Centre for Distance & Online Education
(CDOE)

BACHELOR OF COMMERCE

BCOM 506

PUBLIC FINANCE

Guru Jambheshwar University of Science & Technology, Hisar – 125001

INDEX

Course: Public Finance	
Course Code: BCOM 506	Author: Dr. Arora Gaurav Singh
Lesson No. :01	Vetter: Prof Suresh Kumar Mittal
INTRODUCTION TO PUBLIC FINANCE	

STRUCTURE

1.0 Learning Objectives

This lesson highlights the basic elements of public finance. It defines the basic concepts of public finance and describes their scope, features, objectives etc. The growth pattern of public finance in India has also been described in this lesson. Furthermore, this lesson also deals with the concept of the principle of maximum social advantage.

After reading this lesson, students will be able to:

- Describe the concepts of public finance.
- Explain scope of public finance.
- Identify the objectives and importance of public finance.
- Explain the growth of public finance in India.
- Examine the principle of maximum social advantage.

1.1 Introduction

Be it Monarchies or Republics, public expenditure has always played a major role in development of the economies. It has ensured the creation of capital assets in the country(s) along with inclusive growth of the economy(s). Primary sector improves upon the development of technology intensive techniques. Similarly, when public expenditure is done on secondary sector, it progresses as well. And, with the enhanced expenditure done on the expansion and development of tertiary sector, more FDI and global receipts are ensured. Basically, it can be said that the Public Expenditure done in the right sectors, at the right times, has always ensured inclusive and diversified economic growth.

1.1.1 Definitions

Public Finance is the administration of a country's revenue, expenditures, and debt load via a variety of government and quasi-government institutions. Using public finance as a discipline, we may learn about government services such as subsidies and welfare payments, as well as how taxes, borrowing, foreign aid, and the production of new money are used to pay for them.

In the words of **Adam Smith,** "The investment into the nature and principles of state expenditure and state revenue is called ***Public Finance***".

Dalton explains that "Public Finance is concerned with the income and expenditure of public authorities, and with the adjustment of one to another."

Harold Groves states that "Public Finance is a field of enquiry that treats on income and outgo of governments (i.e., federal, state and local)."

1.1.2 Components of Public Finance

The most important aspects of public finance include actions connected to revenue collection, societal spendingand the implementation of a financing strategy (such as issuing government debt). These are main components of Public Finance-

Tax Collection- Governments rely heavily on taxation as a revenue stream. There are numerous types of taxes levied by governments, some of which include sales tax, income tax, estate tax, and property tax. Duty and tariff revenues on imports, as well as earnings from any non-free public service, are included in this category.

Budget- In a fiscal year, the budget is a plan of the government's spending on various heads. In India, Budget, or The Annual Financial Statement, is presented in the month of February, in the Parliament to get approvals for public expenditure to be done in the fiscal year commencing from 1st April and ends on 31st March.

Expenditures- Everything a government spends money on, such as social services, education, and infrastructure, is considered an expenditure. When it comes to government spending, most of it is geared at increasing overall social well-being of the citizens. In India, majority of the public expenditure is done on giving away subsidies and implementing social welfare schemes.

Deficit/Surplus- There will be a deficit if the government spends more than it earns. It's called a surplus when the government's spending is less than the revenue it receives from taxes.

National Debt- If the government has a deficit i.e., spending is greater than revenue, than it tries to fund the difference by borrowing money either from the Reserve Bank of India or by open market operations, thereby, issuing national debt.

1.1.3 Scope of Public Finance

The scope of public finance diversifies not only into public income and public expenditure but also includes the financial administration of the country along with the management of public debt. This classification of scope has been done by Prof. Dalton, which is explained as follows-

1. **Public Income-** Public income, as the name implies, is the income of the government. Tax revenue and non-tax revenue are the two sources of income for the government. Tax revenue is easy to recognise; it's the money the country's citizens pay in the form of taxes such as income tax, sales tax, and tariffs, among other things. Non-taxable income, on the other hand, includes interest income from loans to other countries, rental and revenue income from government properties, and donations from international organisations, etc. In the public income, taxation methods, classification of revenue, its impact on the economy are studied.
2. **Public Expenditure-** The money that government bodies spend is referred to as public expenditure. For the sake of the country's progress and well-being, the government will logically invest money in areas such as infrastructure, defence, education, and healthcare. To better understand how public spending affects diverse elements including employment, production, growth and other important societal outcomes, researchers in this field look at the goals of government spending and how it is classified.
3. **Public Debt-** It is common for governments to borrow money from other countries or international institutions, such as The World Bank, if expenditures exceed revenues. The debt incurred because of these loans is referred to as public debt. This area of public finance explains the burden of public debt, why it is necessary and its effect on the economy. It also suggests methods to manage public debt.
4. **Financial Administration-**As the name suggests, this subject of public finance is all about managing public money, which includes tax revenue, public spending, and government debt. Preparation, approval, and execution of the federal budget, as well as other federal programmes, comprise financial administration. There is also research into how policies affect the social and economic environments and the ties between governments as well as international relations.

1.1.4 Objectives of Public Finance

Following are the main objectives of Public Finance:

1. **Price Stability-** Public finance controls price variations to maintain price stability. In the presence of inflation and deflation, the economy becomes more unstable, and the prices of goods and services fluctuate. During an inflationary period, the government increases tax rates and capital expenditure. When the economy is in a state of deflation, the government lowers tax rates to help people increase their purchasing power, which leads to an increase in demand.

2. **Infrastructural Development**-Large infrastructural development projects around the country are facilitated by public funds. Public Finance makes it possible to raise substantial amounts of money for the building of infrastructure essential to the maintenance of order, justice, and safety. When it comes to creating infrastructure such as roads, railways, schools, health care, and sewage systems, the government uses every penny as a budgetary weapon.

3. **Resource Allocation**- Public finance can be regarded as an effective Governmental tool for proper and efficient allocation of both, natural as well as man-made resources in the economy, for public and private sectors.

4. **Increasing Economic Growth Rate**- The government's finance department is effective in supporting an economy's greater growth rate. The use of taxing mechanisms by the Government can be regarded as an effective method of shifting resources from consumption to investment. The use of fiscal instruments helps to increase aggregate demand and supply, which in turn speeds up overall economic development. The government uses a variety of mechanisms to do this, including taxes, public debt, and public spending.

5. **Equitable Distribution of Wealth-** Government may eliminate inequities in how wealth and income are distributed among its citizens by implementing the policy of "equitable distribution of wealth." In developing nations, inequality in income distribution is a severe problem since the affluent become richer while the poor get poorer. When there are substantial gaps in wealth, the government imposes more taxes on the profits, income, and assets of the wealthy. The government makes use of this money to provide various sorts of allowances, subsidies, and other forms of assistance to the needy.

6. **Export Promotion-** Public funds help the government promote exports while discouraging imports. Each country's foreign exchange earnings are mostly derived from exports. Foreign governments give subsidies or even exclude export-oriented goods from paying taxes to encourage exports. Subsidized inputs are also provided to produce such goods. In contrast, it raises import duties to discourage citizens from bringing in products, as doing so diminishes the country's foreign exchange reserves.

7. **Attaining favourable Balance of Payments-**The government employs tariffs and various fiscal measures to keep the country's balance of payments positive. Public Finance makes it possible for the government to raise money whenever required, which prevents fiscal deficits. Every expense is carefully considered by the Government resulting in favourable balance of payments.

8. **Balanced Growth and Development-** Public Finance also plays a vital part in the nation's balanced development. The government utilises revenue and spending to close the gap between urban and rural communities, as well as the agricultural and industrial sectors. The government spends money to build infrastructure in rural regions and to provide the rural people with a variety of economic benefits.

9. **Provision of full Employment-** Public finance aims at giving all citizens of the country; improved work prospects. It helps firms thrive and flourish by aiding the overall development of the economy. Business enterprises will need more labour as their size grows, which will lead to more job openings, leading to more employment for the people of the country.

1.1.5 Importance of Public Finance

The importance of Public Finance is listed below:

1. **Ensures stable Economic Growth-** To sustain a high pace of economic growth, it is critical to have adequate public finance. The government employs fiscal instruments to boost both the amount of money in circulation and the amount of money in the economy. A few of the instruments at Government’s disposal include various forms of taxation, public debt, and public spending.

2. **Ensures Price Stability**- To combat inflation and deflation, the government makes use of public funds. Inflation lowers indirect taxes and lowers general spending, while it raises direct taxes and increases capital expenditure. Internal public debt is collected, and investments are mobilised. Deflation simply means reversing the programme.

3. **Economic Stability**- The government uses fiscal tools to stabilize the economy. During prosperity, the government imposes more taxes and raises the internal public debt. The amount is used to repay foreign debt and invention. The internal expenditures are reduced. During the recession, the case is just reversed.

4. **Equitable Distribution of Wealth-** To alleviate inequality, the government utilises its own resources and expenditures. Income, profit, and property of the wealthy are taxed at a higher rate when there is a large discrepancy in income, wealth, and consumption. Through subsidies, allowances, and other direct and indirect benefits to the needy, the money collected is utilised.

5. **Sustainable Allocation of Resources-** The appropriate use of natural, man-made, and human resources needs government funding. This means the government taxes and provides subsidies for the manufacture and sale of less desired items, while imposing less taxes on more desirable goods.

6. **Balance of Trade**-The government encourages exports by lowering or eliminating taxes on export-oriented items, or by granting subsidies. It may be able to provide the inputs at a reduced cost. Imports are taxed more heavily, and so on.

7. **Enhanced Development of Infrastructure**- The government collects taxes and uses the money to build infrastructure. Additionally, it must maintain a sense of order, justice, and security. It must be accompanied with socio-economic change. It employs revenues and expenditures as fiscal instruments for all these purposes.

8. **Emergence of Social Services-** Public financing has become increasingly important owing to the growth of social services that can be delivered more quickly and cost-effectively than individual ones. Education, health care, retirement security, and other forms of financial security are all examples of these types of services. As the demand for these services grows, so does the requirement for public funding to support them.

1.2 Concept of Principle of Maximum Social Advantage

The Principle of Maximum Social Advantage (MSA) is the foundation of Public Finance. Using the Principle of Maximum Social Advantage, it is claimed that public spending and taxation contribute to economic wellbeing when the advantages received from MU (Marginal Utility) of expenditure are equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.

Dalton illustrates the concept of maximal social advantage in the form of-

1. Marginal Social Sacrifice (MSS)
2. Marginal Social Benefits (MSB)

To explain the above, Dalton assumed the following assumptions-:

- Every tax is a sacrifice, and every governmental spending is an investment.
- No additional sources of government income are included in the public revenues. There is a balanced budget, and the government has no surplus or deficit.
- Spending by the government has a declining social benefit, while taxation has a growing social cost.

1.2.1 Marginal Social Sacrifice (MSS)

The marginal social sacrifice (MSS) is the amount of public sacrifice that occurs when an additional unit of tax is levied. As a result of a government tax, the usefulness of every unit is reduced. More burden (marginal sacrifice) caused by additional units of taxes continues to grow, resulting in an ever-increasing overall societal sacrifice, according to Dalton. This is because levying taxes reduces the total amount of money in circulation. The marginal utility of money continues to rise as the supply of money decreases. Every additional unit of taxes eventually has a bigger impact and a higher sacrifice on the society. That's why the amount of marginal societal sacrifice keeps rising. Taxation imposes a cost on the people, but governmental expenditure provides a benefit.

1.2.2 Marginal Social Benefit (MSB)

Taxation imposes a cost on the people, but governmental expenditure provides a benefit. Marginal social benefit is a term used to describe the additional benefit to society that an additional unit of public expenditure provides.

1.2.3 Limitations on the Advantages of Social Status

The notion of Maximum Social Advantage has several flaws, which are as follows-

- It's impossible to measure utility and disutility since there's no effective way to do so.
- Individual members of the community are not included in this discussion, therefore the marginal utility and disutility of public expenditure may be higher or lower than the marginal disutility of taxes for particular individuals. When it comes to distributional equality, this raises the issue.
- It is important to determine how the society's marginal benefits and drawbacks should be distributed.
- This principle's main flaw is that it does not provide a clear benchmark by which the efficiency of various expenditure programmes can be judged.
- While the disutility of taxation might be a global issue, governmental expenditure can be a micro one. As a methodological matter, it is incorrect to regard them as two sides of the same coin. With or without the approval of the principle, the government may have to boost expenditures significantly in the event of large-scale involuntary unemployment.

1.2.4 Social Advantage Tests

The first test of social advantage applied by Dalton is the requirement to keep the society safe from both internal and external threats. We assume that society should be pressed here. No civilization can grow without peaceful coexistence, which isn't a solely economic measure of social gain. Lady U.K Hicks has also devised two criteria for determining whether the operation of public finance is beneficial or detrimental to society. According to her, there are two types of optimums: one for production and one for utility. When it is impossible to raise output of a single commodity by reallocation, we have reached a production optimum. Utility optimum is said to be reached when resources are allocated to one item, without lowering the output of another item. This is a point at which a person's well-being is maximised. Economically, the community's well-being is the focus of the second test. This can only happen if two requirements are met; improvements in manufacturing and distribution are the main factors for the same.

1.3 Check Your Progress

1. Public Finance is the administration of a country's ……………, ……………, and ……… load via a variety of government and quasi-government institutions.
2. Government taxes are of two kinds, …………. and …………. taxes.
3. If the government has a ……….. i.e., spending is greater than revenue, than, it tries to fund the difference by borrowing money either from the Reserve Bank of India or by open market operations, thereby, issuing national debt.
4. Public finance can be regarded as an effective Governmental tool for proper and efficient allocation of both, ……… as well as ……….. resources in the economy, for public and private sectors.
5. ……………. is a term used to describe the additional benefit to society that an additional unit of public expenditure provides.

1.4 Summary

- Public Finance has always acted as a positive influence on the growth and development of an economy. The Government spends on those fields and sectors which are left alone by the private sector. Underdeveloped countries like India, have been on growth spree just for the reason of Public Finance.

- The Principle of Maximum Social Advantage (MSA) is the foundation of public finance. Using the Principle of Maximum Social Advantage, it is claimed that public spending and taxation contribute to economic wellbeing when the advantages received from MU (Marginal Utility) of expenditure are equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.

1.5 Keywords

1. **Public Finance**- Public finance is concerned with the income and expenditure of public authorities, and with the adjustment of one to another.
2. **Public Expenditure**-Public expenditure is spending made by the government of a country on collective needs and wants such as pension, provisions, security, infrastructure, etc.
3. **Resource Allocation**- Resource allocation is the process of assigning and managing assets in a manner that supports an organization's strategic goals.
4. **Maximum Social Advantage-** The Principle of Maximum Social Advantage states that public finance leads to economic welfare when public expenditure & taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to the Marginal Disutility or the sacrifice imposed by taxation.
5. **Marginal Social Benefit-** Marginal social benefit is the change in benefits associated with the consumption of an additional unit of a good or service.
6. **Marginal Social Sacrifice**- Marginal Social Sacrifice (MSS) refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax. Every unit of tax imposed by the government taxes result in loss of utility.

1.6 Self-Assessment Test

1. What is Public Finance?
2. Explain the components of Public Finance?

3. Why is the scope of Public Finance so enlarged in developing economies?
4. What are the objectives of Public Finance?
5. How does Public Finance help in dealing with the situations of Inflation as well as deflation?
6. Why has Public Finance become so important in the recent times?
7. What do you understand by the Principle of Maximum Social Advantage in context of Public Finance?
8. Explain the concept of Marginal Social Benefit.
9. Explain the concept of Marginal Social Sacrifice.
10. Explain the tests applied to understand the concept of maximum social advantage.

1.7 Answers to Check Your Progress

1. Revenue, Expenditure and Debt
2. Direct and Indirect
3. Deficit
4. Natural and man-made
5. Marginal Social Benefit

1.8 References/ Suggested Readings

1. Rao, Govinda. (2018). Public finance in India: Some reflections. DECISION. 45. 10.1007/s40622-018-0172-1.
2. Rao, Govinda. (2018). Public Finance in India in the Context of India's Development Public Finance in India in the Context of India's Development. Decision.
3. Ahuja, D., Pandit, D. (2020). Public expenditure and economic growth: Evidence from the developing countries. FIIB Business Review, 9(3), 228–236.

4. Bhanumurthy, N. R., Prasad, M., Jain, R. (2018). Public expenditure, governance and human development. Economic & Political Weekly, 53(14), 36–43.
5. Bell, Crive (2003), *Development Policy as Public Finance* , Oxford University Press
6. http://www.imf.org/external/work.html

Course: Public Finance	
Course Code: BCOM 506	Author: Dr. Arora Gaurav Singh
Lesson No. :02	Vetter: Prof. Suresh Kumar Mittal
INDIAN PUBLIC FINANCIAL SYSTEM	

STRUCTURE

2.10 References/Suggested Readings

2.0 Learning Objectives

This lesson explains the concept of Indian Financial System. It defines the types of financial instruments along with various financial services. After reading the chapter, the students will be able to-

- Understand the Indian Financial System.
- Understand various Financial Instruments and Services.
- Understand the historic evolution of Financial System in India.
- Understand the Constitutional status of Financial System in India.

2.1 Introduction to Indian Financial System

The financial system facilitates the exchange of cash between lenders and borrowers. Insurance, banking, capital markets and a variety of other service industries in India are overseen by independent authorities. Thereby a country's banking sector contributes significantly towards its economic development by mobilizing and effectively using its surplus cash.There are a number of characteristics of the Indian financial system that are unique. These are mentioned as under-

- A country's economic development is greatly aided by its Financial System.
- It stimulates both savings and investment.
- It links savers and investors.
- It helps in capital generation and formation.
- It helps in risk allocation.

2.1.1 Indian Financial System Components/Constants

India's financial system is made up of the following four primary components:

1. Financial Institutions
2. FinancialMarkets
3. FinancialInstruments/Assets/Securities

4. FinancialServices.

Explanation of the above components-

Financial Institutions-

Financial institutions serve as mediators between investors and borrowers, ensuring the proper operation of the financial system. Their goal is to reinvest extra funds into activities that will yield a higher rate of return. Additionally, financial institutions offer services to organizations (individual, company, and government) seeking guidance on a wide range of issues, from restructuring to diversification plans. A wide range of services are available to organizations seeking to generate money through the markets or in other ways. In addition to acting as a conduit between savers and lenders, financial institutions are also referred to as financial intermediates. Because they take deposits from one set of consumers (the savings group), they also serve as middlemen (borrowers). Mutual funds, like ICCIC, act as financial middlemen by accumulating savings and lending them out to borrowers.

2.1.2 Types of Financial Institutions

Financialinstitutionscanbeclassifiedintotwocategories:

A. BankingInstitutions.

B. Non-BankingFinancialInstitutions

A. Banks and other financial institutions

The Central Bank of India i.e. The Reserve Bank of India has complete authority over the Indian banking industry. It has the responsibility to manage the country's monetary and financial system. It was established under the Reserve Bank of India Act, 1934. However, The Banking Regulation Act, 1949, is the primary law that governs commercial banks in India.

For the most part, Indian banks fall into one of two categories:

1. Organized Sector
2. Non-Organized Sector

1. **Organized Sector:**Commercial banks, cooperative banks, and regional rural banks are all part of the organized banking industry.

a) **Commercial Banks:**A commercial bank can either be a scheduled bank or a non-scheduled one. Only one non-scheduled bank exists at this time. All other financial institutions adhere to a set of regulations known as a schedule. Twenty-seven commercial banks are public sector, private sector and foreign-owned, with the remainder being non-domestic. There were no large private sector banking institutions prior to 1969. In July 1969, 14 private banks with a deposit base of more over 50 crores were nationalized, a crucial step toward public sector banking. Six more banks were nationalized later that year, bringing the total to twenty by the end of the year.

b) **Co-operative banks:** The co-operative banking industry is an important part of the organized sector of Indian banking. It is made up of co-operative societies that are registered in accordance with the laws of the respective states. There are two types of co-operative societies: those that lend money and those that do not lend money. The Indian economy is home to a variety of co-operative credit societies. Rural credit societies, which are largely agricultural, and urban credit societies, which are primarily non-agricultural. There are a variety of co-operative credit organizations that cater to a variety of agricultural lending demands.

c) **Regional Rural Banks**: In order to boost the economy in rural areas, the state government and sponsored commercial banks established up Regional Rural Banks (RRBs). Small farmers and small businesses in rural regions can get banking services and loans through regional rural banks. As a way to help the poorest members of society, the regional rural banks were established. As part of India's rural financial infrastructure, these are critical. At the end of June 2002, there were 196 RRBs, compared to 107 in 1981 and 6 in 1975. From the British era onward, foreign banks have been operating in India. The term "foreign bank" refers to a bank that has a branch in another country and a primary headquarters in the home country. A number of international banks have begun operating in India since the country's liberalization in 1993. For example Citibank is a foreign bank.

2. Non-Organized Sector

Indigenous Bankers, also known as Money Lenders, operate in the unorganized banking industry.

1. **Local Bankers**- An Indigenous Banker is a private organization or individual that acts like a bank by accepting deposits and lending money. They are also financial mediators, just like bankers. A prominent professional money lender who is not a bank or a money lender should be

their major business. The Hundies, a commercial paper is being traded by the indigenous banks.

2. **Money Lenders**- Money lenders rely solely on one source of income. Rural or urban, professional or non-professional, money lenders may be found in all areas of society. Many farmers, merchants, and traders make up this group. They have no regulations in place at all. A hefty interest rate is imposed on their loans.

Non-Banking Financial Institutions-

Non-banking financial institutions may be divided into two major categories: a) Organized Non-Banking Financial Institutions. b) Unorganized Non-Banking Financial Institutions.

1. **The Organized non-banking financial institutions** are as follows:

A. **Development Finance Institutions-** At the national level, these include institutions like as the IDBT, ICICI, SFCs and SIDCs at the state level are the financial and industrial development agencies. NABARD, LDBS, and other agricultural development finance institutions Corporate and industrial clients of development banks are provided with medium and long-term financing as well as assistance with economic development initiatives.

B. **Investment Institutions**- In this category are financial institutions that collect savings from the general public and invest them in corporate and government assets. LIC, GIC, LTT, and mutual funds are among these.

2. **Unorganized Non-Banking Financial Institutions**: A large number of non-banking financial businesses (NBFCs) provide a wide variety of financial services in the unorganized sector. In addition, these firms include 300 consumer finance companies, leasing companies, home finance companies, factoring businesses, credit rating agencies, merchant banks and other financial organizations. NBFCs mobilize public finances and give loanable cash to the general population.

2.1.3 Financial Markets

In order to enable the generation and distribution of credit and liquidity, financial markets provide the following functions:

(i) To act as savings mobilisation middlemen.

(ii) To aid in the development of a more balanced economy.

(iii) To ease the burden of financial burdens.

(iv) To meet the demands of the diverse businesses. There are two distinct types of organised markets:

Both the capital and the money markets

Capital Market

Financial assets with lengthy or indefinite maturities are traded in the capital market. Long-term securities having a maturity time of more than a year are often the focus of this type of trading. Capital markets may be split into three categories: (I) Industrial securities market, (II) Government securities market, and (III) Long-term loans market.

1. **Industrial Securities Market-**As the name suggests, it is a market for industrial securities: (i) equity shares, (ii) preferred shares, and/or (iii) bonds or debentures.

It's a market where companies may raise money or debt by issuing the right instruments. It may be broken down into two parts, namely:

1. Primary or New Issues Market
2. Secondary Market or the stock exchange

Primary Market

There are two types of markets: primary and secondary. Thus, it is often referred to as the New Issue market. Securities that have never been offered to the general public before are known as "primary" securities in the market. New financial securities are traded for long-term money in the main market. As a result, the primary market aids in the development of capital. In a primary market, there are three ways a firm might raise funds, namely:

(i) Public Issue
(ii) Rights Issue
(iii) Private Placement

Selling stock to the general public is the most prevalent technique of acquiring funds for new businesses, it is termed as Public Issue. Existing shareholders are initially given the opportunity to purchase more shares in a company's initial public offering (IPO). It's known as a "Rights Issue”." In a private placement, a small group of investors buys and sells a company's stock privately.

Secondary Market

Securities can be traded on the secondary market. As a result, this market only deals in securities that have already gone through the fresh issue market. Such securities are usually traded on the Stock Exchange, which provides a continuous and regular market for the trading of securities. All of India's stock exchanges are represented in this market. Indian stock markets are governed by the Securities Contracts (Regulation) Act 1956. The Bombay Stock Exchange and National Stock Exchange are India's most important stock markets.

2. **Government Securities Market-** It is also known as the Gilt-Edged SecuritiesMarket. ' Trading in government securities is done in this market. Short-term and long-term government securities are both available in India. This market is for long-term investments, whereas the money market is for short-term investments. All India and State level financial institutions and public sector firms are traded in this market. Improvement Trusts and State Electricity Boards, Improvement Trusts, State Electricity Boards
3. **Long Term Loans Market-** By providing long-term loans to business customers, development banks and commercial banks play a vital role in this industry.Further subcategories of the long-term loans industry include:

(1) Term Loans Market

(2) Mortgages Market

(3) Financial Guarantees Market

The Term Loans Market- In India, the government has established a number of industrial finance organizations at both the national and regional levels in order to provide long-term and medium-term loans to corporate clients. Industrial financing in India is dominated by these development banks. Other financial corporations like as ICICI, IFCI, and IDBI fall within the group.

The Mortgage Market- A mortgage loan is a loan secured by an immovable asset, such as a piece of land. An immovable property's interest is transferred to secure a debt, known as a mortgage. Equitable or legal mortgages are possible options for this loan.

The Financial Guarantee Market- A financial guarantee is a type of promise given by a guarantor to take responsibility for the borrower in the case of default in payments to the lender or investor.

Generally, insurance companies give guarantee to back the debt of large corporations (the borrower) in payments to the market (the lender).

Money Market

Investments having a maturity of one year or less are classified as money market securities. To put it another way, it's a market for short-term investments. Four divisions may be made in the money market.

1. Call money market
2. Commercial Bills Market
3. Treasury Bills Market
4. Short Term Loans Market

Call Money Market- Short-term loans of one to fourteen days are available in the call money market. So, it's quite a bit of a mess. Either the lender or the borrower can request repayment at any time. Since call money markets in India are linked to stock exchanges, several of the country's largest industrial cities such as Bombay, Calcutta, Madras, Delhi, Ahmedabad and others have them. Interest rates fluctuate throughout the day, hour and even Centre to Centre making this market unique. When it comes to call loans, it is really responsive.

Commercial Bills Market- Trade-related Bills of Exchange are traded in this market. The seller may draw a bill of exchange on the buyer in the case of a credit sale. An agreement is made between the buyer and seller to pay at a later datewhich is stated in the bill. The vendor does not have to wait until the due date of the bill before he or she may begin selling. As an alternative, he can receive quick payment by discounting the bill.

The Treasury Bills of Exchange- Treasuries with 'short-term' maturities are traded in this market. A treasury bill is a government-issued promissory note or a financial bill. Because the government guarantees its repayment, it is very liquid. As a means of financing the government's short-term needs, it is an essential tool Treasury bills may be divided into two categories: normal treasury bills and adhoc treasury bills, most commonly referred to as "adhocs." The central government's short-term financial needs are met by issuing ordinary treasury bills to the general public, banks, and other financial institutions. The Reserve Bank of India (RBI) is the only recipient of ad hoc treasury bills. India does not accept Ad Hoc banknotes, although holders of these bills can return them to the Reserve Bank of

India (RBI).

Short Term Loans Market- Short-term loans are offered to business clients in order to cover their working capital needs in this marketplace. There is a strong presence of commercial banks in this sector. Cash credit and overdrafts are two types of short-term loans offered by commercial banks. Industrialists are provided cash credit, whilst businesses are given overdraft facilities. An overdraft is a short-term loan taken out of the current account. Despite this, cash credit is only valid for one year and is held in a separate bank account.

2.1.4 Financial Instruments

A financial instrument is a document that indicates a financial claim on a certain asset. According to the definition of a financial asset stated earlier, it is an asset that has the right at some point in time to be paid back with interest or dividends, as well as a right to get that money back at some point in time. Examples include a promissory note, a bill of exchangeand a Treasury bill.

The following are the many types of financial securities:

1. Primary or Direct Securities
2. Secondary or Indirect Securities

Investing in a company's primary assets

Investing in these assets is a direct investment in the long-term savings of the investors themselves. There are many examples of this, such as publicly traded stocks and bonds.

To put it another way, The ultimate savers are the recipients of these securities, which are issued by middlemen known as "financial intermediaries." In the case of Unit Trust of India and mutual funds, the money pooled is invested in firms by issuing securities in the form of units to the public. Another way to categorize these securities is to look at their length of time. For short-term, medium-term and long-term investments, there are a variety of options. The phrase "short-term" refers to securities that have a maturity date of one year or less. Examples include the bill of exchange, the Treasury bill and so on. A medium-term security is one that has a maturity period of one to five years. e.g. 5 year debentures, long term securities are those having a maturity length of greater than 5 years. For example, ten-year-old Government Bonds.

2.1.5 Financial Services

The quality and range of financial services offered by financial intermediaries is critical to the efficiency of the evolving financial system. It is possible to describe financial services as "activities associated to the selling of money, as well as the benefits and satisfactions they provide to consumers and users." In the financial services business, banks, financial institutions and non-banking financial enterprises are the three primary sectors.

There are two basic kinds of financial services offered by diverse financial institutions, commercial banks and merchant bankers.

1. Asset-based/finance-based services
2. Fee-based or consulting services.

Based on a company's assets or funds basedservices offered by banking and non-banking financial institutions are summarized here-

1. Equipment Lease Financing/Leasing

Rather than purchasing and owning an item, a company might lease it, gaining access to and control over it. Essentially, it's a sort of asset leasing. However, an investment does not need that the company own the asset. It's mostly concerned with obtaining the right to utilize the asset. As a result, the company may choose to lease the asset rather than purchase it. It is important to compare the cost of leasing the asset to the cost of financing the asset through the typical forms of financing, i.e., debt and equity, when evaluating leasing vspurchasing. Due to the fact that lease rentals are similar to interest payments on loans and lease financing is a kind of debt.

3. Hire Purchase and Consumer Credit

Hiring purchase is a type of sale where the buyer gets immediate possession of the goods, the seller retains ownership of them and each instalment is treated as a hire charge until the last instalment is paid. This means that the seller can repossess the goods if any instalment is not paid on time or if the buyer fails to make a timely payment.

Consumer Credit- Individuals can take use of any asset-based financing programs to help them purchase durable consumer items through consumer credit. During a consumer credit transaction, a buyer pays a portion of the purchase price in cash at the time the item is delivered and the remaining amount is paid over a predetermined period of time with interest.

4. **Venture Capital**

   Realistically speaking, the Indian capital market has only recently been opened up to venture capital financing. As the number of technocrat entrepreneurs rises, there is a great need for venture capital businesses in our nation. For the promoters' commitment to be met by financial institutions, these venture capital firms give the necessary risk capital to the entrepreneurs. With the help of venture capitalists (VCs), these businesses are steered in the right direction not just with financial assistance.

5. **Insurance Services**

   For a predetermined sum of money (premium), the insurer, i.e. insurance company, agrees/undertakes to make good the loss suffered by the insured (policy holder) against a specified risk such as fire or compensate the beneficiaries (insured), in case an event, such as a specified accident or death, occurs. The contract between the insurer and the insured is referred to as a "policy" in the document. The insured property is the focus of insurance. Insurable interest refers to the interest of the insured in the subject matter of the insurance policy. Insurers split their services into two categories: (i)Life Insurance and (ii) General Insurance.

6. **Factoring**

   As a fund-based financial service, factoring helps businesses finance their receivables while also making it easier for them to collect these funds. Commercial banks and factoring companies offer short-term financing through account receivable credit. By discounting its customers' bills or invoices, a commercial bank may be able to provide financing. As a result, companies who sell on credit receive money right away. In the world of credit sales, a factor is a financial institution that provides debt management and financing services.

Fee Based Advisory Services

(I) **Merchant Banking:** All of Merchant Banker's financial services are included in fee-based advice services. A merchant banker is a vital part of the financial sector. To begin with, the Industrial Credit and Investment Corporation of India (ICICI) began offering this service in 1974. There has been a dramatic increase in the number of commercial banks since the mid-1970s. Non-banking financial businesses (NBFCS), brokers and so on are all included in this category. Among the services offered by these companies are loan syndication, portfolio management and corporate counseling. Debenture trusteeship, mergers and acquisitions are also offered by these organizations.

(II) **Credit Rating**: The view of the rating agency on the issuer's capacity and desire to satisfy the debt service obligations as and when they emerge is known as a credit rating. Credit ratings are beneficial to investors, corporations (borrowers), banks and financial institutions as a fee-based financial counselling service. Investors use it as a gauge of the creditworthiness of a (debt) issuing program. The rating agency evaluates and publishes any impact on the agency firm of changes in business/economic conditions on a regular basis, so the investor has complete knowledge of the company.

(III) **Stock Broking**: For years, stock exchanges were controlled by the Ministry of Finance and operated as self-regulatory organizations under the Securities Contracts Regulation Act (SCRA). SEBI was established to guarantee that stock exchanges fulfill their self-regulatory duty correctly after malpractices in trading necessitated reform of stock exchanges. As a result, stock broking has evolved as an authoritative source of advice for investors today. An accredited stockbroker is a person who buys, sells or deals in shares and securities on a recognized stock exchange. To practice stock brokerage, every stockbroker must be registered with SEBI. SEBI has the authority to place conditions on a company's registration certificate.

2.2History of Indian Financial System

The rapid economic expansion of every country/economy necessitates an efficient, articulate and sophisticated financial sector. Financial institutions expand in lockstep with economic expansion.But their institutional structure, operational policies, regulations, and legal frameworks varies greatly and are impacted by the current political and economic climate. Financial development in India has been heavily affected by the country's planned economic growth. When India's economy opened up in the early '90s, it had significant ramifications for how the financial sector would grow in years to come. Phase 1 outlines the most important aspects of the Indian Financial System before to 1951. Phase 2 presents the system's most important components during the second phase. Phase 3 is focused to defining the post-1990 future scenario.

Economists have long debated the importance of the financial sector in economic growth. How many changes in the supply of finance affect the economy and employment, as well as the standard of living and social welfare? How does economic growth effect financial development? On such matters, no one has a unified point of view. According to a recent literature review there is no widely recognized model to characterize the link between finance and economic growth in the current research. Finance is not a vital or important aspect in the environment-friendly, appropriate-technology-based, decentralized Alternative Development Model. When it comes to modern industrialism, perceptions might differ greatly even in the most traditional paradigm. There is a belief that financial matters are of no importance at all. Contrary to popular belief, it is regarded as critical.

India's transition from financial repression to financial liberalization is discussed in the following section. In India's second wave of financial sector reform, there are seven interconnected challenges which are to reduce fiscal deficits and increase the availability of long-term financing, including infrastructure by improving legal, regulatory, and supervisory frameworks for banks; developing capital markets further; developing pensions and insurance; improving systems for dealing with weak banks to increase long-term financing for long-term investments.

Phase I: Prior to 1951

Before 1951, the Indian financial system resembled the theoretical model of a traditional economy's financial structure. According to R. L. Bennett, a traditional economy "is one in which the per capita production is low and stable." Pre-1951 financial institutions were aptly described by L.C. Gupta as having a closed-circle character, a semi-organized and narrow industrial securities market, depleted of issuing institutions, and virtually no involvement by intermediary financial institutions in the long-term financing of industry. To put it another way, the financial resources of the sector were severely limited. A lack of financial receptivity to investment prospects in industry is all that this signifies. Financial systems like these were plainly unable to support high rates of industrial expansion—especially the expansion of innovative new businesses.

Phase-II- From 1951 through the mid-1980s

Since roughly 1951, when the financial system had a lot of room for improvement, the system's capacity to give financing and credit to a wide range of businesses was considerably improved. According to planned economic growth in post-1951 India, the Indian financial system underwent significant change. Under the Indian Constitution's Directive Principles of State Policy, a plan for planned economic development was launched in 1951 to achieve the state's wide economic and social goals. In the financial sector, the advent of planning had a significant impact. Mixed economy industrial growth, in which both public and private sectors play a complementary role, necessitated an alignment of financial policy aims with the government's economic strategy. To put it another way, planning referred to the financial system's allocation of resources in accordance with the five-year plans' priorities. Control over credit and finance was suggested by the necessity to allocate money in accordance with this pattern. Four major categories may be used to classify the financial aspects of planned economic development:

Financial institutions owned by the government or the public sector. The strengthening of the organizational framework. Investors are protected and financial institutions are involved in the administration of corporations.

Phase III: Post-Nineties

Since the mid-1980s, the Indian financial system has undergone significant changes, but the implementation of the new economic policy in 1991 was particularly significant. There were a number of reasons why economic changes or new economic policies were needed:

- The rise in the budget deficit was the primary impetus for the introduction of a new economic strategy. When it began in 1981-82, it was 5.4 percent of GDP, and by 1990-91 it had risen to 8.4 percent.

- Balance of payment imbalance occurs when total imports are greater than total exports. With the Rs. 2,214 Crores in 1980-81it grew to Rs. 17,367 in 1990-91.
- During the Iran war of 1990-91, India was unable to receive remittances from Gulf nations, which resulted in a negative balance of payments for India.It was named the Gulf Crisis.
- Deteriorating foreign reserves in 1990-91 were not enough to cover two weeks' worth of imports. Reserves in 1986-87 totaled Rs 8151 crores, which decreased to Rs 6252 crores by 1989-90.
- Inflationary pressure is increasing as a result of rising costs. The high rate of inflation has a negative impact on both local and international demand, resulting in an increase in manufacturing costs.

In recent years, the public sector hasn't made enough money because of the underperformance of several of its companies and the resulting losses. The government had no choice but to implement a new economic policy in light of the aforesaid factors. Free market economics has been the guiding concept of India's economic growth, resulting in a trend of economic liberalization, deregulation and globalization. In order to achieve macroeconomic stability, delicensing of industries and trade liberalization, currency reforms and subsidy cuts were all implemented over time and have had a significant impact on the corporate structure. Other major economic policy changes include financial sector/capital market/banking restructuring privatization, tax reform, DE bureaucratization and changes to company law. It is clear that the role of the government in economic management has diminished in this new economic environment and this trend is expected to continue as economic liberalization/globalization continues to gain steam. Because of this, the government's influence over the distribution of money and credit has diminished significantly, and the Indian Financial System which was dominated by the government until the mid-1980s, is now being restructured around the capital market. There is increasing competition for resources in India's capital market from all sectors of the economy, such as the public sector, the private sector, and state governments. The core of these trends is the fact that the Indian Financial System is prepared to integrate with the local and international savings pool. Investor protection, financial institution privatization, and institutional reform are just a few of the significant changes that have occurred in the Indian financial sector during this time period.

The Indian financial system has been organized in phases since 1991.

Economic reforms include the following:

1. Privatization
2. Globalization
3. Liberalization

It is a term used to describe the process of opening up more and more industries traditionally designated for the public sector to the private sector. Existing public-sector businesses can be sold to the private sector in full or in part.

Due to a decrease in public sector production, privatisation was implemented. Managers at public sector organisations were unable to make quick judgments because they always waited for extended periods of time to make them. As a result, the public sector's productivity plummeted. As a result of these considerations, privatization was created in order to increase competition, improve product quality and benefit consumers. During the economic reforms, the following steps were implemented in relation to privatization:

- The sale of government bond
- There has been a decrease in public sector investment
- The number of public-sector-only industries decreased from 17 to 4.
- Private sector investment was at its highest point.

When a country's economy is integrated more closely with the economies of other countries, the term "globalization" is used to describe this process. According to the globalization strategy, India's economy should have been linked to the rest of the globe, allowing for reciprocal collaboration between Indian businesses and those of other countries. As a result of the Indian economy's globalization, the following steps were implemented:

- An increase in the percentage of foreign investment allowed from 40% to 51%.
- In 1991, an average of 20% devaluation was used to encourage exports, import substitutionand foreign investment.
- The ability to exchange the Rupee for foreign money, such as the dollar or the pound sterling, at a market-determined rate is known as "partial convertibility."

- Export and import tariffs are steadily decreasing.
- A five-year plan for international trade was implemented.

To say that the economy has been liberalized is to say that the government has removed all of its physical and administrative restrictions.

A variety of restrictions, such as those on large-scale real estate investments, licensing policies and foreign exchange controls had been in place before 1991 but these measures only served to exacerbate the already-existing problems of economic inefficiency, inefficiency caused by political interference and corruption. Growth had slowed and the country's foreign exchange reserves were barely enough to cover imports for the next two weeks. Politics was tense, inflation was soaring, and the gulf crisis was on the verge of causing a balance-of-payments deficit. It was necessary to abolish the price cap and repair the bad balance of payments in order to restore economic stability and set the economy on a path of steady development.

The following policies were implemented as a result of India's economic liberalization:

- In 1991, the liberal policy was adopted and the rigorous licensing system was abolished. A new industrial strategy was established, in which all industries save six remained license-free, namely: 1) liquor 2) tobacco weapons of mass destruction 3) Explosives for industrial use 4) noxious materials 5) narcotics.
- Unencumbered by MRTP provisions (monopolies and restrictive trade practices). Companies with assets in excess of Rs. 100 crore do not require government clearance in advance.
- Eliminate restrictions on small-business investment and production growth.
- Importing the technology is not a problem, nor is it necessary to obtain permission to enter into high-tech contracts.

2.3 Reforms and Liberalization in the Financial Sector

Structural reforms in the real economy can only take place if the financial sector is healthy and competitive. Financial sector changes, as noted in the tenth five-year plan, "contribute to more flexibility in the factor and product markets, with the real sector becoming increasingly market-driven and consumed by a competitive environment," as needed. This is only conceivable if the financial system's productivity and efficiency increases. A committee on the financial system was formed up in 1991, while a committee on banking sector reforms was established in 1998. Narasimham Committee I (Committee on Financial Sector, 1991) proposed a comprehensive framework for the reorganization/reform of the system in the light of the preceding peculiarities of Indian Banking after nationalization.

The operations, rules and structure of the banking sector have undergone a major overhaul as a result of the Narasimham Committee I's recommendations. The following is a quick summary:

- By increasing the SLR and CRR in 1980, the government was able to reduce inflationary pressures caused by substantial budget deficits.
- It was decided that the CRR should be reduced. The Reserve Bank of India (RBI) should be able to utilize it as a monetary policy tool. The SLR rate should be linked to market rates and the CRR rate should be based on banks' average costs of funding.
- In 1997, the SLR was cut by 25% and the CRR was cut by 4.5% in 2003 in order to alleviate the negative impact on bank profitability.

Remove interest rate regulation. Deregulation of interest rates was recommended by the panel. The interest rate recommendations were as follows:

- To better represent the current state of the economy, lower interest rates.
- Make the link between deregulation and lower fiscal deficits. Early deregulation might be harmful.
- With the gradual lowering of SLR, deposit rates will rise.
- The end of low interest rates is near.
- The link between the structure of interest rates and the bank rate should be wide.
- The minimum lending rate for banks and other financial institutions should be established as the prime rate.

In April 1998, interest rates for both savings and loans were nearly deregulated. Bank rate-linked loans from the Reserve Bank of India are now available. PLR (Prime Lending Rate) has been related to bank lending rates since 1997.

Capital Adequacy Norms are also included in this category. Phased implementation of BIS guidelines was proposed by the committee. Capital adequacy ratios of 4% and 8% will be met by banks and financial institutions by March 1993 and March 1996, respectively, according to BIS standards. The capital market is available to profitable banks immediately. The standard has been met by all of the financial institutions (except UCO & Indian Bank) Recognition of earnings. The committee voted in favor of:

- Non-performing assets (NPAs) should not be included as revenue in financial organisations that use the accrual style of accounting.
- If the interest on a non-performing asset (NPA) is more than 180 days overdue on the balance sheet date, the asset is declared NPA (past due means outstanding for 30 days beyond due date).
- It takes three years for new standards to be established.
- Phased implementation of income recognition provisions has taken place and is being tightened.
- The financial system's structure, with regards to bank structure, it should move toward a more centralized model.

Bigger banks, like SBI, that potentially have a worldwide character. National banks with branches around the country are participating in universal banking, with 8 to 10 participating in this practice. Branches of local banks operating in a specific geographic area. The focus of rural banks, especially RRBs, is on agriculture financing. For the first time, new private sector banks can be established and international banks can enter. Many private banks have sprung up in recent years. There should be no branch licensing at all. The decision to open or close non-rural branches should be left to the discretion of each bank. Foreign banks should be allowed to open additional branches in the United States. With domestic banks, they should be given the same treatment. The bank should handle the day-to-day operations of the company. Headquarter, zonal office and branch offices are the preferred three-tier structure for national banks. It has been made easier to open a branch. Branches can be opened by domestic banks that meet capital adequacy standards. Customer service relies heavily on computers. Trade unions struck an agreement to implement computerization. Computerization of the banking sector is moving quickly.

The group was in support of a less regulated and more autonomous system. The RBI and the Banking Division of the Ministry of Finance should no longer have separate authority over banks. The RBI should establish a quasi-autonomous agency to supervise banks and financial institutions.

The Board of Financial Supervision (BFS) has been established. Financial institutions, including non-bank financial institutions (NBFCs), are overseen by the BFS.

DFTs (Development Financing Institutions)-Allow them operational flexibility, a measure of competitiveness and a degree of internal control.Syndication or lending involvement should be developed.To the extent that commercial banks are encouraged to offer long-term financing, DFIs should be encouraged to provide working capital financing.DFI cross equity holdings should be abolished.New institutions, such as merchant banks, mutual funds, leasing businesses, venture capital firms, etc., should be subject to a regulated framework. A new division of the Reserve Bank of India should be created to accomplish this goal.Capital sufficiency, debt equity ratio, income recognition and provisioning; good financial and accounting standards; disclosures; disclosures; and asset valuation should be written out.

Others: 1) Directed credit is being phased out: The use of directed credit should be discontinued. The priority sector should be expanded to include marginal framers, small-scale industry, small business and transportation operators, village and cottage industries, rural craftsmen and other weaker elements of the community. This sector should have a credit limit of 10%. Refinancing should be made available to the segments that will be removed from the priority sector.There has been a reduction in the amount of directed credit and the amount of interest rate subsidies. Sections of the priority sectors that were previously considered to be weaker have been updated. Loans to SSI units have seen a boost in interest.

2.Uniform accounting practices are being adopted: There should be a standardization of accounting processes among banks and financial organizations. Income recognition and reserving for questionable debts are two areas in which this is particularly important. Investments should be valued in accordance with the Ghosh Committee's recommendations on financial accounting. Provisioning, income recognition and asset categorization are all governed by strict accounting standards.Investment in government securities is being brought in line with worldwide norms in terms of valuation. Permanent and current investments were defined in 1992, and banks were ordered to hold at least 30 percent of their investments in the current category for the year 1992-93.

3. **Provisioning:** Standard, sub-standard, dubious, and loss assets were among the four classifications suggested by the committee. 10% in the event of poor assets and 100% in the case of dubious debts. A 20% to 50% further provision should be made in the event that a secure loan falls into the doubtful category. A full write-off or a 100% provision should be made for loss assets. Assets have been classified and provisioned.

4. **Openness:** Financial firms' balance sheets need to be made public. The International Accounting Standards Committee (IASB) requires full disclosure. This may be done by following the implementation of standards for revenue recognition and provisioning. Implementing bank computerization will aid in the transparency of financial institutions.

5. A fund for asset recovery (ARF): An ARF with exceptional power should be established, which should be able to remove bad and doubtful obligations from the balance sheet at a discount. The Tiwari Committee's recommendation that special tribunals be established up to speed up the process of recovery should be implemented. Debt recovery tribunals have been established up specifically to deal with this problem of bad debt.Banks have implemented an ombudsman program to expedite client complaints.

Ultimately, the financial sector in a country with high social costs faces tough challenges as the fiscal deficit grows, the balance of payments deteriorates, foreign reserves decline, and prices rise. After Narasimham Committee-I recommendations were implemented, the economy has been improved and is now near to International Standards.

2.4 Financial Federalism under Constitution

The term “fiscal federalism” was introduced by the German-born, American economist Richard Musgrave in 1959. Wallace E. Oakes, in 1999, defined it as, “Fiscal Federalism is concerned with understanding which functions and instruments are best centralised and which are best placed in the sphere of decentralised levels of government. This concept applies to all forms of government: unitary, federal and confederal."

According to fiscal federalism, public sector vertical organisation, fiscal policy institutionsand their interrelation are all taken into consideration.

One must first assess which level of government is most suited to deal with the many budgetary issues at hand. If you start with a common starting position that is that local governments have a lot more knowledge about their constituents than any higher level government, it makes sense for them to provide numerous public goods and services to their residents. In principle, this argues that public goods and services should be provided by the lowest level of government practicable. Subsidiarity and fiscal decentralisation in most sovereign countries also take this into account. Since macroeconomic stabilisation and redistribution are important to national interests, it is conventional wisdom that these policies should be handled by the federal government. The central government may be justified in taking on some responsibilities if the policies they implement have a major impact on other jurisdictions.

Second, a plan for funding a specific level of public goods and services must be developed. According to this approach, government should be responsible for funding and collecting the income needed to provide a certain item or service. In this instance, the provider is more likely to shoulder the entire expenses of providing the service, reducing moral hazard. As tax instruments have diverse features, such as the mobility of their tax base, instruments should be deployed to the level that is most effective in producing revenue. Consequently, tax tools should be allocated such that each government can realistically raise enough income to cover its costs. In actuality, the legal obligations of different levels of government are seldom self-sufficient in terms of funding.

One has to decide the proper tools (and their degree) to equalise discrepancies in fiscal resources and fiscal demands, both across time and between jurisdictions, as a result of the preceding two considerations. There are both vertical and horizontal transfers in most federal systems: transfers between various levels of government, and transfers within the same level of government. Vertical and horizontal fiscal imbalances, or fiscal gaps, are the discrepancies between revenues and expenditures. With the use of borrowing and other forms of transfers (such as tax sharing, conditional and unconditional grants, and transfers based on demographic variables), the revenue and spending gaps between the federal and state governments can be steadied over time.

One has to implement ways to limit excessive spending and borrowing at each level of government if the vertical architecture does not enforce sufficient fiscal discipline. To minimise fiscal free-riding and moral hazard, governments may pursue policies that have negative spillover effects on other jurisdictions and areas because of the linked area and fiscal framework. Governments may also seek to profit from the movement of wealth from one region to another. Deficits in the government's coffers are dealt with in different ways throughout all federal nations, although the tactics employed vary widely.

Finally, it is important to highlight that in many aspects, the distribution of responsibilities and instruments to various levels of government is never clear-cut; there is always some degree of overlap. " For example, many government functions are either shared or coordinated between the federal and state governments. To make matters more complicated, even if tax bases and national standards are uniform across the country, fiscal tools may not always be totally adaptable to local preferences.

Law-making powers are delegated in Article 246 to the various levels of government. Article 246 makes reference of three lists. The Union can legislate on any of the topics listed in the first section. In the Concurrent List (also known as the List II List), both the Union and the States are able to pass laws on the same subject matter, as long as it falls within one of the two lists.

On all three of these lists, taxes is listed as an option. Customs and Excise levies, Corporation Tax, taxes on income other than agricultural income, and more are included in the Union List (I). List II covers taxes such as taxes on automobiles, taxes on liquors, land revenue, taxes on stamp fees, taxes on amusement and luxury, taxes on the sale or purchase of products, and more. No large tax is included in List III, or the Concurrent List.

For example, provisions in the Constitution allow the federal and state governments to work together to levy and collect these taxes in a systematic manner.

Assigned to the States, taxes imposed and collected by the federal government-

1. Centre-imposed taxes, collected and maintained by the States.
2. Income from various taxes can be divided among the taxpayers.

3. Assistance supplied to the States as a result of a grant from the Centre.
4. There are grants available for any public good.

Thus, the Constitution has permitted the states to share the resources amassed by the Centre by splitting the authorities of levying and collecting taxes between the Centre and the States. According to Article 368 of the Constitution, no state or central government can change this list in order to regulate the country's revenue system. At least two-thirds of the state legislatures must agree to these changes. Even while Article 368(2) needs merely 50 per cent of each House's members to approve any amendment to Part XII of the Constitution, the portion the states are entitled to can be changed by Parliament if they so want.

It is necessary for the Central Government to collect elastic taxes for administrative convenience and national policybut the nature of these concerns necessitate that these are governed by the states.

The Changing Face of Fiscal Federalism in India

De jure rather than de facto, the world's democracies have grown increasingly focused on leadership. Electoral positions in India, for example, are heavily dependent on the leadership of political parties. Prime Ministers and chief ministers are elected via popular vote, as has been the case most recently with solid electoral mandates. It is common to see the prime minister gathering support for the ruling party in various state elections.Governing in India has undergone a fundamental shift. Because many social and infrastructural issues fall under the competence of state governments rather than the central government, no chief minister can claim that the central government is unable to give help for clean drinking water, more reliable electricity supplies, or improved agricultural.

It is imperative that the electoral system and parliamentary democracy from which numerous mandates originate be addressed in order to achieve a healthy relationship between state and central institutions. In the early 1950s, the Constitution was enacted, and it established a number of main connections that have since been influenced by politics.

The existence of the Planning Commission for the majority of the post-independence era infused centralization in more ways than one. The Union of States' resources were transferred to the Planning Commission in a parallel entity. In contrast to the Finance Commission, which focused primarily on income, the Planning Commission was more concerned with the capital formation. As a result, the

Finance Commissions have expressed their displeasure with this practise, which they see as contrary to the spirit of the Constitution. Other advancements were the 73rd and 74th Amendments to the Constitution in 1992, which gave Panchayat Raj institutions and Urban Local Bodies distinct powers under the 11th and 12th schedules of the Constitution.

After a Constitutional Amendment was made in 1990, the Inter-State Council was established to implement the Sarkaria Commission's recommendations. The National Development Council was established in 1952, to oversee the work of the Planning Commission and approve their five-year plans and midterm evaluations. However, the centre and state relation again saw a shift when NITI Aayog was established in 2014. The dynamics of centre-state interactions have kept pace with the changing requirements of the period. India's economic policies and governance framework have seen a dramatic shift in recent years.

2.4.1 The Role of Finance Commission

To a large extent, the Finance Commission plays a crucial role in India's federal structure. According to Article 280 of the Constitution of India, the Finance Commission was established to specify the financial connections between the federal government and the different state governments.

The entire gross tax revenues of the Union are assessed by the Finance Commission, which nets out all taxes, surchargesand non-tax revenue to arrive at the net divisible pool (NDP). Until 2000, the divisible pool was limited to income tax and excise duty, but that changed in 2000 when a constitutional amendment was passed. As a result, the Finance Commission consults and visits all state governments and gets their memorandums/submissions as well as those from the central government when considering the allocation of the net divisible pool. Assuming the requirements of the central and state governments are considered, the Commission next decides on how much of the net divisible pool should be allocated to the state governments and how much should be left for the central government.

Finance Commissioners concluded that 42 percent of Net Domestic Product (NDP) should be devolved to the state governments and 42 percent should go the federal government. In addition, a revenue deficit grant under Article 275 was awarded after determining the growth rates of specific state governments and the likelihood of buoyancy in appropriate instances. State governments will also have access to additional federal funds for disaster management and state-specific awards. The Finance Commission sets parameters and subsequently assigns weights to them for interstate allocation of resources among the state governments. These four factors have stayed constant throughout time: Population size and wealth disparity; geographic location and budgetary compliance. Each Finance Commission has had its own unique set of obstacles in assigning weights to these different elements, which have been influenced by the past.

2.4.2 Trends in Fiscal Transfers over the Years

State governments in India rely on budgetary transfers from the central government. Based on the recommendations of the Finance Commission, the majority of transfers are made in the form of tax devolution and grants. A considerable number of transfers are taking place outside of the recommendations of the Finance Commission as a result of the implementation of planned economic development and centrally supported schemes (CSS). Since the Finance Commission's recommendations and those made outside its purview can only provide us a partial picture of central transfers, we must look at the totality of all transfers. Studies demonstrate that the Union can offset suggested vertical and horizontal balances by the Finance Commission to some extent by levying cesses and surcharges and non-Commission transfers.

Since 2015-16, discretionary payments from the central government have decreased as a result of the adoption of the Fourteenth Finance Commission's suggestion. If the government does not use its budgetary space to establish new programmes sponsored by the central government, the Finance Commission's share of total transfers is likely to continue to be the largest.

2.4.3 Emerging Challenges of Financial Federalism in India

India's fiscal federalism faces a variety of difficulties. To begin, the Indian Constitution's Seventh Schedule divides the duties of government into three categories. The union and the states' legislative and budgetary authority is divided up according to this chart. List I focuses on essential topics. In List II, we will find topics that fall under the purview of local governments. To avoid confusion, the central government's legislation always takes precedence over subnational governments' when it comes to List III's Concurrent List.

Consistently expanding its bounds, the Concurrent List is now interfering in state governments' domains, as well as other countries'. In the form of constitutional changes, such as the 42nd Amendment to the Constitution (1975), the subjects of forests and education were moved from the State List to the Concurrent List as part of this official process.

Some changes have been made to the initial delineation. Consider the topic of legislation based on entitlements. An age of entitlement-based standalone law started in India some time ago. The Mahatma Gandhi National Rural Employment Guarantee Act of 2005, the Right of Children to Free and Compulsory Education Act of 2009, and the National Food Security Act of 2013 are all famous instances of this type of legislation. As the areas of employment, education, and nutrition were originally meant to fall under the purview of subnational governments, fiscal authorities should have stepped in.

Second, Article 282 of the Constitution conflicts with the Seventh Schedule's word and spirit. There is no restriction on the Union or a State making grants for any public purpose, even if Parliament or the Legislature of the State does not have legislative authority over it.

It was never intended to be an encompassing provision of the Indian Constitution, but rather an exceptional one to be invoked only on rare occasions. The Second Finance Commission Chairman, Shri K. Santhanam, said:

Assuming this was a key provision for making adjustments between the Union and its constituent states, there would have been no need to develop such a sophisticated system of relations of shares, assignments and grants if such was the intention. Two articles allowing the Centre to aid the States are redundant. One allows assistance through the Finance Commission, while the other allows for broader discretion. Even legislative legislation is unnecessary in the second scenario. It's a given that it will have to be accounted for. However, there is no more action that has to be performed. As a result, I consider this article to be a residuary reserve for the Union to use in the event of an emergency. That was how this Article was employed both by the British Government and, following the transfer of power, prior to the First Five-Year Plan's first year. Only some "Grow More Food Grants" and "Rehabilitation Grants" were awarded under this Article.

N. A. Palkhivala, a Constitutional expert, stated in his opinion presented to the Ninth Finance Commission, "Art. 282 is not designed to enable the Union to make such grants as come legitimately within Art. 275. As stated in Article 282 of the Constitution, "the grantor may make any gift for any purpose, irrespective of the question of whether the grantor has legislative jurisdiction over that purpose."

Using or misusing Article 282 is the basis for all centrally funded initiatives, most of which fall under the jurisdiction of the states. Many of what have come to be known as the "centrally supported plans" have been credited with giving rise to the Planning Commission's existence. With the exception of a committee chaired by former Madhya Pradesh Chief Minister Shivraj Singh Chauhan, the quantity and diversity of these initiatives have remained remarkably stable in spite of several attempts to streamline them. A study conducted by the Fifteenth Finance Commission estimated that there are roughly 211 schemes/sub-schemes under the 29 basic schemes. The so-called umbrella plans hide many of them. In 2019-20, the central government would spend around INR 3.32 trillion on these centrally funded initiatives. Despite the fact that the states frequently complain that these programmes are poorly planned, do not meet their special requirements, and require considerable financial expenditures on the part of the states, no state has opted out of them. Rather of coming to an end, government-sponsored programmes like Ayushman Bharat and Swachh Bharat are growing in breadth and size.

There is also the issue of inconsistency in one's financial situation. There are several terms of reference for the 15th Finance Commission, and one of them is to assess and suggest a strategy for fiscal consolidation. The new Fiscal Responsibility and Budget Management (FRBM) Act mandates that the federal government take the necessary efforts to make certain that the following things happen:

1. The general government's debt does not exceed 60% of GDP.
2. There will be no central government debt that exceeds 40% of GDP in fiscal year 2024/25.

As mandated by the FRBM Act 2003 (Statement of Fiscal Policy, July 2019), the central government debt for 2018/19 RE is estimated at 48.4% of GDP. Likely to be 48 percent of GDP in 2019/20 BE, central government liabilities are expected to decrease. As of 2017, 25.1 percent of GSDP (gross state domestic product) is owed by state governments, with a range of 42.8 percent in the subnational government of Punjab and 17 percent in Chhattisgarh (Reserve Bank of India, 2019). There has been an increase in the total outstanding obligations of states and union territories since 2014. The Ujjwal DISCOM Assurance Yojana (UDAY) and the Farm Loan Waiver are to blame for this.

It's getting increasingly difficult to keep non-tax earnings from the divisible revenue pool because of a rise in taxes and surcharges. Many people are concerned about these troubling concerns and there should be a system in place to make sure they are not undermined by the use of procedures that may be technically and legally sound but may not be sound ethically.

There has been a radical shift in Indian politics. There had not yet been a significant rise in interstate cooperation due to technology and migration when the Constitution of India was written. In a pre-globalized age, nations had a much greater degree of autonomy than they have now, since migration and technology have eroded the frontiers of states without anybody noticing. However, while GVCs are important, it is essential to focus on developing and promoting India's value chain. People in other states may benefit from products and services that were started in one state.

Policy initiatives such as Swachh Bharat and the New Education Policy (NEP), as well as Ayushman Bharat and SwachhJal under the auspices of the JalJeevan Mission, all play an important role in redefining the relationship between the federal government and states. Since these concerns are aimed to meet the fundamental principles of growth multipliers, benefiting all sector of society as well as addressing welfare precepts on housing and employment as essential national goals, they go beyond borders.

There are a number of options to choose from. Taking a closer look at the Seventh Schedule, for example, is critical in today's modern setting, since it allocates governmental tasks. Inconsistencies between the schedule and Article 282 of the Constitution, as well as stand-alone legislation on the various topics, will persist unless the schedule's boundaries are rewritten.

It is also necessary to have a rationalisation policy for centrally supported programmes and central expenditures that is far more credible. In the past, several committees have sought to do so, but the results have proven elusive. The National Organization for Transforming India (NITI Aayog), which is largely a think tank institution and not a financial entity, is even more significant since its position in the financial realm remains a bit ambiguous. There is no centralised body that keeps track of all the government-sponsored programmes and how many and how they may be combined with government spending.

In addition, several economists and policymakers have claimed that there is an institutional vacuum following the elimination of the Planning Commission. For all of its importance, states have begged for a trustworthy institution to serve as a conduit for policy conversation with the executive branch of the government, as is common in many nations. State governments in Australia came together in 2005 to form the Council for the Australian Federation, which serves as a common voice on behalf of the entire country in Canberra. To revive and reignite the Inter-State Council in India is worthy of serious attention.

There is also a discrepancy in the financial storey. A part of the Fifteenth Finance Commission's mandate, as previously indicated, is to assess the existing level of federal and state debt and make recommendations for a plan for prudent fiscal management. Since PFM systems are always being updated, the process of reform is a never-ending one. PFM systems at both federal and state levels have been examined by previous Finance Commissions, which have offered recommendations on different parts of the PFM systems.

A meaningful fiscal partnership should not only be a race for greater resources, but a creative effort to progress toward an Indian value chain that can propel India's development rate toward the goal of double-digit growth. There are times when economic slowdowns must be regarded anecdotally since they are short-lived and cannot affect India's long-term goal. Indians will profit from congruence between their principles and practices as a result of recasting the ideology in a modern environment.

2.5 Check Your Progress

1. Financial institutions serve as mediators between ………… and ……….., ensuring the proper operation of the financial system.

2. The ………………. was established in 1952 to oversee the work of the Planning Commission.

3. As a fund-based financial service, ………..helps businesses finance their receivables while also making it easier for them to collect those funds.

4. The ………………….., which is largely a think tank institution and not a financial entity, is even more significant since its position in the financial realm remains a bit ambiguous.

5. The Finance Commission was established under Article …….. of the constitution.

2.6 Summary

This lesson has dealt with all aspects of Indian financial system, while throwing light on Indian financial markets, institutions and securities. It has also explained the historical evolution of Indian Financial System. It has also dealt with the constitutional status of the financial system and the role of finance commission. Further, it has thrown light on emerging trends of fiscal federalism in India.

Since 2015-16, discretionary payments from the central government have decreased as a result of the adoption of the Fourteenth Finance Commission's suggestion. If the government does not use its budgetary space to establish new programmes sponsored by the central government, the Finance Commission's share of total transfers is likely to continue to be the largest.

A meaningful fiscal partnership should not only be a race for greater resources, but a creative effort to progress toward an Indian value chain that can propel India's development rate toward the goal of double-digit growth. There are times when economic slowdowns must be regarded anecdotally since they are short-lived and cannot affect India's long-term goal.

2.7 Keywords

- **Organized Sector-**Organised sector is a sector where terms and conditions of employment are regular and as per rules and regulations passed by the Government.
- **Unorganized Sector**- It means an undertaking owned by individuals or self-employed employees engaged in manufacturing or selling products or some form of service and employing less than 10 staff in the business.
- **Capital Market**- The part of a financial system concerned with raising capital by dealing in shares, bonds, and other long-term investments.

- **Finance Commission-** The Finance Commissions are commissions periodically constituted by the President of India under Article 280 of the Indian Constitution to define the financial relations between the central government of India and the individual state governments.

2.8 Self-Assessment Test

1. Explain the Indian Financial System.

2. What are the components of Indian Financial System?

3. Explain the difference between organized sector and unorganized sector.

4. Explain the financial markets.

5. What is a capital market. Explain it with an example.

6. What are financial securities?

7. What are financial institutions? Explain the working of India financial institutions.

8. Which reforms were introduced for liberalization of Indian Financial System?

9. Give the historical evolution of Indian Financial System in India.

10. Put some light on the constitutional status of Indian Financial System.

11. Give the role of Finance Commission in India.

12. Give the emerging trends of fiscal federalism in India.

2.9 Answers to Check Your Progress-

1. Investors and borrowers
2. National Development Council
3. Factoring
4. NITI Aayog

5. Article 280

2.10 References/ Suggested Readings

- Ahmad, Asad. (2012). Forecasting Performance of Various Volatility Models on Intra-Day Equity Price in Indian Stock Market. Indian Journal of Finance. 6.
- Mohan, Rakesh& Ray, Partha. (2017). Indian Financial Sector: Structure, Trends and Turns. IMF Working Papers.
- Mohania, Sarvesh&Mainrai, Girish. (2020). The COVID-19 Pandemic and its Impact on the Banking Industry – A Case of National Bank Ltd. Indian Journal of Finance.

Course: Public Finance	
Course Code: BCOM 506	Author: Dr. Arora Gaurav Singh
Lesson No. :03	Vetter: Prof. Suresh Kumar Mittal
BALANCE BUDGET & FISCAL POLICY	

STRUCTURE

3.0 Learning Objectives

This lesson will fulfill the objectives of understanding the concept of balanced budget. Further, it will also introduce the components and importance of Balanced Budget. This lesson also deals with fiscal policy and its components. And finally, it deals with various aspects of Central Government Budget of 2021-22. After reading this chapter, the student will be able to-

- Understand the concept of a Balanced Budget.
- Understand the Fiscal Policy and its components.
- Understand the Union Budget and its various aspects.

3.1 Balanced Budget

To have a balance budget, revenues must match expenditures, and there can never be a budget deficit or surplus. A balanced budget may be applied to any organization that generates operational income and costs, although it is most typically used in government budgeting. There are several definitions of "balanced budget," however it may also refer to a budget that has a surplus and no deficit. As a result, with a balanced budget, income may be higher than costs, but the reverse is not true.

3.1.1 Components of Balanced Budget

Following are the main components of a Balance Budget-

Revenues- The selling of goods and/or services generates money for businesses and non-profits alike. Income taxes, corporation taxes, social insurance taxes, and consumption taxes are the primary sources of revenue for governments.

Expenses- Rent and wages are two examples of expenses for companies and non-governmental organizations, which encompass all costs associated with everyday operations, such as rent. Spending on infrastructure, defense, healthcare, pensions, subsidies and other variables that contribute to the general health of the economy are all examples of government expenditures.

Examples from real life

Due to the volatility of the factors that contribute to surpluses and deficits, it is rare to come across balanced budgets where revenues and expenses are equal. With revenues of $332.2 billion and costs of $346.2 billion, Canada had a deficit of $14 billion at the end of 2017. Those with budget surpluses, such as Germany, Switzerland and South Korea on the other hand may be deemed to have balanced their budgets. This form of budget can also be generated yearly, biennially, and cyclically. During the fiscal year it covers, the budget in an annual Balanced Budget has been equalized. It is possible for the budget to fluctuate across two years with a biannual Balanced Budget. A surplus in one and a deficit in the other of the same amount will result in a biennial budget that is balanced. Economic conditions are taken into consideration by cyclically balanced budgets. When the economy is in a downturn, they are more likely to be in deficit than in excess.

3.1.2 Importance

Governments should minimize overspending by planning a balanced budget, which allows them to allocate funding to the regions and services that need them most. In addition, a budget surplus provides funding for emergencies such as when the government wants to increase expenditure during a recession without borrowing money. Governments can save money on interest rate charges that accumulate on significant loans from lenders (i.e., other nations and/or organizations like the International Monetary Fund (IMF) and the World Bank) by balancing their budgets.

Variance Analysis of the Budget- Using a budget variance analysis, a company compares its actual results to the budgeted statistics. The budget variation known as a beneficial variance occurs when actual revenue and/or expenditures are greater or lower than expected. In the event that actual revenue and/or costs fall short of expectations, this is known as a negative variance. For organizations, a well-balanced budget can lead to a positive variance analysis result.

3.1.3 Balanced Budget Multiplier

A measure of the change in aggregate production caused by equal changes in government purchases and taxes. The balanced-budget multiplier is equal to one, meaning that the multiplier effect of a change in taxes offsets all but the initial production triggered by the change in government purchases. This multiplier is the combination of the expenditures multiplier, which measures the change in aggregate production caused by changes in an autonomous aggregate expenditure, and the tax multiplier which measures the change in aggregate production caused by changes in taxes.The balanced-budget multiplier measures the change in aggregate production triggered by an autonomous change in government taxes. This multiplier is useful in the analysis of fiscal policy changes that involves both government purchases and taxes.The logic behind this multiplier comes from the government's budget, which includes both spending and taxes. In general, a balanced budget has an equality between spending and taxes. As such, the Balanced Budget Multiplier analyses what happens when there is an equality between changes in government purchases and taxes, that is, actions that keep the budget "balanced."

In other words, the Balanced Budget Multiplier indicates the overall impact on aggregate production of a change in government purchases that is matched (that is, paid for) by an equivalent change in taxes. The balanced-budget multiplier, as such, is actually the sum of the expenditures multiplier (for government purchases) and the tax multiplier.

The Balanced Budget Multiplier is equal to one. The "positive" impact on aggregate production caused by a change in government purchases is largely, but not completely, offset by the "negative" impact of the change in taxes. The only part of the impact of the change in government purchases not offset by the change in taxes is the purchase of aggregate production made by the initial injection. Hence, the change in aggregate production is equal to the initial change in government purchases.

A Simple Formulation: The Balanced Budget Multiplier, like the expenditures multiplier and tax multiplier can come in several different varieties based on assumptions concerning the structure of the economy and what components are induced by aggregate production.However, the value of the Balanced Budget Multiplier is the same whether consumption is the only induced expenditure or all components are assumed to be induced. The reason is that all of the "induced" changes in aggregate production caused by changes in government purchases are cancelled out by opposite changes in taxes. So it matters not what components are induced.As such, here is the Balanced Budget Multiplier (m[bb]) based on the combination of the simple expenditures' multiplier and the simple tax multiplier.

$$m[bb] = \frac{1}{MPS} + \frac{-MPC}{MPS} = \frac{1-MPC}{MPS} = \frac{MPS}{MPS} = 1$$

Where MPC is the marginal propensity to consume and MPS is the marginal propensity to save.

The most obvious and most important point is that the Balanced Budget Multiplier has a value of 1. This value indicates that the change in aggregate production is caused by the initial injection of government purchases. The subsequent changes in aggregate production that might be result as government purchases trigger cumulatively reinforcing induced changes in factor payments, income, and consumption are cancelled out by an opposite impact from the change in taxes.

Suppose, for example, that government purchases are increased by $1 trillion using fiscal policy designed to correct a business-cycle contraction. By itself, this $1 trillion government purchases increase would be expected to trigger a $4 trillion increase in aggregate production.However, further suppose that this $1 trillion increase in government purchases is matched by, and paid for with, an equal $1 trillion increase in taxes. By itself, this $1 trillion increase in taxes is expected to trigger a $3 trillion decrease in aggregate production. The net impact on aggregate production of both changes is only $1 trillion, not $4 trillion. If a $4 trillion increase in aggregate production is needed to achieve full employment, then this strategy falls $3 trillion short.

Why does this happen?

- First, the increase in aggregate production triggered by the increase in government purchases is offset by a decrease in aggregate production triggered by the increase in taxes.
- Second, the increase in aggregate production stimulated by government purchases is only partially offset by the decrease aggregate production stimulated by taxes.

The offset is only partial and there is a net impact on production due to the way taxes and government purchases affect aggregate expenditures. All $1 trillion of the government purchases act to increase aggregate expenditures. However, only $750 billion of the taxes (due to a marginal propensity to consume of 0.75) work their way through consumption to decrease aggregate expenditures.

As such, there remains a net increase in aggregate expenditures of $250 billion. Evaluating this net increase of $250 billion using the simple expenditures multiplier of 4 identifies an increase in aggregate production of $1 trillion.Is it just a coincidence that this net increase in aggregate production is exactly equal to the original change in government purchases (and taxes)?Not at all.Only the initial $1 trillion government purchase triggers an increase in aggregate production. Each subsequent round of increased consumption that would be otherwise induced by the multiplier process is offset by decreased consumption resulting by higher taxes. The only expenditure that does not go through the household sector and is not cancelled by taxes is the original government purchase.

Other Multipliers: The tax multiplier is one of several Keynesian multipliers. Two other related multipliers are expenditures multiplier and tax multiplier.

- **Expenditures Multiplier**: The expenditures multiplier measures changes in aggregate production caused by changes in an autonomous expenditure. Like the tax multiplier this comes in several varieties, simple and complex, depending on which expenditures and other components are induced by aggregate production and income. It differs from the tax multiplier in that aggregate expenditures change by full amount of the autonomous change.
- **Tax Multiplier**: The tax multiplier measures changes in aggregate production caused by changes in taxes. Like the expenditures multiplier this comes in several varieties, simple and complex, depending on which expenditures and other components are induced by aggregate production and income. It differs from the expenditures multiplier in that aggregate expenditures change by less than the change in taxes.

Two other multipliers arise from the financial, or money, side of the economy. They are the deposit expansion multiplier and the money multiplier. The deposit expansion multiplier measures the change in bank deposits caused by a change in bank reserves. The money multiplier measures the change in money caused by a change in bank reserves. Both are useful in the analysis of monetary policy.

3.2 Fiscal Policy

Fiscal policy is concerned with the government's tax and spending policies. The word fiscal is derived from the word 'fisk,' which meaning public treasury or government finances, and has been used to describe government spending.

3.2.1 Definitions of Fiscal Policy

1) "Changes in government expenditure and taxation designed to influence the pattern and level of activity." **(Harvey and Johnson)**

2) "We define fiscal policy to include any design to change the price level, composition or timing of government expenditure or to vary the burden structure or frequency of the tax payment."**(G.K. Shawa)**

3.2.2 Components of Fiscal Measures

The manipulation of governmental spending, taxes, and other income streams is what fiscal measures include. A welfare state necessitates that public funds be not neutral. In order to combat both inflationary and deflationary forces, budgets must be continually reevaluated. Functional finance is the term used to describe this approach. The current perspective is that inasmuch as the government is able to alter its own spending or to promote a change in private expenditures, it can influence the amount of income, production, and employment in the economy.

Objectives of Fiscal Policy-

Fiscal policy may be used to achieve a variety of goals, depending on the current state of affairs in a nation.

1) Optimal allocation of economic resources is a primary goal of fiscal policy. As a general rule, fiscal policy should be designed in such a way as to maximize productive capacity. To guarantee this, the government should invest in those public works that provide the most job opportunities.
2) There should be an equal distribution of wealth and income through fiscal policy. It means that fiscal policy should be planned in such a way that it transfers wealth from the affluent to the poor in order to achieve fair income equality.
3) Price stability is maintained through fiscal policy. As a result of a dramatic drop in consumer demand, company activity suffers. Fixed-income groups might be hurt hard by inflation, while speculators and traders could prosper. Fiscal policy must be designed to keep the price level steady enough to benefit everyone in society.
4) Full employment is fiscal policy's most significant goal since via it, most other goals are automatically met. In order to achieve full employment, fiscal policy should be implemented. In order to better understand how taxes affect consumption, saving and investment, this plan envisions the tax structure's future trajectory. Identifying the amount and direction of government spending is a challenge since it must be done while simultaneously taking into account the overall pattern of

total spending currently taking place in the economy, in addition to the specific services being provided. The goals of price stability and full employment are not always compatible.

5) Some of the goals of economic efficiency and growth may clash with the goal of equal distribution. A redistribution of income can be achieved by fiscal policy that transfers money from the wealthy to the less well off. Income redistribution will have a negative impact on savings and capital formation, though. Thus, the goals of equity and growth are at odds.

3.2.3 Instruments of Fiscal Policy

Fiscal policy uses taxes, spending, public debt, and a nation's budget as its primary instruments. Changes in government income or tax rates can be used to stimulate or limit private consumption and investment. Spending on public works, relief, different forms of subsidy, transfer payments, and social security benefits are all examples of governmental spending. Spending by the government generates money, whereas taxation generally reduces it. Fiscal policy in many nations has grown more dependent on managing the country's public debt. It seeks to influence expenditure by changing the amount of liquid assets held.

Inflation For example, at times of high inflation, fiscal policy is focused on reining in excessive spending, whereas in times of depression it is focused on boosting the economy out of its worst despair.

There are a few things to keep in mind while deciding on the right policy instruments:

1. Budgetary Policy that is countercyclical
2. Policy on taxation
3. Management of the Public Debt
4. Spending by the Government

A program of countercyclical budgeting entails imbalanced budget. Deficit spending is a hallmark of a depressed economy's imbalanced budget. By borrowing money from the banks, the government may make its deficits more manageable. By limiting government spending during periods of inflation, the objective seeks to achieve a budget surplus. The government has the option of using some of its budget surplus to pay off its debts. One view holds that a surplus budget has a deflationary effect on national income whereas the opposite holds true for a deficit budget. Deficit budgets are preferred during times of economic hardship when we require an increase in the amount of money coming in. Surplus budgets are preferred in times of inflation when we need to control the excess flow of money.

Contrary to popular belief, maintaining a countercyclical budget is not a simple process. Trying to predict a recession or an inflationary boom is a challenging task. Making adjustments to the budget in light of rapidly shifting economic conditions is made more difficult by the fact that budgets are political decisions that must be made after considerable deliberation and delay. As a result, adjusting certain budget items must be prioritised in order to improve the tool's effectiveness as a countercyclical fiscal policy weapon.

In terms of taxation policy, it is necessary to adjust the structure of tax rates depending on the current state of the economy. For inflationary and deflationary gaps to exist, the amount of disposable money available to consumers is determined by taxes. Public consumption and investment must be encouraged during recession but these activities must be curtailed during an inflationary period.

A broad cut in corporate and income taxation during the depression has been praised by economists since this leaves larger disposable incomes with people encouraging increased consumption, while low company taxation promotes 'venture capital,' so encouraging more investment. Theoretically, tax breaks should stimulate investment, but some people are skeptical. Some have suggested that even a significant decrease in taxes has little effect on an entrepreneur's choices.

New taxes can be charged to remove the excess buying power when inflation is present. In order to avoid a recession and stifling fresh investment, care should be taken not to raise taxes excessively. Spending taxes and excise fees work to keep prices down. Such taxes should be levied during an inflationary period to reduce the present excess consumption of certain items rather than the overall demand. Raising and stabilizing the consumption function may be accomplished most effectively by redistributive taxes. Progressive taxation is a precondition for redistributive taxes to take place. According to this, taxing the wealthy at a higher rate and those making less money at lower rates is necessary to increase consumer spending.

Public Debt Management - An effective programme of public borrowing and debt repayment is a powerful tool against inflation and deflation. Borrowing from non-banking financial intermediaries and commercial banks, drawing from the central bank or creating fresh money are all examples of government borrowing. Anti-inflationary in effect, borrowing from the public via the selling of bonds and securities reduces consumption and private investment. If banks have surplus cash reserves, borrowing from the financial system can be useful during a slump.

As a result, if banks are able to lend excess cash to the government, it will result in a net increase in national income. Withdrawals from the Treasury are inflationary, yet these balances are so little to the economy that they have no impact on it. As a result, the creation of new money causes inflation. When inflationary pressures are high during a conflict, borrowing is required. Therefore, public debt must be controlled such that it decreases the money supply in the economy and limits lending. A budget surplus will allow the government to pay down its debts.

On the contrary, taxes are decreased and governmental spending are boosted during a slump. Borrowing from the public, commercial banks or the country's central bank is used to cover deficits. Consumption and investment will be unaffected by the borrowing of monies that would otherwise be sitting on the sidelines. When a government is in the red, it is extremely difficult to pay off its obligations.

Expenditure by the Government Public spending may be utilised to boost output, revenue, and job creation. Government spending accounts for a sizable chunk of the whole economy's spending. When it is reduced or expanded, it has a major impact on the total revenue. Full employment may be achieved by balancing consumption and investment. Government spending should be reduced to prevent inflation by abandoning initiatives that are only justifiable during deflation. In order to produce a budget surplus, efforts are being undertaken to raise public revenue in addition to reducing spending. Government expenditures can be varied in order to lessen inflationary pressures, despite the fact that there is a limit to how much can be cut (for example, because of political and military reasons).

Public expenditure takes on a stronger role during economic downturns. While pump priming and 'compensatory expenditure' are sometimes used interchangeably, they are actually separate ideas. Pump priming is the process of reviving the economy by increasing public spending to a level where employment and production are gradually restored to desirable levels. It's not clear how much money is being spent on this. The theory goes something like this: if private expenditure falls short, a little injection of state spending can help fill the gap.

Public expenditure on the other hand is meant to compensate for a decrease in private investment, and so is compensatory spending. Private investment losses should lead to an increase in the amount of state spending, which should continue indefinitely until private investment returns to normal. It is expected that these expenditures will have a multiplier effect on income, output and employment levels. Relief spending, subsidies, social insurance payments, public works etc. are all examples of compensating public expenditure. One of the most important conditions for compensating public expenditure is that it should be as effective as feasible; and two, it should not be counterproductive.

It must produce assets that are both commercially and socially beneficial. Investment insufficiency is not only cyclical but also long-term in sophisticated economies, when pump priming expenditures have little impact. As for the public sector: Expenditures on public works, such as roads, schools, parks, buildings, airports and post offices as well as hospitals and other facilities are divided into two categories: those intended to stabilise the economy and those intended to improve quality of life. Interest on public debt, pensions, subsidies, emergency payments, unemployment insurance, and other social security benefits are examples of transfer payments that fall into this category.

Investment in the construction of capital assets is known as capital expenditure, whereas payments to recipients are known as current expenditure. Governments have been advised to maintain a list of public works projects ready in case the economy begins to decline. Investing in the public sector can help boost the confidence of company owners.

The main jobs created by public works initiatives will lead to secondary and tertiary jobs. In order to ensure that public investment does not compete with private investment, such initiatives can be slashed or even discontinued as soon as the economy is on the upswing.

Latest Update about Fiscal Policy of India:

- The Union Budget 2021 has signalled the emphasis on the Development Financial Institutions (DFIs) in the pursuit of long-term infrastructure creation for the revival of the economy.
- The establishment of the Dispute Resolution Committee (DRC) has been proposed in the Union Budget 2021 that can help provide quick relief to taxpayers in tax disputes.

3.2.4 Union Budget 2021-22

In accordance with Article 112 of the constitution, a union budget is a description of the government's anticipated income and expenditures, as stated in the budget. The government's annual financial statement is another name for it. It is the Ministry of Finance's Department of Economic Affairs that is in charge of putting together the budget. This is the first fiscal year of the new 2021-30 decade and the first digital union budget. Amidst the COVID-19 crisis, this budget shows the government's firm commitment to investing in infrastructure development in order to stimulate economic growth.

PART-A

Budgetproposalsfor2021-2022reston6pillars:

1. HealthandWellbeing
2. Physical&FinancialCapital,andInfrastructure
3. InclusiveDevelopmentforAspirationalIndia
4. ReinvigoratingHumanCapital
5. InnovationandR&D
6. MinimumGovernmentandMaximumGovernance

3.2.5 Health and Well Being- HealthSystems

PM Aatma Nirbhar Swasth Bharat Yojana, a centrally sponsored scheme will be launched. It will develop capacities of primary, secondary and tertiary care Health Systems, strengthen existing national institutions and create new institutions, to cater to detection and cure of new and emerging diseases. It will be implemented over 6 years and will be in addition to the National Health Mission. Main interventions under scheme include:

- Support for Health and Wellness Centers.
- Setting up integrated public health labs in all districts.
- Strengthening of the National Centre for Disease Control (NCDC).
- Expansion of the Integrated Health Information Portal to all States/UTs to connect all public health labs;

- Setting up of a National Institution for One Health, a Regional Research Platform for WHO South East Asia Region, etc.

Nutrition: Government will merge the Supplementary Nutrition Programme and the Poshan Abhiyan and launch the Mission Poshan 2.0 to strengthen nutritional content, delivery, outreach and outcome. Universal Coverage of Water Supply and Swachcha Bharat Mission-Jal Jeevan Mission (Urban), will be launched for universal water supply in all 4,378 Urban Local Bodies with 2.86 crores household tap connections, as well as liquid waste management in 500 AMRUT cities. It will be implemented over 5 years.

Urban Swachh Bharat Mission 2.0 will be implemented for over 5 years and main interventions would be: Complete fecal sludge management and wastewater treatment

• Source segregation of garbage

• Reduction in single-use plastic

• Reduction in air pollution by effectively managing waste from construction and demolition activities

• Bio-remediation of all legacy dumpsites

Vaccines: Provision of Rs 35,000 crore made for Covid-19 vaccine in budget estimate (BE) 2021-22. Pneumococcal Vaccine will be rolled out across the country aimed at averting 50,000 child deaths annually. It is a made in India product, presently limited to only 5 states. This vaccine helps prevent pneumococcal disease, which is any type of illness caused by Streptococcus pneumoniae bacteria.

Clean Air & Scrapping Policy: Rs. 2,217 crore to tackle air pollution, for 42 urban centers with a million-plus population

Voluntary vehicle scrapping policy to phase out old and unfit vehicles was announced. Fitness tests have been proposed in automated fitness centers after 20 years in case of personal vehicles and after 15 years in case of commercial vehicles.

3.2.6 Physical, Infrastructure and Financial Capital -

Aatma Nirbhar Bharat-Production Linked Incentive (PLI) Scheme: Rs. 1.97 lakh crore in next 5 years for PLI schemes in 13 Sectors-

• To create and nurture manufacturing global champions for an Aatma Nirbhar Bharat

• To help manufacturing companies become an integral part of global supply chains, possess core competence and cutting-edge technology

• To bring scale and size in key sectors

• To provide jobs to the youth

Textiles: To enable Textile industry to become globally competitive, attract large investments and boost employment generation & exports. Mega Investment Textiles Parks (MITRA) scheme will be launched in addition to PLI, seven Textile Parks to be established over 3 years

Infrastructure: National Infrastructure Pipeline (NIP) has now expanded to 7,400 projects. Budget proposes three ways to address increased funding requirements for NIP:

• By creating the institutional structures;

• By a big thrust on monetizing assets, and

• By enhancing the share of capital expenditure in central and state budgets.

Creation of institutional structures: Infrastructure Financing- Rs. 20,000 crore to set up and capitalize a Development Financial Institution (DFI) – to act as a provider, enabler and catalyst for infrastructure financing. Rs. 5 lakh crore lending portfolio to be created under the proposed DFI in 3 years. Debt Financing by Foreign Portfolio Investors to be enabled by amending InvITs' and REITs' legislations.

Asset Monetization: A "National Monetization Pipeline" of potential Brownfield infrastructure assets will be launched. An Asset Monetization dashboard will also be created for tracking the progress and to provide visibility to investors. Other asset monetization measures include: monetization of railway infrastructure assets/sports stadiums/dedicated freight corridor assets etc. Sharp Increase in Capital Budget: Rs. 5.54 lakh crore capital expenditure in BE 2021-22 – sharp increase of 34.5% over Rs. 4.12 lakh crore allocated in BE 2020-21. Roads and Highways

Infrastructure: More economic corridors are being planned. Advanced Traffic management system in all new 4 and 6-lane highways.

• **Railway Infrastructure**: National Rail Plan for India (2030): to create a 'future ready' Railway system by 2030. Western Dedicated Freight Corridor (DFC) and Eastern DFC to be commissioned by June 2022, to bring down the logistic costs – enabling Make in India strategy. Measures for passenger convenience and safety. Aesthetically designed Vista Dome coach on tourist routes for better travel. High density network and highly utilized network routes to have an indigenously developed automatic train protection system, eliminating train collision due to human error.

• **Urban Infrastructure:** Raising the share of public transport in urban areas by expansion of metro rail network and augmentation of city bus service. Rs. 18,000 crore for a new scheme, to augment public bus transport 'MetroLite' and 'MetroNeo' technologies to provide metro rail systems at much lesser cost with similar experience in Tier-2 cities and peripheral areas of Tier-1 cities.

• **Power Infrastructure:** A framework will be put in place to give consumers alternatives to choose from among more than one Distribution Company. To improve viability of Distribution Companies, a revamped reforms-based result-linked power distribution sector scheme will be launched. The scheme will provide assistance to DISCOMS for infrastructure creation including pre-paid smart metering and feeder separation, upgradation of systems, etc., tied to financial improvements. A comprehensive National Hydrogen Energy Mission 2021-22 to be launched. Ports, Shipping, Waterways. Seven projects to be offered in PPP-mode in FY21-22 for operation of major ports. A scheme to promote flagging of merchant ships in India will be launched by providing subsidy support to Indian shipping companies in global tenders floated by Ministries and CPSEs. This initiative will enable greater training and employment opportunities for Indian seafarers besides enhancing Indian companies share in global shipping.

• **Petroleum & Natural Gas:** Extension of Ujjwala Scheme to cover 1 crore more beneficiaries. to add 100 more districts to the City Gas Distribution network in next 3 years. An independent

Gas Transport System Operator to be set up for facilitation and coordination of booking of common carrier capacity in all natural gas pipelines on a non-discriminatory open access basis.

• **Financial Capital:** A single Securities Markets Code to be evolved. Support for development of a world class Fin-Tech hub at the GIFT-IFSC. A new permanent institutional framework to help in development of Bond market by purchasing investment grade debt securities both in stressed and normal times. Setting up a system of Regulated Gold Exchanges: SEBI to be notified as a regulator and Warehousing Development and Regulatory Authority to be strengthened. To develop an investor charter as a right of all financial investors.

• **Increasing FDI in Insurance Sector:** Increase the permissible FDI limit from 49% to 74% and allow foreign ownership and control with safeguards.

• **Stressed Asset Resolution:** Asset Reconstruction Company Limited and Asset Management Company to be set up to consolidate and take over the existing stressed debt and then manage and dispose of the assets to Alternate Investment Funds and other potential investors for eventual value realization.

• **Recapitalization of PSBs:** To further consolidate the financial capacity of PSBs, further recapitalization of `20,000 crores is proposed in 2021-22. Investment Funds and other potential investors for eventual value realization.

• **Deposit Insurance-** Amendments to the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act, 1961, to help depositors get an easy and time-bound access to their deposits to the extent of the deposit insurance cover. Minimum loan size eligible for debt recovery under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 proposed to be reduced from Rs. 50 lakh to Rs. 20 lakh for NBFCs with minimum asset size of Rs. 100 crore.

• **Company Matters:** To decriminalize the Limited Liability Partnership (LLP) Act, 2008. Easing Compliance requirement of Small companies by revising their definition under Companies Act, 2013 by increasing their thresholds for Paid up capital from “not exceeding Rs. 50 Lakh” to “not exceeding Rs. 2 Crore” and turnover from “not exceeding Rs. 2 Crore” to “not exceeding Rs. 20 Cr”. Promoting start-ups and innovators by incentivizing the incorporation of

One Person Companies (OPCs) To ensure faster resolution of cases by strengthening National Company Law Tribunal (NCLT) framework implementation of e-Courts system. Introduction of alternate methods of debt resolution and special framework for MSMEs. Launch of data analytics, artificial intelligence, machine learning driven MCA 21 Version 3.0 in 2021-22. Disinvestment and Strategic Sales are estimated Rs 1,75,000 crore as receipts from disinvestment in BE 2021-22. New policy for Strategic Disinvestment has been approved. CPSEs except in four strategic areas will be privatized.

NITI Aayog will work out on the next list of CPSEs to be taken up for strategic disinvestment. Incentivizing States for disinvestment of their Public Sector Companies, using central funds. Special Purpose Vehicle (SPV) in the form of a company to monetize idle land. Introducing a revised mechanism for ensuring timely closure of sick or loss-making CPSEs. Government Financial Reforms. Treasury Single Account (TSA) System for Autonomous Bodies to be extended for universal application. Separate Administrative Structure to streamline the 'Ease of Doing Business' for Cooperatives.

3.2.7 Inclusive Development for Aspirational India

• **SWAMITVA** (Survey of Villages and Mapping with Improvised Technology in Village Areas) Scheme extended to cover all states/UTs to bring transparency in property ownership in villages. Scheme aims to map rural inhabited lands using drones and latest survey methods. 'Operation Green Scheme' will be enlarged to include 22 perishable products to boost value addition in agriculture and allied products and their exports. It is presently applicable to tomatoes, onions, and potatoes.

• **Credit Increase**: Agricultural credit target enhanced to Rs. 16.5 lakh crore in FY22 with focus on credit flow to animal husbandry, dairy, and fisheries. 33% increase in Rural Infrastructure Development Fund. Micro Irrigation Fund under NABARD doubled. 1,000 more mandis will be integrated with e-NAM to bring transparency and competitiveness. Agriculture Infrastructure Funds would be made available to APMCs for augmenting their infrastructure facilities. There has been an increase in payment to farmers for wheat, pulses, rice and cotton from 2013 to 2020.

• **Fisheries:** Investments to develop modern fishing harbours and fish landing centres - both marine and inland. 5 major fishing harbours: Kochi, Chennai, Visakhapatnam, Paradip, and Petuaghat to be developed as hubs of economic activity. Multipurpose Seaweed Park to be established in Tamil Nadu to promote seaweed cultivation.

• **Migrant Workers:** One Nation One Ration Card plan is under implementation by 32 states and UTs, reaching a total of 86% beneficiaries covered. Remaining 4 states and UTs will be integrated in the next few months. Portal to collect information on unorganized labor force, migrant workers especially, to help formulate schemes for them. Implementation of 4 labor codes underway.

• Social security benefits for gig and platform workers too.

• Minimum wages and coverage under the Employees State Insurance Corporation applicable to all categories of workers.

• Women workers allowed in all categories, including night-shifts with adequate protection. Compliance burden on employers reduced with single registration and licensing, and online returns.

• **Financial Inclusion:** Under Stand-Up India Scheme for SCs, STs and women, Margin money requirement reduced to from 25% to 15%. To also include loans for all allied agricultural activities. Rs. 15,700 crore budget allocation to MSME Sector, more than double of this year's BE.

3.2.8 Reinvigorating Human Capital

• **Education:** 15,000 schools will be qualitatively strengthened to include all components of the National Education Policy. 100 new Sainik Schools will be set up in partnership with NGOs/private schools/states. Proposal to set up a Higher Education Commission of India, as an umbrella body having 4 separate vehicles for standard-setting, accreditation, regulation, and funding. For accessible higher education in Ladakh, Government proposed to set up a Central University in Leh. Scheduled Castes and Scheduled Tribes Welfare: Set a target of establishing 750 Eklavya model residential schools in tribal areas. Enhanced Central Assistance under the revamped Post Matric Scholarship Scheme for the welfare of Scheduled Castes for 6 years till 2025-2026.

• **Skilling:** Realign the existing scheme of National Apprenticeship Training Scheme (NATS) for providing post-education apprenticeship, training of graduates and diploma holders in Engineering. Initiatives for partnership with other countries in skilling to be taken forward, similar to partnership: With UAE to benchmark skill qualifications, assessment, certification, and deployment of certified workforce. With Japan for a collaborative Training Inter-Training Programme (TITP) to transfer of skills, technique and knowledge.

3.2.9 Innovation and Research and Development

• **National Research Foundation:** It has been announced with an outlay of Rs. 50,000 crore, over 5 years. It will ensure that the overall research ecosystem of the country is strengthened with focus on identified national-priority thrust areas.

• **National Language Translation Mission (NTLM):** This will enable the wealth of governance-and-policy-related knowledge on the Internet being made available in major Indian languages.

• **Deep Ocean Mission:** It will be launched with a budget outlay of more than `4,000 crores, over five years. This Mission will cover deep ocean survey exploration and projects for the conservation of deep sea biodiversity.

• **New Space India Limited (NSIL):** As a PSU under the Department of Space, it will execute the PSLV-CS51 launch, carrying the Amazonia Satellite from Brazil, along with a few smaller Indian satellites.

3.2.10 Minimum Government and Maximum Governance

Measures being undertaken to bring reforms in Tribunals to ensure speedy justice:

National Commission for Allied Healthcare Professionals already introduced to ensure transparent and efficient regulation of the 56 allied healthcare professions. National Nursing and Midwifery Commission Bill introduced for the same in nursing profession. Proposed Conciliation Mechanism with mandate for quick resolution of contractual disputes with CPSEs.

Rs. 3,768 crore have been allocated for forthcoming first digital census in the history of India. Rs. 300 crore grant to the Government of Goa for the diamond jubilee celebrations of the state's liberation from Portuguese. Rs. 1,000 crore for the welfare of Tea workers especially women and their children in Assam and West Bengal through a special scheme.

Fiscal Position: Fiscal deficit in BE 2021-2022 is estimated to be 6.8% of GDP and in Revised Estimate (RE) 2020-21 is pegged at 9.5% of GDP - funded through Government borrowings, multilateral borrowings, Small Savings Funds and short-term borrowings. Gross borrowing from the market for the next year to be around 12 lakh crores. Amendment to Fiscal Responsibility and Budget Management Act (FRBM Act) proposed to achieve targeted Fiscal Deficit level. Contingency Fund of India is to be augmented from Rs. 500 crores to Rs. 30,000 crores through Finance Bill.

Net borrowing for the states allowed at 4% of gross state domestic product (GSDP) for the year 2021-2022 as per recommendation of 15th Finance Commission (FC). Finance Commission (FC). States expected to reach a fiscal deficit of 3% of GSDP by 2023-24, as recommended by the 15th FC.

3.2.11 Fifteenth Finance Commission recommendations:

• Retaining vertical shares of states at 41%.

• Funds to UTs of Jammu and Kashmir and Ladakh would be provided by Centre.

• Rs. 1,18,452 crores have been provided as Revenue Deficit Grant to 17 states in 2021-22, as against Rs. 74,340 crores to 14 states in 2020-21.

• Budget seeks to further simplify Tax Administration, Litigation Management and ease compliance of Direct Tax Administration.

• Indirect proposal focuses on custom duty rationalization as well as rationalization of procedures and easing of compliance.

3.2.12 Direct Tax Proposals

• **Relief to Senior Citizens:** Exemption from filing tax returns for senior citizens over 75 years of age and having only pension and interest income.

• Reducing Disputes, Simplifying Settlement

• Time limit for re-opening cases reduced to 3 years from 6 years.

• Serious tax evasion cases, with evidence of concealment of income of Rs. 50 lakh or more in a year, to be re-opened only up to 10 years, with approval of the Principal Chief Commissioner.

• Setting up the Dispute Resolution Committee for taxpayers with taxable income up to Rs. 50 lakh and disputed income up to Rs. 10 lakhs.

• National Faceless Income Tax Appellate Tribunal Centre to be established.

• Over 1 lakh taxpayers opted to settle tax disputes of over Rs. 85,000 crores through "Vivad Se Vishwas" Scheme until 30th January 2021.

Relaxation to NRIs: Rules to be notified for removing hardships faced by NRIs regarding their foreign retirement accounts and also of double taxation.

Incentivizing Digital Economy: Limit of turnover for tax audit increased to Rs. 10 crores from Rs. 5 crores for entities carrying out 95% transactions digitally.

Relief for Dividend: Dividend payment to REIT/ InvIT exempt from Tax Deducted at Source (TDS). Advance tax liability on dividend income only after declaration/payment of dividend. Deduction of tax on dividend income at lower treaty rate for Foreign Portfolio Investors.

Attracting Foreign Investment for Infrastructure: Infrastructure Debt Funds made eligible to raise funds by issuing Zero Coupon Bonds. Relaxation of some conditions relating to prohibition on private funding, restriction on commercial activities, and direct investment in infrastructure.

Supporting 'Housing for All': Additional deduction of interest, up to Rs. 1.5 lakh, for loan taken to buy an affordable house extended for loans taken till March 2022. Tax holiday for Affordable Housing projects extended till March 2022. Tax exemption allowed for notified Affordable Rental Housing Projects.

Tax incentives to IFSC in GIFT City: Tax holiday for capital gains from incomes of aircraft leasing companies. Tax exemptions for aircraft lease rentals paid to foreign lessors. Tax incentive for relocating foreign funds in the IFSC. Tax exemption to investment division of foreign banks located in IFSC.

Ease of Filing Taxes: Details of capital gains from listed securities, dividend income, interest from banks etc. to be pre-filled in returns.

Relief to Small Trusts: Exemption limit of annual receipt revised from ₹1 crore to ₹5 crore for small charitable trusts running schools and hospitals.

Labor Welfare: Late deposit of employee's contribution by the employer not to be allowed as deduction to the employer.

Incentives for Startups: Eligibility for tax holiday claim for start-ups extended by one more year. Capital gains exemption for investment in start-ups extended till 31st March, 2022.

Indirect Tax Proposals

Custom Duty Rationalization: It fulfills the twin objectives of promoting domestic manufacturing and helping India get on to global value chain and export better. 80 outdated exemptions already eliminated and further review of more than 400 old exemptions. New customs duty exemptions to have validity up to the 31st March following two years from its issue date.

Electronic and Mobile Phone Industry: For greater domestic value addition some exemptions on parts of chargers and sub-parts of mobiles withdrawn.

Reduction in Custom Duty: On certain Iron and steel products, Textile products, Gold and Silver, Chemicals etc.

Renewable Energy: To build domestic capacity: Phased manufacturing plan for solar cells and solar panels to be notified and Duty on solar invertors raised.

MSME Products: Exemption on import of duty-free items rationalized to incentivize exporters of garments, leather, and handicraft items. Exemption on imports of certain kind of leathers withdrawn. Customs duty on finished synthetic gemstones rose to encourage domestic processing.

Agriculture Products: Customs duty on cotton increased from nil to 10% and on raw silk and silk yarn from 10% to 15%. Agriculture Infrastructure and Development Cess (AIDC) on curtain items including petrol, diesel, gold etc. in an attempt to boost agriculture infrastructure. AIDC of Rs. 2.5 per litre has been imposed on petrol and Rs. 4 per litre on diesel.

Rationalization of Procedures and Easing of Compliance: Turant Customs initiative, a Faceless, Paperless, and Contactless Customs measures. New procedure for administration of Rules of Origin.

3.3 Check Your Progress

1. To have a balance budget, revenues must match ………., and there can never be a budget deficit or …………
2. Fiscal policy is concerned with the government's ……. and spending policies.
3. ……………… Scheme extended to cover all states/UTs to bring transparency in property ownership in villages.
4. Set a target of establishing 750 ……….. model residential schools in tribal areas

3.4 Summary

- The lesson has talked about the balanced budget and its importance. Further it has explained the concept of Balanced Budget Multiplier. However, being a developing economy, Indian budget has always been deficit.
- Fiscal Policy deals with government’s taxation and expenditure policy. Fiscal Policy also helps the government in optimal allocation of resources.

- And finally, the Budget of Central Government for the year 2021-22 has been discussed with special emphasis on public expenditure and taxation proposals.

3.5 Keywords

1. **Balanced Budget-** A *balanced budget* is a situation in financial planning or the budgeting process where total expected revenues are equal to total planned spending.
2. **Public Revenue-** The income of the government through all sources is called public income or *public revenue.*
3. ***Public Expenditure-*** *Public expenditure* is spending made by the government of a country on collective needs and wants such as pension, provisions security, infrastructure, etc.
4. **Balanced Budget Multiplier**- A situation in which a government increases spending and taxes at a rate that keeps its budget in balance.
5. **Fiscal Policy**- *Fiscal policy* is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

3.6 Self-Assessment Test

1. What is a balanced budget?
2. Give the importance of balanced budget.
3. What is the concept of balanced budget multiplier?
4. What are the components of balanced budget?
5. What is a fiscal policy?
6. Who makes the fiscal policy in India? Give the whole process.
7. Give various aspects of budget 2021-22.

3.7 Answers to Check Your Progress

1. Expenditures, Surplus
2. Tax
3. SWAMITVA(SurveyofVillagesandMappingwithImprovisedTechnologyinVillageAreas)
4. Eklavya

3.8 References/ Suggestive Readings

- Costello, Anna &Petacchi, Reining & Weber, Joseph. (2016). The Impact of Balanced Budget Restrictions on States' Fiscal Actions. The Accounting Review. 92. 10.2308/accr-51521.
- Raj, Janak&Khundrakpam, J. & Das, Dipika. (2011). An Empirical Analysis of Monetary and Fiscal Policy Interaction in India.
- Pandey, Amrendra&Shettigar, Jagadish. (2018). Impact of Fiscal Policy Initiatives on Inflation in India.

Course: Public Finance	
Course Code: BCOM 506	**Author: Dr. Arora Gaurav Singh**
Lesson No. :04	**Vetter: Prof. Suresh Kumar Mittal**
FINANCIAL AUTONOMY & ACCOUNTABILITY AND INVESTMENT POLICY OF PUBLIC SECTOR	

STRUCTURE

4.0 Learning Objectives

The learning objectives of this lesson are to let the students understand the financial autonomy and accountability of the public sector. The growth of investment in public sector will also be studied. The economic and social appraisal of the finances of state and local Governments will also be studies. After reading this lesson, the students will be able to-

Describe the importance and objectives of financial autonomy and accountability of the public sector

Describe the municipalities, their functions, expenditures and limitations.

Explain the constitutional status of the local Governments in India

Economic and social appraisal of state and local Governments.

4.1 Financial Autonomy and Accountability of Public Sector

When it comes to boosting Public Sectors' performance, arguments have centered on how much financial autonomy and accountability they have. There have been differing viewpoints on the ideal ratio of financial independence to responsibility in order guarantee that these businesses operate effectively and efficiently. In this regard, there is no well-defined formula that can be recommended to the principals (government) and the agents (Public Enterprises) (PEs)/ Public Sector Undertakings (PSUs). Those in charge of the government and the private sector must be made aware of the need of striking a balance between financial accountability and financial control. In order to discover a solution to the problem, both the principals and agents will have to comprehend each other's demands and the constraints they would place on each other.

Concept of Financial Autonomy and Accountability of Public Sector

We all know that public enterprises (PEs) are established up by the government to carry out industrial, manufacturing, commerce, or associated operations. Sometimes, they are a joint venture between the union and state governments and sometimes by either government alone. There are two types of PEs i.e. a) those that are formed up under particular laws of Parliament b) those that are established under the Companies Act. Since PEs are funded by the government, they are accountable to the parliament. Accountability relates to the reporting of one's actions to a higher authority whereas autonomy refers to one's freedom of action. As a result of the financial autonomy granted to PEs, these are empowered to take choices on their own in areas such as investment management, financing and monitoring the financial performance of their own firms. However, in terms of investments, PEs should be allowed to find projects, prepare full feasibility project reports, appraise and evaluate projects, make investment decisions and implement and monitor them without interference from the government. It's also important for them to be able to pick how much money they want to invest in various types of inventory book debts and cash on hand. They should be able to determine the amount of current obligations at any percentage of current assets. The cost of capital may be used as a guide in making financial decisions by these businesses in the long run. They should be able to pick and select from a variety of debt-to-equity alternatives. Bankers, financial institutions and money and capital markets should be open to them when it comes to funding their working capital needs. These businesses should be given the freedom to design their own costing and pricing methods, as well as standards of profitability in accordance with the social limitations imposed on them by the government like any other private sector company to achieve the necessary financial state.

4.1.1 Tiers of Financial Autonomy and Accountability of Public Sectors

Financial independence means how PEs interacts with their surroundings and takes their financial decisions. The Parliament, the government, the Indian Comptroller and Auditor General (CAG), the Supreme Court of India and the High Court of India, the media, and the general public are all examples of the institutions which can ensure the financial autonomy of PEs. In order for PEs to function successfully and efficiently, each of these six institutions might have a clear policy on the financial autonomy it would want to grant them. It is impossible for these institutions to exert too much control over the financial affairs of PEs because they are both 'public' and 'enterprises,' respectively. These organizations' corporate status must be protected by these institutions. This does not mean that the financial decisions of these companies should not be subject to scrutiny. The most important thing to remember is that these institutions should exercise financial controls on PEs only when necessary. A PE's day-to-day financial decision making, which may include matters such as normal purchases and cost allocations, the development of suitable price structures, the selection and use of suitable sources and mix of financing and the installation of financial information systems and the finalization of accounts, etc. should be autonomous. The six institutions, on the other hand, have the power to influence financial policy. If the parliament so wants it may address financial performance and performance position, pricing, financial elements of overseas collaborations and the position of domestic finance in PEs, etc. However, the government may be able to give directives to Public Enterprises (PEs) that require them to deliver specific services at a certain price, even if it is not economically viable. The CAG has the authority to order PEs to follow a specified format for the presentation and disclosure of financial information in their accounts. If the basic rights of citizens are jeopardized, courts may order PEs to make different financial decisions. Certain financial decisions made by PEs may be criticized by the media and the public, causing the PEs to rethink their choices. Public dissatisfaction may result from decisions about pricing and the selection of plant and material suppliers. Public scrutiny of some P.E.s management decisions can sometimes be subdued. In 1970, for example, the Committee of Public Undertakings recommended the formation of a one-man panel to investigate the Indian Oil Corporation's decision to award a contract for pipeline installation to an American company.

P.E.s are held financially responsible for the following items:

- **Important Accounting Decisions**: A rise in depreciation, changes in tender procedures, the valuation of stores and replacements are among these decisions.
- **Disciplinary Concerns-** These include internal audits, processes for purchasing materials, delegation of authority, and watch and ward control over financial activities, are included in this category.

These are a few instances of things that may be left to the business to figure out on its own.

An important part of financial accountability includes financial policies. They'll need a mix of the board's ideas and the parliament's socioeconomic goals. For example, self-financing, capital development plans, dividend rates, repatriation of foreign cash, and consulting fees are all examples of this type of information. PEs may be held responsible for financial success, productivity, and growth by multiple institutions. An essential tool for PEs is the memorandum of understanding (MOU), which outlines their goals and the deadlines they must meet in a particular fiscal year.

Methods of ensuring Financial Autonomy and Accountability in Public Sector:

Methods for Financial Autonomy: To ensure financial autonomy, both external and internal methods have been resorted to. Externally the government spells out the financial freedom of the PEs in regard to several aspects in their articles of association. The limits for investment, commercial borrowings, working capital borrowings, salaries offered to employees and powers of recruitment etc., are specified in the articles of association of PEs. The provisions regarding business budgeting, costing and pricing etc. are also contained therein. The government indicates the extent of autonomy to PEs in respect of pricing, investment and profitability. In the articles of association as well as the enabling acts under which public corporations have been set up the government exercises self-restraint on itself not to interfere in the day to day working of PEs including matters pertaining to financial functioning.

Internally, PEs ensures autonomy at different levels of functioning by enforcing delegation and decentralization of financial powers. In many PEs there is a healthy tradition to hold group meetings which are also known as communication meetings. The workers' representatives are also invited. The problems are discussed and decisions are taken then and there. These meetings deal with the decisions regarding procurement: plant acquisition, investment of funds and acceptance of tender. This instrument provides a great deal of financial autonomy to the executives and work force.

Methods for Financial Accountability: The methods of ensuring financial accountability may be divided broadly into two categories:

1. Organizational methods
2. External methods

The former may take the shape of arrangements which may enable a PE to give a good financial account of it. The external means may be a sequel to the autonomous organization of a PE, created for ensuring that the managers, to whom it does not belong, behave responsibly vis-a-vis the parliament. The organizational means of financial accountability are as follows:

a) Clear financial procedures.

b) Efficient internal audit.

c) Commercial audit by private auditors.

d) Proper internal organization of the enterprise, based on optimal criteria and decentralization.

e) Appointment of a Financial Advisor of the enterprise by the government or under governmental approval.

f) Governmental control is exercised through the Board of Directors of the PE. The Chief Executives and full-time Directors of the PEs are appointed by the government. In most of the enterprises government's representatives on the boards in the form of nominee directors are present. They are from the concerned Administrative Ministry and Ministry of Finance serving in an ex-officio capacity on the board.

g) Reservation of certain financial matters for government approval, under the Articles of Association or under the Act governing a public enterprise.

h) Audit of PEs by the Comptroller and Auditor General is another means of financial accountability. In PEs there is a system of double audit. The accounts of PEs are first audited by the statutory auditors of the enterprise. After this is passed by the Board of Directors of the enterprise, then the supplementary audit is conducted by the office of the C & AG.

Status of Financial Autonomy and Accountability in Public Sector

Even if financial independence is a hot topic, the diktats of parliament and the administrative ministry place a variety of restrictions on PEs. Damodar Valley Corporation is required to report on ten financial items, gain permission on fifteen financial topics and receive instructions from the Ministery on five financial matters under the Damodar Valley Corporation Act (DVC). An official directive can always be issued by a minister on behalf of the public interest, as described above. The government has frequently issued lunch-table guidelines to PEs. Because the government has been too intrusive in the workings of PEs, they have missed the opportunity to connect costs to pricing. These instructions were produced by the Bureau of Public Enterprises (formerly the Department of Public Enterprise). There are more than 200 rules and regulations in the field of finance. From the interest rate that PEs must pay on their borrowings to the dividend pay-out ratio that they must keep in mind while deciding on the retention of earnings, these standards cover a wide variety of issues. Despite the fact that these are only recommendations, they are in a way government directives. Legislators have direct control over some investments in PEs by requiring their prior permission and submitting periodic reports to Parliament. However, this only applies to newly created services, i.e., activities that are being tried for the first time. In addition, these approvals are purely pecuniary and not administrative in nature. ” It is possible to use the contingency fund if parliament is not in session and to get parliament's approval later on if an emergency arises. PEs have extensive processes and procedures in place to safeguard the financial integrity of their businesses. During budget debates and question time, parliament discusses financial concerns affecting PEs. Furthermore, the Committee for Public Undertakings (COPU), a standing committee on PEs established by the parliament, supports PEs on a regular basis to build a suitable perspective in connection to the financial concerns of these organizations. About 600 reports have been presented by the COPU to the parliament. Horizontal studies have also been conducted by the organization. Financial management in PEs, the role and accomplishments of PEs, inventory management, project management, and reducing expenditure on overseas trips are just a few of the studies that have focused on financial elements. The financial responsibility of PEs is a difficult issue because of government regulations. A monthly, quarterly and yearly financial report and return are required by the company. If these businesses are losing money than the administrative ministry must approve even their income budget. In addition to financial audits, the CAG also conducts efficiency and propriety audits on these companies. Due to time overruns and shoddy financial transparency, these companies are disadvantaged in comparison to their private sector rivals.

4.1.2 Problems Pertaining to Financial Autonomy and Accountability in Public Sector

In a democratic democracy like ours, the financial autonomy and responsibility of PEs play a significant role. In reality, these are two independent aspects of PEs' personalities, and the government and PEs' perspectives of the issues linked to responsibility and autonomy diverge. Among the most pressing concerns in this context is the government's insistence on referring all financial matters to it and the PEs' reluctance to provide over the necessary financial information to their administrative departments. Controls are imposed on these businesses because they are viewed as the guardians of public monies by the parliament, the administrative ministry, the CAG and the courts. With public funds, they chose safety and stability above risk and uncertainty. In his work, "A Grammar of Public Enterprises Exercises in Clarification," Professor Ramaswamy Iyer identifies several common objections about government meddling in public sector management. Bureau of Public Enterprises circulars at times address insignificant or non-existent issues. A further concern is the government's excessive monitoring of PEs. All of a PE's investments are reviewed during the yearly plan meetings, and issues are addressed concerning investment decisions that fall within the corporation's authority. PEs are also subject to economic guidelines provided by the government, which limit their authority. Between the abilities that PEs are supposed to have and those they actually use, there is an inconsistency.

4.1.3 Suggestions for improving Financial Autonomy and Accountability in Public Sector

There are a variety of ways in which the financial autonomy and responsibility of PSUs might be increased. Some of the ways are given below:

1. **Commercialization**: It is the first step for these businesses. As a result, PSUs will be able to charge reasonable prices for the goods and services they supply. This will lead to an increase in internal resources and a decrease in the government's financial assistance needed to operate and expand. Government authority over financial problems will be significantly reduced.
2. **Corporations:** Another option is to turn these businesses into corporations. Many sticky issues related to financial autonomy and accountability will be solved by this change in the structure and strategy of PSUs. Several PSUs have expressed their dissatisfaction with their lack of authority to obtain the necessary materials, stores and supplies. There is a strong over-investment in inventory in these firms, according to the government, which believes that they should be closely monitored. Since so many PSUs lack a materials management handbook, the government's suspicion is unquestionable. The lack of such a guidebook has prompted them to buy resources that they don't need. The CAG has often criticized the lack of budget, cost, internal audit, R&D and capital spending guides in audit reports. Many PSUs do not even have a budget handbook to work from. Increased decentralization is a necessity for PEs to have greater control over their financial resources. This goal necessitates the development of clearly defined frameworks. PEs' boards of directors should specify the financial authority granted to each member of the organization. Delegating financial responsibilities to junior employees in PSUs should be encouraged as well. Instead of limiting investments, expenditures, borrowings etc., the government should provide Public Enterprises with only ad-hoc guidelines. If a PSUs budget goes over the suggested limit, it may be necessary to notify the authorities.

3. **Management by Exception Approach:** Management-by-exception is a sound approach. The government should intervene only in such cases where it is necessary to do so in the larger public interest. PSUs should formulate clearly financial strategies and goals which should be both unambiguous and quantifiable. For instance, PSUs might set recommended rate of return on their capital employed and declare a stipulated dividend on their equity, finance their development programmes mostly through internal production of resources and approach the capital market to finance the balance of their expansion needs. A clarity in financial objectives will enable PSUs to achieve the required financial autonomy from the government. It will also lead to self-imposed restrictions. This will obviate the need for the government to tighten, financial restrictions on them.
4. **Management by Objective (MBO):** There must also be a serious application of the Management by Objectives (MBO) for accomplishing financial objectives. It is desirable to eliminate the repeated audits in PSUs which are typically fruitless. It needs to be underlined that the equivalents of PSUs in the private sector are not compelled to undergo so many audits. The audit technique has to undergo a modification in order to deliver the intended outcomes. PSUs' operations and ideology must be explained to the auditors. Autonomy and accountability may be met in large part through the use of yearly reports. They can be a useful tool for gaining greater independence for PSUs while simultaneously satisfying the demands of the parliament, CAG and the courts. PSUs' annual reports, according to an examination, are frequently published after their due dates. The time it takes to finalize and propose these bills to the legislature might range anywhere from a year to 10 years. These reports often lack essential information on changes in output, productivity, pricing, profitability, comparative performance and more. The preparation and presentation of annual reports by Public Sector Units must be improved. Many writ petitions that have a financial impact on PSUs have been allowed by the High Courts and the Supreme Court. Some of these have to do with the purchase of materials and the payment of pensions, for example. There is a need to remove PSUs from the scope of articles 12 and 14 in order to allow them to operate in the current competitive environment without any handicaps.

4.1.4 Recent Trends in Financial Autonomy and Accountability in Public Sector

There's been a lot of talk recently regarding the connection between PSUs and the government and the topic of their autonomy and responsibility. This committee was established in 1984 by India's government to look at different elements of public enterprise management, such as government-to-PSU interactions, PSU managerial autonomy, financial authority over investments and capital budget, and so on. Its findings are summarized below.

According to the report, the government should focus on long-term strategic planning and policy rather than the day-to-day operations of PSUs. The government's job is to make sure that the money it invests in businesses yields a reasonable return and that the businesses' operations are in line with their stated goals such as creating jobs, charging fairly and making effective use of limited resources. It was agreed upon by the Committee that companies operating in key areas including energy and metals such as steel, coal and lignite etc. should work closely with ministries on issues like investment planning, price fixing and financial administration. In order for their plans to work they must be incorporated into the overall national strategy. For non-core public companies, however, raising money via public deposits or debentures and borrowing from financial institutions is an option that does not require the approval of the government. The discussion of the Administrative Ministry's Demands for Grants might be used to discuss the performance of PSUs under the Ministry's jurisdiction.

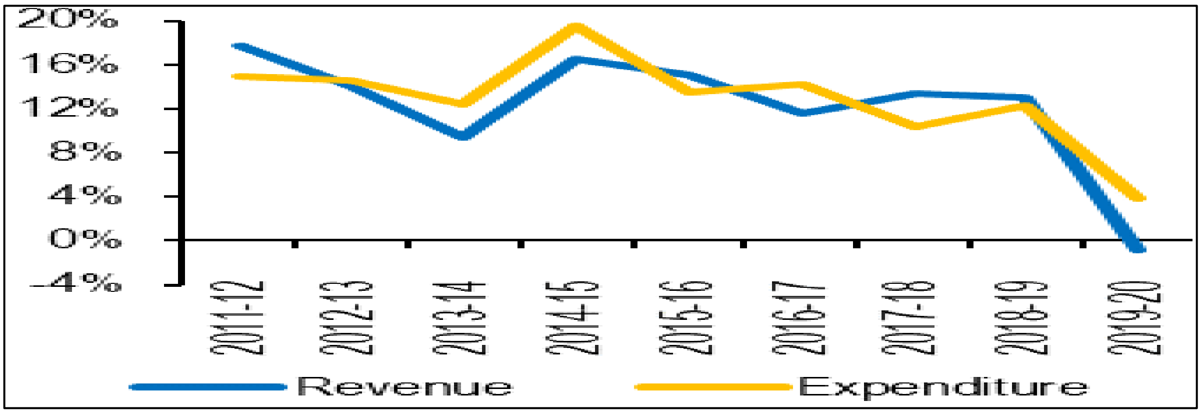
Also, in 1981, the Economic Administration Reforms Commission, chaired by the now-deceased L.K. Jha, looked at the issue of PSU autonomy and responsibility in greater detail. According to the Committee, additional checks and controls are implemented at every level in the name of public accountability, which hinders executive action, concentrates decision-making powers in the Ministry and actually dilutes the accountability of management. To ensure that (a) accountability concepts and instrumentalities do not undermine the autonomy of PSUs and thus hamper the very objectives for which they ought to be accountable and (b) that what is sought to be secured is accountability in the wider sense of answerability for the performance of tasks and the achievement of results, rather than in the narrow sense Only legislative limits that apply to both public and private sector entities should limit their autonomy, according to the Committee's recommendation. Also, once PSU investment choices have been made and appropriate cash has been granted, management should be permitted to proceed without requesting any further permission. Government guidelines and instructions to PSUs should also be extensively re-evaluated and only those that are relevant to main goals and/or performance metrics should be kept. There is no doubt that the government is firmly in favor of giving more power to PSUs and lowering their wide-ranging financial constraints. According to the budget speeches of the finance minister, the economic survey findings of 1991-92, and the letter delivered to the World Bank President by Finance Minister on development strategy, it can be gathered that numerous efforts are being taken by this administration in this respect. 'Competitive and non-competitive' PSUs are proposed by the government. Competitive PSUs have been found in about 140 central-level units. Market forces will steer these businesses in their financial decisions. Rather of publishing new rules, the government wants to stop issuing them all at once. In some cases, public sector units may be allowed to make their own financing, pricing and costing decisions. If they can come up with the right processes and structures to accomplish their overall financial goals, they will be free to do so. Non-core businesses will not receive any funding from the government. They will have to generate their own resources and raise funds from the stock markets to meet their financial obligations. These businesses will see a 20% reduction in equity investment. There will be just one government nominee on the board of directors of PSUs. It's possible to reduce or eliminate the number of audits. Annual reports from public sector companies are being used by the government to improve the quality of financial reporting. A primary aim for the various state governments in the country is to streamline the compilation of state-level public enterprise annual reports and accounts.

4.2 State of State Finances in India (2020-21)

As a result of the economic recession in 2019-20, the state's revenues essentially stagnated, compared to the previous year. With the advent of the COVID-19 epidemic and stringent lockdown restrictions in 2020-21, economic activity decreased. As a result of this, both the federal and state governments' tax collections have been further impacted while the government's expenditures have risen as a result of giving assistance to the most disadvantaged and boosting public investment in order to stimulate economic growth. This has led to an increase in borrowing by governments to support their budgets. As a result of weaker GST receipts, the union government has had to raise its compensation to the state and local governments which has put a strain on its budget. State-owned electricity distribution businesses face additional risks due to their ongoing financial difficulties. Our focus here is on current patterns in state government budgets, as well as recent changes.

4.2.1 Developing Themes in State Finances

1. Low Growth in Receipts and Expenditure: Nominal GDP (inflation-adjusted GDP) rose at 7.2 percent in 2019-20, which is lower than the budget projection of 12 percent growth. This resulted in a reduction in devolution of tax money from the union government, but it also affected the states' own tax revenues. Over the last year, state revenue receipts fell by 0.8 percent, a far cry from the 20 percent planned increase. In 2019-20, state spending growth was limited at 3.9 percent (average growth during 2011-19 was 13.8 percent). With the inflexibility of revenue spending, capital outlay witnessed an 8.7 percent drop in its budget from the preceding year.

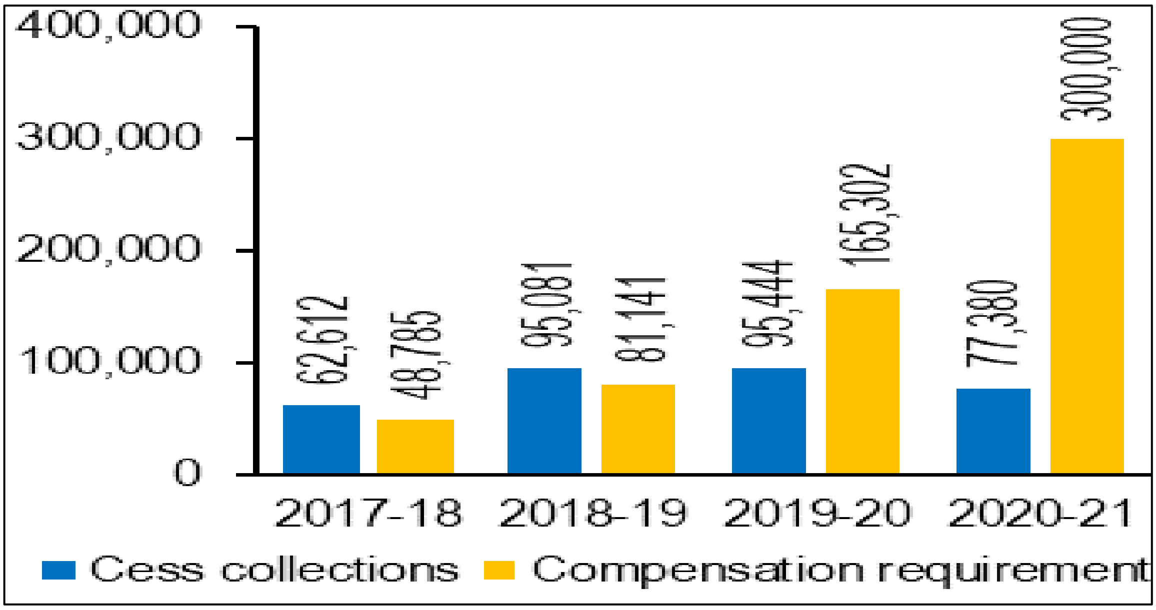


Source- PRSIndia.org

2. **Increased reliance on borrowing in 2020-21**: The first half of 2020-21 saw a fall in economic activity as a result of COVID-19. Tax income has decreased as a result of this. As of April-October 2020, revenue revenues in 21 states were down 13% from the same time previous year. The Centre has authorized all states to raise their borrowings this year in order to maintain spending. From 3% to 4% of GDP, the fiscal deficit limit has been increased. Additional 1 percent GDP will be authorized if four reforms are implemented: one nation, one ration card, easy business, electricity distribution and urban local body/utility. (0.25% of GSDP for each reform). By December 11, 2020, state governments would have borrowed Rs 4.6 lakh crore (net) from the market, an 82.5 percent increase over the same period last year.

3. **GST compensation cess collection insufficient to pay compensation to states:** A cess is used to make up for any shortfall in a state's GST collection. Compared to 2018-19, the GST compensation

needed by states in 2019-20 was Rs 1.65 lakh crore. Due to this shortage, the 2020-21 cess collection was partially used to fill the gap. More than 2.3 lakh crore rupees will be short in 2020-21, when states' compensation requirements are expected to climb further. Additional borrowings by states would cover some of this (Rs 1.1 lakh crore), while the rest will be paid for by prolonging cess receipts beyond June 2022. States that rely on compensation will have a revenue shortfall after June 2022 because of the expiration of the guarantee (this could be significant for some states such as Punjab where this item accounts for 20 percent of the revenue receipts in 2019-20).



Source- PRSIndia.org

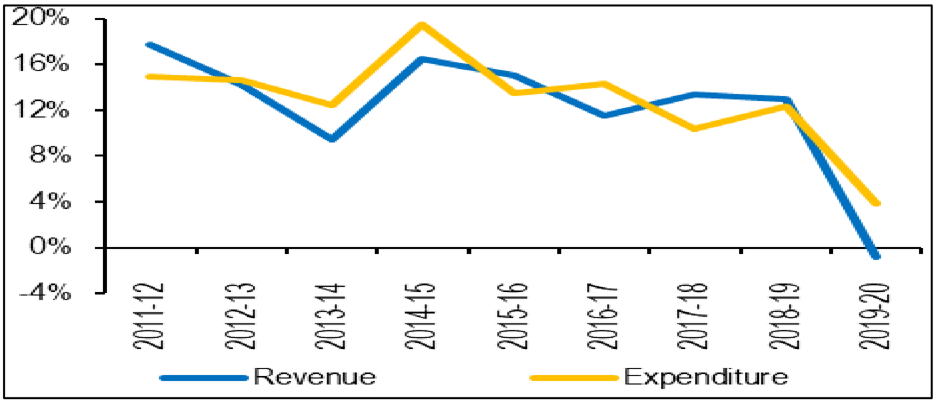
4. **Increasing share of cess and surcharge in Centre's tax revenue**: Tax and surcharge income collected by India's government climbed from 0.9% of GDP in 2012-13 to 1.7% in 2019-20. Tax revenue as a percentage of GDP fell from 10.4% to 9.9% over the same period. Tax money from cess and surcharge is not included in the central government's allocation of tax revenue with the states. Because of this, the divisible pool has shrunk due to the increased percentage of cess and surcharge in the total tax collection.

5. **Government expenditure on health below target**: As a result of COVID-19, attention has been drawn to the provision of healthcare services. According to the 2017 National Health Policy, the federal government should spend 2.5 percent of GDP on health care by 2025. It has climbed from 0.9 percent of

GDP in 2015-16 to 1.1 percent of GDP in 2020-21, which is a significant increase (a cumulative increase of 0.2 percent of GDP in six years). The National Policy also called on governments to spend at least 8% of their budgets on health by 2020. Nobody has set aside 8% of their budgets for health care in 2020-21.

4.2.2 Revenue shortfall due to the economic slowdown led to muted growth in expenditure in (2019-20)

This year, the union government predicted a nominal GDP increase of 12 percent (real GDP + inflation) in its 2019-20 budgets. However, preliminary GDP estimates show that nominal GDP grew by 7.2 percent in 2019-20. They didn't fulfil their revenue expectations since the union and state budgets assumed a 12 percent GDP growth for 2019-20. As a result, states witnessed a reduction in the amount of tax money they were projected to receive from the federal government. States' overall revenues fell by 0.8 percent in 2019-20 compared to the previous year as a result of this. Growth of 13.6 percent is a far cry from the forecasted 20% and the average annual growth rate of 13.3 percent between 2011 and 2019.



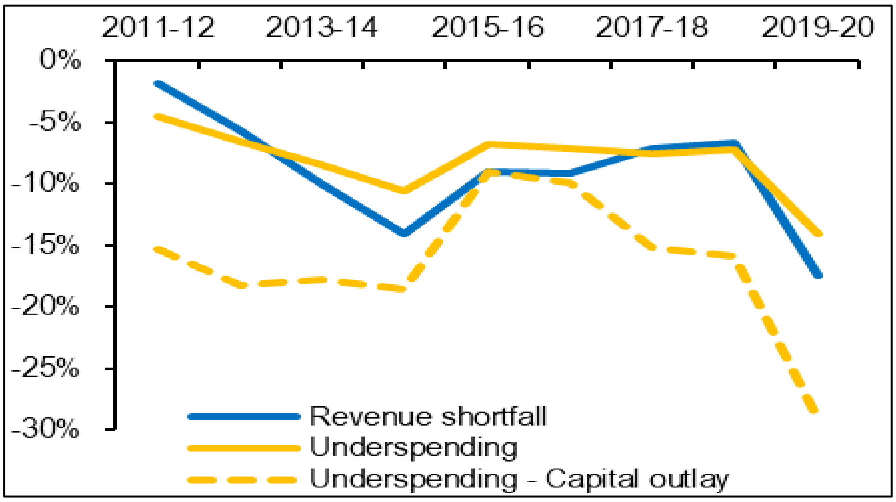
Source- PRSIndia.org

Revenue Receipts Shortfall: As a result of the economic downturn and lower income tax rates for domestic enterprises, the Centre's gross tax collection fell by 3.4% in 2019-20, compared to 2018. Because of this, devolution to states, which generally accounts for 27% of their revenues, decreased? The 2019-20 devolution was further decreased by Rs 58,843 crore as a result of the additional devolution that the Centre provided in 2018-19 beyond what was really due. As a result, states received

Rs 6,50,677crore in devolution in 2019-20, which is 20% less than the budget projection of Rs 8,09,133 crore. Revenue from the GST, which is charged on the consumption of most goods and services, was negatively impacted by the decline in demand. The gross GST income (Centre+ States) grew by merely 4% in 2019-20, compared to 2018. The compensation grants would have shielded states from the effects of a decrease in GST collection because states may count on a 14% increase in their GST revenue until 2022. However, the government postponed the payment of Rs 65,546 crore in grants.

Impact on Expenditure: The decline in revenue receipts led to a reduction in spending and an increase in borrowings, respectively. In 2019-20, state spending climbed by only 3.9% over the previous year, a far cry from the 13.8% average rise witnessed between 2011 and 2019. Since wages, pensions, and interest accounted for over half of the revenue expenditure, capital expenditures took the brunt of the shortfall. Revenue spending grew by 6%, but capital investment fell by 8.7% over the previous year. Additionally, state borrowing climbed from 2.37 percent of GDP in 2018-19 to 2.5 percent of GDP in 2019-20, resulting in a larger fiscal imbalance.

High Budget Estimates: While preparing their budgets for the upcoming year, states have regularly underestimated their revenue sources. Both (i) aggressive growth expectations for the future year, and (ii) unrealistic' revised estimates' used as base revenue for this year, may be to blame for this. As a result, governments have seen a decline in tax income over time. It is possible for states to either borrow more money or reduce their projected spending in such a situation. Budget Responsibility and Budget Management Acts limit states' fiscal deficits to 3% of gross domestic product, which forces them to slash spending. Capital investment has been slashed since revenue expenditure is more difficult to alter.



Source- PRSIndia.org

With COVID-19 impacting revenue, states rely more on borrowing for expenditure in 2020-21: According to the 2020-21 federal budget, the nominal GDP (i.e., real GDP plus inflation) will expand by 10% in 2020-21. Most states assessed their nominal expand growth rate in the range of 8% to 13%. With COVID-19 and lockdown causing a 22.6 percent and a 4% contraction in the first two quarters, it is possible that growth in 2020-21 will really be negative. Real GDP is expected to shrink by 7.5% this year, according to the RBI. Due to the lower-than-anticipated tax collection, revenue from the federal government and the states is expected to fall short of expectations. States' revenues fell by an average of 13% in compared to the same time in 2013. This year, these states produced 52% of their revenue in the period from April to October, but just 37% of their full-year objective. A 22 percent increase in revenue for 2020-21 was based on the previous year's revenues, which is substantially greater than 2019-20's revenue growth. For the first several months of this year, the Centre distributed devolution from its tax receipts based on budget forecasts, rather than actual tax collections, to help states with their financial flow. A year-round shortfall in the Centre's gross tax collection will be taken into account in the total devolution in 2020-21, which may influence the devolution revenues for the rest of the year. This is expected to have a greater impact on states that get a larger percentage of their revenue through devolution.They need to either raise their borrowing or cut back on spending to sustain their budgets in 2020-21, because state revenues will be severely limited. State fiscal deficits can be increased from 3% of GDP to 5% of GDP during 2020-21 in order to boost borrowing capability (i.e., an additional borrowing of Rs 4.28 lakh crore). Up to 3.5 percent of GDP can be unconstrained in budget deficits under the new 5 percent ceiling.

Reforms in four sectors (0.25 percent of GSDP each reform): One nation, one ration card; ease of doing business; urban local body/utility; and power distribution will be authorised for the remaining 1 percent of GSDP. The market borrowings authorised to states have been approved on a temporary basis and may be altered later in the year, so be aware of this. States have borrowed Rs 4.6 lakh crore through market borrowings (net of loans for GST compensation) as of December 11, 2020, an increase of 82.5 percent over net market borrowings made during the same time previous year.

States have also taken efforts to postpone or limit their expenditures in light of the COVID-19 pandemic's financial shortage and changed spending priorities. In April-October 2020, capital expenditure fell by 25.3 percent compared to the 3.2 percent fall in expenditures across the 21 states. States would get 50-year interest-free loans totalling Rs 12,000 crore (equal to 2% of their 2020-21 capital outlay plans) from the Centre, with Rs 2,000 crore of that amount conditional on the changes described above.

4.2.3 State of Local Finances in India

Municipalities in India have taken on more responsibility due to the country's rapid urbanisation. Municipal governments are continually searching for extra cash from various sources in order to address the magnitude and complexity of urbanisation. It is imperative that efforts are made to preserve and expand urban productivity, which in turn depends on the quality and degree of urban infrastructure. There has been a rise in the demand for urban infrastructure services as a result of growing earnings, fast population expansion and an overall increase in economic activity. The economy's development potential would be jeopardised if local governments were unable to keep up with expanding demand.

Functions of Local Bodies

When it comes to municipal government functions, they differ greatly between countries, as well as within countries. Even yet, there are certain recurring themes. It is common to categorise the functions of a local government (e.g., a municipality) in three broad categories-

1. **Essential Civic Functions-** Provision and maintenance of fundamental (or vital) civic services is the primary role of municipalities. Street lighting, water supply and sewage disposal, fire protection, abattoirs and basic health care are among the services provided by municipalities. The municipalities are responsible for these services.
2. **Regulatory Functions-** Industry, trade and building are all subject to these regulations. For example, municipalities impose fines for breaking laws and regulations through issuing licences, permits and different fees of various types. The cost of administration and surveillance should be included in regulatory fees. It would impose a burden on resources if these services were subsidised.
3. **Agency Functions-** These are functions (e.g. protection of environment) which are funded out of state revenues by specific transfers.

4.2.4 Financing of Local Bodies

For municipal governments, the following regulations are outlined in public finance literature-

1) Where the benefits of a local public service are measurable and accrue to readily identifiable individuals/households within a jurisdiction, user charges are the most appropriate method of financing the service.
2) Taxes on local inhabitants should be used to pay for local public services that are difficult to identify and assess the benefits to individuals and families. Traffic management, street lighting, security and general administration are all examples of this type of service.
3) Services that have a positive impact on other jurisdictions should be prioritised.
4) By use of inter governmental payments. A wide range of social welfare activities are included in these programmes.
5) To finance long-term capital projects, long-term borrowings are the most appropriate method of financing.

In order to supplement their financial resources, higher-level governments frequently impose taxes on lower-level organisations. When it comes to delegating taxes to local governments, tax literature proposes the following:

1) If a tax is "immobile" or "location-specific," and its burden cannot be transferred to another jurisdiction, it should be given to the local government. A good example is property tax.
2) The local tax base should be clearly recognised and its incidence should be made clear to the public. '

It's important that tax revenue is consistent, predictable and rising. It is important that the tax rate schedule has a suitable amount of progressivity. Finally, the tax should be simple to manage. Based on the above reasons, the following taxes are often assigned to local governments:

(a) Property Tax,
(b) Entertainment Tax,
(c) Tax on Professions,
(d) Tax on advertisements and
(e) Octroi/Tolls.

4.2.5 Role of State Finance Commission

The State Finance Commission is set up under Article 243-I read with Article243-Y of the Constitution. It is required to review the financial position of the municipalities and make recommendations as to the principles which should govern the distribution between the State and the Municipalities of the net proceeds of taxes, duties, tolls and fees leviable by the State which may be divided between them and the allocations between the Municipalities of their respective shares of such proceeds. The determination of the taxes, duties, tolls and fees which may be assigned to or appropriated by the municipalities, the grants-in-aid to Municipalities from the Consolidated Fund of the State, the measures needed to improve the financial position of the municipalities and any other matter referred to the Finance Commission in the interest of sound finance of the municipalities.

As required under the Constitution, all State Governments have set up Finance Commissions. These State Finance Commissions (SFCs) are expected to strengthen local bodies so that they may function as democratic units for the socio-economic development of urban and rural areas of our country.

The task of the First Finance Commission of a State was difficult and arduous in the absence of precedence and it was expected to make suo moto all such studies in areas which never existed before. Nevertheless, the work of the First Finance Commission was crucial because it paved the way for subsequent commissions. The following observations may be made in this regard:

1. The new Constitutional arrangement (Seventy-fourth Amendment) implies that the whole range of a State‘s tax revenue is open to sharing with municipalities. SFCs are expected to evolve principles of tax assignment, tax sharing, and grants to municipalities with a view to mitigate their weak financial position. They are also required to evolve criteria with regard to adequacy and objectivity of grants.
2. Sharing of State tax revenue with municipalities depends wholly on the discretion of State Government.
3. In determining devolution of funds, the SFCs would do well to keep in mind, *inter alia*, the following factors.
   (a) Resource position of the State.
   (b) Normative deficits of municipalities. Any system which underestimates the gap between revenue and expenditure should be discouraged.
   (c) The degree of dependence of municipalities for funds on the State Government.
   (d) Capacity of a municipality to utilized evolved resources.
   (e) A State Finance Commission may consider introduction of a system of incentives and disincentives into the entire governmental grants on objective lines. Municipalities which are able to raise resources through levy of user charges and benefit taxes should be considered for incentive grants from the State Government.

4.2.6 Municipal Commercial Borrowings

The majority of local governments' capital projects are funded by the allocations of the union and state governments. Internal municipal resources, institutional resources such as HUDCO and multilateral organisations are further sources of financing. In light of the urgent need to minimise the fiscal deficit, the Central and State Governments' capacity to provide extra cash is restricted. Following financial sector reform, low-cost institutional funding will not be available. The capital market should be opened up to local authorities in these situations so they may raise more funds. Indian financial markets have recently expanded and modernised, suggesting that inflows of money into stock and debt markets are relatively significant provided acceptable rates of return are offered.

Rationale for municipal commercial borrowings

Using long-term borrowings to finance long-term initiatives is both fair and economical. Future generations will enjoy free-riding if long-term capital projects are financed using current income and/or short-term borrowings. Considering that the advantages of a capital project are realised over a long period of time, including many generations of tax payers, the payback burden of such projects should fall on both current and future generations.

Limitations

Municipalities' attempts to enter the financial markets have been thwarted by a number of obstacles that may be divided into two groups: those imposed by higher levels of government and those imposed by outside circumstances.

The Indian Constitution restricts the borrowing capacity of state governments, which, in turn, restricts the borrowing ability of local governments that fall under them, in a variety of ways. Due to the fact that borrowings by lower-level governments are usually backed by the higher-level government, the latter is entitled to set such limits. Type of debt, debt amount, debt duration, and usage of debt money are all subject to these constraints. Before the debt can be floated, it must first be approved by higher levels of government, which can be time consuming. This means that no municipal body can borrow money unless the State Government specifically authorises it to do so. In cases where the loan amount is greater than Rs. 25 lakh or the repayment duration is longer than 30 years, the Local Authorities Loan Act, 1914 requires central clearance for local borrowing (a Central Legislation). Furthermore, municipalities' poor track record as borrowers, their lack of confidence in financial intermediaries, and their low creditworthiness are among the most significant 'other limitations'. Despite these difficulties, a few Indian towns have been able to access the bond market effectively.

4.3 Growth of Public Sector Investment in India

It is only after independence that the public sector has been able to participate in the economy on a large scale. For decades before to 1947, public sector investment was confined to a handful of state-owned industries such as salt mills and the quinine plants. During the course of India's economic development, public enterprise emerged as a significant contributor. In 1948, the Government of India issued an Industrial Policy Resolution that put the public sector on the map. An aggressive national strategy should be aimed at increasing output by every method available together with efforts to ensure that it is distributed fairly. State participation in industry and the conditions under which private company can function must be evaluated in this perspective. Since then, the public sector has grown at a breakneck pace. During the Second Plan the notion that state companies would play a dominant role in the economic growth of the country was established.

The methods of formation of public enterprises in India are three:

(i) By nationalization of existing enterprises. The State Bank of India, the Life Insurance Corporation of India, the Air India, the nationalisation of 28 Banks are included in the first category.

(ii) By starting new enterprises on its own initiative. The Hindustan Steel, the National Coal Development Corporation, the Fertilizer Corporation of India, Hindustan Aeronautics etc. fall in the second category.

(iii) By taking over sick units. Units under National Jute Corporation, Bengal Chemicals, Indian Iron and Steel Corporation of India, belong to the third category.

In India, the majority of public enterprises are located in the country's capital city. Central and state governments make up only a small percentage of total capital, accounting for only a small portion of the total amount of capital in the United States. On both an absolute and relative basis, public sector investments have been significant over the course of the plan period. From 1970 to 1990, the total amount invested by the public sector was consistently rising. It was more than 46 percent of the total investment made in the First Plan (46.4/53.6). At 65% of total investment, the public sector had a significant role. Even though the public sector's share of national income is rising, it is still very low when compared to the private sector's share. It makes up 25 percent of the gross national product (GNP).

The following table shows the growth of Investment in the Central Public Sector.

The Table : Growth of Investment in the Public Sector		
Period	Total Investment (Rs. crore)	No. of Enterprises
Plan I	29	5
Plan II	81	21
Plan III	953	48
Plan IV	3902	85
Plan V	6237	112
Plan VI	8275	186
Plan VII	42811	233
Plan VIII	118492	246

There is no doubt that the amount of money invested and the number of businesses has expanded gradually with each new strategy. A rise in public sector investment also has a direct impact on job opportunities. Public sector employment rose from 5 million in 1956 to 10 million in 1968, and then to 20 million in 1990. Government investment in capital-intensive projects has reduced the public sector's contribution to employment in India, despite it being the country's most significant part of the economy.

The significant rise of public sector investment has taken place in the context of Indian political evolution and the balance of political forces. When it comes to social and economic issues, the Indian National Congress has always used extreme language. It was stated in the Lahore Resolution of 1929 that in order to alleviate poverty and misery among Indians and to improve conditions for the majority of the population, radical changes needed to be made to society's current economic and social structure. Key industries and services, natural resources, railways, rivers, ships, and other modes of public transportation are to be owned or controlled by the state, according to the Karachi Resolution. Congress established the National Planning Committee in 1938.

In spite of the ideological differences between Gandhians and Nehru's radicals, nationalisation of defence industries and the ownership of public utilities was achieved – ideological differences about other key industries, bank-ing, and insurance continued until 1948 when the First Industrial Policy Resolution attempted to compromise between different ideo-lo-gical viewpoints – the First Industrial Policy Resolution of 1948. In 1956, the Second Industrial Policy was launched, outlining the government's and the private sector's respective responsibilities. The Industrial Policy Resolution proceeded to allocate industries between the two sectors after the immediate nationalisation of all industry was deemed out. Atomic energy, weapons, ammunition, and railroads were all set to remain monopolised by the government. For the state to establish new businesses in iron and steel, shipbuilding, mineral oils, coals, etc., would have the exclusive right, with potential exceptions in the national interest. As far as industrial investments go, the rest is left open for both the private and public sectors to set up new businesses simultaneously, with the promise of increasing state involvement, particularly in relation to key industries like fertilisers and essential medicines.

Since the scope and need for development are so great, the First Plan held that it is best for the public sector to develop those industries where private enterprise is unable or unwilling to put up the resources required and take on the risks involved, while allowing private enterprise to develop the rest of the field free of government interference and oversight. In many aspects, the second IPR in 1956 was a reiteration of the first, with the exception that it placed a stronger emphasis on the significance of the public sector. For 17 industries, the state would either have absolute mo-nopoly or the sole right to create new in-dustrial facilities in the first group of industries. However, it permitted private businesses to build up additional units in the interest of the nation. In the second category, the state would gradually develop new entities in 12 additional industries. The remaining industries were to be left mostly to the private sector, although the state still had the option of entering. Although the second IPR closely resembles the first, it appears that it was published in light of the government's change to a more overtly socialist posture in part to re-emphasize public sector importance and requirement to restrict private sector expansion.

Insofar as heavy industries often entailed undertakings in which private sector would not have chosen to deploy its capital or have had the finances to do so, the Second Plan's move to heavy industries gave a greater edge to the second IPR. Consequently, both the new industrial strategy and the socialist viewpoint dictated movements toward public-sector investment in the Second Plan. Since independence, it's impossible to avoid the conclusion that the government has been the driving force behind the country's economic progress, particularly its industrial boom. Although in theory true, the public sector has fallen short of expectations. Imported technology may not always be well-chosen because of bureaucracy or tradition-bound management practises. Due to the public sector's low efficiency, its high production costs are evident. Delays, lack of clear policies, and over-staffing are to blame for this.

4.4 Financial Appraisal of Public Sector Investment

Another term for an economic study that may be used interchangeably with the term "cost benefit study" is "extensions of financial study." Governments and international organisations frequently use economic analyses to assess whether or not specific initiatives or policies would enhance the well-being of a community and, thus, should be supported. Cost benefit analysis should be frequently used to examine large government-funded projects and programmes because it helps the analyst to decide whether a project will have a beneficial impact on the welfare of a country. For every private initiative seeking government subsidies or policy assistance such as tariff protection, the government should do a cost-benefit analysis. Cost benefit analysis is concerned with the welfare of all businesses, customers and the government in a given country, whereas financial analysis is concerned with the interests of the implementing agency or enterprise. However, the well-being of foreigners is unimportant to an economic study. To decide whether or not to proceed with several large-scale publicly sponsored irrigation, hydroelectricity and water supply projects in the country's parched central and western regions in the 1930s, the federal government turned to the cost-benefit analysis approach, or CBA and derived much of the modern cost-benefit analysis theory and practise from ground-breaking work by Little and Mirrlees, Dasgupta, Marglin and Sen in their UNIDO Guidelines, Harberger, Corden, Squire and Van Der Tak as well as other authors whose works have been included in Layard Various writers have provided a slew of additional helpful additions. To address concerns like these, a cost-benefit analysis employs microeconomic, macroeconomic, and international trade theory to analyse real-world scenarios. Which option should be pursued?

A) Building a new bridge, or enhancing the current ferry service?

B) Either the raw bauxite and coal should be exported, or an export-oriented aluminium refinery should be created.

C) Alternatively, should computers be manufactured in-house or imported?

D) In the long run, will this irrigation project be more beneficial to the local population and better utilise resources than the highway project?

E) To create electricity, what type of fuel should be used?

A financial assessment, which assesses how economically lucrative different policies and possible investments are, isn't enough for the government to address these concerns. For a variety of reasons, this is critical. As a first step, governments normally seek to achieve a range of goals that go beyond profit maximisation when it comes to the provision of public goods such as social services and legislation. To maximise profits from state-owned firms, governments should privatise them, as the private sector is likely to be more efficient at accomplishing this aim. The government's main goal is to maximise the well-being of the people in the community. The simplest economic goal is to maximise the amount of GNP that each individual receives. Another goal may be to protect and enhance national security, as well as to ensure the preservation of the environment. Even from this small list, it's clear that several of these goals are at odds with one another. Governments employ cost-benefit analysis to assess the impact of various competing initiatives on community welfare, as defined by all of these diverse criteria. Cost benefit analysis is one of the most often used tools in government. There are several pricing distortions and flaws in the factor and products markets, which is another significant cause for cost benefit analysis. Prices reported in domestic markets in many nations reflect a wide range of distortions, such as taxes and subsidies as well as monopoly rents and tariffs. A government's ability to determine whether projects will have a positive impact on the community's well-being will be limited if it relies on market prices of the project's inputs and outputs. A cost-benefit analysis will attempt to account for these distortions by computing economic, or shadow, prices while doing the study. The shadow pricing of the project's inputs and outputs, such as labour and capital, traded products and non-traded items, will represent the real economic worth of these inputs and outputs to the economy concerned in international commerce. When doing a cost-benefit analysis, market prices are replaced by shadow prices.

Economic Appraisal of Public Sector Investment

The steps in preparing a standard economic appraisal are outlined below:

1. **Definition of Objectives**: The starting point and in many ways the most crucial aspect for the appraisal of an investment proposal is the specification of the objectives of the proposal and

their relation to the overall objectives of the unit. No appraisal of the project can be meaningful unless the objectives are clearly defined.

2. **Identification of Options:** It is necessary to identify the widest possible range of options at the earliest stage of the planning process. One alternative that should be considered is the possibility of the objective being met by the private sector. In developing various options, the first option to be considered is the base case of “does nothing" i.e., retain the status quo. This is not to say the base case will not involve costs; in many cases doing nothing (for example continuing with a low maintenance program) will result in cost penalties. One benefit of doing something may be the avoidance of these costs. In the case of asset replacement decisions it may involve deferral of replacement and continued maintenance and or eventual replacement with a new asset of comparable standard to that being replaced. In the case of an expansion of activities the base case would represent a continuation of the existing system or policies.
3. **Identification of Costs and Benefits**-The With-Without Principle: This is the basic principle of any type of project evaluation. In practice, it means that an attempt should be made to estimate the "the state of the world" as it will exist with the project in existence. This should be contrasted with the "state of the world" that would have existed in the absence of the project i.e.; the "do nothing" option.

This principle has two important implications:

- First, economic evaluation must not simply be a comparison of before project conditions with after project conditions because such comparison would attribute the contribution of all pre-existing trends and external factors to the project itself. For example reductions in on-going costs due to changed work practices should not be attributed to savings from an investment in new plant if the changes in work practices would have been introduced regardless of the investment decision.
- Second, the analysis should include all impacts both beneficial and otherwise of the proposal being evaluated. In particular not only should the intended effects or benefits which are the objectives of the project be included but also the subsidiary or indirect effects. The importance of the with-without principle cannot be overstated. Failure to adopt it may lead to meaningless results.

4. **Valuation of Costs and Benefits:** When considering how impacts should be valued in practice, it may be convenient to classify impacts into three categories:

i) Costs and benefits which can be readily identified and valued in money terms (e.g. value of additional electricity supplies to users, travel time savings).

ii) Effects which can be identified and measured in physical terms but which cannot be easily valued in money terms because of the absence of market signals and consequential disagreement as to the rate of valuation (e.g. museums, reduction in pollution).

iii) Impacts which are known to exist but cannot be precisely identified and accurately quantified, let alone valued (e.g. Crime prevention effects of police programs, comfort improvements in new trains, aesthetic effects of beautification programs). When considering benefits and costs which either cannot be valued or cannot be quantified there can be a tendency to concentrate on the benefits and ignore the costs.

Specific Issue-

a) **Avoidance of Double Counting or Overstating of Benefits**: In enumerating the costs and benefits of a proposal, care should be taken to avoid double counting. For example, the construction of a dam may increase the value of the land which is to be irrigated as a result of the increased ability of the land to grow crops. The increased value of the land merely reflects the market's capitalization of the increased output stream. Inclusion of the net value of the increased output and the increased land value would count the same benefit twice. Another danger is the overstatement of benefits by attributing the total output of a process to a single input. In the above example, the total value of the crops made available by the water irrigation project should not be attributed to the project. Rather the net value of the additional production should be derived by deducting all additional input costs from the value of the additional output, i.e., the costs of labor, capital and other inputs such as fertilizer and fuel should be deducted from the value of the output. Measured in this way the value of net output, subject to provision for a normal profit provides a measure of the willingness to pay for water. Hence, the inclusion of this benefit would also require adjustment for actual payments made for water provided.

b) **Treatment of Inflation**: Due to inflation, costs and benefits which occur later will be higher in cash terms than similar costs or benefits which occur earlier. There are two different ways to tackle this issue. Either nominal values can be used for each time period and then discounted with a nominal discount rate, or real cash flows can be used discounted by a real discount rate. In practice it is considered that the use of real cash flows and discount rates may simplify the forecasting and calculation processes.

c) **Use of Shadow Prices**: A shadow or accounting price is the price that economists attribute to a good or factor on the argument that it is more appropriate for the purpose of economic calculation than its existing price, if any. In evaluating any project, the economist may effectively correct a number of market prices and also attribute prices to unpriced gains and losses that it is expected to generate. He will, for example, add to the cost of a factor or subtract from the cost of a good, in making allowance for some external diseconomy. Wherever the amounts of a good, to be added to or subtracted from the existing consumption are large enough, the economist will substitute for price the more discriminating measure of benefit, consumer surplus. Certain gains or losses to an enterprise he will value as zero, since for the economy at large they are only transfer payments. The cost of labour that would otherwise remain idle, he must value at its opportunity cost; not at its wage; and so on.

Discounting of Future Costs and Benefits:

a) **The Concept of Discounting**: The costs and benefits flowing from an investment decision are spread over time. Initial investment costs are borne up front while benefits or operating costs may extend far into the future. Even in the absence of inflation, a rupee received now is worth more than a rupee received at some time in the future. Conversely, a rupee's cost incurred now is more onerous than a rupee's cost accruing at some future time. This reflects the concept of time preference which can be seen in the fact that people normally prefer to receive cash sooner rather than later and pay bills later rather than sooner. The existence of real interest rates reflects this time preference. In order to compare the costs and benefits flowing from a project it is necessary to bring them back to a common time dimension. This is done by discounting the value of future costs and benefits in order to determine their present value. The process of discounting is simply compound interest worked backwards.

b) **The Recommended Discount Rate**- Private Sector entities sometimes require that the rate of return on a particular project exceeds the return expected on an alternative project which might otherwise be undertaken. Or they might stipulate a return somewhat in excess of the cost of borrowed funds. Public sector decision-makers will be encouraged to invest in projects which generate returns greater than the government's test discount rates. Three alternative bases for the setting of the discount rate have been proposed: social time preference; opportunity cost of capital; and cost of funds. The first two concepts of the discount rate relate to the opportunity cost of the resources used in the public sector investment projects. Resources could be used elsewhere and the discount rate attempts to measure such opportunities foregone. In principle the social time preference rate and the opportunity cost of capital should be the same. However, for various reasons such as private sector profit and capital constraints in the public sector, the two will differ. Typically, the opportunity cost of capital will be greater than the social time preference rate.

Resources devoted to public investment will be at the expense of current consumption or private sector investment. In a growing economy with rising living standards, a rupee's consumption today will be more valued than a rupee's consumption at some future time for, in the latter case, the rupee will be subtracted from a higher income level. This so-called marginal social rate of time preference is, of course, not easy to measure. If alternatively, public investment takes place at the expense of private investment then, from an economic efficiency viewpoint, public investments of an economic nature should not be sanctioned if they are expected to earn significantly lower rates of return than those same resources might earn (before tax) in the private sector (the so-called marginal social opportunity cost). This concept is also difficult to measure accurately. The concern is not with the average rate of return in the private sector, but with the marginal rate - that is with the rate which would be earned by the private sector if additional capital allowed further private investment to occur. In theory a perfectly competitive capital market will see equality of the consumer's marginal rate of time preference, the investor's rate of return on the marginal project and the market rate of interest. In practice interest rates provide limited guidance to the estimation of discount rates on these bases. In the face of the difficulty of measuring discount rates on these bases, it has sometimes been argued that the appropriate rate of return or discount rate should be derived from the interest rate at which government borrows funds in the market. But given the dominant position of government in the capital market, the variability of interest rates and the wide range of factors which impact on interest rates this is quite an inadequate way of deriving the appropriate discount rate.

c) **Impact of Discount Rates on ProjectRanking**: It should be noted that the choice of the discount rate is an important issue as it can have a significant impact on the ranking of options/projects and hence their choice. In general, as the discount rate rises projects with larger initial outlays and lower ongoing outlays become relatively less attractive compared with projects with lower initial outlays and higher ongoing outlays. Thus, a higher discount rate would favour maintenance options as against asset replacement. Similarly in the case when net benefits are spread far into the future, the higher the discount rate, the more net benefits far in the future are downgraded in present value terms relative to net benefits closer to hand. Thus, short lived options are favoured by higher discount rates relative to long-lived options.

d) **Decision Criteria**: Once all the costs and benefits over the life of the programme have been identified and quantified, they are expressed in present value terms. Using the discounted stream of costs and benefits, the following decision measures should be calculated. Investment decision making is primarily concerned with three types of processes:

- The screening process, whereby the decision maker, faced with a range of independent projects and adequate resources, must accept or reject the individual projects.
- The choice process between mutually exclusive projects, whereby the decision makers must choose from a range of mutually exclusive projects (commonly directed at similar objectives).
- The ranking process, whereby the decision maker is faced with resource constraints which prevent all acceptable projects from being preceded with- hence the projects must be ranked in an objective manner.

Social Appraisal of Public Sector Investments

The financial or traditional economic project appraisals implicitly assumed that income distribution issues are beyond the concern of the project analyst or that the distribution of income in the country is considered appropriate. However, in many, if not most, developing and developed countries governments are not only interested in increasing efficiency but also in promoting greater equity. In most countries the existing distribution of income is clearly not considered to be ideal by the government or the population. Social cost benefit analysis or the social appraisal of project has evolved to respond to this need.

A social appraisal of a project goes beyond an economic appraisal to determine which projects will increase welfare once their distribution impact is considered. The project analyst is not only concerned to determine the level of a project's benefits and costs but also who receives the benefits and pays the costs. Social appraisal therefore tackles the moral and theoretical dilemma-that a project is worth undertaking if it has the potential to produce a Pareto improvement in welfare.

4.5 Check Your Progress

1. Financial freedom is divided into six levels, …………, the government, …………………., the Supreme Court of India and the High Court of India, …………….. , and the general public are all examples of these institutions.
2. …………. can help in increasing the financial autonomy and responsibility of PEs.
3. PEs are now included in the definition of "state" under Articles ….. and …… of India's Constitution
4. Provision and maintenance of fundamental (or vital) …………. is the primary role of municipalities.
5. The …………… cost of a project is incurred at the time that labor, machinery and other inputs are used for construction

4.6 Summary

The lesson above has recognised the importance of financial autonomy and financial accountability of the Government. It has also talked about the state finance commission along with the state of expenditure and revenue of various municipalities in India. Further, this lesson has put light on financial and economic appraisal of the projects and public sector investment. Social appraisal has also been taken into account.

4.7 Keywords

- **Financial Autonomy**- An organization's ability to decide freely on its internal financial affairs.
- **Financial Accountability**- Financial accountability results from holding an individual accountable for effectively performing a financial activity, such as a key control procedure within a financial transaction process.
- **Public Enterprises-** Those enterprises which are wholly or partly owned by the state and controlled through a public authority.
- **State Finance Commission**- A State Finance Commission reviews the financial position of the panchayats in a state and makes recommendations to the Governor.
- **Municipalities-** A city or town with its own local government, or the local government itself.

4.8 Self-Assessment Test

1. What is financial accountability? Explain the whole concept.
2. What do you understand by the term financial autonomy.
3. Give the importance and process of investment in Public Enterprises.
4. How has the growth of investment in Public Enterprises happened in India?
5. Give the constitutional status of state and local Governments.
6. Which steps are involved in economic evaluation?
7. What are the functions of local bodies in India?
8. What are the problems pertaining to financial autonomy and accountability in India? Give suggestions to overcome them.
9. What is the Role of Cost Benefit Analysis in Project Development? Give its Evaluation and Implementation.

4.9 Answers to Check Your Progress

1. Parliament, CAG, Media

2. Commercialization
3. Articles 12 and 14
4. Civic Services
5. Economic Capital Cost

4.10 References/ Suggested Readings

1. Schillemans, Thomas. (2013). The Public Accountability Review. A Meta-Analysis of Public Accountability Research in Six Academic Disciplines. Working Paper, Utrecht University School of Governance.
2. Smyth, Stewart. (2007). Public Accountability: A Critical Approach. 6.
3. Ahlin, Jesper (2018). The impossibility of reliably determining the authenticity of desires: implications for informed consent. _Medicine, Health Care and Philosophy_ 21 (1):43-50.
4. Halfdansdottir, Berglind ; Wilson, Margaret E. ; Hildingsson, Ingegerd ; Olafsdottir, Olof A. ; Smarason, Alexander Kr &Sveinsdottir, Herdis (2015). Autonomy in place of birth: a concept analysis. _Medicine, Health Care and Philosophy_ 18 (4):591-600.
5. Bandyopadhyay, Simanti, "Performance Evaluation of Urban Local Governments: A Case for Indian Cities" (2012). ICEPP Working Papers. 70.
6. Bovens, &Goodin, &Schillemans, Thomas. (2014). The Oxford Handbook of Public Accountability.

Course: Public Finance	
Course Code: BCOM 506	**Author: Dr. Arora Gaurav Singh**
Lesson No. :05	**Vetter: Prof. Suresh Kumar Mittal**
EXPENDITURE TRENDS AND EXPENDITURE POLICY	

STRUCTURE

5.0 Learning Objectives

This lesson highlights the basic elements of public expenditure in India as a concept. It also explains the components of Public Expenditure along with the factors that influence it. It also discusses about the changing trends and patterns of public expenditure in India. Further, it has discussed about the changes introduced in Indian Budget in 2021.

After reading this lesson, the students will be able to-

- Understand the concept of Public Expenditure.
- Understand the factors that influence Public Expenditure.
- Understand the components of Public Expenditure.
- Understand various recommendations and changes in the budget.

5.1 Public Expenditure in India

The term "public expenditure" refers to money spent by the federal or state governments (e.g. central government, state governments, lower level governments like district office, grammepanchayat, etc.). These costs are incurred for the benefit of the general public and the smooth operation of government institutions. According to many schools of thought, public spending has varying levels of importance. In the 19th century, when laissez-faire policies were in place, the government's participation was minimal. The role of public spending as a tool for fiscal policy has grown throughout time as theories of public expenditure have evolved. When it comes to ensuring a fair distribution of wealth and a level playing field for all citizens, market mechanisms have fallen short. Because of this, governments throughout the world have a critical role to play in public spending.

Public expenditure has been rising steadily for decades now. The breadth of government actions includes national defense, police and internal security, education and health sector development, poverty alleviation initiatives and more. As we move on to examine the "trends in public expenditure in India," we'll quickly mention some of the more significant ones. Based on historical evidence, German economist Adolph Wagner (1883) devised a rule he dubbed the "law of ever growing governmental action" (studied primarily for Germany and some other countries). According to the legislation, the reach of government is always expanding due to three fundamental factors:

- A greater degree of economic growth;
- A higher level of state administrations and protective measures;
- Welfare functions. The various levels of government (e.g. central, state, and local) tend to expand both vigorously and broadly (i.e. vertically as well as horizontally).

Law and order, police, defense and other recurrent expenditures are referred to as "intense increase of spending" in this context. The term "excessive expenditure," on the other hand refers to projects like building new schools, hospitals, and other public infrastructure. It's worth noting that Peacock and Wiseman (1961) looked at the rise in UK public spending from 1890 to 1955. They came to the conclusion that public spending grows in a step-like way rather than smoothly and continuously. As a result of their research, they came up with three key hypotheses.

(i) The 'Displacement Effect Hypotheses' are the first that come to mind. According to this, an increase in tax income drives an increase in governmental spending. War, refugee inflowand other large-scale disturbances need increased government spending which in turn raises tax burdens for the general public. As a result, the previous low level of spending and taxation is raised to a new and greater level when such occurrences occur. As a result, the term "displacement impact" is appropriate.

(ii) The 'Inspection Effect Hypothesis' is the second one. Even when the big disruptions are finished, the economy does not return to its pre-disruption levels of expenditure and revenue because of the displacement impact. People's tolerance for greater taxes grows as time passes and as a result, the overall amount of expenditure and taxation rises. As a result of such significant and inevitable disruptions, the government (as well as the general public) are forced to address issues that were previously ignored.

(iii) The 'Concentration Effect Hypothesis' is the name given to the third hypothesis. At times of rapid development, the central government has a greater inclination to expand than the sub-national or local governments.

5.1.1 Factors of Influence on Public Expenditure

Public expenditure is influenced by a number of demographics, political, and public issues. The following is a list of them-

1. **Population Density-** One of the primary drivers of rising governmental spending is the world's rapidly expanding population. Large populations necessitate the creation of more schools, hospitals, roads and other public infrastructure than smaller populations necessitated by their lower populations. The government intervenes in population increase by enacting laws on family planning and building the infrastructure necessary to implement such policies.
2. **Development of Democracy**- When it comes to governance, democracy requires more money because of the way it is set up. Maintaining the political institutions is an ongoing process. Among other things, elections would have to be held on a regular basis at all levels of government. As a result, countries with democratic systems of administration always have greater levels of government spending. Local leaders will also be more receptive to the needs of their constituents in order to boost their prospects of re-election. All jurisdictions need to establish large-scale 'public goods' which require continuous funding for their upkeep (known as non-plan or revenue expenditure). As a result, the political and governmental system of a country always plays an important role in large-scale public expenditure.
3. **The Welfare State**- State spending on individuals and the community was largely ignored during laissez-faire policies in the 19th century when the state was referred to be a "police state." Neglected were the numerous benefits of increased public spending, such as increased output and employment, decreased inequality of income and so on. The concept of a "modern state" has developed over the course of several decades. There was a shift in thinking from "police state" to "welfare state," where the emphasis is on welfare-related measures to improve the lives of the most disadvantaged citizens. For example, the government would have to have a stronger role in creating jobs, social security measures and other welfare-related infrastructure. To ensure full employment of the jobless peoplethe "theory of public expenditure" acknowledged the market mechanism's distortions. Because of these and other considerations as well as an increasing concern for the general welfare of the populace the amount of public funds used has skyrocketed throughout time.

4. **Defense Expenditure**-In today's world, every government is concerned about protecting its borders. The risk of warfare necessitates those nations arm themselves. This, in turn, necessitates a large-scale public investment in their military capabilities. An increase in government and administration: It takes a lot of money from the government to put up a large-scale administrative structure. Decentralized governance systems are more common in nations with broad geographic areas (e.g. Canada, Australia, India). A large-scale police and public services apparatus is needed in every part of the country to maintain internal security, public administration, the public sector and other functions of the government.
5. **Alleviation of Poverty**-Chronically poor countries have to spend a lot of money on poverty alleviation programmes in order to get out of the hole they're in. India and other developing nations rely significantly on public programmes to enhance the well-being of its poorest citizens in order to lift them up to participate and profit from the country's mainstream growth.
6. **Urbanization**-Expanding public services in urban areas is a need for countries with a big and expanding urban population (such as establishment of better-quality schools, drainage system, hospitals, drinking water facilities, better law and order condition in the society, etc.).
7. **Income Re-distribution-**There are policies that collect taxes in wealthy states and spend them in impoverished ones, resulting in the transfer of revenue. Income Re-distribution: For example, the government collects taxes from wealthy districts, with some of the money going toward the development of impoverished places. As a result of their lower degree of development, certain areas are unable to raise enough money on their own. Therefore, under a federal setup, the scope of governmental expenditures is broad.

5.1.2 Trends in Public Expenditure

An Indian quasi-federal structure specifies three characteristics for the various levels of government:

1. Functional responsibilities are divided between 29 States and 7 Union Territories; each state has its own revenue sources; and each territory has a system for inter-governmental fiscal transfers. All of these duties are critical to ensuring a stable fiscal climate not just at the central level but also at the local level.
2. Expansion of Expenditure in States and the Center: The Union list and the State list detail the expenditure areas of the federal and state governmentsrespectively. Among the Union list's

many responsibilities are defense, macroeconomic stability, banking and foreign trade. To sustain 'high employment, price stabilityand an adequate pace of economic growth', fiscal policy is used as a technique of stabilizing the macroeconomic element. Central government is also in charge of matters in which the advantages of public expenditures might be felt by many states (e.g. railways, defense, national highways, atomic energy, space, shipping and inland water ways). Maintaining public order, the agriculture sector, the health and sanitation of citizens are among the responsibilities of the state governments. Education, transportation, and social insurance are under the concurrent list of functions that fall under common authority. Thus, under the quasi-federal system of India, the majority of the powers are held by the central government, which has been bolstered by the central planning idea. However, because of the Indian economy's decentralized structure, a considerable part of aggregate expenditure in the economy is carried out at the sub-national level. As a result of this, a legitimate issue arises: What is the economic reason for the use of public funds by state governments? The government's primary responsibility is to produce and distribute commodities and services. By providing public goods in a variety of ways, the government's primary goal is to meet varied needs across a wide range of demographics and socioeconomic groups. Schools and colleges are needed more in communities with a younger population than in those with a big elderly population, which necessitate more hospitals, old-age homes and social security pension-related legislation. With this in mind, Musgrave claimed that the state governments should bear the burden of spending in accordance with local demand. Local politicians, who are closer to their constituents, are better able to assess the demand for local public goods. Consequently, decentralization of public goods is considered as the ideal alternative since it can identify and meet the needs of public goods in different regions, resulting in maximum social welfare rather than a uniform public good being provided from a single location.

5.1.3 Changing Expenditure Patterns in India-

The British government's primary concerns before independence were national defense and civil administration. As a result, these services accounted for a significant portion of public spending. There is little doubt that both federal and state governments have focused on eradicating poverty since independence. In order to meet these goals, the role of public expenditure has changed throughout time in India's economic development.

Each 'five-year plan' has had a different structure and focus in order to meet the needs of the country at the time. As an example, under the first five-year plan (1951-56), agriculture was the government's primary concern, including irrigation and electricity development. More emphasis was placed on industrial growth, notably heavy and fundamental industries in the second five-year plan (1956-61). Poverty eradication and the development of self-sufficiency were the goals of the fifth five-year plan (1974-78). After 1980, the governmental debt skyrocketed, necessitating massive interest payments. As a result, initiatives to cut the deficit and stabilize growth were devised by the government. A macroeconomic stabilization program was consequently established by the government in July 1991. As a result, a new economic policy known as "liberalization, privatization, and globalization" began to open the economy. As a result, the eighth five-year plan (1992-1997) switched the emphasis of public spending to "removing infrastructural restrictions." A significant portion of the government's budget was spent on energy, transportation, and communications. During the ninth plan, the momentum remained strong (1997-2002). As a result, we can see how the government's goals influenced the rate of rise in Indian public spending.

Table 5.1- Percentage of Public Expenditure of Central and State Governments as GDP of India

Year	Central Government Expenditure	Combined State Governments Expenditure	Centre + State Governments Combined Expenditure
1991	16.6	16.0	26.5
1995	14.4	14.1	23.7
2000	14.8	15.4	25.2
2001	15.1	15.4	25.8

2010	15.1	14.6	26.6
2011	14.1	14.6	25.8
2015	13.1	18.7	27.7
2020	15.3	19.1	31.1

Note: Figures are percentage to GDP

Source- RBI and EPW Foundation

The RBI and the EPW Foundation are the sources of this information. India's post-independence mixed economy model places a premium on public spending because of its long-term significance. As a result, the government was given main responsibility for constructing the capital and infrastructure necessary to spur economic growth. For the federal government, public expenditure in India has decreased from 17 percent of GDP in 1991 to 13 percent in 2015. However, it further increased to 15.3 percent in 2020. There was a drop from 16 percent in 1991 for state governments, but a rise to 15 percent by 2011 for state governments. Public Expenditure,Combined for Centre and States decreased from 2011 to 2015, but states' expenditure climbed as a result of the 14th Finance Commission's decision to boost financial devolution to states from the centers' earnings [from 32% to 42%]. Between 1991 and 2011, the central government's share of overall expenditures (including those of the states) was around the same (26 percent); but, in 2015, that share climbed slightly to 28 percent and further to almost 32 percent in 2020. For the achievement of the Millennium Development Goals, education and health care are two of the most critical spending areas. Agriculture, transportation, and communication are other key areas where public spending should be increased. Because so much public spending goes into "interest payments," one major issue has been the steadily expanding debt burden. When it comes to solid public finance, it's a given that a high debt load will reduce the amount of money available for development spending. Governments of all levels need to keep a close eye on debt levels. Costs of revenue and costs of capital In India, the entire public expenditure is divided into two parts:

Revenue expenditure and Capital expenditure, according to the Union budget. The former entails a greater outlay of resources yet produces fewer results. Revenue expenditures include things like pensions, wages, subsidies and interest payments, among other things. It's necessary to incur them year after year because they don't result in new productive assets. On the other side, capital spending results in the production of assets. Investments in the formation of tangible or intangible capital assets (e.g. expenditure on purchase of land, buildings or machinery, expenditure on building schools and hospitals, government investment in shares or expenditure which reduces liabilities such as repayment of loan). A long-term investment, capital expenditure, is hence the norm. In all cases, the revenue expenditure is greater than the capital expenditure. As a matter of fact, this is despite government efforts to increase the proportion of capital spending to revenue spending. Before 1985, the central government's RE/CE ratio was close to 2. This showed that revenue expenditures accounted for roughly twice as much of overall spending as capital expenditures. After 1985, the discrepancy between RE and CE in the center grew to a maximum of 8% by 2009. This shows a steady decline in capital expenditures as a percentage of revenue expenditures. According to state government financial records (which were already over 2 in the 1970s), this trend has continued since 1980, culminating in a ratio of RE/CE of more than 5 in the year 2000. Since the amount of revenue spending is decreasing, this means that the share of capital expenditure is likewise decreasing across state governments.

Non-Plan Expenditure and Plan Expenditure- Plan and non-plan expenditures are subcategories of revenue and capital expenditures, respectively. Plan expenditures are the costs spent as a result of programs or initiatives outlined in five-year strategic plans. 'Central plans' on agriculture, irrigation projects, rural development, transportation, and communications, as well as 'central assistance' (i.e. grants) provided by the central government to the patterns of Public Expenditure in India 27 States and Union Territories for their development plans are included.Expenditures not included in the five-year plan are referred to as non-plan expenditures. These are expenses for things that are already committed in some way. As a result of the Plan/Non-Plan bifurcation of expenditure, a High-Level Expert Committee on Efficient Management of Public Expenditure (HLEC, 2011) found, budget allocation has become fragmented, making it difficult to estimate delivery costs and to relate budget allocation to outcomes. It has also been noted that 'out of overall cost, only 30% is spent on the plan'. The HLEC has held that the division of government expenditure into development and non-development does not provide a clear picture of the development and non-development characteristics since the result of a scheme depends on total expenditure and not just plan expenditure. Because of this, it has proposed that budget classifications be removed from both the national and state budgets.

5.2 Budget: An Introduction

Definition- It is stated in Article 112 of the Indian Constitution that the annual financial statement or the Union Budget is a declaration of the government's anticipated revenue and spending for the ensuing year.

The Union Budget is the government's financial statement for the fiscal year, which begins on April 1 and ends on March 31. Revenue and capital budgets make up the bulk of the federal government's budget.

In the revenue budget, the government's revenues and expenditures are taken into account. Revenue is divided into two categories: tax and non-tax. The government's revenue expenditure is the money spent on the day-to-day operations of the government and on numerous public services. As a result of government spending exceeding revenues, the government has a deficit.The government's capital expenditures and revenues are included in the government's capital budget. A large portion of the government's capital revenues come from loans from the public, foreign governments, and the RBI. Equipment, machinery, buildings, health care, and educational facilities are examples of capital expenditures. When the government spends more than it receives, it has a fiscal deficit.

5.2.1 Committee Report on Introduced Reforms in the Budget(2021-22)

In March 2021, the Estimates Committee of the Parliament (chaired by GirishBhalchandraBapat) released a report titled "Recent Budgetary Reforms for Better Management of Government Expenditure." Central and state governments' finances were examined by the Committee in light of several central government budgetary measures. Following reforms have been introduced in the Union Budget 2021-22:

- The presentation of the union budget on February 1 instead of late February.
- The merging of plan and non-plan spending in the budget, and
- Integration of the rail budget with general expenditure.

5.2.2 Suggestions for Reforms in Union Budget

Highlights of the Committee's findings and recommendations include the following:

1. **Mention of State Wise Allocation of Funds**:Union Budget at a Glance gives an overview of the budget including the allocation for main central government program, according to the Committee. This document however, does not include the allocation of monies to other states. According to the Committee, many individuals want to know how much money the central government allocates to each state. Because of this, the average citizen has no idea how much money is coming from the state government and how much money is coming from New Delhi. For the sake of openness, the Committee urged the central government to provide state-by-state allocation data in the union budget materials.
2. **Readability of Budget**:It was pointed out by the Committee that the union budget documents are so lengthy that the average person and elected officials just do not have the time to read through and comprehend them all. Members of Parliament should be briefed on the specifics of the budget documents soon following the presentation of the budget in LokSabha, the Committee advised.
3. **Unspent Balances of States in Bank Accounts**:Funds given to states by the federal government are held in state treasuries until they are disbursed to the appropriate implementing agencies, according to the Committee. As a result of this practice, some state governments are able to generate a significant amount of interest on the remainder of their grants and programs. The Committee proposed that the central government identify the interest earned by various states on such unspent balances in banks and establish criteria (if necessary) for the appropriation of the funds gained by them, if they exist.
4. **Advancement of the Budget Cycle**: The Committee noted that the Appropriation Bill was adopted by Parliament before to the start of the fiscal year in 2017-18, when the Union Budget Cycle began. States have time to design and propose their budgets in line with Union budgets, as the whole budget is accessible to the Ministries at the beginning of the year. The rate of central government spending in the first three months of fiscal year 2017-18 increased, according to the Committee. There was, however, a significant slowdown in spending in 2018-19. The Committee urged the Department of Economic Affairs (DEA) to investigate the causes of the slowdown in 2018-19 spending and take remedial measures.

5. **Underspending**:The Committee noticed that the DEA undertakes a mid-year assessment of all Ministries' expenditures and revises their spending ceilings for the year depending on the progress of expenditure thus far and their capacity to spend in the remaining year. However, despite the progress in budget cycles, savings were found in 99 departments in 2017-18, 97 in 2018-19, and 100 in 2019-20 (i.e., underspending or under-utilizing allocations). Consequently, the Committee suggested that this tendency be stopped and the monies allocated to the government in the union budget are utilized to their fullest potential.
6. **Monitoring the Implementation of the Schemes**: Because a Secretary of a Ministry/Department serves as the department's Chief Accounting Officer, he or she is responsible for overseeing project and program progress. In any event, the Committee highlighted that the Secretary of the DEA, as the main controller of the central government's accounts is also responsible for overseeing all of the initiatives and programs of the various Ministries and Departments. That system should be put in place to track the progress of Ministries/Departments on projects and schemes, so that chronic defaulters who haven't updated the progress may be discovered when distributing the funding.

5.2.3 Trends in Railway Finances

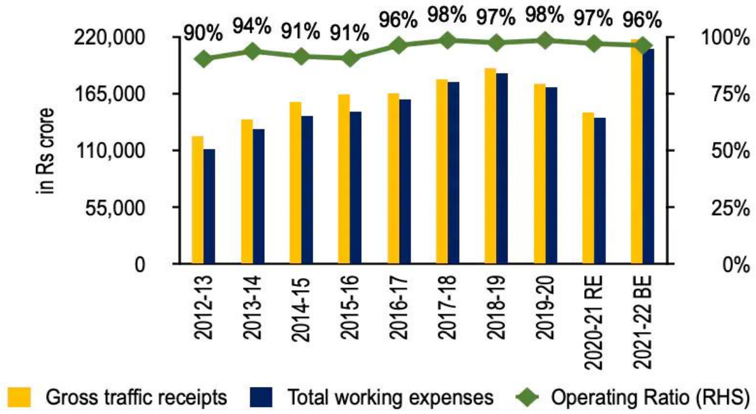
Railways has been trying to earn its own money for the previous few years. Earnings from running freight and passenger trains have been dropping in recent years. Due to a decrease in both freight and passenger traffic increase, this has occurred. There has been a steady decline in rail traffic share over the last few decades. As of 2020, rail freight traffic is expected to account for just 27% of overall freight volume. NITI Aayog (2018) stated that the drop in freight share was due to a lack of capacity and a lack of pricing competitiveness.

As a result of cross-subsidizing its passenger operations, the Railways' freight prices are high. There were losses of Rs 46,025 crore in passenger and coach services during the financial year 2017-18, whilst freight generated a profit of Rs 45,923. As a result, all of the profits from freight operations were used to compensate for the losses incurred by passenger and other bus services. Total passenger revenue in this period was Rs 48,643 crore. This means that 95% of the company's revenue was lost in the passenger industry. As a result, in 2017-18, Indian Railways spent Rs 1.95 for every penny it generated from passenger service.

Due to Pay Commission adjustments, the cost of pay for the Railways has been steadily rising over the past few years. In addition, the Railways are spending more money on pensions, which is a waste of money because it doesn't create any income. Over the next two years, the Railways are expected to spend Rs 93,676 crore on salaries and benefits for its employees, an increase of 4 percent compared to 2019-20's figures. As many as 40 percent of the Railways workforce was over the age of 50 in 2016-17, which might lead to an increase in the pension expense.

Due to diminishing revenue production and increasing revenue spending, the transporter's operating surplus has decreased. Operating ratio (ratio of working expense to traffic income) has continuously remained above 90% for the previous many years.

Figure 1: Operating Ratio

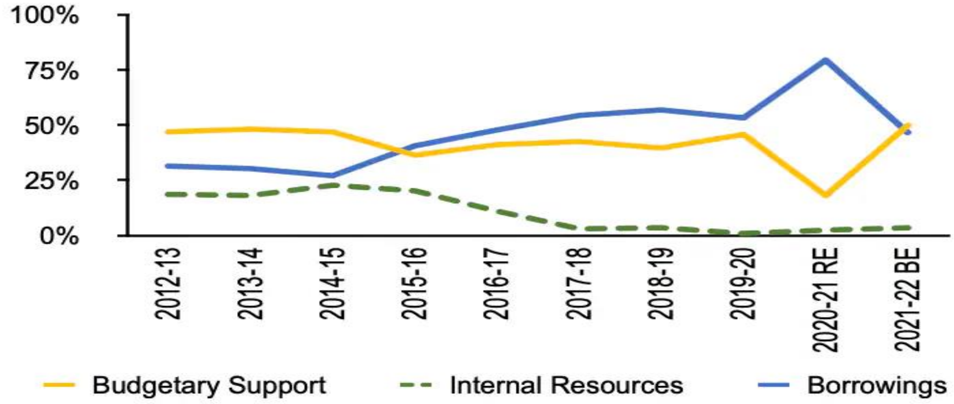


Sources: Expenditure Profile, Union Budget Documents; PRS.

As a result, Railways has had to rely on borrowing and financial support from the federal government to pay for its capital expenditures. Until recently, the federal government's fiscal assistance for Railways' capital expenditures was the principal source of funding. There has been a growing amount of extra-budgetary funding for capital expenditures since the 2015-16 fiscal year (or borrowings). Borrowings might worsen the financial status of the Railways by increasing their dependence.

Extra-budgetary funds covered 53% of capital expenditures in 2019-20. Extra-budgetary resources are expected to raise Rs 1,00,258 crore in 2021-22, while the federal government's budgetary contribution is expected to be Rs 1,07,300 crore.

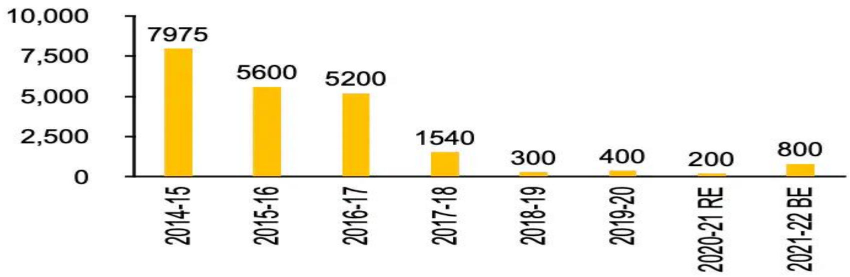
Figure 2: Source of funds - capital expenditure



Note: RE – Revised Estimates, BE – Budget Estimates.
Sources: Expenditure Profile, Union Budget 2021-22; PRS.

As a result of a lack of funding, Railways is unable to invest in several of its main funds. When new assets are purchased to replace old ones, the Depreciation Reserve Fund (DRF) is used to cover the cost of those purchases. In 2021-22, the DRF is expected to get an allocation of Rs 800 crore. A decrease in DRF funding has occurred over the past few years. This fund was predicted to have Rs 96,403 crore in over-aged asset replacements by the end of 2018-19 by CAG (2020).

Figure 3: Appropriation to DRF (in Rs crore)



Source: Expenditure Profile; Union Budget Documents; PRS.

It has been observed by the Ministry of Railways that the fall in appropriation to DRF is due to a large portion of renewal and replacement works with safety implications being sponsored through the Rashtriya Rail SanrakshaKosh (RRSK). All three years from 2018-19 to 2020-21, however, the actual appropriation to RRSK was less than the required amount. The Railways had set out Rs 5,000 crore for RRSK in 2021-22.

5.3 Check Your Progress

1. The term ………… refers to money spent by the federal or state governments.

2. According to the ………………. an increase in tax income drives an increase in governmental spending.

3. In March 2021, the ………………………(chaired by GirishBhalchandraBapat) released a report titled "Recent Budgetary Reforms for Better Management of Government Expenditure.

4. Under the first five-year plan (1951-56), …………was the government's primary concern, including irrigation and electricity development.

5.4 Summary

This can be summarized that this lesson has successfully dealt with the concept of Public Expenditure. It has also talked about the changing trends of Public Expenditure in India as per the requisites of the five- year plans. Further, the required changes andsuggestions have been discussed for better understanding.

The Union Budget is the government's financial statement for the fiscal year, which begins on April 1 and ends on March 31. Revenue and capital budgets make up the bulk of the federal government's budget.In the revenue budget, the government's revenues and expenditures are taken into account. Revenue is divided into two categories: tax and non-tax. The government's revenue expenditure is the money spent on the day-to-day operations of the government and on numerous public services.

5.5 Keywords

- **Public Expenditure-** Public expenditure is spending made by the government of a country on collective needs and wants such as pension, provisions security, infrastructure, etc.

- **Plan Expenditure-**Plan expenditure is that component of government expenses which helps increase the productive capacity in the economy. It includes outlays for different sectors, such as rural development and education.
- **Non-Plan Expenditure**- Non-plan expenditure is what the government spends on the so-called non-productive areas and is mostly obligatory in nature. It includes salaries, subsidies, loans and interest.
- **Revenue Expenditure**- Revenue expenditures are short-term expenses used in the current period or typically within one year.
- **Capital Expenditure-** Capital expenditure is the money spent by the government on the development of machinery, equipment, building, health facilities, education, etc. It also includes the expenditure incurred on acquiring fixed assets like land and investment by the government that gives profits or dividend in future.

5.6 Self -Assessment Test

1. What is Public Expenditure?

2. Explain various types of Public Expenditure.

3. What are the factors that influence Public Expenditure in India?

4. What have been the trends in Public Expenditure in India?

5. Comment on the changing public expenditure patterns in India.

6. Explain the Committee Report on Introduced Reforms in the Budget.

5.7 Answers to Check Your Progress

1. Public Expenditure
2. 'Displacement Effect Hypotheses'
3. Estimates Committee of the Parliament

4. Agriculture

5.8 References/ Suggested Readings

1. Yun, Wong. (2020). Assessment of public expenditure efficiency: a review. Journal of economics and sustainability. 2. 27-38. 10.32890/jes2020.2.2.3.
2. Kumar, Ravindra& Mishra, Kushendra. (2019). Analytical study of Public Expenditure and Economic Development in India: A Global Vision. 22. 3029-3035.

Course: Public Finance	
Course Code: BCOM 506	Author: Dr. AroraGaurav Singh
Lesson No. :06	Vetter: Prof. Suresh Kumar Mittal

PUBLIC DEBT AND EXPENDITURE: DEBT MANAGEMENT; PUBLIC EXPENDITURE AND PUBLIC BUDGET

STRUCTURE

6.0 Learning Objectives

This lesson has introduces the concept of public debt and its management. It further throws light on Public expenditure and Public Budget as well. After going through this, the student will be able to learn the following things-

- What is Public Debt and what are the various ways to raise it.
- How this Public Debt can be managed by the Government so that fiscal can be controlled.
- The concepts of Public Expenditure
- Budget and its types.

6.1 Introduction

Public Debt means borrowing money by the government of a country from private persons and groups of individuals, from banks and non-bank financial institutions (NBFIs).

6.1.1 Classification of Public Debt

The Public Debt can be classified into following forms:

1. **Internal and External Public Debt**- It is common for states to borrow money from individuals and financial institutions in their own nation when revenue is no longer sufficient.Short-term or long-term loans, or both, can be used to raise money for the state. All of the nation's savings can be borrowed if the state is in a severe situation. There will be no money left to support commerce and industry as a result. However, in the usual era, the state can only borrow money that is left over from the businesspeople after completing all of the company's requirements.

International money markets, other countries' governments and international organizations like the International Monetary Fund are examples of external lenders. It is common for a state to seek out loans from other states when it is short on funds. There is a limit to the amount of money that foreign governments can lend. They carefully examine the borrowing country's financial situation, tax-bearing ability, per-capita income and the intended use of the loan. To lend a large amount of money, a foreign government must be confident in its financial situation and the country's ability to collect taxes.

2. **Productive and Unproductive Debt**- Debt that is projected to produce assets that will generate enough revenue to cover the principal and interest on the debt is referred to as 'productive debt'. To put it another way, they are supposed to pay for themselves; they are self-liquidating. Such debt has been dubbed as "Reproductive Debt" by J.L. Hans. When a company raises money for unproductive assets or high unproductive spending, it is considered to have "unproductive debt." Such a debt is a waste of time and resources. War or the prevention of war is a deadweight debt that must be paid.
3. **Short Term Loans and Long-Term Loans**- There are two types of loans: "short-term loans," which have repayment terms of one year or less, and "long-term loans," which have repayment terms of one year or more. Short-term loans are needed for the following reasons:
    - Short-term borrowing is used if the government's spending needs exceed its revenue. As soon as the market interest rate rises over a certain level, the government takes out a short-term loan and waits for the interest rate to fall before borrowing more money to finance its different initiatives. They see a secure and lucrative chance to invest their spare cash in government short-term loans.
    - Long-term borrowing is used when short-term loans are insufficient to meet the government's financial needs. The following benefits are associated with long-term loans:

    1. Long-term loans allow the state to undertake huge projects like the construction of canals, hydroelectric projects and other structures and roads. The government may comfortably spend these loans since they are not expected to be returned in a timely manner.
    2. Long-term loans are also a necessity for enhancing a country's defence capabilities.
    3. Investment opportunities in long-term loans are attractive to commercial banks and insurance organizations. Because long-term interest rates are greater than short-term interest rates.

4. Because of this, it is possible for the government to pay back long-term loans at a time suitable to her. These loans can also be repaid at a cheaper interest rate in the future.
5. When interest rates are low, the government has the option of taking out a long-term loan and using the money to carry out public works projects at a reduced price.

6.1.2 Causes of Increase in Public Debt

- War or preparation for war, especially nuclear programmes.
- To cover the current account deficits in order to reduce the budget deficits.
- To carry out public-benefit projects
- Demand for economic expansion
- Public sector inefficiencies and corruption.

6.1.3 Purpose of Public Debt

- Temporary loans from the central bank can be used to bridge the gap between revenues and expenditures. In Pakistan, the government issues "Treasury Bills" that must be repaid within one year after being issued.
- To alleviate the economic downturn and fund the government's public works programme.
- By taking away the public's purchasing power, inflation may be controlled.
- Financing economic growth, particularly in developing nations, is a fourth priority.
- Investing in the public sector in order to help public companies grow and thrive.
- The finance of war, weaponry, and ammunition

6.1.4 Methods of Debt Redemption

Various Debt Repayment Options are as following:

1. **Utilization of Surplus Revenue**- This is a dated approach that has no place in today's business environment. Having a surplus in one's budget is rare. It is impossible to reduce the national debt even if the government has a surplus.
2. **Purchase of Government Bonds**- The government has the option to buy back its own shares on the market, thereby eliminating its obligation to the extent of that purchase. In some cases, this

might be done by utilizing extra funds or borrowing at cheap rates, depending on the circumstances

3. **Terminable Annuities-** It is possible to plan to pay the creditors a certain sum over a number of years in order to totally wipe off a long-term debt. An annuity is a type of yearly payout. As these annuities are paid, the government's finances will be under a lot more strain than they would be if simply interest had to be paid.

4. **Conversion of high Interest Rated loans to low interest rated loans-** A government may have taken out a large loan at a high interest rate and then converted it into a low-interest loan. A high-rated loan can be converted into a low-rated one if the interest rate reduces.

5. **Sinking Fund-** In the end, the sinking fund is the most crucial approach. Every year, a fixed amount of money is set aside from the existing earnings for the repayment of all loans. In other words, the amount to be set aside is calculated in such a way that the total amount amassed over time, along with the interest, is sufficient to pay off the loan.

6.1.5 Burden of Public Debt

As long as the debt is used for beneficial reasons (e.g. to irrigate crops or build roads), it will not be a burden. If the debt is unproductive, it will have both a financial and an economic impact on the country.

1. **Burden of Internal Debt-** There are two types of internal debt i.e., debt that is owed by an individual to the government and debt that is owed by a group of individuals to the government. Thus, money is shifted from one part of the society to another. There is no financial load on the economy in this situation. However, it might be a significant financial strain on the community. The government must raise taxes in order to pay interest and the principal amount of the debt. Lenders get what taxpayers pay them. Lenders tend to be wealthy individuals and indirect taxes tend to be levied disproportionately on the poor. Wealth may be moved from the poor to the wealthy as a result of this policy.
2. **Burden of External Debt-** A series of transfers of wealth are made from the foreign lender to the borrowing country and back again when the debt is repaid. The entire community bears the financial burden of the borrowing country's interest payments to the foreign lenders. The true

burden of foreign debt is also weighing heavily on the community. In order to pay off the foreign lender's debts, the government will have to tax the citizens severely. It has a negative impact on the production of income, consumption and distribution. As a result, the foreign lender has a direct impact on the country's economic development.

6.1.6 Role of Public Debt in Developing Economies

The Importance of Public Debt in a growing economy:

1. Taxation should cover at least the current expenditure on basic government services, and borrowing should be used to support government expenditure that results in the building of long-term capital assets. Because productive investment requires public borrowing, it creates more economic output.
2. It is utilized as a means of mobilizing resources that might otherwise be held in real estate and jewellery.
3. Government bonds are a safe and stable kind of income-yielding asset that may be held by the public
4. Interest rates are influenced by the management of governmental debt
5. The public is now a major tool for developing monetary policies.
6. The government of a developing country raises funds through public loans in two different ways:
   a) Market Borrowing- Long-term and short-term government bonds and treasury bills sold to the public in the capital market
   b) Non- Market Borrowing- The issuing of debt to the public that cannot be traded or exchanged in the capital market, such as National Savings Certificates.
7. In terms of loans, there are two types: voluntary and coerced. Compulsory borrowing or forced loans are a middle ground between taxes and borrowing. As with taxes, it is a mandatory contribution to the government, but repayment is required, and interest is charged on all loans.

6.1.7 Difficulties in Public Borrowing in Under Developed Countries (UDCs)

1. The organized capital and money markets in UDCs do not exist or are extremely tiny. The economy's capital requirements can't be met with the available resources.

2. Real estate and jewelryfor exampleare an example of a non-productive sector of the economy that is hoarding resources.
3. A lack of monetary movement in rural regions makes it impossible to properly mobilize rural savings.
4. Prices for government assets are also risingwhich makes people less interested.

6.1.8 Effects of Public Debt on Production, Consumption, Distribution and Level of Income and Employment

1. **Effects on Production**: Public debts are raised to finance productive enterprises of various kinds, e.g., steel works, cement, multipurpose projects, construction of ships, railway lines and highways, heavy electrical and engineering works, mining, oil refining, etc.
2. **Effects on Consumption**: When people subscribe to government loans, they generally have to curtail consumption. Since investment of funds raised by borrowing raises the level of employment and as a result raises the level of consumption.
3. **Effects on Distribution**: Public loans transfer money from rich to government. The fiscal operations of the government are to benefit the poor primarily. The incomes of the poor increase directly through increased employment or it benefits them in directly through the enlargement of social services.
4. **Effects on the Level of Income and Employment**: In modern times, public borrowing is resorted to in order to raise funds for financing agriculture, industry, mining, transportation, communication, etc. It increases employment opportunities, the level of income and standardof living.
   i) **Deadweight Debt-** Debts that are not backed by any tangible assets are known as "deadweight debts". To put it simply, "Deadweight is that which incurred in the consequences of expenditures which in no manner boost the creative potential of the society, providing neither money revenue nor a future flow or utilities." Wartime loans are considered deadweight debts since there are no assets to pay them off.
   ii) **Passive Debt-** A second type of debt is known as "passive debt," which is when the government takes out loans to spend on initiatives that do not generate any money or benefit

the economy. Public Parks, museumsand other people facilities are just there to entertain the public.

iii) **Active Debt-** If a project directly contributes to a community's ability to generate income and increase its productive capacity, it is considered an active debt.

6.2 Public Debt Management

Setting up and carrying out an effective strategy for raising funds for the government at the lowest feasible cost over the medium and long term, while maintaining a reasonable degree of risk, is the goal of public debt management. Additional public debt management objectives, such as creating and maintaining an efficient market for government securitiesshould be met under this plan. Macroeconomically, governments should aim to keep public debt growth at a manageable pace and ensuring that the debt can be paid under a variety of conditions, including economic and financial market stress, while still achieving their desired costs and risks. In spite of the fact that the fiscal and monetary policy authorities are responsible for adhering to debt limitations and completing debt sustainability analyses, public debt managers should share their concern that public sector borrowing continues to be sustainable. Government financing requirements and debt levels affect borrowing costs and debt managers should make sure that fiscal authorities are aware of this. The public sector debt service ratio and the ratios of public debt to GDP, exports, and tax income are examples of metrics that address the issue of debt sustainability. A wide range of circumstances should be taken into account while evaluating such indicators. Every government has to make decisions on how much risk it is willing to takewhich areas of the government's balance sheet debt managers should be accountable for, and how to manage the government's contingent liabilities. There is increasing agreement on sensible public debt management techniques on several of these challenges.

That can also lower the risk of financial shocks and contagion. Among these are recognizing the advantages of having clear debt management objectives, weighing risks against costs, separating debt management objectives and accountability (in conjunction with consultation and information sharing between the debt manager and the central bank), and managing refinancing and market risks and interest costs of debt burdens carefully. Finally, there is a requirement to carefully manage debt burdens and their associated costs.

Some of the most common causes of economic crisis have been poorly constructed debt portfolios in terms of duration, currency, or interest rate composition as well as excessive contingent liabilities. Regardless of the current exchange rate regime, for example, regardless of whether the debt is local or foreign currency, crises have often been caused by governments focusing too much on prospective cost cuts. Debt with a short term or floating interest rate Large-scale issuance of these debt instruments has resulted in when the country's creditworthiness deteriorated, it left government finances vulnerable to fluctuations in economic and financial market circumstances. It is imperative that this obligation be repaid. the use of too much risky for foreign currency debt is the fact that it might fluctuate in value. Monetary and/or exchange rate pressures if they occur investors grow wary about refinancing the government's debt because of a lack of interest. Delaying or preventing a default on the government's own debts.

Contingency liability management and effective government debt management can reduce a country's susceptibility to financial risk and contagion. When it comes to dealing with financial crises, the government is better equipped to handle them if its debt portfolio is more resilient.

Due to the fact that a government's debt portfolio is generally the country's largest financial portfolio, sound risk management methods are needed because of the complexity and riskiness of the financial structures that make up the debt portfolio. It is equally critical for private sector risk management to have sound risk management from the government. Governments may decrease their exposure to interest rate, currency, refinancing, and other risks by implementing sound debt frameworks. To support these arrangements, many governments set objectives and ranges for key risk indicators or target portfolios relating to the intended currency composition, duration, and maturity structure of the debt in order to direct borrowing and other debt operations. Targets made public can assist to improve the predictability and openness of the system, helps investors by decreasing the level of uncertainty around debt management activities.

Debt crises have brought to light the necessity of efficient and liquid domestic capital markets and solid debt management methods. Government debt management policies may not have been sole or even the primary cause of these crises, but the maturity structure and interest rate and currency composition of the government's debt portfolio, along with substantial obligations in respect of explicit and implicit contingent liabilities—not least in relation to the financial sector—have contributed to the severity of these crises. Even if macroeconomic policy settings are sound, hazardous debt management practices raise the economy's vulnerability to economic and financial shocks. A simple adjustment in borrowing maturities and debt servicing costs may be all that is needed to mitigate these risks, as well as a change in the composition and age of foreign currency reserves. Additionally, governments must verify that they are adhering to transparent and good fiscal and budget management practices by reviewing criteria and governance systems related to contingent liabilities.

6.3 Public Expenditure

There are three types of government spending i.e. central, state, and local. The term "public expenditure" refers to these three types of government spending. Both the governments and society as a whole gain from these kinds of expenditures.

An intellectual notion in the eighteenth century was that public spending was a waste of time and money. Public expenditures should be maintained to a minimum as much as possible. In the twentieth century, especially after the Second World War, this type of conservative thought faded. The scope of the government's operations has broadened as a contemporary state is referred to as a "welfare state." As a result, even in capitalist nations where the laissez-faire principle is in effect, we can now explain why public spending has increased so dramatically over the world.

6.3.1 Factors Contributing to a rise in Public Expenditure

(a) **Size of the country and its Population Density**: Nearly every country's territory has become larger. The contemporary government's actions can even be found in no-man’s land. Assuming a country's size remains constant, population growth in the developing world has been extraordinarily rapid. Government spending on defense, police, and the courts have risen in tandem with the increase of administrative activity.

(b) **Military Expenditure**: Threats of conflict have led to a massive increase in government spending. In the second part of the twentieth century, there have been no major conflicts. However, the prospect of conflict has not gone away; rather, it is still very much present. As a result, a higher portion of the nation's budget must be devoted to preparing for the possibility of a military conflict.

(c) **Social Security**: A 'police state' of the 19th century has been replaced by a "welfare state" of the 20th and 21st centuries. Capitalism does not mean abandoning all socialistic ideals. Since socialism is widely accepted in this country, current administrations have taken a public stance in favor of the well-being of the general populace. People's well-being is promoted through a variety of socio-economic programs. There is a lot of money spent by modern governments to promote economic growth. Products and services are produced as a result. The government provides funding for this type of initiative. There has been a remarkable increase in the number of welfare activities as well. For the provision of different social security benefits, it incurs financial obligations. The government have significant attention to social areas including health, education, and so forth. For example, it provides transportation, powerand other forms of economic infrastructure. All of this necessitates a significant financial investment. Modern governments are the only source of funding for these initiatives since they demand a large number of money. However, the political leaders (Ministers, MPs, and MLAs for political mileage, as well as bureaucrat shape and influence many of the government's social programs.

(d) **Development of the Economy**- The importance of modern government in molding an economy is enormous. It is impossible for private capitalists to finance the growth of a country's economy. Modern governments have taken advantage of the private sector's inability to invest in many industries in order to spur economic growth. The availability of economic infrastructure has a significant impact on the pace of economic growth. In order to strengthen an economy's structure, it is necessary to build up its economic infrastructure. The government, of course, has to spend money to pay for these initiatives.

(e) **Price Rise**- As a result of the price increase, inflationary pricing rises are frequently blamed for a surge in government spending.

6.3.2 Types of Public Expenditure

1. Developmental and Non-Developmental Expenditures: A useful classification of public expenditure rests on whether a particular expenditure by the Government promotes development. All those expenditures of Government which promote economic growth are called developmental expenditure.Expenditure on irrigation projects, flood control measures, transport and communication, capital formation in agricultural and industrial sectors are described as developmental. On the other hand, expenditure on defence, civil administration (i.e., police, jails and judiciary), interest on public debt etc., are put into the category of non-development expenditure.It may be noted that, till recently, expenditure on education and health were regarded as non-developmental type. It has now been realised that the expenditure on education and public health promotes the growth of what is called human capital which promotes economic growth as much as physical capital, if not more. Therefore, these days, expenditure on education, research and health are generally regarded as developmental expenditure.It is worth noting that division of Government expenditure into developmental or non-developmental is the modern counterpart of the distinction drawn by classical economists between productive and unproductive public expenditure, which has been a subject of great controversy.For instance, it has been pointed out that even Government expenditure on defence and civil administration helps to maintain conditions in which productive activity can be carried out. It is, therefore, claimed by some that indirectly, expenditure on defence and civil administration is also productive.Thus, we see that what Government expenditure is developmental or productive and what non-developmental or unproductive is not based on any objective or fool-proof criteria and is therefore somewhat arbitrary.

2. **Revenue and Capital expenditure-** Public expenditure has been classified into various categories. Firstly, Government expenditure has been classified into revenue expenditure and capital expenditure. Revenue expenditure is a current or consumption expenditure incurred on civil administration (i.e., police, jails and judiciary), defence forces, public health and education.

This revenue expenditure is of recurrent type which is incurred year after year. On the other hand, capital expenditure is incurred on building durable assets. It is a non-recurring type of expenditure. Expenditure incurred on building multipurpose river projects, highways, steel plants etc., and buying machinery and equipment is regarded as capital expenditure.

Transfer Payments and Expenditure on Goods and Services. Another useful classification of public expenditure divides it into transfer payments and non-transfer payments. Transfer payments refer to those kinds of expenditure against which there is no corresponding transfer of real resources (i.e., goods and services) to the Government.

Expenditure incurred on old-age pensions, unemployment allowance, sickness benefits, interest on public debt during a year etc., are examples of transfer payments because the Government does not get any service or goods against them in the particular year.

On the other hand, expenditure incurred on buying or using goods and services is a non-transfer payment as against such an expenditure, the Government receives goods or services. It is therefore called expenditure on goods and services. It may be noted that expenditure on defence, education, health etc., are non-transfer expenditure as in return for these, Government obtains the services of army personnel, teachers, doctors etc., as well as some goods or equipment's used in these activities.

Investments expenditure is undoubtedly non-transfer expenditure as through it Government obtains capital goods. It is worthwhile to mention that whereas in case of transfer payments, it is the beneficiaries that decides about the use of resources, in the case of non-transferable type of expenditure, the Government itself decides about the use of real resources, especially whether they are to be used for consumption or investment purposes.

3.**Plan and Non-PlanPublic Expenditure**-Plan expenditure pertains to the money set aside for productive purposes like various projects of ministries. It is spent on productive asset creation through Centrally-sponsored programmes and flagship schemes.Non-plan expenditure is what the government spends on the so-called non-productive areas and is mostly obligatory in nature. It includes salaries, subsidies, loans and interest. However, Government of India has abolished this type of Public Expenditure since 2016.

Findlay Shirras has laid down the following four canons of public expenditure:

(i) Canon of benefit

(ii) Canon of economy

(iii) Canon of sanction

(iv) Canon of surplus

1. **Canon of Benefit**- It is imperative that public expenditure be done in a way that maximises the advantages to society, according to the Canon of Benefit. To put it another way, public funds should not be used to benefit a specific subset of citizens. As a result, public money should be

invested in areas where the whole population benefits, rather than specialised advantages. However, in many cases, public funds are used to benefit a specific group (say, dalits, tribals). The canon of benefit does not apply to this type of governmental spending. Investing public funds in a backward area is good for the community's well-being.

2. **Canon of Economy**- In the Canon of Economy, economy does not equal being stingy. Wasteful and exorbitant spending is what it alludes to. Spending public money must be done in a way that maximises its value and efficiency. Public spending efficiency necessitates a reduction in expenses. The canon of economics must be respected in order to get the most advantage from any public expenditure initiative.The growth of the productive sectors would be stifled if the government spends more money than it earns. Consequently, the social benefit is reduced. Accordingly, the canon of utility and economics are inextricably intertwined.
3. **Canon of Sanctions**- In accordance with the canon of sanction, as proposed by Shirras, it is forbidden to spend public funds without the approval of an authorised authority. Only if expenditure is approved can arbitrary spending be prevented. It is also impossible to guarantee public expenditure efficiency if it is not sanctioned.
4. **Canons of Surplus-** This canon advocates avoiding a public-sector deficit. Saving is a virtue for the government as well, just as it is for people. In order for the government to have a surplus, it must plan its budget such that government revenue surpasses the government's expenditures. Expenditures cannot be covered by a deficit. Shirras' fourth canon—the canon of surplus—is not considered important by current economics. Deficit financing, according to them, is the best way to fund government economic programmes.

6.3.3 Importance of Public Expenditure

"The very best of all plans of finance is to spend little, and the finest of all taxes is that which is least in quantity," according to an old-fashioned aphorism. This theory has no adherents in the modern world. J. M. Keynes stressed the need of government spending in the 1930s. It is commonly referred to as the "welfare state" in the modern world. Because of this, contemporary government's responsibilities have grown significantly. Even in less developed countries, modern governments are engaged in a variety of social and economic initiatives (LDCs).

1. **Economic Development-** It is impossible for a country with a weak economy to invest large sums of money in order to improve its economy. In order to ensure a steady supply of basic and essential products and services, the government has invested heavily in the growth of these businesses. National income and employment prospects expand as a result of public spending. Development of economic infrastructure is also essential to economic growth. Developing countries, such as India, must undertake a variety of projects, such as road-bridge-dam development, power plants, transportation and communications, and so on. In order to speed up the pace of economic growth, these social overhead capital or financial infrastructures are essential. It is important to keep in mind that private investors are unable to make such large expenditures in the different infrastructure projects. The government must take on these kinds of programs. The more money the government spends, the more prosperous the economy becomes.
2. **Fiscal Policy Instrument-** In terms of fiscal policy, public spending is seen as a significant instrument. During a recession, public spending provides and expands job prospects. Consequently, public spending can help to avoid recurring cyclical variations in economic activity. During a recession, it is advised that more and more government spending be made since it provides employment and incomes. On the contrary, when the economy is experiencing inflation, the government must reduce its spending. Because of this, it is claimed that cyclical swings may be considerably reduced by managing public spending. In other words, anti-cyclical fiscal policy includes varying governmental expenditures. It is important to remember that public expenditure is not the only factor that affects the economy. As essential, if not more, is what the spending is used for or how well it is spent. An investment's efficacy and efficiency are directly related to its quality. Inflation can be caused by excessive spending. In addition, if the government is forced to levy large taxes, incentives would be lost. As a result, it is critical to minimize wasteful spending in order to reap the rewards of increased economic growth. It's possible that using it as a tool for fiscal policy might be counterproductive.
3. **Redistribution of Income-** It is possible to utilize public spending as an effective fiscal tool for the distribution of wealth and income. The government spends a lot of money on low-income families. The government may enhance the economic status of the poor by giving subsidies, free education, and health care services to these individuals.

4. **Balanced Regional Growth-** Regional inequities can be reduced by increased public spending. The government can compete with the more sophisticated sections of the country by redistributing resources to those areas that are lagging behind. People from all around the world need this to keep their integration and togetherness strong. Disintegrating forces emerge as a result of regionally unbalanced growth. The cure to these retrograde groups is public expenditure. This means that the goals of public spending can be classified as both economic and social. It's important to make sure that government spending is purely for the benefit of the public, and not for the benefit of any one-person, political party, or other organization.

6.4 Public Budget

The word 'budget' is derived from the French word 'Bougette', which means a pocketbook or leather purse. 1733's "Opened the Budget" was the first usage of the word, a parody on Walpole's financial strategy for that year. There were times when it was customary for Chancellor of the Exchequer to arrive in Parliament with a leather bag full of documents pertaining to the country's finances. For this reason, as soon as he set out to present his financial plans before Congress, the House of Representatives would open his "budget," or the bag, and the term "budget" was coined to describe the financial statements of countries. Since then, the current definition of budget has come to mean the document that provides estimates of revenue and spending for a country, generally over the course of an annual cycle. The term "budget" has a variety of meanings, including the following: When it comes to finances, a budget is a financial plan that summarizes the financial experience of previous years, states a current strategy, and forecasts it for the future.

(i) A budget is a description of the anticipated income and expenditures of an organization for the upcoming fiscal year, produced in advance of the new fiscal year's beginning." -Dimock

(ii) "Budget is a plan of funding for the approaching fiscal year," says Harold R. Bruce

(iii) When it comes to revenue and expenditures, an itemized estimate is required." —Munro

(iv) According to this definition, "Budget is a detail of estimated revenues and expenditures-a comparison chart of revenues and expenditures-and in addition to this it is an authority and direction provided to the competent authority granted for the collection of revenues and expenditure of public money." —Wilne.

The following are the elements of a budget, based on the definitions above:

(i) Statements of expected revenue and proposed expenditures;

(ii) It is a statement of the expected revenue and proposed expenditures, which must be sanctioned by some authority; and

(iii) It is for a limited period, generally an annual period;

(iv) It also sets forth the procedure for collecting and administering the revenue and expenditures.

The state's financial operations revolve around the state's budget. Scale and limit of all financial operations are included in one single entity. It is worth noting, however, that the definition of a budget is no longer limited to just stating how much money is expected to be generated and spent. As a result, it now has a more expansive connotation. "The full status of material finances as stated in the ministerial statement brought before the legislature," as well as the government's "orderly administration of financial matters," have been part of financial management throughout time. For the State as a whole, it serves as the foundation for monitoring and controlling its finances in the same way home finances are monitored and controlled. It puts in motion a series of events that have a significant impact on the government's daily operations."

Budgets serve a variety of objectives, as outlined below-

1. It guarantees that the executive is legally and financially accountable to the legislative.
2. It guarantees that subordinates are held accountable to their superiors in the administrative system.
3. Allocation, distribution and stabilisation are all goals of this social and economic policy tool.
4. It enables the government's operations and services in a more effective manner.
5. Administration and coordination are simplified since all government agencies may work from a single blueprint.

6.4.1 Types of Budget

The following are some examples of budgets:

1. Annual or long-term budgets

Government budgets are typically yearly in nature, which means budgets are planned for a certain year. Most commonwealth nations begin and conclude their financial year on 1st of April, while in the United States, Australia, Sweden, and Italy it begins and ends on 1st of July. French New Year's Day and December 31st are the days on which these events take place.

Long-term budgeting or establishing a budget for three or more years, is a common practise in several nations that have embraced a policy of planned economy. Long-term planning rather than long-term budgeting is what is provided for in these budgets, as long-term financial planning over a number of years is what is needed to fund the plan.

Estimated plan expenditures in these nations are spread out over a period of time. Although the plan and its expected expenditures are approved, this does not constitute a vote on the full period's funding. A portion of each year's national budget will be dedicated to implementing the legislatively-approved plan for that year.

It is characterized as a "single budget" when all of the government's expenditures are included in one document. It is advantageous to have a single budget since it exposes the total financial status of the government.

It is termed multiple budgeting if there are distinct departmental budgets that are passed by the legislature. In India, there are two budgets: one for the railroads and one for the rest of the government. Since 1921, there has been a distinct railway budget. Single-budgeting is the norm in England.

A budget is surplus if the projected revenues are more than the estimated expenditures, or if the budget is balanced. However, if revenues fall short of expenditures, the budget is in deficit. In the eyes of the economists, a budget deficit is a sign that the country is on the right track. It is only possible to have a balanced budget if income and expenditures are equal. Deficit budgets are the norm in the budgets.

In a cash budget, the projections of various sources of income and expenditure are supplemented by the actual amounts that will be collected or spent over the year.It doesn't matter if the income is realised or the expenditure is incurred in the same financial year, the revenue and expenditure are budgeted in that financial year. In India, the United Kingdom and the United States, cash budgeting is used, but in France and other continental nations, revenue budgeting is used.

The current norm is to have departmental or performance budgets, in which each department's earnings and expenditures are bundled together. No information is provided as to what activities or performances are to be funded by the budget.If you want to know how much money you're spending on a project, you need to look at the entire cost. It is prepared in terms of functions, programmes, activities, projects, such as in the case of education (a function). For example, the training of teachers is one of the tasks included in the programme a thing to do. The last functional unit is the project. It denotes a large-scale undertaking, such as the building of a new building such as a schoolhouse. Adopting performance measures is advised by the A.R.C. central and state government budgets in all of its ministries and agencies Governments that were directly responsible for the implementation of development projects.

6.4.2 Principles of Budget Making

Developing a budget is an important part in implementing economic and social reform. Without it, there can be no long-term growth in society. It's a good thing if it should adhere to a set of budgetary rules. The following are some of the most important budgeting principles:

1. **It should be a Balanced Budget**- In order for a budget to be balanced, the expected expenditures should not exceed the revenues or income. The term "Balanced Budget" refers to a budget in which the spending and revenue numbers are equal or substantially equal. 'Surplus Budget' and 'Deficit Budget' are both terms used to describe budgets in which expenditures fall short of projected revenues. As in Executive administrations, budget balancing is essential to financial stability, argues Mr. P.K. Wattal. "It holds the same place in the financial administration as the preservation of law and order." Budgetary imbalances are destined to erode investor confidence and cause inflation, which if left unchecked might lead to national tragedy." However, an occasional deficit budget should not be a reason for alarm. In some cases, a deficit budget is not only acceptable, but vital, according to the latest economic thinking. They argue that the present capitalist economy's faults may be remedied through the use of a deficit budget. When it comes to emerging countries, deficit spending is increasingly the norm. In order to fulfil the enormous expenses of growth plans, it is often necessary to resort to this method. Beyond a certain point, however, there is little benefit to running a deficit budget.
2. **Executives are responsible for budget formulation**- As the head of the administration, he is in the greatest position to determine how much money is needed to manage it. As a result, the

budget should fall under the purview of the CEO. But the process of drafting the budget is enormous, and he needs the help of a team of experts. Each country's budget planning is assisted by a Ministry of Finance (India), a Treasury (England), or a budget bureau (the United States). "No demands for grants can be made unless on the proposal of the Executive," is a well-accepted concept in Parliamentary government. Furthermore, the concept makes it apparent that the budget is prepared only by and for the Executive. The Executive's requests can be reduced or rejected by the Parliament, but they cannot be increased. As a result, the Chief Executive, as the person who has the real authority to spend the funds, is in a better position to determine how much money is needed for a specific project and therefore cannot be held liable for spending funds that were not necessary. The waste and overindulgence that would ensue would be evident. However, in the United States of America, there is a division of powers and all legislative tasks including money bills are held by Congress, which is therefore competent to both lower and raise expenditure and taxation.

3. **Estimates should be on Cash Basis**- The budget should be prepared on the basis of actual receipts and expenditures expected during the year, not on the basis of receipts that will be realized in future years or expenditures that are ordered in the current year but are likely to be incurred in the following financial year, for example, if certain sums on account of tax arrears relating to the year are expected to be incurred in the following financial year. Similarly, if a payment obligation was incurred in a prior year but satisfied in a subsequent year, it should only be included in the expenditure for the subsequent year. A benefit of having cash estimates is that public accounts may be completed considerably more quickly than when they are produced on a demand and liability basis, according to P. K. Wattal. It can take years or even decades to determine the ultimate surplus or deficit in several European nations if the latter procedure is adopted. For financial control, delayed accounts lose a significant amount of their value. In the beginning of 1937, the French Budget for 1920 was finally concluded.
4. **Gross Income rather than net income should be used for budgeting:** The budget should show a clear picture of the country's gross rather than net income. It's important to include all of the government's revenues and expenditures, not just its net position. However, if there is a department that is expected to spend $500,000 and get $500,000, the budget should reflect that

total rather than just $500,000 because that's the amount of money the department is expected to bring in. Using the net method, the department would only ask for a grant of Rs. 10 lakhs, denying the legislative authority over the Rs. 45 lakhs in expenses it paid for with its own funds. This would be the result. To maintain comprehensive control over the Legislature's finances, gross budgeting is needed.

5. **As much as feasible, estimates should be accurate**: The Budget's estimates should be as accurate as feasible. Over- or under-estimating should be avoided at all costs. All required expenditures should be funded, but the quantity should be the bare minimum. Expenditures can be overestimated and underestimated, both of which have the potential to jeopardise the entire budget when it comes time to implement the plan. Even though the heads of all the ministries have been told that they should strive to be as efficient and waste-free as possible, departments in India tend to under-estimate their income and over-estimate their spending. There should be exact Estimates- Using the prior three averages of the receipts and expenditures under various headings as a starting point, and making suitable adjustments owing to exceptional situations that may be expected, can result in an extremely accurate estimate. As a second step, detailed estimates should be broken down into major-heads, minor-heads, sub-headsand detailed heads of revenue and expenditure. As part of a close budget, the services and goods included in every vote should be clearly stated, and no 'lump sum' amount should be requested under any heading. Block grants can't be avoided in some departments, like Public Works, because it's impossible to know exactly how much will be spent on repairs and maintenance of government buildings, canals and roads. No lump sum requests for unclear objectives should be allowed, however, unless there are specific exceptions to this rule. Only in the rare circumstances may such requests be given to the public purse.
6. **There should be an annual Budget**- A budget's annuity is one of the most crucial aspects of the financial plan. According to this rule, the budget must be produced annually. In other words, the legislature should provide the Executive one year's worth of funding. The legislature can afford to delegate budgetary authority to the Executive for a year at a time. It's also the very minimum time frame required to carry out the financial plan. There is no need to abandon long-term planning just because the budget is yearly. However, even while the legislature may be called

upon to approve the plan in theory and broad framework as is the case with our Five Year Plans, long-term budgeting is not really used by these nations that have accepted the policy of planned development.

7. **Rule of Lapse**- Unspent funds must lapse to the Public Treasury under the annuality principle of budgeting and the government cannot spend them unless re-authorized in the next year's budget. Effective financial management necessitates adherence to this lapse rule. If a department's accumulated balances could be carried forward into the next year, it would be able to operate independently of the legislature until the funds are spent. However, this rule is flawed from a financial planning perspective. To avoid losing their funding, the departments know that they must spend them before the end of the fiscal year. Because of this, they spend the money lavishly, with little regard for its urgency or value. We have a system where the federal and state governments can set aside money from their own budgets, as well as from contributions from other governments and non-profit organizations, to create reserves or reserve funds that can then be used for the purposes for which they were set up in the first place. However, even though the general principle known as "rule of lapse" is accepted, the Finance Ministry has repeatedly reassured the Administrative Ministries that where grants have not been fully utilized for valid reasons, the Finance Ministry is willing to consider proposals for the allocation of provision for the unused amounts either in the original budget for that year or through supplementary grants for that year. There are hopes that ministries would take positive efforts to avoid a rush of spending in the last months and to avoid making purchases in a hurry just to avoid a grant lapse.
8. **Treasury Control**- While the legislature gives the government permission to spend money, it has no say in how that money is actually spent. That is the government's responsibility. The British Treasury in England has the best system of management and internal control, not only in relation to the development of the budget, but also in regard to the day-to-day oversight of the flow of funds to operational agencies. It is able to exert management control over the many operational divisions because of its authority to approve funds and to employ people.
9. **Executive Discretion**- If the Executive is to supervise the operations of the spending departments, it must be granted significant discretion in the allocation of appropriation. According to M. Rene Stourum, the only person who can accurately evaluate a ship's position

and speed is the pilot, because he is the only one who can see the power and direction of wind and currents that may impede or delay his progress. Legislators should specify the broad scope of the spending agency' responsibilities while leaving it to the executive branch to figure out the specifics of how to carry out the mandates set forth in the legislation. Re-appropriation from one minor head to another should be possible. Moreover, it should be able to deal with any financial emergencies that may arise. Executive discretion is demonstrated through the creation of a contingency fund in the name of the President of India to deal with financial emergencies

10. **The Form of Estimate should correspond with the Form of Account-** As a result of this rule, the budgetary and accounting headings must match up. This makes it easier to create budgets, monitor them, and keep track of them.
11. **Single Budget**- Finally, a key premise of budgeting is that the government should have a single budget that accounts for all of its income and expenses. All of the government's financial activities may be seen clearly in a single budget. Some departments may have surpluses while others may have deficits, depending on the quantity of department-specific budgets. As a result, it will be impossible to determine the government's overall net financial condition without extensive computations and revisions. 'Extraordinary Budgets,' on the other hand, are a violation of this concept. An exception to this notion of a single budget is established in nations like India where separate budgets are drawn up for commercial operations like the Railways. Indian Railways have had its own budget since 1924. It is quite legal for the railways to keep their earnings once they have contributed to the national income. India, too, has a single budget called the General Budget that was implemented in 2017. As outlined by Dimock, the most critical Budget principles include: transparency, clarity and comprehensiveness; unity; regularity; correctness; and integrity and accuracy. Publicity here refers to the budget being made available to the public and not being discussed behind closed doors. The budget should be easy to grasp in accordance with the idea of clarity. A complete picture of government revenue and spending is what we mean when we say something is "comprehensive." One should be able to see the government's whole financial position. Government revenues should be merged into a single fund to be used for all expenditures, which is what the term "unity" refers to. To be periodic, funds should be approved for a specific period of time, after which they expire or are reassigned

if they aren't used. According to the definition of accuracy, the budget forecasts should be based on correct data Integrity dictates that the budget should be executed in its entirety, as established in the first place. No deviations are allowed. The principles outlined above are universally adhered to, but with some regional variations.

6.5 Check Your Progress

1. …………..means borrowing money by the Government of a country from private persons and groups of individuals, from banks and non-bank financial institutions.
2. ……….. should cover at least the current expenditure on basic government services, and ………… should be used to support government expenditure that results in the building of long-term capital assets.
3. ……… is a plan of funding for the approaching fiscal year.
4. ………… are responsible for budget formulation.
5. ………….. funds must lapse to the Public Treasury.

6.6 Summary

- The governments borrow the money from various sources in order to meet the deficits.The Public Debt can be internal as well as external. It can be long term as well as short term.
- Public Debt plays an important role in developing economies. There resources are always limited. So, Public Debt can help them in meeting their financial requirements effectively.
- Public Expenditure can be of many types such as Developmental, Non-Developmental, Plan and Non-Plan Public Expenditure and Revenue and Capital Public Expenditure.
- Public Budget is a plan or statement of expected revenue and expenditures. It should be balanced and feasible based on executive discretion.

6.7 Keywords

- **Internal Debt-** In public finance, internal debt or domestic debt is the component of the total government debt in a country that is owed to lenders within the country.

- **External Debt**- External debt is the portion of a country's debt that is borrowed from foreign lenders through commercial banks, governments, or international financial institutions.
- **Treasury Bills-** These are government bonds or debt securities with maturity of less than a year.
- **Balanced Budget**- A balanced budget is a situation in financial planning or the budgeting process where total expected revenues are equal to total planned spending.
- **Fiscal Policy**- Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

6.8 Self-Assessment Test

1. What do you understand by Public Debt?
2. What are the causes of increase in Public Debt?
3. Explain the purpose of Public Debt?
4. What are various methods of debt redemption?
5. Who bears the burden of Public Debt?
6. What role does Public Debt play in developing economies?
7. What are the difficulties faced by Governments of Underdeveloped economies in public borrowing?
8. What are effects of Public debt on Production and consumption in a country?
9. What are the effects of Public Debt on employment in a country?
10. What are the effects of Public Debt on distribution and level of Income in a country?
11. Comment and explain the concept of Public Debt Management in India.
12. What is Public Expenditure? Explain the whole concept.
13. What is the principle behind budget making?

6.9 Answers to Check Your Progress

1. Public Debt
2. Taxation, Borrowing
3. Budget
4. Executives

5. Unspent Funds

6.10 References/Suggested Readings

1. *"Budget Meaning in the Cambridge English Dictionary". Retrieved 2021-02-25.*
2. Budget Analysts, Bureau of Labor Statistics
3. Cliche, P. (2012). "Budget," in L. Côté and J.-F. Savard (eds.), Encyclopedic Dictionary of Public Administration, [online], http://www.dictionnaire.enap.ca/Dictionnaire/en/home.aspx

Course: Public Finance	
Course Code: BCOM 506	Author: Dr.AroraGaurav Singh
Lesson No. :07	Vetter: Prof. Suresh Kumar Mittal
DEBT AND FEDERAL FINANCE: INDIAN FEDERAL FINANCE AND GOVERNMENT DEBT	

STRUCTURE

7.0 Learning Objectives

This lesson highlights the basic elements of federal finance as a concept. It defines the basic concepts of federal finance and also describes their scope, features, objectives etc. Next, this lesson also deals with public debt, its types and its sources.

After reading this lesson, students will be able to:

- Describe the concepts of federal finance in India.
- Explain the historical evolution of financial federalism in India.
- Identify the characteristics and importance of federal finance.
- Explain the concept of Public Debt.
- Examine the sources of public debt in India.

7.1 Finance Federalism in India

Fiscal Federalism refers to the separation of responsibility between the several levels of government when it comes to public expenditure and taxation. The principles of fiscal federalism and income sharing between the federal government and the states were codified in the Government of India Acts of 1919 and 1935 respectively. It's a great way for the government to save money. Provisions in the Constitution allow the Union and States to coordinate their efforts to levy and collect taxes in a systematic manner, such as:

1. Taxes levied by the federal government but delegated to state governments.

2. Taxes imposed by the federal government, but collected and held by the states themselves.

Income from various taxes can be divided among the taxpayers.Grants from the federal government to the individual states.

In recent years, India's federal-state fiscal ties have seen substantial transformations. Since the beginning of 2015-16, there have been three major shifts in the federal-state budgetary relationship:

1. In January 2015, the Planning Commission was abolished and the NITI Aayog was established in its place.

2. The Fourteenth Finance Commission's (14th FC) recommendations for higher tax devolution to the states from the fiscal year 2015-16 onwards.
3. The Constitutional amendment to introduce the Goods and Services Tax (GST) and the establishment of the GST Council for the central and state governments to deliberate and jointly take decisions.

7.1.1 Historical Evolution of Financial Federalism in India

The Government of India Act, 1935, is credited with laying the groundwork for India's current federal financial structure. The broad principles of financial independence for the provinces were the basis for this legislation.As a result of accepting this fundamental principle of federal finance, India's constitution takes the following actions to ensure that the centre is financially secure:

i. Avoidance of Double Taxation

ii. More flexible and higher-yielding income streams have been given to central government.

iii. The topics of money and banking, currency and coinage, as well as the authority to use deficit financing, have all been handed to the center.

iv. The center has been given access to some 'exclusive' revenue streams. Remaining abilities are concentrated in the center. The distribution of functions and financial resources in an efficient manner:(a) the Union list, (b) the States list, and (c) the Tertiary list.

v. The ability to shift financial resources from centre to states: The constitution specifies following ways to accomplish this:a) Lending b) Resource transfer flexibility: The Finance Commission recommends central to state resource transfers every five years.

7.1.2 Characteristics of Indian Federal Finance

There are two types of government expenditures: Those incurred by the federal government and those incurred by state governments. The Constitution clearly outlines their authority and rights.

The federal government's sources of revenue and expenditures are distinct from those of the states. The federal government also provides financial assistance to the states.In spite of the fact that states have been granted autonomy, they are nonetheless subservient to the national government. No state can break away from the rest of the country on its own.The constitutional provisions seek to resolve any financial dispute that may arise between the federal and state governments. A federal financial system is governed by India's government.

However, constitution also states that governments at all levels should be able to operate independently of each other in their separate, constitutionally defined, areas of responsibility. There is a clear separation between the roles of union and various states government in the constitution.

Every government must be able to raise enough money to carry out its responsibilities. There should be separate sources of money for each government; and each government should have complete control over its resources in order to satisfy its own requirements.As a country, India has to rethink its fiscal federalism.

Horizontal Imbalances: NITI Aayog has taken the place of Planning Commission. NITIAayog has decreased the government's policy outreach by depending solely on the Finance Commission as a tool of fiscal federalism. Regional and subregional disparities might rise as a result of this strategy. States have varying degrees of achievement owing to their diverse growth rates and developmental position in terms of social or infrastructure capital, which results in horizontal imbalances. These horizontal imbalances can be divided into two categories:

Type I is concerned with imbalance in ensuring that essential public goods and services are adequately provided.

Type-II is concerned with imbalance in growth-accelerating infrastructure or transformative capital shortages.

Vertical Imbalances: The fiscal disparity between the various levels of government in respect to their constitutionally mandated expenditure duties is the cause of vertical imbalance. When it comes to taxes in India's fiscal federalism, the central government has more say. Taxes are collected by the central government at a rate of around 60 percent, but it only accounts for about 40 percent of all public spending. In the third tier of elected local authorities and panchayats, such vertical disparities are much more pronounced. As India's urbanization increases, the quality of local public goods decreases, and this has a detrimental impact on the environment and climate change as a whole.

Restructuring of Fiscal Federalism: Restructuring India's Fiscal Federalism is necessary.Vertical and horizontal disparities may be eliminated through reforming the Finance Commission, NITI Aayog and GST as well as decentralization.

The Finance Commission should not be tasked with both providing essential public services and managing capital shortfalls. It should be limited to addressing the imbalance in basic public goods. (Type I) and India's National Infrastructure Investment and Reforms (NITI Aayog) (Type II).

With various parameters for allocation, it should be involved with capital allocation in a different way than the Finance Commission. State and sub-state inequities in infrastructure development need to be reduced by a considerable amount of money (1 to 2 percent of GDP) allocated to NITI Aayog. Independent assessment offices should be established by NITI Aayog to monitor and evaluate the use of government funding. It has the ability to negotiate the transfer of resources between states, thus it should be included in the decisionmaking process.

New fiscal federalism may be achieved through decentralization and state finance commission strengthening.An urban local body or the Panchayati Raj institutions consolidated fund are examples of local public finance.As part of the third-tier consolidated fund, both the central and state governments shall contribute an equal share of their CGST and SGST revenues. To finance public goods in metropolitan areas, one-sixth of the value added tax (CGST) and sales tax (SGST) should be shared with third-tier municipalities.

The 3Fs of democratic decentralization (funds, functions and functionaries) should be appropriately implemented by the State Finance Commissions and the Union Finance Commission.Goods and Services Tax (GST) should be streamlined in both its structure and by making certain that with appropriate taxes on sin items, zero-rating exports, and modifying the Integrated Goods and Services Tax (IGST) and the e-way bill, a single-rate GST can be implemented. Unlike other taxes, the GST is a comprehensive, multi-stage, destination-based tax. The GST is a single, national indirect tax. The GST council is the most significant decision-making body for the implementation of the tax. The GST Council should have its own secretariat and independent specialists in order to carry out changes in an informed and transparent way.

7.2 Introduction to Public Debt

In India, the consolidated government liabilities that must be paid from India's Consolidated Fund are known as public debt.

The entire amount borrowed by the government of a country is known as the public debt. The complete liabilities of the Union government, which must be paid from the Consolidated Fund of India, are included in the concept of "public debt" in India. The phrase can also be used to refer to the total debts owed by the federal and state governments together. However, the federal government explicitly separates its debt obligations from those of the states. General Government Debt (GGD) or Consolidated General Government Debt (CGGD) refers to the combined obligations of the federal and state governments.

7.2.1 Public Debt Meaning:

Debt analysis is critical since the government relies largely on market borrowing to fund its operational and development needs. In the study of public debt, several elements such as the debt-to-GDP ratio, debt sustainability and the sources of government debt are studied. According to the fact that about a quarter of the government's spending goes toward interest, it is clear why the Union has such enormous debt problems.

7.2.2 Types of Public Debt

Constitutionally, Public Debt is of two types, Internal Public Debt and External Public Debt. The Indian Constitution addresses these types of debts in its various articles which are as under:

- Article 292 states that the central government of India can borrow the amount specified by the Parliament from time to time.
- Article 293 states that the state governments can only borrow from the internal sources. However, as per the recommendations of 12th Finance Commission, state governments can get external financing for various projects if the central government provides the sovereign guarantee for these borrowings.

7.2.3 Internal Public Debt vs External Public Debt

To lessen its dependency on foreign borrowing, the Union government has taken a deliberate approach for many years now. More than 93% of the total public debt is owed by the government alone. External loans, on the other hand, are not regarded as market loans. They have been financed by institutional lenders at low interest rates. There is no risk to interest rates or currencies in the majority of these external loans.Two major kinds of internal loans, marketable and non-marketable, make up the bulk of state debt.There are two types of marketable debt: dated government securities (G-Secs) and treasury bills (T-bills). Debts issued to state and public sector banks, as well as to the National Small Savings Fund (NSSF) are considered non-marketable since they have a maturity period of 14 days.

7.2.4 Sources of Public Debt

The following are the sources of Public Debt-

- G-secs, or dated government bonds.
- T-bills or Treasury Bills
- A Third-Party Contribution
- Borrowings for the short term

Definition of Public Debt by the Union Government- Debts accrued by the government of India are referred to as "public debt" by the Union government. Article 292 of the Constitution mandates this.Public Debt Management in India is critical.The Reserve Bank of India, as mandated by the Reserve Bank of India Act of 1934, serves as both the government's bank and its debt management. Money, remittances, foreign exchange, and financial transactions are handled by the Reserve Bank of India on behalf of the government. The Reserve Bank of India (RBI) also receives deposits from the government of India. There has been a recent push to set up a government agency dedicated to managing public debt similar to what is seen in other industrialized nations. NITIAayog has proposed the development of an organization to handle the country's debts, for example Public Debt Management Agency (PDMA).

Comparison of Public and Private Debt:

Public debt is the money owed by the federal government, while private debt includes loans taken out by private businesses and people.Nearly half of the country's GDP is owed to the federal government. As a result, if the public debt is measured as a percentage of GDP, it rises to 68 percent, which includes the obligations of states.

7.3 Check Your Progress

1. Provisions in the Constitution allow the ………….. to coordinate their efforts to levy and collect these taxes in a systematic manner.

2. Vertical and horizontal disparities may be eliminated through reforming the ……….., …………… and ………., as well as decentralization.

3. ……………of the Constitution defines any monies received outside the Consolidated Fund of India as public debt

4. There are two types of debt: ……………….

7.4 Summary

This lesson has dealt with the federal features of Public finance in India. Federal simply means where both centre and states are involved. So, how the avenues revenue is divided between them has been explained. After that, this lesson has thrown light on public debt, its various types and its sources in India.

Debts accrued by the government of India are referred to as "public debt" by the Union government. Article 292 of the Constitution mandates this.Public Debt Management in India is critical.The Reserve Bank of India, as mandated by the Reserve Bank of India Act of 1934, serves as both the government's bank and its debt management. Money, remittances, foreign exchange, and financial transactions are handled by the Reserve Bank of India on behalf of the Government.

7.5 Keywords

- **Public Debt-**The total amount, including total liabilities, borrowed by the government to meet its development budget.
- **Private Debt-** Private debt, or private credit, is the investment of capital to acquire the debt of private companies (as opposed to acquiring equity).
- **Federal Finance-** It refers to the system of assigning the source of revenue to the Central as well as State Governments for the efficient discharge of their respective functions.

7.6 Self-Assessment Test-

1. What do you understand by Federal Finance?

2. What are the components of Federal Finance?

3. What is Public Debt?

4. Explain the types of Public Debt.

5. Give difference between external and internal Public Debt.

6. What are various sources of Public Debt in India?

7.7 Answers to Check Your Progress-

1. Union and the States

2. Finance Commission, NITI Aayog and GST

3. Article 266 (2)

4. Public Debt and Private Debt

7.8 References/ Suggested Readings-

1. Bilan, Irina &Ihnatov, Iulian. (2015). Public Debt and Economic Growth: A Two-Sided Story. International Journal of Economic Sciences. IV. 24-39. 10.20472/ES.2015.4.2.003.
2. Nazmus Sadat Khan,2016. In Search of Causality Between Debt and Growth: A Graphis Theoretic Approach. Economics Bulletin, Access Econ. Vol 36(2). Pages 677-687.
3. Aloysius, Carlin. (2016). An empirical study of the impact of public debt on economic growth of India.
4. Bexheti, Abdylmenaf&Sadiku, Murat. (2018). Empirical analysis of the effects of public debt on economic growth of Republic of Macedonia.

Course: Public Finance	
Course Code: BCOM 506	Author: Dr. AroraGaurav Singh
Lesson No. :08	Vetter: Prof. Suresh Kumar Mittal
PUBLIC REVENUE AND INDIAN TAXATION SYSTEM	

STRUCTURE

8.0 Learning Objectives

This lesson highlights the basic elements of public revenue. It defines the basic concepts of public revenue and its classification as done by various economists. It also describes the canons of taxation along with the features of a good taxation system. This lesson also focuses on the characteristics of Indian Taxation System.

After reading this lesson, students will be able to:

- Describe the concepts of public revenue.
- Explain features of public revenue.
- Explain the characteristics of a good taxation system.
- Explain the characteristics of Indian Taxation System.

8.1 Public Revenue: Meaning

For the government to carry out its numerous responsibilities for the benefit of society, it has to raise funds from the people.In economics, finance plays an important role in the study of production and consumption. The means of production, on the other hand, a government's ability to spend money comes from two sources: consumption and public revenue. Public income or public revenue refers to the total amount of money the government receives from all sources. However, according to Dalton, the word "public income" can be defined in both broad and limited senses. Revenue generated by the public. Public Revenues include everything, i.e., taxes, the price of products and services provided by the public sector, and other revenue sources from governmental activity, such as fines, charitable donations, grants and borrowing from banks. Public revenues, contain all the government's income for a certain period.

8.1.1 Various Classifications of Revenues

1. **Adam Smith's Classification** – Adam Smith classified public revenue into two categories-

a. Revenue from the People

b. Revenue from the State Property

Revenue from the people includes tax revenue and revenue from state property includes revenue obtained from public enterprises as well as that revenue which are derived from the property in possession of the state.

2. **Bastable's Classification** – Like Adam Smith, Bastable has also divided public revenue into the following two categories –

a) That income which the state receives from its various functions just like a private individual.

b) Those income which the state derives in the own capacity as "State".

The first category includes all the income which the state derives in the form of fees and prices, while the second category includes taxes and levies. This classification is also limited and narrow like that of Adam Smith. This classification does not appear to be compressive from one other angle also, that is, fee, gifts, fines, and special assessments are difficult to be classified into separate groups.

3. **Prof. Adam's Classification –** Prof. Adam has divided the public revenue into three categories–

a) **Direct Revenue** – This includes income from (a) public domains, (b) public industries, (c) Gratuities, etc., (d) confiscations and indemnities. These categories include all the income which the State derives from public land and public enterprises like rail, roads, highways, post and telegraph and other incomes which the state derives due to the ownership of productive enterprises.

b) **Derivative Revenue** – This includes taxes, fees, assessments, fines, and penalties, i.e., the income derives from the people is grouped under this head.

c) **Anticipatory Revenue** – This includes income from the sale of bond or other forms of commercial credit. It also includes income from the treasury notes. This group deals mainly with the revenue derived from the public credit.

8.1.2 Administrative Revenue

Revenues from fees, fines, forfeiture and escheats, as well as from specific assessments, are referred to as "administrative." The government's administrative efforts include all these sources of revenue. According to Taylor, administration revenues are a byproduct of administration.

Fees- For a certain series, a fee is an obligatory donation that serves a public purpose: As described by Professor Seligman, fees are payments made to cover the costs of government services that are repeated on a regular basis. Although primarily for the benefit of the public, the fee payer receives significant advantages.

Profits from the sale of goods and services- Direct receipt of a product or service in exchange for payment and an approximate adjustment of the amount paid to the cost separate commercial income from other types of revenue. Revenues from commercial activities might come from two primary sources. They might be the result of either public property or public business.

Public property Income - Governments across the world possess a variety of real estate, including land and buildings, as well as mining and other natural resources. These properties can be sold or leased to generate cash for the government. Such money can be obtained through selling timber, bamboos, leaves and other forest products as well. When mining or fishing rights are leased to private parties, the government can reap enormous profits. The term "income from the public domain" refers to revenue generated by public enterprises.

In recent times the public sector is becoming more and more important in the various countries. Many vital goods and services are produced and sold by the government for various reasons. As part of its socialist and social planning policies, the government may also join the economic sphere. State revenue is generated by selling commodities and services produced at public firms.

Included in revenues from public enterprises are receipts from transportation, post offices, and other state-owned businesses. To provide these products and services, the government charges a fee. Public sector firms in India, however, have not performed well until recently. As a result, the railway's finances have been shaky. The non-tax revenue generated by the Posts and Telegraphs Department has been small. Many other government-run enterprises have operated in the red for years because they avoided paying a price for goods or services the government created. It's an agreed-upon payment. Thirdly, a fee paid by an individual to enjoy a good or service. It's all about you, and you get paid for it. A tax is levied, however, to help the community.

Grants and Donations- People, businessesand organizations can all donate money to charitable causes. Gifts are given out of the goodness of one's heart. Many patriotic and public-spirited people and organizations give their time and money freely to support various causes around the country. These presents are mainly intended to support those who have been afflicted by natural disasterssuch as floods, droughts, or earthquakes. For example, gifts can be made to the Prime Minister Relief Fund. Countries and organizations from the world may send gifts to the governments as well. Anywhere in the globe, the

Red Cross sends presents to those in need of assistance. "Gifts, on the other hand, are not a major source of money for the government."

Taxes collected by the Government

Public income or public revenue refers to the total amount of money the government receives from all sources. Taxes, pricing of products and services provided by public companies, money from administrative operationssuch as fees, penalties, etc.,gifts and grants are all examples of public revenue.

8.2 Characteristics of Taxes

The following are the three features of a tax:

1. First of all, when a tax is levied, it is an obligatory payment to the state by the residents or even by aliens who are subject to its authority because of their domicile or property, and this money is used for general or common purposes. Thus no one may refuse to pay a tax because he doesn't get any advantage from particular state services or doesn't have the ability to vote, so he's exempt from paying a tax. As a result, everyone who gets taxed by the State, regardless of age, citizenship, or immigration status, must do so. In addition, tax evasion is punishable by law.
2. Secondly, a tax is a personal responsibility for the taxpayer. Taxpayers have a responsibility to pay the tax if they are legally required to do so, and they should not try to avoid it in any way. If a tax is imposed on an individual's income, the public authority may not be aware of all the sources of that income. All of a person's income must be reported and taken into account for calculating taxes in this case.
3. The third attribute is that the tax payers' contributions may not be used just for their own advantage, but rather for the benefit of the entire community. As an individual is unable to satisfy all of these demands, especially those that require a large investment, such as the construction of a hospital, the state provides these services for the benefit of all citizens. As a result, taxes are levied on all those who can afford to pay them to spread the load.

8.2.1 Purpose of Taxes

Defining tax is, of course, essential before discussing taxation in further depth. Different economists have defined tax in a variety of ways. In simple words, Taxes are money paid by taxpayers for government services.

Taxation's Purposes or Goals

Taxes are imposed and collected for what purpose? As a rule of thumb, taxes are used to achieve the following objectives:

1. **To Raise Public Funds-** The primary goal of taxes is to produce revenue for the government to keep up with the ever-increasing costs of government. This goal is especially important in developing economies, where the government has taken on the role of providing a basic standard of life and actively participating in the growth of the economy. The public sector has been steadily expanding in many economies, making this goal even more important.
2. **Reducing Income Disparity**- One of the main features of underdeveloped countries is the wide disparity in income between people in the upper and lower sections of society. Because of this, one of the most significant goals of the growth programs in these nations is to reduce income and wealth inequality. To achieve a fairer distribution of wealth and income, taxes attempt to tax the wealthy excessively and provide benefits to the poor.
3. **Increasing Social Mobility**- Taxes are collected for the benefit of the public and the greater good of society. Use of taxes in favor of entrenched interests or for the benefit of a certain group in ways that are not acceptable to the wider public is not permitted. Tax income is used to improve the overall well-being of the country, not just a certain group.
4. **Restriction on Manufacture and Use of Hazardous Items**- It is also an important part of government revenue collection, as well as a measure to keep society healthy and respected in a healthy state. Taxes on cigarettes, alcohol, and other intoxicants earn less money for the government than other taxes, but its primary goal is to protect the public's health.
5. **Import and Export Controls-** Import and export tariffs, on the other hand, raise money, but their precise goals are different. For this reason, import tariffs are imposed to limit the import of items that may undermine the "baby" businesses in the nation. Importing luxury products may

be taxed at a high rate so that money may be used for other purposes in the country. Like this, there may be an export tax imposed on commodities that are necessary 'inside the country, and their export may impair national production or consumption to prohibit their export. As a result, one of taxation's primary goals is to keep the economy in line with the demands of the country.

8.2.2 Canons of Taxation

Taxation places a financial burden or demands a personal sacrifice on those who pay it. The repercussions of taxation, on the other hand, can be widespread. The tax system should be designed to impose the least amount of hardship on the community as feasible. It's for this reason that the tax system should be built on clear laws and principles. Otherwise, both the goal of taxes and the issue of social justice may be jeopardized. So, a tax that increases the gap between rich and poor may be extremely productive, but it should not be endorsed since it violates the social fairness principle. Taxes should be avoided if they have a negative impact on a country's productive system.

Thus, economists and public officials have from time to time put forth some principles in order to design a solid and efficient tax system, which the tax structure should validate. It's hard to overstate the importance of Adam Smith's contributions in this area. Some of his tax canons or maxims, which are still revered for their clarity, simplicity and prudence by taxing authorities, were put down by him.

Other economists came up later and put down other taxation canons to go along with Dr. Smith's.

1. To begin with, there is the **Canon of Equitable Ability**. "The subjects of any state should contribute towards the government's maintenance in as nearly a proportion to their different talents as practicable," says Adam Smith. "That is, in proportion to the revenue that they each receive under the protection of the State." " To attain equality of sacrifice, the tax burden should be imposed in a way that considers the relative talents of the taxpaying public. Equal sacrifice does not imply that everyone must pay the same amount. Equality in taxes means that the wealthy pay a bigger share and the less fortunate a lesser share. According to some, the canon of ability means proportionate taxes. However, this canon truly advocates for progressive taxes, making this a fair and equitable approach.
2. For both taxpayers and the government, it's critical that the **Canon of Certainty** is upheld. The rate of tax, the method of collection and the timeframe for payment must all be known to the

taxpaying public. Taxation should be as uniform as possible. Corruption and bribery will be rampant if this is not addressed. The taxpayers would be harassed unnecessarily because of this situation. It's like how governments struggle to build realistic budgets if they don't know how much money taxes will bring in and can only guess and make the estimate. As a result of what Adam Smith had decided, "Every individual should be required to pay a specific and not arbitrary tax. The contributor and everyone else should know exactly when and how much they're expected to pay and when " Because people are already familiar with an old tax, it causes the least amount of trouble. So, it's commonly referred to: "An outdated tax is not a tax at all.

3. The **Canon of Convenience** stems from the Canon of Certainty, thus it's a logical progression. In addition to ensuring that the date and mode of payment are known, the coins should be struck in such a way that they create the least amount of hassle. That's what Adam Smith said, as a result "There should be a time or method of payment that is most convenient for taxpayers to pay their taxes.
4. When it comes to the **Canon of Economics**, Adam Smith spelled it out in the following manner: "As a general rule, taxes should be designed so that they take as little money out of the people's pockets as possible, in addition to the money they bring into state coffers."

8.2.3 Qualities of a Good Taxation System

The following are the qualities of a good tax system:

1. **Equity-** It is important to ensure that the burden of a tax is as low as possible under a fair tax system. In addition, it should be divided fairly and equally among the various groups in the community. To bear the largest weight, one must have broad shoulders. To attain this goal, the tax systems direct and indirect taxes must be properly blended. When it comes to equality, the Indian tax system is woefully inadequate. The Indian tax system is heavily reliant on indirect taxes, which reflects the system's inequitable character.
2. **Productivity-** There are two ways to look at the phrase "productivity." First and foremost, the tax system must be designed so that the government has enough money to cover its costs. Taxes should be levied in a way that has no negative impact on the country's ability to create. Secondly, there is a lot to be desired in the Indian tax system when it comes to production. For example, the Indian income tax system has an unfavorable effect on the residents' desire to wear.

3. **Elasticity** - The tax system should be able to supply the government with more money as the country's economy grows. Because of this, the tax system should generate greater revenue during times of emergency or disaster. Then, it should be feasible to earn extra money by raising taxes or raising rates a little bit. To make the tax system more flexible, two things are required. First and foremost, direct, and indirect taxes must be properly blended. As a second point, certain sources of income should be set aside solely for dire circumstances like times of war or other natural disasters. Because the government's income continually expanding in line with its needs, the Indian tax system meets the canon of flexibility.
4. **Convenience**- To ensure that the tax system is as convenient as possible for all taxpayers, government officials should also consider their own convenience. Since taxpayers make sacrifices by paying taxes, the government must ensure that they are not subjected to unnecessary hardship. In addition, the tax system should be straightforward for the average taxpayer to grasp. Although the Indian tax system meets the canon of convenience, it fails miserably to meet the canon of simplicity. It's a convoluted tax structure that's much beyond the capabilities of the common citizen.
5. **Absence of Tax Evasion**- The tax structure of the country should be designed such that there is no room for people to evade taxes. To achieve this goal, a balanced mix of commodities and personal taxes is needed. Tax avoidance will be minimized as a result. The Indian tax system has a lot to learn from this perspective. Tax evasion is on the rise in the country, with the business elite most likely to engage in it.
6. **Maximum Social Advantage**- in Dalton's view, a tax system based on the premise of "greatest social gain" is the most efficient. It should be the goal of any tax system to benefit the largest number. Also crucial is that the tax system should not have an unfavorable effect on the country's ability to create goods and services. The Indian tax system does not appear to meet this standard of maximum social benefit.
7. **Economical**- A good tax system should be cost-effective to the government in the sense that the expense of collecting taxes should be little in comparison to the income generated by them.
8. **Multiple Taxes**- Good tax systems use several taxes instead than just one single one. It's ideal to focus on a few large levies for most of the tax collection, according to Dalton.

9. **Income**-Elastic- It should be flexible based on a person's income. Increases in national revenue should lead to an increase in taxation, which should be more than proportional.

8.2.4 Problem of Justice in Taxation

1. **The Physiocratic Theory of taxes**- This is the first idea of taxesand it is founded on the belief that land may provide a net surplus. It all began in France, where the Physiocratic School of Economic Thought was born. The Physiocrats, on the other hand, argued that agriculture alone could produce a net return and contribute to the country's wealth, hence they advocated for a single direct tax on land. On the other hand, Henry George of San Francisco supported a single tax on the state's appropriation of unearned increment.
2. **Financial Theory** - There are a variety of views on how taxation should be distributed throughout the population. As a financial theory, it is commonly referred to as the "colb plucking the goose with as little shrieking as possible concept."
3. **The Principle of Equity**: Modern writers have placed a great deal of stress on justice and have recommended that tax burdens should be distributed in accordance with the notion of equality. Equity is often defined as fairness or justice when it comes to the tax burden being shared between all taxpayers. The concept of equity has two components: the treatment of persons in the same and different situations. Those who are similarly well-off from a financial standpoint should pay the same amount in taxes. Horizontal equity is another name for this type of investment strategy. People in different circumstances should be treated differently, and those who are "better off" should pay more taxes than those who are less fortunate: 'Vertical equity' is the term for this.
4. **Cost of Service Theory**: It's one of the oldest tax-distribution theories out there, and it's still widely used today. Based on this principle, taxes should be based on the government's cost of providing various services to individual taxpayers. Taxpayers are required to pay a tax equivalent to the amount of service they received. According to this, the more expensive something is, the more taxes should be levied on it. According to this model, the government works as a producer of a commodity, charging customers a price equivalent to the amount of money it costs to create.

5. **Benefit Theory of Taxation**- According to this view, taxes should be levied in proportion to the advantages that citizens receive from government services. Therefore, you should pay to the expense of other facilities in proportion to the advantages they provide to your own life. The primary assumption of the idea is that the more advantage a man receives, the more taxes he should pay. Taxes are necessary because of this concept. It also measures the advantages that individuals obtain in the event of specific taxes, such as the gas tax, improvement tax, and so on.

8.2.5 Characteristics of Indian Tax System

It has long been the belief of the Indian government that tax policy is an efficient means of regulating the economy while also creating economic incentives and disincentives. Because of this, our tax system has developed the following characteristics:

1. Rapidly shifting provisions and tariffs have complicated the system. Consistent with this, many of these provisions have proved self-defeating.
2. Exemptions, refunds, concessions, fines and other provisions abound throughout the system. Notifications, explanations and other procedural information are also included. All of this has resulted in a system that is extremely complicated and, in the opinion of some, detrimental.
3. The authorities have long acknowledged the need to simplify the tax system, but their efforts have only served to further complicate it.
4. The tax base in our country is quite limited. A substantial number of taxpayers are engaging in tax evasion and avoidance on a massive scale. They are aided in their endeavor by a slew of convoluted tax laws and regulations, as well as the broad discretion granted to tax authorities.
5. There have also been many voluntary disclosure schemes that provide tax evaders a chance to pay, tax (sometimes on a concessional basis) on hidden income and wealth, and so on, which have all contributed to the problem of tax evasion.
6. Most of our tax revenue comes from indirect taxes. Inflationary pressures are fed by themas opposed to direct taxes. They are more cumbersome, and as a result, the distribution of resources is distorted. They have a reputation for being quite regressive. Because of widespread evasion, certain exemptions from indirect taxes have failed to decrease their regressive character.
7. The government has used tax holidays and other concessions on a systematic and selective basis to promote certain industries considered essential for the overall balanced growth of the

economy; to promote and assist small-scale industries and self-employment; to encourage and support the establishment of new businesses, the promotion of labor-intensive techniques, the reduction of regional economic imbalances, and the reduction of unemployment via these activities.

8. Some argue that the depreciation allowances are based on the acquisition costs of assets rather than the replacement costs. Because of this, capital formation is discouraged.
9. Customs taxes on imports have been imposed; income tax and various types of tax relief have been provided for exports.
10. By shifting excise charges from a specific to a value added base and replacing excise duties with VAT, the government has made a long-term effort to reform indirect taxes.

8.3 Check Your Progress

1. According to ………………………………., taxes should be levied in proportion to the advantages that citizens receive from government services.
2. ……………….. refers to the total amount of money the government receives from all sources.
3. Indian Taxation System is …………. in nature.
4. The subjects of any State should contribute towards the government's maintenance in as nearly a proportion to their different talents as practicable refers to ……………………….
5. …………….. includes income from public domains, public industries, Gratuities, etc., confiscations and indemnities

8.4 Summary

- Public Revenue has always been very important for Indian government due to its socialist nature. The government has tried to enhance its public revenue avenues over the time so that works of social welfare, infrastructural development etc. can be ensured.
- The Taxation system in India is progressive in nature. However, the required changes have to be incorporated to make it more resilient.

8.5 Keywords

1. **Public Revenue-** Public revenue refers to the income received from all sources for the purpose of public expenditure.
2. **State-** Government of the country
3. **Income Disparity**- Income Disparity is the degree to which total income is distributed unevenly throughout a population.
4. **Elasticity of Taxation**- The degree to which the increase in the tax rate causes a change in the tax base is called the elasticity of taxes.

8.6 Self-Assessment Test

6. Explain the concept of Public Revenue.
7. Give the classification of Public Revenue as explained by various economists.
8. Explain Bastable's Classification of Public Revenue.
9. What is Administrative Revenue?
10. What are the characteristics of a Good Taxation System?
11. What are the Characteristics of Indian Taxation System?
12. Explain the purpose of tax collection in an economy.

8.7 Answers to Check Your Progress

1. Benefit Theory of Taxation
2. Public Revenue
3. Progressive
4. Canon of Equitable ability
5. Direct Revenue

8.8 References/ Suggestive Readings

1. Panda, Priyabrata& Das, Kishore. (2020). Direct Tax Reform in India: An Impact Analysis with Special Reference to Government Revenue. XXXXI. 66-85.
2. Kleven, H. J., Kreiner, C. T., &Saez, E. (2015). Why can modern governments tax so much? An agency model of firms as fiscal intermediaries. *Econometrica*, forthcoming.
3. https://www.oecd-ilibrary.org/economics/raising-more-public-revenue-in-indonesia-in-a-growth-and-equity-friendly-way_a487771f-en
4. Asquer, Alberto. (2018). Public Sector Revenue- Principles, Revenues and Management
5. Singh, S.K. (2010). Public Finance in Theory and Practice.

NOTES

NOTES

NOTES