal utility** — i.e., the **additional satisfaction** from each extra unit of tax or expenditure.

Let:

- $\mathbf{MU_x}$ = Marginal utility of public expenditure
- $\mathbf{MD_x}$ = Marginal disutility of taxation

The **maximum social advantage** is achieved **when:**

MUx = MDx

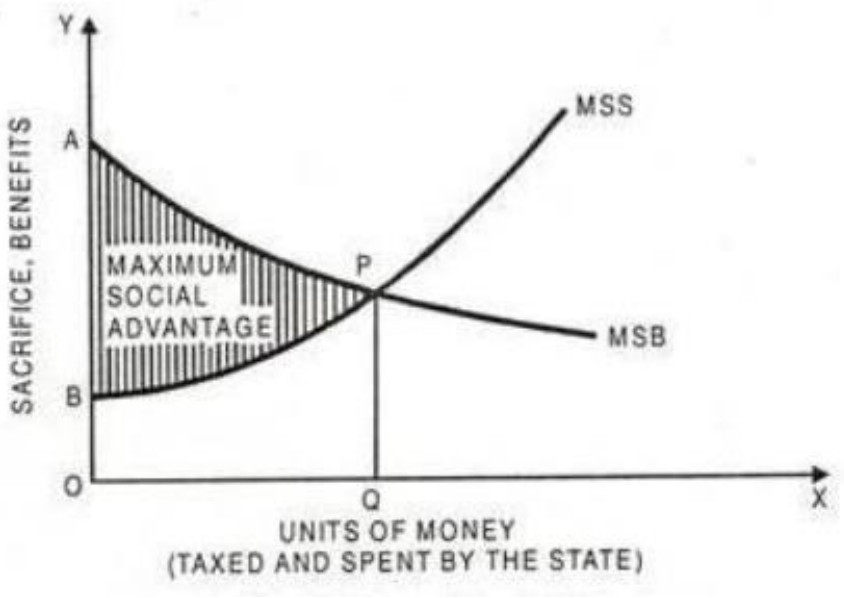
That is:

The government should continue taxing and spending **until** the **marginal social benefit from public spending equals the marginal social sacrifice from taxation.** Beyond this point, further taxation reduces welfare.

4. Diagrammatic Explanation

Imagine two curves:

The **Marginal Social Benefit (MSB)** curve slopes **downward** — as public spending increases, each extra rupee gives **less additional benefit**.



The **Marginal Social Sacrifice (MSS)** curve slopes **upward** — as taxation increases, each extra rupee collected causes **more hardship**.

The two curves intersect at point **E**, where: MSB=MSS

At this equilibrium point:

- Social welfare is **maximized**.
- The government's fiscal operations are **optimal**.

Any deviation from this point:

- **More taxation** ⇒ sacrifice > benefit → welfare falls.
- **Less taxation/spending** ⇒ benefit > sacrifice → welfare not maximized.

5. Assumptions of the Principle

1. **Public expenditure increases social welfare.**
2. **Taxation causes social sacrifice.**
3. Both **can be measured** in monetary or utility terms.
4. The **law of diminishing marginal utility** applies to both income and expenditure.
5. The **government acts rationally** to maximize social welfare.

6. Importance / Implications

- Guides **budgetary policy**: helps in deciding **how much to tax** and **how much to spend**.
- Promotes **economic efficiency** by balancing costs and benefits.
- Encourages **social justice** by preventing excessive taxation or wasteful spending.
- Provides a **theoretical foundation** for **welfare economics** and **functional finance**.

7. Criticisms

1. **Difficult to measure utility and disutility:** It's impossible to measure people's happiness or sacrifice precisely.
2. **Different individuals experience taxation and benefits unequally:** A tax that's painful for the poor may be minor for the rich.
3. **Assumes rational and benevolent government:** In reality, political and bureaucratic motives may distort spending.
4. **Ignores time lags:** The effects of taxation and expenditure occur at different times.
5. **Simplistic:** Modern economies are far more complex; other factors (like inflation, employment, investment) also matter.

8. Modern Relevance

Though theoretical, the principle still serves as a **guiding philosophy**:

- Governments should seek **social benefit, not just revenue balance**.
- Fiscal policy should aim for **maximum welfare**, **not maximum taxation**.
- It forms the **ethical and economic basis** of **welfare state budgeting**.

The Benefit Approach

The **Benefit Approach** to taxation is based on the idea that: **Taxes should be paid by individuals in proportion to the benefits they receive from government services.**

In simple words, those who **benefit more** from the activities of the government should **contribute more** to its revenue. It's similar to paying a **price for public goods and services** — like a fee or charge.

Example:

- ✓ A person who **drives frequently** benefits more from **public roads**, so they should pay more taxes (like road tax, fuel tax).
- ✓ A **business owner** benefits from **law and order, infrastructure, and transport**, so they should contribute more to the cost of these services.

Thus, taxation under this principle is seen as a **payment for services rendered by the government**.

2. Core Idea

The **Benefit Principle** connects taxation to **public expenditure**:

- Government **spends money** on providing public goods (defence, roads, education, etc.).
- Individuals and businesses **enjoy benefits** from these goods.
- Therefore, they should **contribute to government revenue** in proportion to those benefits.

It treats the relationship between the government and citizens as a **give-and-take relationship**: "Pay according to what you get."

3. Main Forms of the Benefit Approach

Economists have suggested two main versions:

a. Voluntary Exchange Theory (Wicksell and Lindahl Model)

Proposed by **Knut Wicksell** and **Erik Lindahl**, this theory views taxation as a **voluntary exchange** between the government and its citizens.

- The government provides **public goods and services**.
- Citizens pay **taxes as prices** for these services.
- When each taxpayer's **tax share equals the value of benefits received**, there is **fiscal equilibrium** and **social welfare is maximized**.

Lindahl Equilibrium:
This occurs when:

- Each taxpayer pays taxes equal to the **marginal benefit** they get from public expenditure.
- The **sum of these taxes** covers the **total cost** of public goods.

b. Benefit Principle in Practical Terms

In modern fiscal systems, the Benefit Approach appears in forms such as:

- **User charges or fees** (e.g., toll tax, water charges, electricity bills)
- **Excise duties on fuel**, since drivers use public roads
- **Vehicle registration taxes**
- **Airport tax or passenger service fee** in travel

These are all **benefit-based taxes** — the payer directly benefits from the service funded by the tax.

4. Assumptions of the Benefit Approach

1. **People can estimate benefits** they receive from public services.
2. **Taxes can be assigned individually** based on benefits received.
3. The **government provides measurable benefits** (public goods).
4. Citizens act **rationally**, like buyers in a market.
5. The **state acts neutrally**, providing services according to collective demand.

5. Diagrammatic Explanation

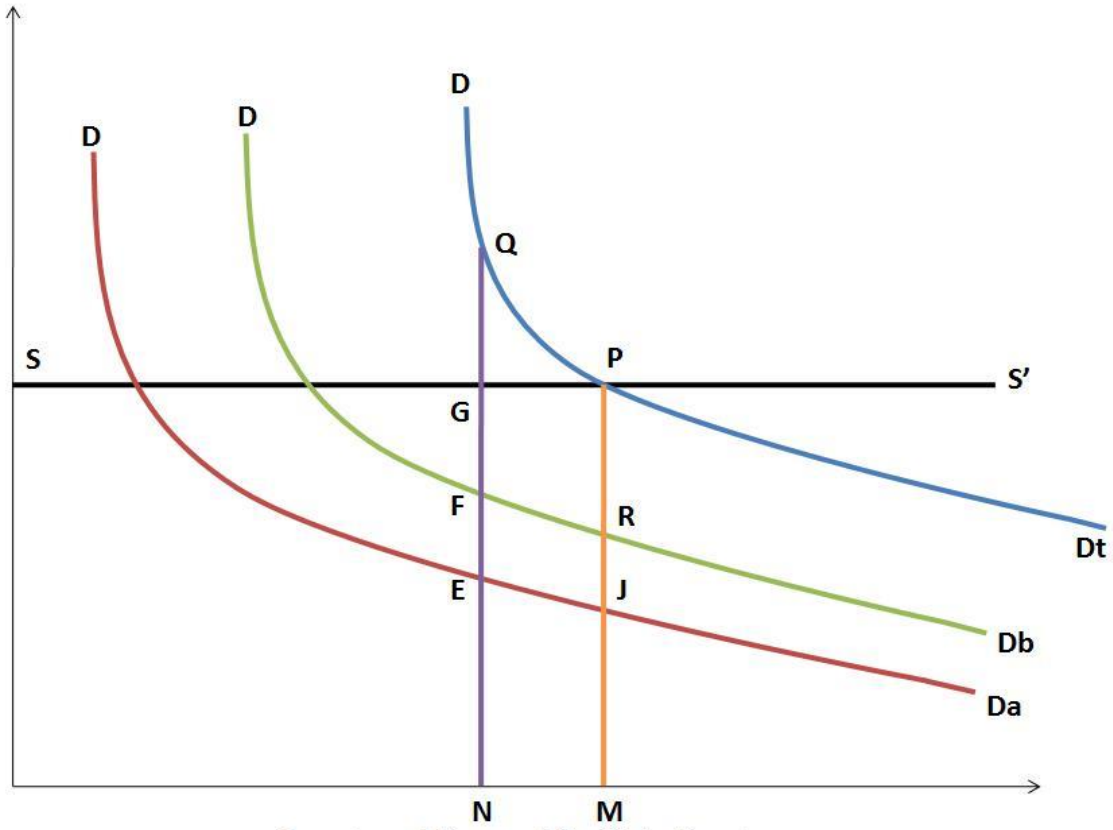
Imagine a graph with:

- **X-axis:** Quantity of public goods/services
- **Y-axis:** Price or tax paid

Each individual has a **demand curve** for public goods (showing their willingness to pay for benefits).
The **Lindahl equilibrium** occurs where the **sum of all individual demand curves equals the cost of supplying** those public goods.

This is the point where:

Total Willingness to Pay=Cost of Providing Public Goods and **fiscal balance** is achieved.



Supply and Demand for State Services

6. Merits of the Benefit Approach

Merit	Explanation
1. Justice and Fairness	Each person pays for what they receive — it's fair and reasonable.
2. No Arbitrary Taxation	Taxes are linked to benefits, reducing resentment.
3. Efficiency	Encourages efficient use of public resources — people value what they pay for.
4. Clear Connection	Establishes a direct relationship between tax payment and government services.
5. Useful for Local Governments	Works well for municipal or utility services (water, sanitation, transport).

7. Demerits / Criticisms

Criticism	Explanation
1. Public Goods are Non-Measurable	Many public goods (like defence, police, justice) benefit everyone equally — can't measure individual benefits.

2. Ignorance of Ability to Pay	A poor person benefits as much as a rich one but can't pay equally. It ignores income inequality.
3. No Voluntary Exchange in Reality	In real life, taxes are **compulsory**, not voluntary. Citizens can't refuse to pay taxes.
4. Not Suitable for Redistributive Goals	Welfare states use taxes to reduce inequality — the Benefit Principle doesn't support this.
5. Complex Administration	Calculating benefits for each taxpayer is impractical.

8. Modern Relevance

Though not practical for all taxes, the **Benefit Approach** still influences fiscal systems today — especially in:

- **Local taxation** (property tax, utility charges)
- **User fees** for government services
- **Environmental taxes** (polluters pay principle)
- **Toll roads and parking fees**

Modern fiscal policy blends **the Benefit Approach** with the **Ability-to-Pay Principle** to ensure both **fairness** and **equity**.

The Ability-to-Pay Approach

The **Ability-to-Pay Principle** states that: Taxes should be levied on individuals **according to their capacity to pay**, **not according to the benefits** they receive from government services.

In simpler terms: Those who **earn more or possess more wealth** should contribute **more** to government revenue, because they have a **greater ability** to bear the tax burden.

Example:

- ✓ A **rich person** and a **poor person** both benefit from public roads, defence, and police protection — but the rich can afford to pay more taxes.
- ✓ So, the government charges **higher income tax rates** to the rich and **lower rates** (or exemptions) to the poor.

Thus, taxation becomes an **instrument of equity and social justice**, not just a payment for services.

2. Core Idea

The principle focuses on **equity (fairness)** in distributing the **tax burden**.
It assumes that:

- ✓ The purpose of taxation is to **raise revenue** for public needs.
- ✓ The government should **not expect equal payment** from all but **proportionate contribution** based on their **economic capacity**.

Hence, **equitable taxation** is one where: Tax burden $\propto$ Ability to pay

3. Types of Equity under the Ability-to-Pay Principle

There are **two main kinds of equity** this approach tries to ensure:

a. Horizontal Equity

People with **equal ability to pay** should pay **the same amount of tax**.

Example: If two people earn ₹10 lakh each per year, both should pay the same tax, regardless of their occupation or lifestyle. It ensures **equal treatment for equals**.

b. Vertical Equity

People with **unequal abilities to pay** should pay **different amounts**, usually with higher earners paying **progressively more**.

Example: If person A earns ₹10 lakh and person B earns ₹50 lakh, person B should pay **a higher amount and a higher rate of tax**. It ensures **unequal treatment for unequals**, maintaining fairness.

4. Measures of Ability to Pay

Economists have proposed three ways to measure a person's **ability to pay taxes**:

Measure	Meaning	Example
1. Income	The flow of earnings from work, property, or investment.	Income tax
2. Property or Wealth	Ownership of assets reflects capacity to pay.	Wealth tax, property tax
3. Expenditure	People who spend more can afford to contribute more.	Luxury tax, expenditure tax

Among these, **income** is considered the **best measure** because it reflects both earning and spending power.

5. Forms of Taxation under the Ability-to-Pay Approach

Based on the taxpayer's capacity, taxation can take different forms:

a. Proportional Taxation

Everyone pays the **same percentage** of income as tax.

Example: If the tax rate is 10%, both a person earning ₹1 lakh and another earning ₹10 lakh pay 10% of their income. This is **simple** but doesn't promote equality.

b. Progressive Taxation

Tax rates **increase with income** — higher earners pay a **larger proportion** of their income as tax.

Example:

- Income up to ₹3 lakh – No tax
- ₹3–10 lakh – 10%
- ₹10–20 lakh – 20%
- Above ₹20 lakh – 30%

This is the **most equitable form**, as it reduces income inequality.

c. Regressive Taxation

Lower-income groups pay a **higher percentage** of their income compared to higher-income groups.

Example: Indirect taxes like GST or sales tax affect the poor more because they spend most of their income on consumption. This system is **unjust** under the Ability-to-Pay Principle.

6. Merits / Advantages

Merit	Explanation
1. Promotes Social Justice	Richer people contribute more, helping reduce economic inequality.
2. Ensures Equity	Tax burden is shared according to capacity, not benefits.
3. Simple and Logical	Based on measurable indicators like income or property.
4. Enhances Welfare State	Provides funds for redistributive policies (education, health, welfare).
5. Reduces Class Conflict	Creates harmony between rich and poor by linking tax to fairness.

7. Demerits / Criticisms

Criticism	Explanation
1. Difficult to Measure Ability	Income and wealth may not always reflect true ability — hidden income, exemptions, etc.
2. May Reduce Incentive to Work/Invest	High progressive taxes can discourage productivity and entrepreneurship.
3. Subjective Judgments	What is "fair" or "equal" differs by individual or government view.
4. Possibility of Tax Evasion	Wealthy individuals may find loopholes to avoid high taxes.
5. Administrative Complexity	Progressive systems are harder to calculate and enforce.

8. Comparison: Benefit Approach vs. Ability-to-Pay Approach

Basis	Benefit Approach	Ability-to-Pay Approach
Main Idea	Pay taxes according to benefits received.	Pay taxes according to ability or capacity.
Nature of Taxation	Like payment for services.	Based on economic capacity.
Objective	Efficiency — equal exchange of benefits and payments.	Equity — fairness in tax burden.
Applicability	Suitable for local and specific services.	Suitable for general public services and welfare.
Justice Type	Commutative justice (give-and-take).	Distributive justice (fair sharing of burden).
Examples	Road tax, water tax, tolls.	Income tax, property tax, wealth tax.

9. Modern Relevance

In today's welfare-oriented economies, the Ability-to-Pay Principle is the foundation of progressive taxation systems worldwide. It aligns taxation with: Social equity, Economic justice, Redistribution of income.

Governments use this approach to: Fund welfare programs, Reduce inequality, Promote inclusive development.

Equal Sacrifice Principle

The **Equal Sacrifice Principle** is based on the **Ability-to-Pay theory** and was developed mainly by **Alfred Marshall** and **A.C. Pigou**.

It states that: **"Taxes should be distributed among citizens so that each person sacrifices the same amount of utility (satisfaction or happiness) as a result of paying taxes."**

In simple words: Everyone should **feel the same pain or sacrifice** after paying taxes — regardless of how rich or poor they are. The goal is **justice in taxation**, not in terms of money paid, but in terms of **loss of satisfaction** due to taxation.

2. Core Idea

According to this principle: **Money has diminishing marginal utility** — that is, the satisfaction gained from each additional rupee decreases as income increases. Therefore, a **rich person** loses less satisfaction when paying ₹1000 than a **poor person** does. To make both sacrifice **equally**, the **rich must pay more** than the poor.

Hence, taxation should be **progressive** — higher-income individuals should pay **not only more money** but also a **larger percentage** of their income.

3. The Law of Diminishing Marginal Utility (Foundation)

This principle depends on an important economic law:

"As a person's income increases, the utility (satisfaction) derived from each additional unit of income decreases."

Example: For a poor man, ₹1000 may mean food and survival means a very high utility. For a millionaire, ₹1000 hardly affects their comfort means very low utility.

So, equal money taxes do **not** cause **equal sacrifices**. To achieve equality, taxes must rise with income — hence, the **progressive tax system**.

4. Types of Equal Sacrifice

Economists like Pigou identified **three interpretations** of what "equal sacrifice" can mean.

a. Equal Absolute Sacrifice

Each taxpayer should give up **the same absolute amount of utility** through taxation. That means the **total loss of satisfaction** caused by paying taxes should be the same for everyone.

However, since the rich derive less utility from each rupee, they must pay **more tax in money terms** to experience the same absolute loss.

Result: Progressive taxation.

b. Equal Proportional Sacrifice

Each taxpayer should sacrifice the **same proportion of their total utility**. In other words, the **percentage of satisfaction** lost due to tax should be the same for everyone.

Example: If the tax reduces a poor man's satisfaction by 10%, it should also reduce a rich man's satisfaction by 10%.

Result: Progressive taxation — but less steep than the equal absolute sacrifice case.

c. Equal Marginal Sacrifice

The **last unit of money** (the marginal utility) left after paying taxes should yield the **same satisfaction** for all taxpayers.

This means the tax should be distributed in such a way that **everyone has the same marginal utility of income after paying tax**. This is considered the **most ideal and just principle**.

Result: Strongly progressive taxation — ensures the **maximum total utility** for society.

5. The Condition for Maximum Social Welfare

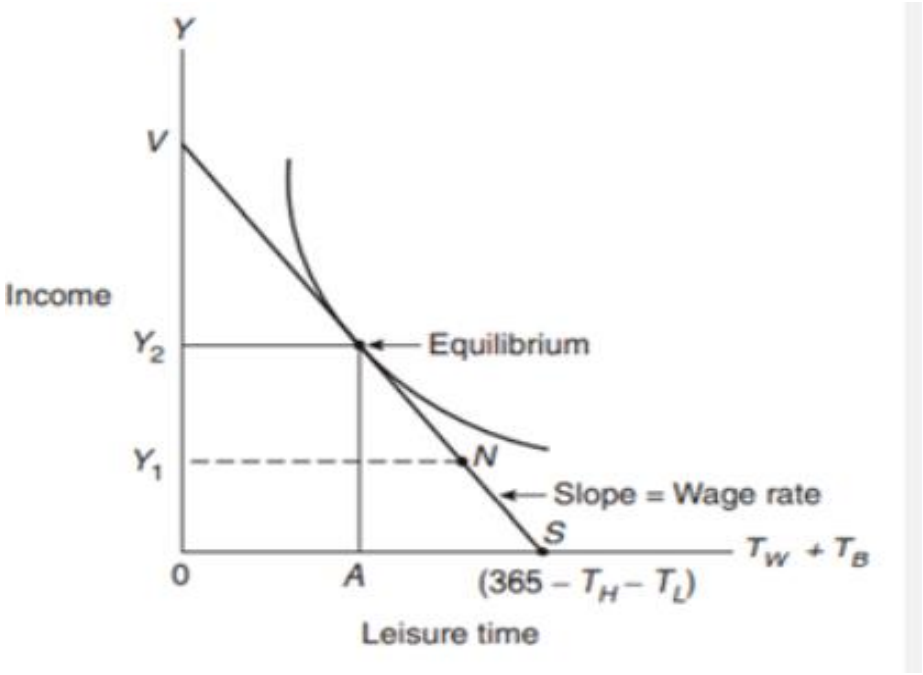
The **Equal Marginal Sacrifice Principle** leads to the **Principle of Least Aggregate Sacrifice**, which states that:

Taxation should be so distributed that the **total sacrifice (loss of satisfaction) of society is minimized**, and **social welfare is maximized**.

When the **marginal utility of income after tax** is **equal across all taxpayers**, total welfare reaches its **maximum** level.

6. Diagrammatic Explanation

In the diagram X-axis represents leisure time and Y-axis represents Income. The **utility curve** is sloping, (sloping upward but flattening), showing **diminishing marginal utility of income**.



When tax is imposed, a poor person's utility drops sharply for a small amount of tax and a rich person's utility drops slightly for a large amount of tax. Hence, **progressive taxation** equalizes the **sacrifice** among all individuals and ensures **equitable distribution** of tax burden.

7. Assumptions of the Principle

1. **Utility of income can be measured** (at least in relative terms).
2. **Utility diminishes** as income increases.
3. The **objective of taxation** is to achieve **justice and welfare**.
4. The **government can design taxes** to equalize sacrifice.
5. Taxpayers are **rational** and respond to real income changes.

8. Merits / Advantages

Merit	Explanation
1. Ensures Justice in Taxation	Everyone bears an equal burden in terms of satisfaction, not money.
2. Promotes Progressivity	Rich pay more — aligns with ability-to-pay and social justice.
3. Minimizes Total Sacrifice	Leads to maximum aggregate welfare (least aggregate sacrifice).
4. Logical and Ethical Basis	Connects taxation with fairness and moral responsibility.

5. Supports Welfare Objectives	Reduces inequality and increases social welfare.

9. Demerits / Criticisms

Criticism	Explanation
1. Utility Cannot Be Measured	It's impossible to measure or compare satisfaction between individuals.
2. Subjective Differences	People have different preferences — same income gives different utility.
3. Difficult to Apply in Practice	Governments cannot know exact utility loss for each taxpayer.
4. Ignores Incentives	High taxes on the rich may reduce productivity and investment.
5. Static Concept	Doesn't consider changing social needs, inflation, or public expenditure impact.

Fiscal Policy and its Instruments

The term **Fiscal Policy** refers to the **use of government's revenue and expenditure measures** to influence a country's **economic activity**.

In other words: **Fiscal policy** is the government's policy regarding **taxation, public spending, and borrowing** — used to achieve **economic stability, growth, and welfare.**

It is one of the **major tools of macroeconomic management**, along with **monetary policy** (which deals with money supply and interest rates).

Definition:

According to **Harvey and Johnson**:

"Fiscal policy is the policy under which the government uses its expenditure and revenue programs to produce desirable effects on national income, production, and employment."

2. Objectives of Fiscal Policy

Fiscal policy is designed to achieve the following **broad objectives**:

Objective	Explanation
1. Economic Stability	To control inflation or deflation and stabilize the economy.
2. Full Employment	To generate jobs by stimulating demand and investment.

3. Economic Growth	To promote development by increasing productive capacity.
4. Equitable Income Distribution	To reduce income and wealth inequalities through progressive taxation and welfare spending.
5. Price Stability	To prevent wild fluctuations in prices and maintain purchasing power.
6. Resource Mobilization	To collect revenue for development and public services.
7. Balanced Regional Development	To promote growth in backward areas through fiscal incentives.

3. Instruments (Tools) of Fiscal Policy

The government uses **three main instruments** to implement fiscal policy:

1. Taxation

2. Public Expenditure

3. Public Borrowing (or Public Debt)

A. Taxation

Taxation is the **primary source of government revenue**. Through taxes, the government can influence: **Disposable income**, **Consumption**, **Investment**, **Savings.**

Types of Taxes:

Direct Taxes – Paid directly by individuals and firms (e.g., income tax, corporate tax, wealth tax).

Indirect Taxes – Collected through goods and services (e.g., GST, excise duty, customs duty).

Role of Taxation in Fiscal Policy:

1. **Control Inflation:** Increase taxes to reduce disposable income and curb demand.
2. **Fight Recession:** Cut taxes to encourage spending and investment.
3. **Redistribute Income:** Use progressive taxation — the rich pay more.
4. **Mobilize Resources:** Collect revenue for public projects.
5. **Influence Private Investment:** Offer tax rebates and incentives to industries.

B. Public Expenditure

Public expenditure refers to **government spending** on goods and services, infrastructure, social programs, and defence. It is a **powerful fiscal tool** because it directly affects **aggregate demand**, **employment**, and **economic growth**.

Types of Public Expenditure:

1. **Revenue Expenditure:** Routine spending like salaries, pensions, subsidies, and interest payments.
2. **Capital Expenditure:** Investment in long-term assets like roads, schools, hospitals, and power plants.

Role of Public Expenditure in Fiscal Policy:

1. **Stimulate Growth:** Increase spending on infrastructure and industries.
2. **Generate Employment:** Launch public works programs during unemployment.
3. **Reduce Inequality:** Provide welfare programs, subsidies, and social security.
4. **Stabilize Economy:** Increase or decrease spending to control business cycles.
5. **Encourage Development:** Invest in education, health, and rural areas.

C. Public Borrowing

When tax revenue is insufficient to meet expenditure, the government resorts to **public borrowing** — from the public, banks, or foreign institutions.

Types of Borrowing:

- **Internal Borrowing:** From citizens, banks, or central bank (via bonds, treasury bills).
- **External Borrowing:** From foreign governments or international organizations (like IMF, World Bank).

Role of Public Borrowing in Fiscal Policy:

1. **Finance Deficits:** To cover fiscal deficits without raising taxes immediately.
2. **Control Inflation:** Borrow from the public to reduce money supply.
3. **Promote Development:** Use loans for productive investment in infrastructure.
4. **Stabilize Economy:** Borrow during recessions and repay during booms (counter-cyclical policy).

4. Types of Fiscal Policy

Depending on the **economic condition**, fiscal policy may be:

Type	Description	Objective
1. Expansionary Fiscal Policy	Government **increases spending** and/or **reduces taxes**.	Used during **recession or unemployment** to boost demand.
2. Contractionary Fiscal Policy	Government **reduces spending** and/or **raises taxes**.	Used during **inflation** to cool down the economy.
3. Neutral Fiscal Policy	Expenditure = Revenue (balanced budget).	Used when the economy is stable.

5. Fiscal Policy and Economic Stability

Fiscal policy plays a major role in controlling **business cycles**:

Economic Condition	Fiscal Policy Action	Expected Result
Inflation	Increase taxes, reduce expenditure	Reduce demand and stabilize prices
Deflation / Recession	Reduce taxes, increase expenditure	Stimulate demand and employment

Thus, fiscal policy acts as a **stabilization tool** — expanding or contracting government spending and taxation to balance the economy.

6. Deficit Financing (Special Instrument)

Sometimes, the government deliberately spends **more than its income** and finances the gap by **printing new money** — this is called **deficit financing**. It is used:

- To promote growth in developing countries
- To increase employment during depression

However, excessive deficit financing can cause **inflation**.

7. Role of Fiscal Policy in Developing Economies

In developing countries like **India**, fiscal policy plays an important role in:

- Mobilizing savings and resources
- Building infrastructure
- Promoting industrial and agricultural development
- Reducing poverty and unemployment

- Achieving regional balance
- Supporting welfare and sustainable growth

Fiscal tools are used not only for **stability**, but also for **development and social justice**.

8. Limitations of Fiscal Policy

Limitation	Explanation
1. Time Lags	Policy decisions take time to implement and take effect.
2. Political Constraints	Governments may avoid unpopular tax or spending cuts.
3. Administrative Delays	Poor coordination can reduce effectiveness.
4. Inaccurate Forecasts	Wrong estimation of revenues or deficits can worsen instability.
5. Deficit and Debt Burden	Continuous borrowing may lead to high public debt.

Unit III: Budget and Taxation

Role of Government in a Modern Economy – Public Budget: Types and Structure – Taxation – Features of a Good Tax System – Direct and Indirect Taxes – Concept of Impact – Incidence and Shifting of Taxation – Elasticity and Determination of Tax Burden – Optimal Taxation.

Role of Government in a Modern Economy

A **modern economy** is complex, globalised, technology-driven, and interdependent. Markets alone cannot ensure efficiency, equity, stability, and sustainability. Therefore, the government plays a **multidimensional role** to correct market failures, promote welfare, ensure inclusion, and maintain macroeconomic stability.

1. Regulatory Role

(a) Ensuring Fair Competition

- Prevents monopolies, cartels, price-fixing.
- Competition law, antitrust laws, SEBI regulations.

(b) Consumer Protection

- Food safety standards, MRP rules, product quality mandates.
- Example: BIS standard marks, food labelling rules.

(c) Labour Regulation

- Minimum wages, equal pay, maternity benefits, safety norms.
- Important for **gender economics** → ensures gender-equal labour rights.

2. Allocation Function (Provision of Public Goods)

(As per **Musgrave's framework**)

(a) Public Goods

Markets fail to provide goods that are: **Non-excludable** (cannot prevent usage) and **Non-rival** (one person's use doesn't reduce others' use)

Examples: National defence, Street lighting, Public broadcasting, Judiciary.

(b) Social Goods / Merit Goods

Provided to promote welfare even if people may not pay for them: Education, Healthcare, Sanitation, Rural roads. These reduce inequalities and promote **human capital formation**.

3. Redistributive Role (Equity and Social Justice)

(a) Taxation Policies

- Progressive taxation: higher taxes on high-income groups
- Wealth tax, capital gains tax, corporate taxes

(b) Public Expenditure

- Subsidies (food, fertiliser, housing)
- Social welfare schemes (MGNREGA, PM-KISAN)
- Pensions, scholarships, old-age support

(c) Gender Equity

Government intervenes to reduce gender-based inequalities:

- Gender budgeting
- Women-specific schemes: SHGs, microcredit, maternity benefits, safety laws

4. Stabilisation Function (Macroeconomic Stability)

As per **Keynes**: Government must stabilize the economy.

(a) Controlling Inflation

- Monetary policy support

- Supply management
- Price controls on essential goods

(b) Reducing Unemployment

- Public works (MGNREGA)
- Skill training programmes
- Infrastructure investments

(c) Managing Business Cycles

- Stimulus packages during recession
- Austerity during booms

5. Developmental Role

This is **crucial for developing countries** like India.

(a) Infrastructure Development

Government builds: Roads, railways, ports, airports, Power supply, Water systems,

Digital infrastructure. Private sector depends on these for functioning.

(b) Industrial and Agricultural Development

Establishing PSUs, Supporting MSMEs, Minimum Support Price for farmers, Agricultural R&D.

(c) Human Capital Formation

Government investments in: Education, Health, Nutrition, Skilling & reskilling

6. Correcting Market Failures

Markets fail due to:

- Externalities
- Information asymmetry
- Natural monopolies
- Public goods problems

Examples

- Pollution → government imposes regulations
- Asymmetric information → insurance regulation
- Natural monopoly → Electricity, water → regulated prices

7. Promoting Economic Growth and Innovation

Government as Facilitator

- Ease of doing business
- Start-up policies
- FDI reforms
- Research funding
- Digital India, Make in India

Modern Role

- Data governance
- AI regulation
- Cybersecurity laws

8. Social Welfare and Poverty Alleviation

Government supports vulnerable groups:

- Women, children, elderly
- Persons with disabilities
- SC/ST/OBC communities
- Migrant workers

Key schemes:

- Public Distribution System
- Ayushman Bharat
- ICDS
- Ujjwala Yojana

9. Environmental Protection and Sustainable Development

Regulatory Role

- Pollution control standards
- Environmental Impact Assessment (EIA)
- Forest conservation laws

Promotional Role

- Renewable energy subsidies

- Electric vehicle support
- Climate-change adaptation programmes

10. Gender Empowerment – Special Focus (Since your syllabus includes Gender Economics)

How government shapes gender equality:

- Women's safety laws
- Reservation in local bodies
- Maternity benefits
- Microcredit through SHGs
- Policies encouraging women's workforce participation
- Gender Budgeting → ensures every ministry allocates funds for women

This is a **central component** of a modern welfare state.

11. Role in Globalisation

Government ensures:

- Trade agreements
- Tariff & non-tariff barriers
- Exchange rate stability
- Foreign investment regulation
- Participation in WTO, IMF, World Bank

Helps domestic industries compete globally.

12. Crisis Management Role

Examples:

- COVID-19 measures (lockdowns, vaccination, relief packages)
- Financial crisis management
- Disaster management (NDMA)

Government acts as the **"protector of last resort."**

13. Digital Governance (New-Age Role)

Increasingly important in a modern economy.

Government responsibilities:

- Digital payments ecosystem (UPI)
- E-governance services
- Data protection and privacy laws
- Cybersecurity infrastructure

Real-Life Examples (As You Like Real-Life Applications)

1. **Why Government Provides Free Education & Health?**
   Because they are **merit goods** → society benefits more than individuals.
2. **Why Government Imposes Pollution Tax?**
   To correct **negative externalities** created by factories and vehicles.
3. **Why LPG subsidy for women (Ujjwala)?**
   To empower women and reduce health risks → linking gender + welfare.
4. **Why RBI Intervenes During Rupee Fluctuations?**
   To stabilise foreign exchange markets.
5. **Why Government Gives MSP?**
   To protect farmers from volatile markets.

Conclusion

In a modern economy, the government is **not just a regulator** but a **provider, protector, facilitator, and promoter** of economic and social development. It ensures:

- **Efficiency** (correction of market failures)
- **Equity** (reduction of inequalities)
- **Stability** (macroeconomic balance)
- **Sustainability** (environmental protection)
- **Inclusiveness** (gender equality, poverty reduction)

Thus, the government plays a **central role** in ensuring balanced and equitable economic development.

Public Budget: Types

A **public budget** is a **financial statement prepared by the government** that shows:

- **Expected revenues (income)** for a year
- **Planned expenditures (spending)** for various public purposes

It is usually presented **annually**, approved by the legislature, and acts as a **tool for economic planning, redistribution, and fiscal management**.

TYPES OF PUBLIC BUDGET

There are several ways to classify public budgets.

1. Balanced Budget

When **government revenue equals government expenditure** then it is known as balanced budget. For example, If the government expects ₹10 lakh crore revenue and plans to spend ₹10 lakh crore → **Balanced Budget**.

Advantages

- Financial stability
- No debt burden

Limitations

- Not practical during recessions or emergencies
- Limits welfare spending

2. Surplus Budget

When **government revenue greater than the government expenditure**, is known as surplus budget. For example, If the government collects ₹15 lakh crore but spends only ₹13 lakh crore → **Surplus Budget**.

It is used: To control inflation, To reduce fiscal deficit, When the economy is booming.

Limitations

- Reduces public investment
- May slow down economic growth

3. Deficit Budget

When **government revenue is less than the government expenditure**, it is known as deficit budget. This situation is very common in developing countries (like India).

Example

Revenue ₹18 lakh crore

Expenditure ₹25 lakh crore → **Deficit Budget** of ₹7 lakh crore.

How Government Covers Deficit?

- Borrowing (domestic or external)
- Printing money (rare)
- Disinvestment

When Used?

- Recession
- War
- Development planning

4. Performance Budget

A budget that links **money spent** with **results achieved**. It answers:

- What was the purpose of spending?
- What outcome was achieved?

Example

Education department: ₹1000 crore allotted
Outcome: 10,000 classrooms built, 1 lakh teachers trained.

This is used for better accountability.

Purpose

- Measures efficiency
- Improves performance of departments

5. Programme Budget

Budget is prepared **programme-wise** or **scheme-wise** instead of department-wise.

Example

Instead of "Ministry of Health Budget," programmes are listed like:

- National Health Mission
- Ayushman Bharat
- TB Eradication Programme

It helps identify spending on each **specific programme**.

6. Zero-Based Budget (ZBB)

Every year's budget starts from **zero**. Every department must **justify all expenditures** from the beginning.

Example

If last year ₹10 crore was given to a department, this year it is **not automatically approved**. They must justify each rupee again.

Advantages

- Eliminates waste
- Increases efficiency

7. Gender Budget

A budget that focuses on **gender equality** and allocates funds specifically for the welfare of women and girls.

Example

Funds for:

- Girl child education
- Women safety
- SHGs
- Maternity benefits

India introduced gender budgeting in **2005-06**.

8. Outcome Budget

A budget that focuses on **measurable results**, not just expenditure. It answers: "What effect did the spending produce?"

Example

If ₹5000 crore spent on rural roads: Outcome → number of villages connected, reduction in travel time.

9. Capital and Revenue Budget

(a) Revenue Budget

Includes:

- **Revenue receipts** (tax, non-tax income)
- **Revenue expenditure** (salaries, subsidies, interest payments)

This is for normal functioning of government.

(b) Capital Budget

Includes:

- **Capital receipts** (borrowings, loans, disinvestment)
- **Capital expenditure** (roads, bridges, dams, schools)

This creates assets and adds to development.

10. Supplemental / Excess / Vote-on-Account Budget

These are **parliamentary budget types**:

(a) Supplementary Budget

Additional funds required during the year.

(b) Excess Budget

When actual expenditure > approved amount.

(c) Vote-on-Account

Temporary permission to spend until full budget is passed.

11. Medium-Term Budget

Prepared for **3–5 years**, used for fiscal planning, not just annual.

12. Emergency Budget

Prepared during crises: War, Pandemic, Natural disasters.

Example: COVID-19 Atmanirbhar Package.

Structure of Public Budget

The **structure of a public budget** refers to **how the government budget is organised, classified, and presented**. It shows **where the money comes from (receipts)** and **how the money is spent (expenditure)**.

1. Revenue Budget

The **Revenue Budget** includes:

A. Revenue Receipts

These are incomes the government earns **without creating any liability** or **reducing any asset**.

Two types:

1. **Tax Revenue:** Income Tax, Corporate Tax, GST, Customs Duties, Excise Duties, etc,
2. **Non-Tax Revenue**: Fees & fines, Interest receipts, Profits from public enterprises (LIC, SBI, Railways), Dividends, Spectrum auction fees, etc,

B. Revenue Expenditure

These are expenditures that **do not create assets** or **reduce liabilities**.

Examples: Salaries and pensions**,** Subsidies**,** Interest payments**,** Defence revenue expenditure**,** Grants to states**,** Education, health, welfare schemes (day-to-day running expenses)

2. Capital Budget

The **Capital Budget** includes transactions that **create assets** or **create liabilities**.

A. Capital Receipts

These either:

- **Create liability**, or
- **Reduce asset**

Examples:

- Borrowings (internal and external loans)
- Disinvestment of PSUs
- Loan recoveries from states/enterprises
- Small savings deposits
- Provident fund collections

B. Capital Expenditure

These expenditures **create long-term assets** or **reduce liabilities**.

Examples:

- Construction of roads, bridges, railways, dams
- Purchase of machinery for government departments
- Loans given to states and PSUs
- Equity investment in PSUs
- Defence capital expenditure (weapons, aircraft)

3. Fiscal Indicators Section

The budget also includes important **fiscal indicators**, such as:

- **Fiscal deficit** (Total expenditure – Total receipts excluding borrowings)
- **Revenue deficit** (Revenue expenditure – Revenue receipts)
- **Primary deficit** (Fiscal deficit – Interest payments)

- **Effective revenue deficit**
- **Debt-to-GDP ratio**

This section explains the government's financial health.

4. Budget Explanatory Memorandum

This part provides:

- Notes on tax proposals
- Subsidy details
- Data tables
- Explanation for increases/decreases in allocations
- Economic assumptions used

It helps the parliament understand the budget.

5. Demand for Grants

Each ministry submits **"Demands for Grants"** which include:

- Their required expenditure
- Purpose of expenditure
- Plan and non-plan classification (earlier)
- Schemes and programs

It must be approved by the legislature.

6. Finance Bill

This is the legal part of the budget that includes:

- All tax proposals
- Amendments to direct and indirect tax laws
- New taxation rules

Without passing the Finance Bill, budget can't be implemented.

7. Appropriation Bill

This bill authorizes the **withdrawal of money** from:

- Consolidated Fund of India
- Contingency Fund
- Public Account

It gives the government legal power to spend money.

8. Plan and Non-Plan Classification (Earlier Structure)

Although discontinued since 2017, it was an important part earlier.

(a) Plan Expenditure

- Five-Year Plans
- Development schemes
- Capital projects

(b) Non-Plan Expenditure

- Salaries
- Pensions
- Interest payments
- Maintenance expenditure

9. Budget Annexures

These include:

- Macro-economic framework
- Tax revenue trends
- Deficit decomposition
- Subsidy analysis
- Department-wise expenditure tables
- Outcome-based performance reports

10. Gender Budget, Child Budget, SC/ST Sub-Plan (Modern Structure)

Modern budgets also include **social classifications**.

A. Gender Budget

Shows allocation for:

- Women welfare
- Safety
- Education
- Health
- SHGs

- Economic empowerment

B. Child Budget

Funds allocated for children under:

- Education
- Health
- Nutrition (ICDS)

C. SC/ST Sub-Plan

Funds for:

- Scheduled Caste communities
- Scheduled Tribe communities
- Inclusive development

This is important for **gender and social economics**.

Conclusion

The **structure of the public budget** is a systematic arrangement that shows:

- how the government earns money (receipts),
- how it spends money (expenditure),
- what laws and bills support the process, and
- What social goals like gender equality and welfare are integrated.

It makes the budget **transparent, accountable, and easy to evaluate**.

Taxation – Features of a Good Tax System

MEANING OF TAXATION

Taxation refers to the process by which the government **collects compulsory payments (taxes)** from individuals, households, and businesses to finance public expenditure.

In other words: Taxation is **the compulsory payment** made by citizens to the government **without expecting a direct benefit in return**.

FEATURES OF A GOOD TAX SYSTEM

(A good tax system is one that ensures fairness, efficiency, and adequate revenue.)

Economists like **Adam Smith**, **Musgrave**, and **Dalton** have given principles for a sound tax system.

1. Equity / Fairness

A good tax system must be **just and fair**.

(a) Horizontal Equity

People with **same income** should pay **same tax**.

(b) Vertical Equity

People with **higher incomes** should pay **higher taxes** (progressive taxation). This ensures **social justice** and reduces inequality.

2. Certainty

As per **Adam Smith's canon**, the taxpayer must clearly know:

- How much tax to pay
- When to pay
- How to pay

No confusion or hidden rules.

3. Convenience

The method of payment should be: Easy, Simple and Comfortable for taxpayers

Examples: Online tax payment portals, TDS (Tax Deducted at Source), Easy GST filing.

A convenient system increases compliance.

4. Economy in Collection

The cost of collecting taxes should be **low** compared to the revenue collected.

- No expensive procedures
- No wastage
- Efficient administrative machinery

A good tax system should avoid unnecessary bureaucracy.

5. Elasticity of Taxation

The tax system must be **flexible** so that revenue automatically increases when:

- Income rises
- Trade grows
- Prices increase

Example: Progressive income tax automatically increases government revenue when incomes rise.

6. Productivity

A good tax system must generate **adequate revenue** to fund: Public services, Defence, Infrastructure, Welfare schemes. The tax base should be **broad**, not narrow.

7. Simplicity

Tax laws must be: Easy to understand, Free from complexity, Written in simple language.

Complex systems encourage: Evasion, Corruption and Litigation.

8. Diversity of Taxes

A good tax system should not depend on **only one type** of tax.

It must include:

- Direct taxes (income tax, corporate tax)
- Indirect taxes (GST, customs)

This ensures stability and reduces risk during economic fluctuations.

9. Tax Neutrality

Taxes should **not distort**: Production, Consumption, Investment decisions

Example: Tax should not discourage savings or employment.

10. Efficiency

The tax system should:

- ✓ Promote economic growth
- ✓ Encourage investment
- ✓ Reduce evasion
- ✓ Ensure smooth functioning of markets

A good tax system **supports development**, not obstruct it.

11. Ability-to-Pay Principle

People should pay taxes **according to their income and wealth**. This principle ensures: Justice, Redistribution, Reduced inequality. It is essential for welfare-state budgeting.

12. Administrative Efficiency

The tax administration must be: Well organized, Transparent, Free from corruption, Quick in resolving grievances. It helps in efficient administration increases public trust.

Direct and Indirect Taxes

Direct Taxes

A **direct tax** is a tax that is paid **directly by the person on whom it is imposed**. The burden **cannot be shifted** to someone else. The person who pays the tax has to **bears the tax**.

Simple idea: You pay → You bear.

Key Characteristics

1. **Cannot be shifted**: The person who is taxed must pay it personally.
2. **Based on income or wealth**: Higher income = Higher tax.
3. **Progressive in nature**: The burden increases with capacity to pay.
4. **Collected directly by the government**: Usually through the Income Tax Department.

Examples (with everyday meaning)

✓ Income Tax

If you earn a salary, you pay income tax. You cannot pass it to someone else.

✓ Corporate Tax

Companies pay tax on profits. The company itself pays.

✓ Wealth Tax / Property-related taxes

If you own expensive assets or property, you pay the tax.

Real-life Example

If your salary is ₹50,000 per month, tax is cut directly from your salary (TDS). Only **you** are responsible to pay it. You **cannot shift it** to your neighbour or employer.

Indirect Taxes

An **indirect tax** is a tax that is imposed on **goods and services**. The person who sells the product collects the tax, but the **final burden is on the consumer**.

Simple idea:

You pay → Someone else bears.
(or)
Tax shifts from seller → consumer.

Key Characteristics

1. **Can be shifted**: The seller collects tax from the buyer.
2. **Based on consumption**: You pay tax when you buy goods, not based on how much you earn.
3. **Regressive in nature**: Everyone pays the same tax on goods, whether rich or poor.
4. **Collected through businesses**: Businesses collect tax and pass it to the government.

Examples (with everyday meaning)

✓ GST (Goods and Services Tax)

When you buy anything — food, clothes, mobile phone — GST is included in the price.

✓ Customs Duty

Paid on imported goods, like foreign cars, perfumes, laptops.

✓ Excise Duty (now merged into GST for most goods)

Manufacturers used to pay this on production.

Real-life Example

You buy a shirt for ₹1,000. If GST is 5%, you pay: ₹1,000 + ₹50 (GST). The shopkeeper takes ₹50 from you and gives it to the government. Here the **tax burden shifted** from seller → buyer.

Concept of Impact

When a tax is imposed, it does not always stay on the person who is legally required to pay it. Sometimes, the person who pays the tax **passes it on** to someone else. To understand who finally bears the burden of the tax, public finance uses two ideas:

- **Impact of tax**
- **Incidence of tax**

Meaning of "Impact" of Tax

Impact of a tax refers to the *initial* or *immediate* point at which a tax is imposed and collected. It is the moment when the tax hits the taxpayer directly.

In simple words: **Impact = on whom the tax is first imposed and collected.**

- It occurs **at the time of transaction** (buying, selling, earning income).
- It happens **before** the tax is shifted or passed on.

It tells us **who pays the tax first**, not who ultimately bears it.

Examples to Understand Impact

1. GST on a product

A shopkeeper pays GST to the government when selling goods. **Impact**: Shopkeeper (because the tax hits him first). Later, he adds GST to the product price → burden is passed to consumer (incidence).

2. Income Tax deduction

Your employer deducts TDS from your salary. **Impact**: You (because the tax is collected from your income immediately). Here, **impact = incidence** because you cannot shift the tax.

3. Excise duty on manufacturers

A tax is imposed on a manufacturer. **Impact**: Manufacturer, Later, manufacturer increases selling price → burden goes to wholesaler/retailer/consumer.

Key Features of Impact

1. **Immediate payment**: Impact occurs at the moment the tax is charged.
2. **First point of contact**: It identifies the person who pays the tax *first*, not finally.
3. **Happens before shifting**: The taxpayer at the impact stage may or may not shift the burden.
4. **Applies mostly to indirect taxes**: Because indirect taxes can be shifted, while direct taxes usually cannot.

Impact vs Incidence (for clarity)

Concept	**Meaning**	**Focus**
Impact	The person on whom the tax is first imposed	Immediate payer
Incidence	The person who finally bears the burden	Ultimate consumer/bearer

Example: GST

- Impact → Shopkeeper
- Incidence → Customer

Incidence and Shifting of Taxation

1. Incidence of Taxation – Meaning

Incidence of taxation refers to the person who *finally bears* the burden of the tax after all shifting is completed.

It answers one question: **Who ultimately pays the tax out of their own pocket?**

This may or may not be the same person on whom the tax was originally imposed.

Simple Explanation

A shopkeeper collects GST from you on a product. He pays that GST to the government. But **you** pay more price because of GST.

So:

- **Impact**: Shopkeeper (tax hits him first)
- **Incidence**: Consumer (burden falls on him finally)

Thus, **incidence = final resting place of the tax burden**.

Types of Incidence

1. **Direct Incidence**
   The person on whom the tax is imposed also bears the burden. (Example: Income tax paid by individuals)
2. **Indirect Incidence**
   The person on whom the tax is imposed shifts it to someone else. (Example: GST burden shifted to consumers)

Real-Life Examples

1. Petrol Price

Government imposes tax on oil companies → they increase petrol price → consumer pays more.

- Impact: Oil company
- Incidence: Consumer

2. House Rent

Property tax imposed on a landlord → landlord increases rent → tenant bears tax through higher rent.

- Impact: Landlord

- Incidence: Tenant

2. Shifting of Taxation – Meaning

Shifting of taxation means transferring the burden of a tax from the person on whom it is imposed (impact) to another person (incidence). It explains *how* the tax burden moves through the economy.

In simple words: **Shifting = Passing the tax burden to someone else.**

Example: A manufacturer pays GST → he increases price → wholesaler increases price → retailer increases price → consumer bears burden.

Types of Tax Shifting

There are **three** types:

1. Forward Shifting (most common)

Burden moves **from producer → wholesaler → retailer → consumer**.

Example: GST, excise duty, customs duty

- Manufacturer pays tax
- Adds tax to selling price
- Consumer ends up paying more

Flow: Producer → Consumer

2. Backward Shifting

Burden moves **backwards**, meaning the taxpayer reduces payment to previous parties in chain.

Example:

If government increases tax on sellers and sellers **reduce the price they pay to suppliers**, then burden shifts backwards.

Flow: Retailer → Wholesaler → Manufacturer → Labour (in form of reduced wages)

Illustration: A manufacturer facing high excise duty may reduce wages or reduce payment to raw material suppliers.

3. Sideways (or Horizontal) Shifting

Burden shifts **to another group in the same stage of production**.

Example:

- Two competing firms: Firm A raises prices due to tax

- Firm B also raises prices even though its costs didn't change (to match the market)

Here burden shifts **within the same group**.

Why Does Shifting Occur?

Shifting depends on:

1. Price Elasticity of Demand

- If demand is inelastic (petrol, milk), firms can shift most of the tax to consumers.
- If demand is elastic (luxury goods), shifting becomes difficult.

2. Market Power

- Monopolies can shift easily
- Perfect competition reduces shifting power

3. Nature of Tax

- Indirect taxes shift easily
- Direct taxes rarely shift

Impact vs Shifting vs Incidence

Concept	**Meaning**
Impact	Who pays the tax first
Shifting	How the burden moves from one person to another
Incidence	Who ultimately bears the tax

Ultra Simple Example (Full Chain)

Government imposes GST on manufacturer:

1. **Impact**: Manufacturer
2. **Shifting**: Manufacturer → wholesaler → retailer
3. **Incidence**: Consumer (final payer)

Elasticity and Determination of Tax Burden

The **tax burden** (who ultimately bears a tax) depends heavily on the **price elasticity of demand and supply** for the taxed good. Why?

Because **elasticity shows how sensitive buyers and sellers are to price changes**.

When a tax raises the price:

- If buyers cannot reduce consumption → they bear more burden.

- If sellers cannot reduce production → they bear more burden.

Thus, **the side of the market that is LESS elastic (more rigid) bears MORE of the tax.**

1. Tax Burden and Elasticity of Demand

If demand is inelastic → consumers bear more tax.

Inelastic demand = people must buy even if price increases.

Examples: Petrol, Cigarettes, Medicines, Salt.

So when these goods are taxed:

- Sellers raise price easily
- Consumers keep buying
- Consumer incidence is high

Real Life Example – Petrol

Even if petrol price goes up by ₹5–10 because of tax, people still buy → majority burden falls on consumers.

If demand is elastic → sellers bear more tax.

Elastic demand = people quickly reduce consumption with small price increase.

Examples: Ice cream, Luxury clothes, Restaurant food, Electronics.

So when taxed:

- Sellers cannot raise price (customers will run away)
- Sellers absorb tax → **Producer incidence is high**

2. Tax Burden and Elasticity of Supply

The tax burden also depends on how easily producers can adjust output.

If supply is inelastic → sellers bear more tax.

Inelastic supply = seller cannot reduce production or exit the market.

Examples:

- Agricultural products in short-run
- Perishable goods (milk, vegetables)
- Land (perfectly inelastic in long-run)

When tax is imposed:

- Sellers cannot escape

- Prices cannot rise much
- **Seller bears more burden**

If supply is elastic → consumers bear more tax.

Elastic supply = sellers can easily shift or stop production.

Examples: Manufactured goods, Clothing, Packaged foods

Here:

- Producers can reduce output or switch industries
- They shift burden to consumers
- Consumers bear more burden

3. Combined Effect: Who Bears the Tax?

In reality, tax burden depends on **both** elasticities.

General rule: **The side of the market that is LESS elastic bears MORE burden.**

4. Cases Explained Clearly

Case 1: Demand Inelastic, Supply Elastic

Example: Petrol

- ✓ Consumers have no alternative
- ✓ Producers can easily shift tax

Consumers bear most of the burden

Case 2: Demand Elastic, Supply Inelastic

Example: Fresh vegetables

- ✓ Consumers can shift to substitutes
- ✓ Farmers must sell immediately (perishable)

Producers bear most of the burden

Case 3: Both Demand and Supply Inelastic

Example: Essential medicines

- ✓ Consumers must buy
- ✓ Producers cannot easily adjust
- ✓ Burden shared, but **larger on consumers**

Case 4: Both Demand and Supply Elastic

Example: Luxury imported goods

- Consumers have many alternatives
- Sellers can shift to other goods

Both sides share burden, but **small burden on both** because tax raises price less.

5. Real-Life Examples You Can Use

1. Cigarettes (Demand inelastic)

Even if price rises due to tax, people buy → consumers bear large share.

2. Gold Jewellery (Demand elastic)

People reduce purchase if tax rises → sellers bear more burden.

3. Rent / Land Tax (Supply inelastic)

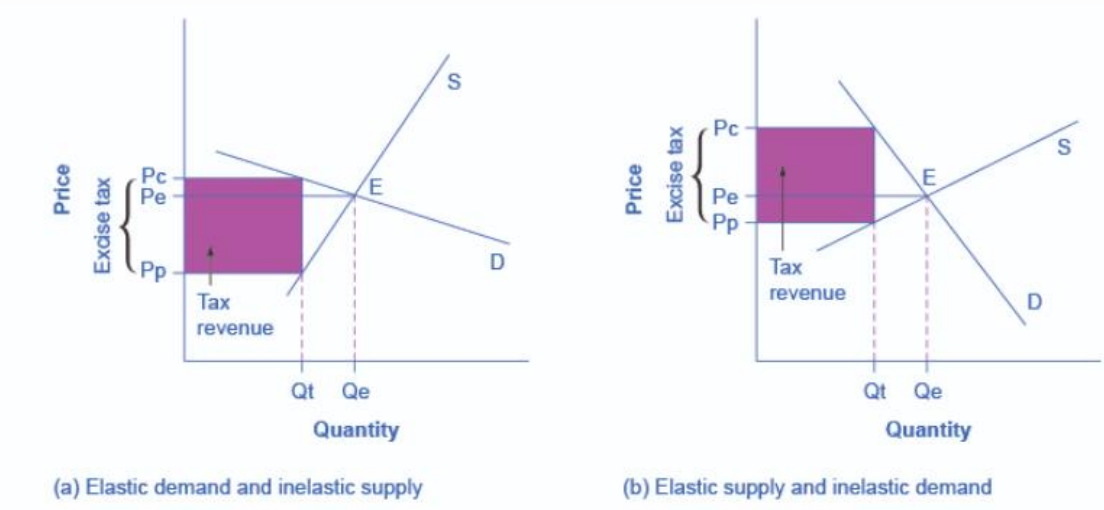
Land cannot be increased → landlords bear more burden, cannot shift much.

4. Restaurant Food (Supply elastic)

Restaurants quickly adjust → consumers bear more burden.

6. Graphical Intuition

A steep curve is inelastic, and a flat curve is elastic. Steep (rigid) side which bears more burden and the flat (flexible) side which bears less burden.



Optimal Taxation

Optimal taxation refers to designing a tax system that raises the required revenue for the government at the *lowest possible economic and social cost*.

In other words: **A tax is optimal when it collects enough money without harming economic activity, fairness, or efficiency.**

It tries to balance:

- **Equity (fairness)** → rich pay more, poor protected
- **Efficiency** → taxes should not distort choices too much
- **Revenue** → government must still collect enough money

Optimal taxation finds the **best combination** of these goals.

Why Do We Need Optimal Taxation?

If taxes are too high, people stop working or investing. If taxes are too low, government cannot provide public services. So the question becomes:

How can the government raise ₹X crore with minimum damage to the economy and maximum fairness?

Optimal taxation provides that answer.

Guiding Principles of Optimal Taxation

Economists generally rely on **three major principles**:

1. Efficiency (Avoiding Excess Burden)

Taxes should:

- ✓ Not discourage work
- ✓ Not reduce savings/investment too much
- ✓ Not distort production decisions

Example: High taxes on income reduce willingness to work → not optimal.

2. Equity (Fairness)

Two types of fairness matter:

Horizontal equity where people with the same income should pay the same tax.

Vertical equity where people with higher income should pay more (progressive taxation).

Example: GST on essential goods is kept low to protect the poor.

3. Administrative Simplicity

A tax should be:

- Easy to understand
- Cheap to administer
- Difficult to evade
- Simple to comply with

Complex taxes are not optimal even if they are theoretically perfect.

Tools/Theories Used in Optimal Taxation

Economists use several important ideas:

1. Ramsey Rule (Least Distorting Taxes)

Proposed by Frank Ramsey.

Rule says: **Tax goods with inelastic demand at higher rates, and goods with elastic demand at lower rates.**

Why?

Because consumers don't reduce consumption of inelastic goods much → less distortion.

Examples of high inelasticity taxes: Petrol, Cigarettes, Liquor.

Examples of low elasticity taxes: Luxury items, Electronics, Cars.

2. Ability-to-Pay Principle

Rich has more ability to bear tax, that is the reason they are imposing progressive income tax. This ensures **fairness** in an optimal system.

3. Benefit Principle

People should pay taxes according to the benefit they receive from public services.

Example: Road tax, Toll tax.

These are considered part of optimal tax design.

4. Optimal Income Tax Theory (Mirrlees Model)

James Mirrlees (Nobel Prize) analysed: How to design income tax that balances equality with economic incentives.

Main idea:

- If tax is too progressive then the rich stop working

- If tax is too flat then the poor don't get support

Optimal taxation finds the ideal middle point.

Examples of Optimal Taxation in Real Life

1. GST Structure in India

- ❖ Lower rates on essential goods which protects the poor.
- ❖ Higher rates on luxury goods which demonstrates fairness.
- ❖ Input tax credit which avoid cascading and increases the efficiency.

This is closer to "optimal taxation."

2. "Sin Taxes"

Tax on: Tobacco, Alcohol, Pollution. These reduce negative externalities and raise revenue. (Optimal because they reduce harm while collecting funds.)

3. Progressive Income Tax

Imposed on: Higher slabs for high incomes and Lower slabs for low incomes. This balances the **equity** and **revenue**.

Unit IV: Public Expenditure and Debt

Public Expenditure: Cannon and Classification – Wagner's Law of Public Expenditure – Public Debt: Meaning and Types, Burden of Public Debt – Principles of Public Debt Management – Deficit Financing.

Public Expenditure

Public expenditure refers to all the expenses incurred by the government (Central, State, and Local governments) for the welfare of the people, maintenance of law and order, development of the economy, and smooth functioning of the administration.

In simple words: **Public expenditure = Government spending on various activities for public welfare and economic development.**

It includes spending on:

- ✓ Education
- ✓ Healthcare

- ✓ Defence
- ✓ Infrastructure (roads, bridges, railways)
- ✓ Social welfare schemes
- ✓ Salaries of government employees
- ✓ Subsidies
- ✓ Public debt interest
- ✓ Rural development, etc.

Definition of Public Expenditure

1. Dalton's Definition

"Public expenditure refers to the expenses of public authorities—national, state, and local—for meeting the various needs of the citizens."

2. Findlay Shirras

"Public expenditure includes all government expenses for the satisfaction of collective needs of society and for promoting economic and social welfare."

3. Prof. Wagner

"Public expenditure is the spending made by the state to carry out its functions, both traditional (like defence, justice) and modern (education, public health, social security)."

Cannon

Canons of public expenditure are the *basic principles* or *rules* that tell the government **how to spend public money in a wise, efficient, fair, and beneficial manner**.

The Important Canons of Public Expenditure

1. Canon of Benefit

Government expenditure should create **maximum benefit** for people. Money spent should improve people's lives and increase welfare.

Examples

- Building hospitals
- Providing clean drinking water
- Giving scholarships to poor students

These expenditures benefit society, so they follow this canon.

2. Canon of Economy

Government should **avoid wasteful expenditure**. Public money is collected from taxpayers. So, the government must spend it **carefully, efficiently**, and without unnecessary expenses.

Example

- Avoiding unnecessary foreign trips
- Not overspending on government buildings or offices

3. Canon of Sanction

Every expenditure must be **properly approved** by authorities. Money must not be spent without permission. It should go through proper procedures, audits, and legislative approval.

***Example*:** Government departments must obtain approval from the Finance Ministry before spending.

4. Canon of Adequacy

Government should spend **enough** to meet the needs of the country. Sometimes, spending less is harmful. Important sectors need adequate funds.

Examples

- Enough money for national defence
- Adequate funds for education and health
- Sufficient funds for disaster relief

5. Canon of Productivity

Public expenditure should **increase production and growth**. Money spent should help increase the country's economic power.

Examples

- Spending on roads, railways, and electricity
- Funding research and development
- Supporting agriculture and industries

These increase productive capacity.

6. Canon of Elasticity

Public expenditure should be **flexible**. Government should be able to **increase or decrease** spending depending on the situation.

Examples

- During natural disasters, spending must increase.
- During normal times, spending can be controlled.

7. Canon of Surplus

During good economic times, the government should try to maintain a **surplus** (more income than expenditure). Surplus can be used during emergencies.

***Example*:** Saving money during years of high tax revenue.

8. Canon of Publicity

Government expenditure must be **transparent**. People should know how public money is used.

Examples

- Publishing budgets
- Providing expenditure reports to the public

9. Canon of Equality

Expenditure should ensure **fairness** and **reduce inequalities**.

Examples

- Spending more on poor regions
- Welfare schemes for weaker sections
- Free education and healthcare for the needy

Classification

Public expenditure can be classified in several ways depending on the **nature**, **purpose**, **time period**, and **impact** of the spending. Economists classify it to understand how the government uses resources and how it affects the economy.

1. Revenue Expenditure vs. Capital Expenditure

(A) Revenue Expenditure

- Day-to-day expenses of the government.
- Does **not create assets.**
- Does **not reduce liabilities.**

Examples:

- Salaries, pensions

- Subsidies
- Interest payments
- Maintenance of roads, hospitals
- Grants to states

(B) Capital Expenditure

Spending that **creates assets** for the country Or **reduces liabilities**

Examples:

- Building roads, bridges, dams
- Purchasing machinery
- Investment in public sector enterprises
- Loan repayment

2. Productive vs. Unproductive Expenditure

(A) Productive Expenditure

- Increases the productive capacity of the economy
- Leads to economic growth

Examples: Education, Health, Roads, irrigation, Agricultural and industrial development

(B) Unproductive Expenditure

Does **not directly** contribute to economic growth.

Examples: Defence spending, Law and order, Administration (Essential but not income-generating.)

3. Developmental vs. Non-Developmental Expenditure

(A) Developmental Expenditure

- Promotes **economic and social development**
- Increases welfare

Examples: Education, Health, Housing, Transport and communication, Rural development.

(B) Non-Developmental Expenditure

Required for **general functioning of the government**.

Examples: Defence, Police, Judiciary, Tax collection, General administration.

4. Plan vs. Non-Plan Expenditure ***(Earlier used in India)***

(A) Plan Expenditure

- Spending related to **Five-Year Plans.**
- Development projects.

Examples:

- ✓ Construction of dams
- ✓ Rural electrification
- ✓ New education schemes

(B) Non-Plan Expenditure

Regular or routine expenditure.

Examples: Defence, Pensions, Interest payments, Subsidies.

5. Transfer vs. Non-Transfer Expenditure

(A) Transfer Expenditure

Government gives money **without receiving goods/services** in return. Examples: Pensions, Scholarships, Subsidies, Social security payments.

(B) Non-Transfer Expenditure

Government receives goods/services in return. Examples: Salaries to government employees, Payments for construction work, Purchase of materials, etc.,

6. Grants-in-Aid vs. Purchased Expenditure

(A) Grants-in-Aid

- Assistance given to state governments or institutions
- For development or functioning

Examples: Grants to universities, Grants to panchayats, Grants to NGOs.

(B) Purchased Expenditure

Buying goods and services. Examples: Purchase of machinery, Purchase of vehicles, Payment for construction.

7. Welfare vs. Administrative Expenditure

(A) Welfare Expenditure: Improves quality of life. Examples: Education**,** Health**,** Nutrition programs**,** Housing schemes.

(B) Administrative Expenditure: For functioning of government machinery. Examples: Salaries of IAS, IPS**,** Maintenance of government offices**,** Law and order expenses.

Wagner's Law of Public Expenditure

Wagner's Law, proposed by **Adolph Wagner**, a German economist, states that:

"As an economy grows, government expenditure also increases continuously and at a faster rate."

This is also called:

- **The Law of Increasing State Activity**
- **Wagner's Hypothesis**

Meaning

Wagner observed that when countries progress from **traditional** to **modern industrial economies**, the **role of the government expands**. As a result, government spending naturally increases. So, **public expenditure is not static; it grows along with economic growth.**

Key Idea of Wagner's Law

Wagner identified three main reasons behind the rise in government expenditure:

1. Social and Welfare Responsibilities Increase

As societies become more advanced, people demand:

- Better education
- Better healthcare
- Social security
- Better law and order
- Infrastructure (roads, public transport)
- Public utilities (water, electricity)

Government must spend more to meet these needs.

2. Expansion of Administrative and Protective Functions

Modern governments must:

- Maintain internal law and order
- Protect the country (defence)
- Regulate markets

- Enforce laws and contracts

As the population and economy grow, administrative spending increases.

3. Promotion of Economic Development

Industrial and modern economies need:

- Transport and communication
- Energy systems
- Scientific research
- Industrial support
- Public investment in key sectors

Government must invest heavily in these areas → expenditure rises.

The Core Relationship

Wagner's Law says:

Public Expenditure (PE) increases > Rate of Economic Growth (GDP)

That means PE grows **faster** than GDP as the country develops.

Assumptions of Wagner's Law

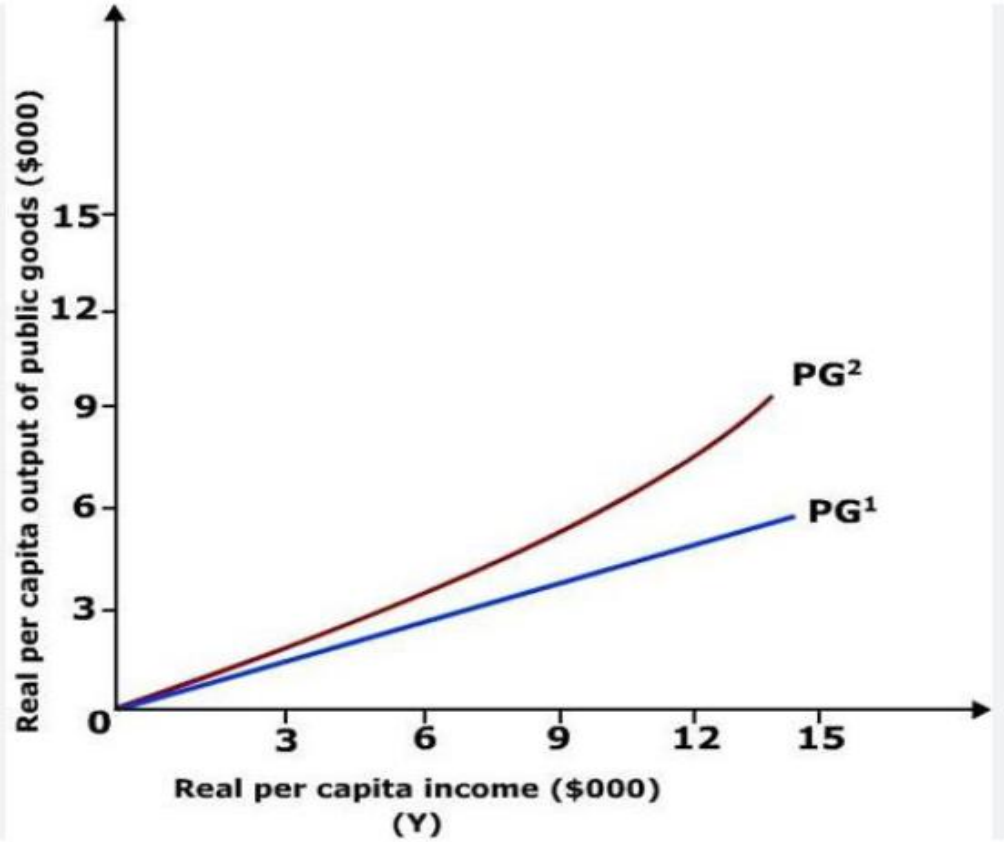
1. Economy is progressing from traditional → industrial stage.
2. Social progress increases demand for public services.
3. Government has the capacity to spend more.
4. People accept higher taxation for welfare.
5. Market alone cannot provide essential public goods.

Implications / Importance

- Helps explain why modern governments become larger over time.
- Justifies rising public expenditure in developing countries.
- Shows that public spending is a natural response to economic growth, not a result of bad budgeting.
- Influences fiscal policy planning.

Diagram Explanation

From the diagram, X-axis represents the real per capita income (GDP) and the Y-axis represents the per capita output of public goods or Public Expenditure. Here, the curve slopes upward showing that there is a positive relationship.



Criticisms of Wagner's Law

1. **Not applicable to all countries** — especially very poor or very rich countries.
2. **Does not consider economic crises** (during recession, spending may fall).
3. **Ignores political factors** influencing expenditure.
4. **Does not explain short-term expenditure changes**.
5. **Assumes only one-way relationship**, but sometimes public expenditure leads to economic growth (reverse).

Public Debt: Meaning and Definition

Public debt refers to the **total borrowings of the government** from internal and external sources to meet its financial needs.

In simple terms: When government income (taxes, fees) is not enough, it borrows money. This borrowed money is called public debt.

The government may borrow from:

- Individuals
- Banks

- Reserve Bank of India (RBI)
- Financial institutions
- Other countries
- International organizations (IMF, World Bank)

Public debt is also called:

- **Government debt**
- **Sovereign debt**

Definitions of Public Debt

1. Prof. Dalton

"Public debt is the debt owed by the government to individuals, institutions, and foreign countries."

2. Prof. Adam Smith

"When the government borrows to meet its deficit, such borrowing constitutes public debt."

3. Findlay Shirras

"Public debt refers to all types of borrowings by the government to finance public expenditure which cannot be met out of its current revenue."

4. Indian Public Finance Definition

"Public debt is the amount of money the government borrows to cover a budget deficit or to invest in development projects."

Types of public Debt

Public debt can be classified in several ways depending on **who lends**, **duration**, **purpose**, and **nature** of the loan. The following are the types of public debt:

1. Internal Debt vs. External Debt

(A) Internal Debt

Borrowings **within the country** from domestic sources.

Examples:

- ✓ Loans from RBI
- ✓ Loans from commercial banks
- ✓ Treasury bills

- ✓ Government bonds
- ✓ Loans from public & financial institutions

Money comes from inside the country.

(B) External Debt

Borrowings from **foreign countries** or **international institutions**.

Examples:

- ✓ Loans from World Bank
- ✓ IMF assistance
- ✓ Loans from foreign governments (Japan, USA, etc.)
- ✓ Loans from international agencies (ADB, IDA)

Money comes from outside the country.

2. Short-term, Medium-term, and Long-term Debt

(A) Short-term Debt

- Repayable within **1 year**
- Mainly for temporary financial needs

Examples: Treasury bills, Ways and Means Advances.

(B) Medium-term Debt: Repayable in **1 to 5 years**

Examples: Market loans**,** Government bonds of 3–5 years.

(C) Long-term Debt

- ✓ Repayable **after 5 years**
- ✓ Used for major developmental projects

Examples:

- 10-year bonds
- 20-year government securities
- Long-term foreign loans

3. Productive Debt vs. Unproductive Debt

(A) Productive Debt

- ✓ Used for **developmental purposes**
- ✓ Generates income or increases productive capacity

Examples: Loans for irrigation projects, Loans for power plants, Loans for infrastructure.

These debts **pay back** themselves in the long run.

(B) Unproductive Debt

- ✓ Does **not generate income**
- ✓ Used during emergencies or wars

Examples: War loans, Disaster relief loans.

Necessary, but no economic return.

4. Redeemable Debt vs. Irredeemable Debt

(A) Redeemable Debt

- ✓ Has a **fixed repayment period**
- ✓ Government promises to repay on maturity

Examples: 10-year securities, Treasury bills.

(B) Irredeemable Debt

- ✓ No fixed repayment date
- ✓ Government repays when convenient
- ✓ Also called **perpetual debt**

Examples: Old-style perpetual bonds

(Note: Rare today.)

5. Voluntary Debt vs. Compulsory Debt

(A) Voluntary Debt

Citizens **choose** to lend money.

Examples: National Savings Certificates, Government bonds, Voluntary deposits in schemes.

(B) Compulsory Debt

Government **forces** citizens to lend during emergencies.

Example: Compulsory provident fund contributions, Forced loans during war (historical).

(Not common in modern times.)

6. Funded Debt vs. Unfunded Debt

(A) Funded Debt

- ✓ Long-term debt

- ✓ Repayable after many years
- ✓ Usually carries low interest

(B) Unfunded Debt

- ✓ Short-term debt
- ✓ Used for immediate financial needs
- ✓ Does not require a sinking fund

7. Capital Debt vs. Revenue Debt

(A) Capital Debt

- ✓ Used for creating **assets**
- ✓ Developmental in nature

Example: Loans for construction of highways, dams, schools.

(B) Revenue Debt

- ✓ Used for **current expenditure**
- ✓ Non-developmental.

Example: Loans to pay salaries or subsidies during deficit.

Burden of Public Debt

The **burden of public debt** refers to the **costs and negative effects** that government borrowing creates for:

- The **present generation**
- The **future generation**
- The **economy as a whole**

When the government borrows, it has to **repay** the debt in the future with **interest**. This repayment creates various types of burdens.

Types of Burden of Public Debt

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

1. Direct Money Burden

This is the **rise in taxes** that people must pay because the government needs money to repay the debt.

Examples:

- Increase in income tax
- Increase in GST
- Increase in excise duties

People pay **more taxes** due to public debt → this is a direct burden.

2. Indirect Money Burden

Borrowing can create indirect effects such as:

- Increase in prices (inflation)
- Reduction in consumption
- Lower savings
- Increase in production costs

People pay **more indirectly** even if taxes do not rise.

3. Real Burden

This refers to the **loss of welfare** or **reduction in standard of living** due to public debt.

Reasons:

- Higher taxes reduce disposable income
- Inflation reduces purchasing power
- Cut in public services due to debt repayment

Real burden means **people become poorer** in terms of welfare, not just money.

4. Burden on Future Generations (Intergenerational Burden)

If government borrows today, **future generations** must repay the loan through:

- Higher taxes
- Lower government expenditure
- Higher interest payments

Future generation bears the repayment burden for debt they didn't create.

*(Applies mainly to **external debt**.)*

5. Burden of External Debt

External debt creates a **heavier burden** than internal debt because:

- Borrowed money must be repaid in **foreign currency**
- Interest payments go to **foreign countries**

- Country’s foreign exchange reserves may reduce
- May affect India’s credit rating

External debt reduces a nation's wealth and foreign exchange.

6. Resource Transfer Burden

When government borrows from within the country, it **takes resources away** from:

- Private investment
- Industry and business
- Productive sectors

This can reduce economic growth.

7. Administrative Burden

Government needs a large administrative system to manage:

- Borrowings
- Interest payments
- Debt records
- Repayment schedules

This creates additional costs and pressure on public finances.

8. Psychological Burden

People may feel insecure if:

- Government borrows too much
- Taxes keep increasing
- Inflation rises
- Investors lose confidence

This affects trust in the economy.

Principles of Public Debt Management

Public Debt Management refers to how the government **plans, borrows, manages, and repays** its debt. To ensure stability and avoid financial crisis, the government follows certain principles.

1. Principle of Safety

The **first priority** is ensuring that:

- The government can **repay the debt** without difficulty.
- Borrowing does not create instability in the economy.

✓ Loans must be raised from **safe and reliable sources**.
✓ High-risk borrowing should be avoided.

2. Principle of Economy

Government should borrow **at the lowest possible cost**.

This means:

- Minimising **interest payments**
- Choosing sources with **favourable terms**
- Avoiding expensive short-term loans

The aim is **to reduce the financial burden** on the government.

3. Principle of Productivity

Public debt should be used for **productive purposes**: Infrastructure, Education, Irrigation, Power, Health, Industrial development. Productive use generates income and helps repay the debt.

"Borrow for development, not for wasteful spending."

4. Principle of Flexibility

Debt policy must be flexible enough to:

- Adjust to changing economic conditions
- Borrow more during emergency situations
- Reduce borrowing when the economy is stable

✓ Flexibility helps maintain financial stability.

5. Principle of Stability

The government should maintain:

- A **stable debt structure**
- A **balanced mix** of short-term and long-term loans
- Stable repayment schedules

This prevents financial shocks and ensures long-term confidence.

6. Principle of Transparency

Debt management should be:

- Open
- Clear
- Well-documented
- Auditable

People and investors should know:

✓ How much the government is borrowing
✓ Why it is borrowing
✓ How it will repay

Transparency builds **trust** and avoids misuse.

7. Principle of Diversification

Government should:

- Borrow from **multiple sources**
- Issue **various types of securities**
- Avoid dependence on one lender

Examples of sources: Public, Banks, RBI, Foreign institutions, International organisations.

Diversification reduces **risk**.

8. Principle of Minimising Burden

Public debt management must ensure that borrowing does NOT create excessive burden on:

- ✓ Present generation
- ✓ Future generations

Taxes do not become too high at the same time welfare programs are not affected

Aim: **Borrow without hurting people's welfare.**

9. Principle of Coordination with Fiscal and Monetary Policy

Debt management must be in harmony with:

- **Monetary policy** (by RBI)
- **Fiscal policy** (government budget)

Proper coordination ensures:

✓ Control of inflation
✓ Stable interest rates
✓ Balanced economic growth

10. Principle of Maintaining Credibility

The government must maintain a **good reputation** as a trustworthy borrower.

This requires:

- Timely repayment
- Honouring commitments
- Maintaining stable policies

A credible government can borrow at **lower interest rates**.

Deficit Financing

Deficit Financing means **the government spends more than it receives** in the form of revenue, and the **gap (deficit)** is filled by: Borrowing from the public, borrowing from banks, or printing new money (borrowing from RBI).

Formal Definition

1. Raja J. Chelliah

"Deficit financing refers to the creation of new money for meeting the budget deficit of the government."

2. Dalton

"Deficit financing means enhancing expenditure by creating new money, especially when current revenue is not enough."

3. Indian Definition

"Deficit financing is the practice of financing a budget deficit by borrowing from the central bank and thus increasing currency circulation."

Why is Deficit Financing Used? (Purpose)

Governments use deficit financing mainly for:

1. Economic Development

- Building roads, dams, railways
- Infrastructure projects

2. Removing Unemployment

- Public works programs
- Government job schemes

3. Removing Poverty

- Welfare schemes
- Subsidies

4. During Emergencies

- War
- Natural disasters
- Recession

5. Promoting Investment

- Injecting money into the economy
- Encouraging production and industries

Methods of Deficit Financing

Government meets deficit by:

1. Borrowing from RBI

- RBI prints new currency
- Most direct form of deficit financing

2. Borrowing from Commercial Banks

- Banks buy government securities

3. Borrowing from Public

- Sale of treasury bills
- Bonds
- Savings schemes

4. External Borrowing

(Not preferred for deficit financing in India.)

Effects of Deficit Financing

Positive Effects

1. Leads to Economic Growth: More money = more investment = more development.

2. Reduces Unemployment: Government spending creates jobs.

3. Helps During Recession: Boosts demand and production.

4. Useful for Poor Countries: Where tax revenue is limited.

Negative Effects

1. Inflation (Most Important): Printing money increases prices in the economy.

2. Debt Burden: Borrowing increases interest payments.

3. Inequality: Rich benefit more from inflation.

4. Currency Devaluation: Value of the rupee may fall.

5. Fiscal Imbalance: Too much deficit financing weakens financial stability.

Unit V: Indian Public Finance

Budget of the Government of India (Previous Financial Year) – Sources of Public Receipts (Tax and Non-Tax, GST and its Impacts) – Components of Public Expenditure – Sources of Public Borrowing and Debt Liabilities – Deficits – Appraisal of FRBM Act 2004 – Fiscal Federalism: Centre and State Relations – Recommendations of Last 3 Finance Commissions.

Budget of the Government of India (Previous Financial Year)

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1. Meaning

The **Budget of the Government of India** for the **previous financial year** refers to: "The statement of the government's estimated income (revenues) and planned expenditure for the financial year that has just ended."

India's financial year is **1 April to 31 March**. "Previous financial year" means:

- ✓ If you are in **2025–26**, the previous year is **2024–25**.
- ✓ If you are in **2024–25**, the previous year is **2023–24**.

This budget shows **how much money the government expected to receive** and **how it planned to spend**, and it is used for **reviewing economic performance** and **policy evaluation**.

2. Why is the "Previous Financial Year Budget" important?

✓ **Evaluates government's fiscal performance:** Shows whether the government kept spending within limits or exceeded it.

✓ **Checks policy effectiveness:** We see if schemes (education, health, infrastructure, welfare) received sufficient funds and how well they were implemented.

✓ **Indicates economic priorities:** For example, if the government spent more on capital expenditure, it means a push for long-term growth.

✓ **Acts as a base for next year's budget:** The next budget depends on what worked or failed in the previous year.

3. What does the Previous Year Budget Contain?

It covers the same components as the current budget but focuses on *estimates* and *policies* applied in that year.

(A) Revenue Budget

1. **Revenue Receipts**
    - ✓ Tax revenue (GST, income tax, corporate tax)
    - ✓ Non-tax revenue (dividends, interest, fees)
2. **Revenue Expenditure**
    - ✓ Salaries, pensions
    - ✓ Subsidies
    - ✓ Health, education running expenses
    - ✓ Interest payments

(B) Capital Budget

1. **Capital Receipts**
    - ✓ Borrowings
    - ✓ Loans returned to the government
    - ✓ Disinvestment proceeds
2. **Capital Expenditure**
    - ✓ Building roads, railways, ports
    - ✓ Defence capital items
    - ✓ Long-term investments

4. Key Terms Used in the Previous Year Budget

✓ **Fiscal Deficit:** Total expenditure – total revenue (excluding borrowings).

✓ **Revenue Deficit:** Revenue expenditure – revenue receipts.

✓ **Primary Deficit:** Fiscal deficit – interest payments.

✓ **Capital Formation:** Investment in infrastructure and durable assets.

These indicators show how strong or weak the government's financial condition was.

5. What the Previous Financial Year Budget Usually Highlights

While specific numbers change each year, the **structure** of highlights remains the same:

1. Growth and Development Priorities

- Infrastructure
- Green energy
- Digital India
- Manufacturing push

2. Social Welfare Commitments

- Food security
- Health missions
- Scholarships
- Rural employment (MGNREGA)

3. Fiscal Management

- Targets for fiscal deficit
- Borrowing limits
- Steps to reduce subsidies leakages

4. Reforms and New Schemes

- Tax simplification
- Technology-based governance
- Investment promotion policies

5. Sector-wise Allocations

- Agriculture
- Railways

- Defence
- Education
- Health
- Social justice ministries

Budget of the Government of India (Previous Financial Year)

The Government of India's budget for the previous financial year (2024-25) included a revised fiscal deficit of 4.8% of GDP, total receipts (excluding borrowings) of ₹31.47 lakh crore, and total expenditure of ₹47.16 lakh crore. A record dividend from the Reserve Bank of India (RBI) helped the government meet its fiscal target.

Key figures for FY 2024-25:

- **Fiscal Deficit:** The final fiscal deficit came in at ₹15.77 lakh crore, which amounted to 4.8% of GDP, meeting the revised target.
- **Total Expenditure:** Total expenditure was ₹46.55 lakh crore, with capital expenditure at ₹10.52 lakh crore and revenue expenditure at ₹36.03 lakh crore.
- **Total Receipts (excluding borrowings):** The government's total receipts reached ₹30.78 lakh crore, 97.8% of the annual target.
- **Net Tax Receipts:** Net tax receipts stood at ₹24.99 lakh crore, comprising 97.7% of the revised estimate.
- **RBI Dividend:** A record dividend of ₹2.69 lakh crore from the RBI played a significant role in managing the government's finances for the year.

Budget highlights:

- **Increased Capital Expenditure:** The government prioritized infrastructure development, with capital expenditure exceeding its annual target.
- **Tax Collection:** Direct tax collections grew, while income tax collections fell slightly short of estimates. Non-tax receipts, bolstered by the RBI dividend, exceeded the target.
- **Fiscal Consolidation:** The government maintained its fiscal consolidation roadmap, aiming to reduce the fiscal deficit to below 4.5% by 2025-26.

Sources of Public Receipts (Tax and Non-Tax, GST and its Impacts)

Public receipts refer to **all the income that the government receives**. These receipts finance public expenditure, development projects, welfare schemes, and administrative functions.

They are broadly divided into **Tax Revenues** and **Non-Tax Revenues**.

1. Tax Revenue

Tax revenue is the amount the government collects through **compulsory payments** from individuals and firms. No direct benefit is returned to the payer.

A. Direct Taxes

These are taxes **paid directly by individuals or firms** to the government. The burden **cannot be shifted** to someone else.

Examples: Income Tax, Corporate Tax, Wealth Tax (abolished, but conceptually relevant), Capital Gains Tax, Gift Tax, Securities Transaction Tax (STT).

B. Indirect Taxes

These are taxes **paid on goods and services**. The burden **can be shifted** from producer to consumer.

Examples (before GST): Excise Duty, Service Tax, VAT, Entertainment Tax, Luxury Tax.

Today, most indirect taxes in India come under GST.

2. Non-Tax Revenue

Non-tax revenues are incomes received by the government **without imposing taxes**. These are regular, recurring incomes.

Main Forms of Non-Tax Revenue

A. Fees

Payments for specific government services (e.g., passport fees, exam fees, court fees).

B. Fines and Penalties

Payments for violating laws (e.g., traffic fines, environmental penalties).

C. Profits and Dividends

Income from:

- Public Sector Undertakings (PSUs) like ONGC, SBI

- RBI surplus transfer

D. Interest Receipts

Interest on loans:

- Given by central government to states
- To public sector enterprises

E. Licences and Permits

Income from granting permission (e.g., telecom spectrum licence fees).

F. External Grants

Financial assistance from: World Bank, IMF, Foreign governments.

G. Escheat

Property of a person who dies without legal heirs goes to the government.

3. GST (Goods and Services Tax)

GST is a **single, unified indirect tax** on the supply of goods and services across India. Launched on **1 July 2017**, it replaced many indirect taxes like excise duty, VAT, service tax.

GST Structure

- **CGST** – Central Goods and Services Tax
- **SGST/UTGST** – State/Union Territory GST
- **IGST** – Integrated GST (on inter-state supply)

GST Council

A constitutional body (under Article 279A) that decides GST rates, rules, exemptions.

4. Impacts of GST

Positive Impacts

1. One Nation, One Tax

Simplified taxation by replacing: Excise, VAT, Service Tax, Entry Tax, Luxury Tax, Entertainment Tax, many state-level taxes.

2. Reduces Cascading Effect

Earlier: Tax on tax (VAT + Excise + Service tax).

Now: Input Tax Credit removes double taxation.

3. Encourages Ease of Doing Business

- Uniform rates
- Online filing
- Transparent system

4. Boosts Formalisation

More firms register under GST → Increases tax base and government revenue.

5. Growth in Logistics Efficiency

Check posts removed → trucks move faster → lower transport cost.

Negative Impacts / Challenges

1. Technical and Compliance Burden

Many small businesses struggle with: Monthly returns, Documentation, Digital filing.

2. Revenue Uncertainty for States

Earlier states collected their own taxes (VAT).
Now they depend on:

- SGST
- IGST settlement
- Compensation cess

3. Higher Rates on Certain Goods

Some items fall under 28% + Cess (luxury items, tobacco, aerated drinks).

4. IT System Glitches

Initial years faced:

- Portal errors
- Delay in refunds (mainly for exporters)

Components of Public Expenditure

Public expenditure refers to **all the spending by the government** (central, state, and local bodies) to perform its functions such as administration, development, defence, welfare, and economic growth.

Public expenditure can be classified into several components. The main components are as follows:

1. Revenue Expenditure

These are expenditures that **do not create assets** and **do not reduce liabilities**. They are recurring or operational in nature.

Examples:

- Salaries of government employees
- Pensions
- Interest payments on loans
- Subsidies (food subsidy, fertilizer subsidy)
- Grants to states and local bodies
- Day-to-day expenses of ministries

Purpose: To maintain **regular functioning** of the government.

2. Capital Expenditure

These are expenditures that **create long-term assets** or **reduce government liabilities**. They contribute to long-term economic development.

Examples:

- Construction of roads, railways, bridges, airports
- Purchase of machinery, equipment
- Investment in public sector enterprises
- Loans given to states/PSUs
- Acquisition of land
- Capital defence expenditure

Purpose: To improve **productive capacity**, **infrastructure**, and **economic growth**.

3. Plan Expenditure (earlier classification)

(Relevant historically)

Before 2017, expenditure was divided into **Plan** and **Non-Plan**:

Plan Expenditure:

Money spent on **development programmes** under the Five-Year Plans.

Examples:

- Agriculture development schemes

- Industrial development
- Education missions

This classification is no longer used, but conceptually important.

4. Non-Plan Expenditure (earlier classification)

Included:

- Defence
- Subsidies
- Interest payments
- Salaries
- Pensions
- Maintenance expenditure

This category also ended in 2017.

5. Developmental Expenditure

This expenditure promotes **economic and social development**.

Examples:

(A) Social Services:

- Education
- Health
- Housing
- Drinking water
- Social security
- Welfare of SC/ST/OBC

(B) Economic Services:

- Agriculture
- Industry
- Power
- Transport and communication
- Rural development

6. Non-Developmental Expenditure

This is essential for **general administration** and **security**, but not directly productive.

Examples:

- Defence and police
- Administration
- Judiciary
- Interest payments
- Pensions
- Tax collection machinery

7. Transfer Payments

Payments made by the government **without receiving goods or services** in return.

Examples:

- Scholarships
- Pensions
- Unemployment benefits
- Grants to states and local bodies
- Welfare payments

These reduce inequality and support vulnerable groups.

8. Productive and Unproductive Expenditure

A. Productive Expenditure:

Promotes economic growth and increases national income. Examples: Irrigation projects, Transport infrastructure, Power generation.

B. Unproductive Expenditure:

Does not directly add to national income. Examples: Interest payments, Defence expenditure, Law and order (But still necessary.)

9. Mandatory vs. Discretionary Expenditure

A. Mandatory:

Cannot be reduced easily. Examples: Interest payments, Salaries, Pensions, Defence.

B. Discretionary:

Government can change the amount each year. Examples:

- ✓ Education programmes
- ✓ Skill development schemes
- ✓ Infrastructure spending

10. Welfare Expenditure

Money spent on **improving living standards** of the people.

Examples:

- Public distribution system (PDS)
- Social security schemes
- Health insurance (Ayushman Bharat)
- Mid-day meal scheme

Sources of Public Borrowing and Debt Liabilities

Public borrowing refers to **the loans raised by the government** to meet its expenditure when revenue is insufficient. These borrowings create **public debt**, which becomes a **liability** for the government.

Borrowing is a major component of fiscal policy and helps the government finance development, welfare, and investment programmes.

1. Sources of Public Borrowing

Public borrowing comes from two broad sources:

A. Internal (Domestic) Borrowing

Borrowing from **within the country**. This is the major source for the Government of India.

Key instruments:

1. Market Loans (Government Securities / G-Secs)

- Treasury bills (91-day, 182-day, 364-day)
- Dated securities (long-term bonds: 5, 10, 20 years)

These are purchased by banks, insurance companies, mutual funds, and the public.

2. Borrowing from RBI

- Ways and Means Advances (WMA)

- Overdraft facility
- Direct purchase of government securities (under special situations)

3. Borrowing from Commercial Banks

Banks invest in government securities as part of their **Statutory Liquidity Ratio (SLR)** requirement.

4. Borrowing from Financial Institutions

- LIC
- GIC
- EPFO
- NABARD
- SIDBI
- Other government-owned institutions

They invest in government bonds and lend long-term funds.

5. Small Savings Schemes

Money collected from:

- Post office savings
- National Savings Certificates (NSC)
- Public Provident Fund (PPF)
- Kisan Vikas Patra (KVP)
- Senior Citizen Savings Scheme

Government borrows from the National Small Savings Fund (NSSF).

6. Provident Funds

Government takes loans from:

- General Provident Fund (GPF)
- Contributory Provident Fund

7. State Government Borrowings

State governments borrow through:

- State Development Loans (SDLs)
- Loans from central government

B. External Borrowing

Loans taken from **outside the country** (foreign sources).

1. Bilateral Loans

From foreign governments:

- Japan
- Germany
- France
- USA
- UK

2. Multilateral Loans

From international institutions:

- World Bank
- IMF
- Asian Development Bank (ADB)
- BRICS New Development Bank

3. External Commercial Borrowings (ECBs)

Loans raised in foreign currency from:

- International banks
- Foreign investors
- Global bond markets

4. Sovereign Bonds

Government may issue bonds in international markets (rarely used by India).

2. Debt Liabilities of the Government

Debt liability means **the responsibility of the government to repay borrowed money along with interest**. Public debt is classified into:

A. Internal Debt Liabilities

Debt owed **within the country**.

Includes:

- Market loans (G-secs)

- Treasury bills
- Ways and Means Advances
- Borrowing from RBI
- Loans from NSSF
- Provident fund liabilities
- Special securities issued to oil companies, FCI, etc.

This is the **largest part** of India's public debt.

B. External Debt Liabilities

Debt owed to **foreign lenders**.

Includes:

- Loans from international organisations (IMF, World Bank, ADB)
- Loans from foreign governments
- External commercial borrowings
- Foreign currency denominated bonds

External debt is usually **concessional**, meaning lower interest and longer maturity.

C. Other Liabilities (Public Account Liabilities)

These are funds that **do not belong to the government**, but are kept in trust and must be repaid.

Includes:

- Provident fund deposits
- Small savings deposits
- Postal insurance
- Reserve funds
- Deposits of local bodies and other institutions

These form a major part of the "Public Account of India".

3. Why Do Governments Borrow?

- To finance budget deficit
- To build infrastructure
- To maintain welfare schemes
- To stabilise the economy during recession

- To support long-term development
- To meet emergencies (war, disaster, pandemic)

Deficits

In public finance, **deficit** refers to a situation where **government expenditure exceeds government receipts** during a financial year. It shows the **gap between income and spending**, which the government must cover through borrowing or other means.

Deficits indicate the **financial health** of the government and its level of fiscal discipline.

Types of Deficits

The main types of deficits are:

1. Revenue Deficit

Definition:
Revenue deficit occurs when **Revenue Expenditure > Revenue Receipts**.

Formula:

Revenue Deficit = Revenue Expenditure – Revenue Receipts

Meaning:

- Government is unable to meet its regular day-to-day expenses from its revenue income.
- Indicates weak financial management.

Example:

If revenue expenditure is ₹20 lakh crore and revenue receipts are ₹15 lakh crore:
Revenue deficit = ₹5 lakh crore.

2. Fiscal Deficit

Definition:
Fiscal deficit is the **excess of total expenditure over total receipts (excluding borrowings)**.

Formula:

Fiscal Deficit = Total Expenditure – (Revenue Receipts + Non-Debt Capital Receipts)

Meaning:

- Shows how much the government needs to borrow.
- Indicates overall financial imbalance.

Example:

If fiscal deficit is 5% of GDP → The government is heavily borrowing to finance its budget.

3. Primary Deficit

Definition:
Primary deficit is **fiscal deficit minus interest payments**.

Formula:

Primary Deficit = Fiscal Deficit – Interest Payments

Meaning:

- Shows the deficit excluding past debt obligations.
- If primary deficit is low, it means most borrowing is used to pay interest on old loans.

4. Budget Deficit (Old Concept)

(Not used in Indian budget now but important for exams)

Definition:
Budget deficit =
Total Expenditure – Total Receipts (including borrowings).

This concept is outdated and replaced by **fiscal deficit**.

5. Monetised Deficit

Definition:
The portion of the fiscal deficit that is financed by **the RBI printing new money** or directly purchasing government securities.

This increases money supply.

6. Effective Revenue Deficit

(Introduced in 2012–13)

Definition:
Revenue deficit excluding grants given to states for capital creation.

Formula:

Effective Revenue Deficit = Revenue Deficit – Grants for Creation of Capital Assets

Shows how much of the revenue deficit is due to purely consumption expenditure.

7. Trade Deficit *(Generally included in macroeconomics)*

Occurs when **imports > exports** of goods and services.

Although not part of the Union Budget deficit, it affects the external sector balance of the economy.

8. Current Account Deficit (CAD)

Part of Balance of Payments.

Occurs when the **value of imports of goods, services, and transfers exceeds exports**.

Why Do Deficits Matter?

- High deficits increase government borrowing
- Raises interest burden
- Can cause inflation
- Reduces funds for development
- May lead to debt trap
- But moderate deficits support growth during recession

Appraisal of FRBM Act 2004

The **FRBM Act, 2004** was enacted by the Government of India to bring **fiscal discipline**, reduce deficits, improve financial transparency, and ensure long-term macroeconomic stability. An appraisal means **evaluating its achievements, strengths, weaknesses, and limitations**.

1. Achievements / Positive Appraisal

1. Brought Fiscal Discipline

- Forced the government to control deficits.
- Fiscal deficit reduced significantly in the years after the Act was implemented.

2. Encouraged Transparency

The Act made it compulsory to publish:

- ✓ Medium-Term Fiscal Policy Statement
- ✓ Fiscal Policy Strategy Statement
- ✓ Macroeconomic Framework Statement

This improved transparency and accountability.

3. Reduced Revenue Deficit

- The Act encouraged the government to contain revenue expenditure and increase revenue receipts.
- Revenue deficit fell in the early years after FRBM was implemented.

4. Promoted Long-Term Planning

- Introduced a **medium-term fiscal framework**, forcing the government to think beyond one budget year.

5. Improved Investor Confidence

Lower deficit and stable fiscal policy increased:

- ✓ Foreign investment
- ✓ Domestic investor confidence
- ✓ India's credit rating

6. Helped in Macroeconomic Stability

- Discouraged excessive borrowing
- Improved inflation control
- Controlled unproductive expenditure

2. Limitations / Criticisms

1. Too Rigid During Economic Slowdowns

The Act restricted government spending even during crises, such as: 2008 global financial crisis and COVID-19 pandemic.

In such periods, governments *need* flexibility to borrow more and support the economy.

2. Overambitious Targets

- Targets like revenue deficit elimination and fiscal deficit reduction to 3% of GDP were difficult to achieve.
- Deadlines were repeatedly postponed.

3. Weak Enforcement

- No strict penalties for violating targets.
- The Act relied on moral responsibility, making compliance weak.

4. Focused More on Numbers Than Quality

- Emphasis was on reducing fiscal deficit, **not on improving quality of expenditure**.
- Productive capital expenditure was sometimes cut just to meet targets.

5. Did Not Fully Address State-Level Deficits

- States have their own FRBM Acts, but coordination is weak.

- State deficits remain a major concern.

6. Limited Control on Off-Budget Borrowings

Government avoided deficit limits by using: Food subsidy borrowing by FCI, Oil bonds, Special securities. These were outside the budget, reducing transparency.

3. Amendments and Reforms After FRBM 2004

2012 Amendment

- Introduced **Effective Revenue Deficit**
- Introduced **Medium-Term Expenditure Framework**

2016 N.K. Singh Committee Review

Recommended:

- Debt-to-GDP target
- Greater flexibility (escape clauses)
- Fiscal Council

Some recommendations were adopted, but not all.

Fiscal Federalism: Centre and State Relations

Fiscal Federalism refers to the **financial relationship between different levels of government**, mainly **the Centre and the States** in India. It deals with how financial powers, revenue sources, and expenditure responsibilities are divided, and how resources are shared.

In India, fiscal federalism is guided by the **Constitution**, **Finance Commission**, **Planning system**, **GST Council**, and various Central schemes.

1. Constitutional Basis of Fiscal Federalism

The Constitution clearly divides:

A. Taxation Powers

- **Union List**: Income tax (except agricultural), excise duty, customs, corporation tax, etc.
- **State List**: Land revenue, excise on alcohol, property tax, and stamp duty.
- **Concurrent/Shared**: GST under Article 246A gives taxing power to both Centre and States.

B. Expenditure Responsibilities

- **Centre**: Defence, railways, national highways, foreign affairs

- **States**: Public health, education, police, agriculture, local infrastructure

2. Vertical Fiscal Imbalance

Vertical imbalance means **revenue and expenditure do not match at each level**.

- Centre → more revenue powers, fewer responsibilities
- States → fewer revenue powers, more responsibilities (health, education, welfare)

To correct this, transfers are made from **Centre to States**.

3. Horizontal Fiscal Imbalance

Horizontal imbalance exists **between states** due to differences in:

- income levels
- population
- resources
- development
- tax base

Poorer states need additional financial support.

4. Instruments of Fiscal Federalism in India

A. Finance Commission (Article 280)

Finance Commission recommends:

- How **tax revenue of Centre is shared with states** (vertical devolution)
- How revenue is distributed **among states** (horizontal devolution)
- Grants-in-aid to states

It is the backbone of federal transfers.

B. Intergovernmental Transfers

1. Tax Devolution

Percentage of central taxes that must be shared with states. (Example: approx. 41% recommended by the 15th Finance Commission).

2. Grants-in-Aid

Funds given under Article 275.
Types:

- Revenue deficit grants

- Disaster management grants
- Sector-specific and state-specific grants

C. GST Council

A cooperative federal institution created by the **101st Constitutional Amendment (2016)**.
It ensures:

- Uniform tax rates
- Joint decision-making
- Harmonised indirect taxation

Centre and States participate equally.

D. Centrally Sponsored Schemes (CSS)

Schemes in which both Centre and States share expenditure. (e.g., MGNREGA, PMAY, NHM).

They ensure national priorities but sometimes reduce state autonomy.

E. Borrowing Powers

- **Centre**: Can borrow internally and externally.
- **States**: Can borrow only within India and require **Centre's approval** if they have outstanding loans to the Centre.

5. Issues/Challenges in Fiscal Federalism

1. Growing Vertical Imbalance

States depend heavily on central transfers, especially after GST subsumed many state taxes.

2. GST Compensation Issue

States lost revenue after GST introduction and demanded compensation.

3. Centrally Sponsored Schemes

Some states feel **CSS reduces financial freedom** because they must follow central guidelines.

4. Unequal Growth Among States

Southern and western states grow faster; eastern and northern states lag → horizontal imbalance widens.

5. Borrowing Restrictions on States

Severely limits their developmental spending.

6. Political Conflicts

Centre–state tensions affect fund flow and cooperation.

6. Recent Trends Towards Cooperative Federalism

- GST Council meetings
- Greater tax devolution by Finance Commission
- NITI Aayog promoting cooperative federalism
- Centre giving more untied funds (in some periods)

Recommendations of Last 3 Finance Commissions

The Finance Commission (FC) is constituted every five years to recommend how revenues should be shared between the Union and States. The last three commissions are:

- **13th Finance Commission (2010–15)**
- **14th Finance Commission (2015–20)**
- **15th Finance Commission (2021–26)**

1. Thirteenth Finance Commission (2010–2015)

(A) Tax Devolution

- Recommended **32%** share of the divisible pool of central taxes to the states.
- This was **an increase** from the 12th FC's 30.5%.

(B) Grants-in-Aid

Recommended various grants such as:

- **General Purpose Grant**
- **State-specific grants**
- **Local body grants** (₹87,519 crore)
- **Disaster Relief Grants** through the newly formed *National Disaster Response Fund (NDRF)*

(C) Fiscal Consolidation

Suggested a **fiscal roadmap**:

- ✓ Centre to reduce fiscal deficit to **3% of GDP** by 2014–15.
- ✓ States collectively to maintain a fiscal deficit of **3% of GSDP**.

Encouraged states to enact **Fiscal Responsibility Acts**.

(D) Goods and Services Tax (GST)

- Recommended a **GST compensation package** for states.
- Suggested strengthening the GST design for seamless credit.

(E) Incentives

- Incentives for **improving tax collection**, **power distribution reforms**, and **environmental conservation**.

2. Fourteenth Finance Commission (2015–2020)

This commission is known for a **major shift toward fiscal federalism and state autonomy**.

(A) Tax Devolution

- Recommended **42%** share of central taxes to states.
- **Highest ever** at the time.
- Strengthened state financial independence.

(B) Grants to Local Bodies

Recommended:

- ✓ **₹2.87 lakh crore** to local bodies.
- ✓ Focus on **basic services**, **sanitation**, and **capacity building**.

(C) Disaster Management

- Recommended creation of **State Disaster Response Funds (SDRFs)**.
- Funds shared in the ratio:
  - ✓ **90:10** for special category states
  - ✓ **75:25** for other states

(D) Fiscal Consolidation

- Suggested continuation of a **3% fiscal deficit** target for states.
- Allowed a **0.5% flexibility** if states fulfilled conditions (like revenue reforms).

(E) Centrally Sponsored Schemes (CSS)

Recommended **rationalisation**:

- ✓ Some schemes should be fully taken over by the Union.
- ✓ Some schemes should be transferred completely to the states.

This allowed states to have greater **functional and financial autonomy**.

3. Fifteenth Finance Commission (2021–2026)

Two reports:

- **2020–21 (Interim)**
- **2021–26 (Final)**

(A) Tax Devolution

- Recommended **41%** share of central taxes to states.
- Reason for reduction from 42% → 41%:
  - To account for the creation of **Union Territories of Jammu & Kashmir and Ladakh**.

(B) Criteria for Distribution Among States

Included indicators such as:

- **Income distance** (45%)
- **Population 2011** (15%)
- **Forest & ecology** (10%)
- **Demographic performance** (12.5%)
- **Tax and fiscal efforts** (2.5%)

This encouraged states to perform better in **population control**, **tax collection**, and **environmental conservation**.

(C) Grants-in-Aid

Recommended grants for:

- **Local governments** (₹4.36 lakh crore)
- **Health sector** (major focus after COVID-19)
- **Performance-based grants**:
  - ✓ Nutrition outcomes
  - ✓ Judiciary
  - ✓ Agriculture reforms

(D) Disaster Management

Recommended strengthening the **National Disaster Risk Management Fund (NDRMF)** and **State Disaster Risk Management Funds (SDRMF)**.

(E) Fiscal Consolidation

Centre and States should aim for:

- ✓ **3% fiscal deficit target**
- ✓ A combined debt-to-GDP path that returns to sustainable levels.

(F) Defence and National Security

Recommended setting up a **non-lapsable Modernisation Fund** for defence and internal security.