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M.A. Final (ECONOMICS)

PAPER - IV (A)

PUBLIC ECONOMICS

MADHYA PRADESH BHOJ (OPEN) UNIVERSITY
RAJA BHOJ MARG (KOLAR ROAD), BHOPAL

POST GRADUATE PROGRAMME
M.A. (FINAL) ECONOMICS

Paper - IV (A)
M.A. (FINAL) ECONOMICS

DISTANCE EDUCATION
PUBLIC ECONOMICS

BLOCK : I

Unit 1 Basic concepts of public economics
Unit 2 Economics planning and development

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PAPER - IV (A)   M.A. (FINAL) ECONOMICS

BLOCK - I
Public Economics

INTRODUCTION

The Geography Shclies the earth as habitat of human societies, it is naturally concerned with the study of climate as the dominant element in the natural environment. The influence of weather and climate on human societies is so varied and all pervading that innately become the important components of our physical environment. The welfare, safety and owalit of human society are subject to the profound effects of the vagaries of weather and climate. Since climatology and Oceanography in India progresses at a quick pace and it is our wish to keep abreast of the latest developments and to refleel in the text some new facts and ideas.

Block-I filted climatology consist of 3 units and all these three units are ferther sub divided into sub topics explains rasions aspects climatology and weather.

BLOCK 1 INTRODUCTION TO PUBLIC ECONOMICS

The block opens with introduction to public economics and related concepts. In first unit, the role of government in organized society has been discussed with the concept of mixed economy. Public sector and private sector are discussed with public private partnership. Finally the unit ended with the description on public vs. private sectors especially in context of Indian economy.

The second unit covers the aspects related to economic planning and development.

Government as an agent of economic planning will be the first area of discussion followed by public choice theory; rationale for public policy; public policy and provision of public and local goods; provision of infrastructure facilities; public policy and allocation of resources and inequalities; problems of regional imbalances and disparities and policy initiatives for balanced regional growth.

UNIT 1

BASIC CONCEPTS OF PUBLIC ECONOMICS

Objectives

After studying this unit, you should be able to understand and appreciate:

- The concept public economics
- The role of government in the society
- The approach of mixed economy
- Public sector, private sector and their linkages
- Public private partnership

Structure

1.1 Introduction
1.2 Role of government in organized society
1.3 Mixed economy
1.4 Public sector
1.5 Private sector
1.6 Public private partnership
1.7 Public vs. private sectors
1.8 Summary
1.9 Further readings

1.1 INTRODUCTION

Public economics (or economics of the public sector) is the study of economic issues concerning the public sector (including government) and its interface with the private sector (including households, businesses, and markets) in a mixed economy. While much of economics is based on how markets work, public economics considers the functioning of government and its role and scope in promoting economic well-being.

Broad methods and topics include:

- Analysis and design of public policy
- Public-Finance theory and its application
- Distributional effects of taxation and government expenditures
- Analysis of market failure and government failure.

Emphasis is on analytical and scientific methods and normative-ethical analysis, as distinguished from ideology. Examples of topics covered are tax incidence, optimal taxation, and the theory of public goods.

1.1.1 Markets and governments efficiency and failure

Public good

A public good has the feature that the marginal cost of an additional individual enjoying it is zero. Examples include an army, street lighting, radio signals or information. If there is an army defending one person in a country, a street lamp for one person, a radio signal for one person, then it is with no extra cost that two or more people use the service. For information, whose character as a public good was emphasised by Joseph Stiglitz, an old aphorism of philosopher Bertrand Russell holds true,

"If I have one apple and you have one apple and we exchange apples, we both have one apple. But if you have an idea and I have an idea and we exchange ideas, then we both have two."

The problem of the public good is that if people can use the good or service at the same time and cannot be excluded from its use (which with a cost they sometimes can, e.g. encoding a Wifi signal with a password) then people can "free-ride" on its use. Consumers will not be contributing to the costs of production. Because producers cannot recoup enough expenses, there will be an underproduction of public goods. There is therefore a role for state intervention. The government through taxation can get all people to contribute.

1.1.2 Public expenditure

Public goods

Public goods are [non-excludable] and [non-rivaled]. Something is non-excludable if its use is cannot be limited to a certain group of people. For example, since one cannot prevent people from viewing a firework display it is non-excludable. Something is non-rivaled if one person's consumption of it does not deprive another person, again (to a point) a firework display is non-rivaled - since one person watching a firework display does not prevent another person from doing so.

- The demand for pure public goods

- Efficient output of a pure public good
- The free rider problem

Public choice and the political process

- Arrow's impossibility theorem
- Public choice theory
- Right-financing

Externalities and government policy

- Internalization of externalities
- The Coase Theorem. The Coase theorem states that when trade in an externality is possible and there are no transaction costs, bargaining will lead to an efficient outcome regardless of the initial allocation of property rights.

1.1.3 Particular sectors

- Health care
- Defence and technology
- Social security
- Welfare and employment
- Education
- Regulated markets
- Emergency and local services

1.1.4 Public finance and tax

Public finance is a field of economics concerned with paying for collective or governmental activities, and with the administration and design of those activities. The field is often divided into questions of what the government or collective organizations should do or are doing, and questions of how to pay for those activities. The broader term, public economics, and the narrower term, government finance, are also often used.

1.2 ROLE OF GOVERNMENT IN THE ORGANIZED SOCIETY

Anthropologists tend to identify different types of societies differentiating them on the basis how they tend to be organized. Civilizations fall within what we would call states - a society defined by a centralized political structure and a central bureaucracy.

The first literate states developed in the Near East by about 3000 BC, having evolved out of village communities within a millennium, a tiny segment of time by prehistoric standards. In the millennia that followed, state-organized societies emerged elsewhere in the Old World, in India, Greece, China, and Southeast Asia. They also developed out of village societies in Mexico and the Andes after about 1500 BC.

Food production led to major changes in human life, vastly enhancing people's ability to exploit and manipulate the natural environment. But human societies *everywhere* were closely adapted to their environments, living in fundamental ecological balance with their surroundings. With the emergence of state-organized societies, the pre-industrial civilizations with their dense urban populations and new social orders, human societies became more interdependent and in more constant competition for land and resources. Slowly, the world order changed until, with the emergence of regional, then global, empires, the myriad societies of the globe were linked through ties significant and insignificant in an intricate web of economic, cultural, and political interdependence.

What is a state-organized society, a "civilization?" Definitions abound in the academic literature and surround three institutions-the notion of civilization itself, and what is called a state-organized society. It's now time to look more closely at pre state and state-organized societies.

Pre-State societies are small scale societies based on the community, the band, or the village. They vary greatly in their degree of political integration. In many, the community is the largest political unit, with no centralized authority whatsoever. In others, several communities may join together for some cooperative political or social activity, but there is no permanent political authority over all of them. Still other pre-state societies are much more elaborately organized, with many communities under the overall authority of a centralized or supreme political authority, which can sometimes be a hereditary leader. However, these societies lack the highly stratified class structure and other characteristics of the state.

State-organized societies are on a large scale. All state-organized societies are autonomous political units, with many communities within their boundaries. They share a number of common features:

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State-organized societies are on a large scale. All state-organized societies are autonomous political units, with many communities within their boundaries. They share a number of common features:

(1) There is a centralized political structure and a central bureaucracy that runs the state. Kin-based relationships are less important and specialization in economic and socio-political organization essentially replaces earlier forms of kin-organization. The emergence of non-kin-based relationships is a primary element of a state.

(2) There is a rigid social stratification that concentrates power in the hands of privileged elite at the head of the social pyramid. Other classes include artisans, priests, and other specialists. Most people were commoners, farmers, fisher folk, and other food producers. Slaves were the lowest of the low and below commoners.

(4) States are supported by intensified food production capable of supporting large numbers of non-food producers. Such intensification took many forms, but often involved state-organized water control and distribution systems. For example, irrigation canals were vital in Egypt and Mesopotamia, while the Aztecs of Mexico developed a huge system of swamp gardens to support more than 600,000 people.

(5) Elaborate public buildings, which served as temples, administrative centers, and dwellings for the elite are hallmarks of states (and civilizations.) Writing, or some equivalent form of record keeping, also was a essential element of dealing with the complexity of states.

States were not necessarily advantageous to everyone. Early states were societies where inequality was a reality, and where government was coercive. Government was usually controlled by a very small number of people. The elite maintained a monopoly on the use of force, and on the justice system. It was no coincidence that the rulers of many of these civilizations were perceived as having a special relationship to the gods. For example, Ancient Egyptian pharaohs were considered to be gods on earth. It was they who presided over the lavish public ceremonies that paid homage to the gods, recited the familiar chants that validated both the authority of the deities and their state. The Pharaoh was the owner of everything in Egypt in a literal sense.

Very often, social inequality was justified through elaborate fictions. For instance, the Shang rulers, who governed much of northern China 3,500 years ago, were

considered intermediaries between the gods, the revered ancestors, the cosmos, and the living. They lived in isolated compounds, surrounded by a landscape of humble farming villages that has been called the "Green Circle." Shang lords and their successors maintained an elaborate fiction of their direct kin ties not only with the gods, but with the common people, who lived apart from them. In reality their authority was based on their monopoly of force to back their draconian decisions.

One of the most complex of all state-organized societies was ancient Rome, which for centuries presided over a vast empire centered on the Mediterranean Basin and extending at times far into Asia and as far as the Rhine and Danube Rivers. This was a highly centralized state, in the hands of patrician elite that controlled not only political and social life, but most of the empire's wealth as well. The elite presided over a highly ranked society of merchants, artisans, and commoners. The lowest of the low were slaves, criminals and prisoners of war, who worked war galleys, labored in state mines, and on other public works. The empire was based on a highly efficient and very productive agricultural system, supported by a complex infrastructure of merchant ships and roads that allowed the authorities to move both food and armies from one end of the empire to the other with great dispatch. This infrastructure was essential, for Rome's grain was grown not in Italy, but in outlying provinces like North Africa, Spain, and Egypt.

One of the most important things that we, as thinking beings, can ask ourselves is "What is the role of government in society?" But to answer it, we must first define government in a manner that satisfies all of us.

The thing that separates a government (or law, or the state, depending on the writer -- I am known to use all three) from any other civic or social organization is that governments may legally initiate the use of force. Nothing and nobody else may do this. Not you, not me, not the Elks, not GM, not the Southern Baptist Convention, not Greenpeace, not Trek Bicycles, not Public Citizen, not the United Auto Workers, not your neighborhood block club, not ANYBODY -- except government. Only government has this power, which is called the police power. And politics is nothing more than deciding how this power should be used. That's why, when Chairman Mao Zedong said,

"All political power comes from the barrel of a gun," he was not philosophizing or speaking in abstract. He was stating a basic axiom.

Bear that in mind. Any time you elect a legislator, mayor, or other government official, you are hiring them to hold and use a gun on the people, including yourself. They may not do so directly, but anyone with the power to pass laws or write regulations has the power to decide when the police should come after you. And "you are disobeying a law" is ALWAYS reason enough.

Everything that a law demands that you do, or forbids you to do, is at gunpoint, if necessary - at the threat of death. Perhaps not for the offense itself, but if you are stubborn enough about not accepting the penalties that government places on you for breaking its laws, you can easily find yourself under the barrel of a policeman's gun.

The defining characteristic of government IS the legal use of force. And if the use of force is legal, then it also should be just. Now, just who is the government? In unjust societies, it is whoever has the power to force the others to his will. But in democratic societies, the government is either us or our representatives acting on our behalf.

In fact, the reason that mankind ever formed governments in the first place was to protect ourselves from others using force to kill us (violating our right to life), or to make us do their will (violating our right to liberty), or to take what was ours (violating our right to property). Everybody agrees that when somebody comes to hurt or kill you, or to enslave you, or to rob you, you can defend yourself. Government is the same thing, only in groups. The point of having a government is to organize force for the defense of a group or community (be it a neighborhood, a town, a city, a state, or a nation). And the government IS us. So at what point does it become justice for the government to do by force that which it is *un*just for US to do by force?

The answer is, "Never." The role of government is to defend our lives, our liberty, and our property, from those who would violate them, and to punish those who do so by making them pay us restitution. When a government limits itself to this, people are pleased with it, to the very limited extent that they have to think about it at all. And they do not care whether it is an autocracy, an oligarchy, a democracy, a despot, or a republic -- except for those who want to use the police power to compel others to do their will.

We don't care what it is that you want the government to do for you -- if you can't see yourself doing it, gun in hand, then don't ask that the government hold the gun and do it for you. It is neither our job nor that of the government to use force to stop us from being stupid, or hateful, or immoral, or discriminatory, or to help the poor, or provide medical care, or schooling, or art, or homes. It is not for you, or me, or the government, to stop people from making informed voluntary exchanges, in business, employment, housing, friendships, churches, civic organizations, or love, no matter what the circumstances.

I might be able to tolerate government intervention in those few cases where it supports a public good (and there are very few real public goods), or in the case of regulating natural monopolies (and there are few natural monopolies, and innovation often creates competition, eliminating them).

All of us look out for ourselves at all times. And almost all of us would love to be able to draw upon the resources of others without paying everything that they might demand. Throughout history, whoever has held the police power, be they few or many, has used it to benefit themselves at the expense of everyone else. When it was just a few, it was obvious and unjust. But as more and more people participate in the political process, nearly every single group has used government to benefit itself at the expense of everyone else.

And it's hardly surprising that they do so. After all, everyone else has done it. The group getting the benefit gains enormously, so it is worth it to them to lobby hard for it. Everyone else loses only a little, so it's worth little to fight it. And so we lose a little here to Steel, a little there to Medicine, a little elsewhere for the children, and on and on and on until it adds up to half of what we make. And all the while, using the government to steal gains more and more legitimacy, and people wind up having either to lose their moral outrage at violation of rights, or else lose their respect for all laws, including those that protect rights.

If we are going to have a just society, we must limit government to its core functions: protection of life, protection of liberty, protection of property, punishing those who transgress those rights, and gaining restitution from them for their victims.

1.3 MIXED ECONOMY

A mixed economy is an economic system that includes a variety of private and government control, or a mixture of capitalism and socialism.

There is not one single definition for a mixed economy, but relevant aspects include: a degree of private economic freedom (including privately owned industry) intermingled with centralized economic planning and government regulation (which may include regulation of the market for environmental concerns, social welfare or efficiency, or state ownership and management of some of the means of production for national or social objectives).

For some states, there is not a consensus on whether they are capitalist, socialist, or mixed economies. Economies ranging from the United States to Cuba have been termed mixed economies.

The mixed economy as an economic ideal is supported by social democrats as a compromise between socialism and free-market capitalism, among others.

The term mixed economy was coined to describe economic systems which stray from the ideals of either the free market, or various planned economies, and "mix" with elements of each other. As most political-economic ideologies are defined in an idealized sense, what is described rarely if ever exists in practice. Most would not consider it unreasonable to label an economy that, while not being a perfect representation, very closely resembles an ideal by applying the rubric that denominates that ideal. However, when a system in question diverges to a significant extent from an idealized economic model or ideology, the task of identifying it can become problematic. Hence, the term "mixed economy" was coined. As it is unlikely that an economy will contain a perfectly even mix, mixed economies are usually noted as being skewed towards either private ownership or public ownership, toward capitalism or socialism, or toward a market economy or command economy in varying degrees.

There is not a consensus on which economies are capitalist, socialist, or mixed. It may be argued that the historical tendency of power holders in all times and places to limit the activities of market actors combined with the natural impossibility of monitoring and constraining all market actors has resulted in the fact that, as we understand a "mixed

economy" being a combination of governmental enterprise and free-enterprise, nearly every economy to develop in human history meets this definition; though some systems may be so close to being completely one way or the other that to call them mixed is redundant and it is more meaningful just to call them a free market economy or a planned economy/ command economy.

1.3.1 Elements of a mixed economy

The elements of a mixed economy typically include a variety of freedoms:

- To possess means of production (farms, factories, stores, etc.)
- To participate in managerial decisions (cooperative and participatory economics)
- To travel (needed to transport all the items in commerce, to make deals in person, for workers and owners to go to where needed)
- To buy (items for personal use, for resale; buy whole enterprises to make the organization that creates wealth a form of wealth itself)
- To sell (same as buy)
- To hire (to create organizations that create wealth)
- To fire (to maintain organizations that create wealth)
- To organize (private enterprise for profit, labor unions, workers' and professional associations, non-profit groups, religions, etc.)
- To communicate (free speech, newspapers, books, advertisements, make deals, create business partners, create markets)
- To protest peacefully (marches, petitions, sue the government, make laws friendly to profit making and workers alike, remove pointless inefficiencies to maximize wealth creation)

With tax-funded, subsidized, or state-owned factors of production, infrastructure, and services:

- libraries and other information services
- roads and other transportation services
- schools and other education services
- hospitals and other health services
- banks and other financial services
- telephone, mail and other communication services

- electricity and other energy services (e.g. oil, gas)
- water systems for drinking, agriculture, and waste disposal
- subsidies to agriculture and other businesses
- government-granted monopolies to otherwise private businesses
- legal assistance

and providing some autonomy over personal finances but including involuntary spending and investments such as transfer payments and other cash benefits such as:

- welfare for the poor
- social security for the aged and infirm
- government subsidies to business
- mandatory insurance (example: automobile)

and restricted by various laws, regulations:

- environmental regulation (example: toxins in land, water, air)
- labor regulation including minimum wage laws
- consumer regulation (example: product safety)
- antitrust laws
- intellectual property laws
- incorporation laws
- protectionism
- import and export controls, such as tariffs and quotas

and taxes and fees written or enforced with manipulation of the economy in mind.

1.3.2 Relation to form of government

The mixed economy is most commonly associated with social democratic forms of government. However, given the broad range of economic systems that can be described by the term, most forms of government are consistent with some form of mixed economy.

1.3.3 Historic examples

The American School (also known as the National System) is the economic philosophy that dominated United States national policies from the time of the American

Civil War until the mid-twentieth century as the country's policies evolved in a free market direction. It consisted of a three core policy initiatives: protecting industry through high tariffs (1861-1932) (changing to subsidies and reciprocity from 1932-1970's), government investment in infrastructure through internal improvements, and a national bank to promote the growth of productive enterprises. During this period the United States grew into the largest economy in the world, surpassing England (though not the British Empire) by 1880.

Dirigisme is an economic policy initiated under Charles de Gaulle of France designating an economy where the government exerts strong directive influence. It involved state control of a minority of the industry, such as transportation, energy and telecommunication infrastructures, as well as various incentives for private corporations to merge or engage in certain projects. Under its influence France experienced what is called "Thirty Glorious Years" of profound economic growth.

Social market economy is the economic policy of modern Germany that steers a middle path between socialism and capitalism and aims at maintaining a balance between a high rate of economic growth, low inflation, low levels of unemployment, good working conditions, public welfare and public services by using state intervention. Under its influence Germany has emerged from desolation and defeat to become an industrial giant within the European Union.

Although nominally socialist, the economy of Syria is in practice a mixed economy comprising large state enterprises and small businesses

1.4 PUBLIC SECTOR

The public sector, sometimes referred to as the state sector is a part of the state that deals with either the production, delivery and allocation of goods and services by and for the government or its citizens, whether national, regional or local/municipal.

Examples of public sector activity range from delivering social security, administering urban planning and organizing national defenses are discussed in later section.

The organization of the public sector (public ownership) can take several forms, including:

- Direct administration funded through taxation; the delivering organization generally has no specific requirement to meet commercial success criteria, and production decisions are determined by government.
- Publicly owned corporations (in some contexts, especially manufacturing, "state-owned enterprises"); which differ from direct administration in that they have greater commercial freedoms and are expected to operate according to commercial criteria, and production decisions are not generally taken by government (although goals may be set for them by government).
- Partial outsourcing (of the scale many businesses do, e.g. for IT services), is considered a public sector model.

A borderline form is

- Complete outsourcing or contracting out, with a privately owned corporation delivering the entire service on behalf of government. This may be considered a mixture of private sector operations with public ownership of assets, although in some forms the private sector's control and/or risk is so great that the service may no longer be considered part of the public sector. (See the United Kingdom's Private Finance Initiative.)

In spite of their name, public companies are not part of the public sector; they are a particular kind of private sector company that can offer their shares for sale to the general public.

1.4.1 Role of the Public Sector

The role and scope of the public sector and state sector are often the biggest distinction regarding the economic positions of socialists, liberals and libertarian political philosophy. In general, socialists favor a large state sector consisting of state projects and enterprises (although some socialists favor a large cooperative sector instead). Social democrats tend to favor a medium-sized public sector limited to the provision of universal programs and public services. Economic libertarians and minarchists favor a small public sector with the state being relegated to protecting property rights, creating and enforcing laws and settling disputes, a "night watchman state". Anarchists favor no public sector at all, with these powers enforced by voluntary associations or private organizations which are hired to provide these services.

1.5 PRIVATE SECTOR

In economics, the private sector is that part of the economy which is both run for private profit and is not controlled by the state. By contrast, enterprises that are part of the state are part of the public sector; private, non-profit organizations are regarded as part of the voluntary sector.

A variety of legal structures exist for private sector business organizations, depending on the jurisdiction in which they have their legal domicile. Individuals can conduct business without necessarily being part of any organization.

The main types of businesses in the private sector are:

- Sole trader
- Partnership, either limited or unlimited liability
- Private Limited Company or LTD-limited liability, with private shares
- Public Limited Company – shares are open to the public. Two examples are:
  - Franchise – business owner pays a corporation to use their name, receives spec for the business
  - Workers cooperative – all workers have equal pay, and make joint business decisions

In countries where the private sector is regulated or even forbidden, some types of private business continue to operate within them.

The private sector focuses on the needs of the shareholders.

1.5.1 Employment

The private sector employs the majority of the workforce in some countries. However, in some countries such as the People's Republic of China, the public sector employs most of the workers.

1.6 PUBLIC–PRIVATE PARTNERSHIP

Public-private partnership (PPP) describes a government service or private business venture which is funded and operated through a partnership of government and one or more private sector companies. These schemes are sometimes referred to as PPP, P3 or P^3.

PPP involves a contract between a public sector authority and a private party, in which the private party provides a public service or project and assumes substantial financial, technical and operational risk in the project. In some types of PPP, the cost of using the service is borne exclusively by the users of the service and not by the taxpayer. In other types (notably the private finance initiative), capital investment is made by the private sector on the strength of a contract with government to provide agreed services and the cost of providing the service is borne wholly or in part by the government. Government contributions to a PPP may also be in kind (notably the transfer of existing assets). In projects that are aimed at creating public goods like in the infrastructure sector, the government may provide a capital subsidy in the form of a one-time grant, so as to make it more attractive to the private investors. In some other cases, the government may support the project by providing revenue subsidies, including tax breaks or by providing guaranteed annual revenues for a fixed period.

Typically, a private sector consortium forms a special company called a "special purpose vehicle" (SPV) to develop, build, maintain and operate the asset for the contracted period. In cases where the government has invested in the project, it is typically (but not always) allotted an equity share in the SPV. The consortium is usually made up of a building contractor, a maintenance company and bank lender(s). It is the SPV that signs the contract with the government and with subcontractors to build the facility and then maintain it. In the infrastructure sector, complex arrangements and contracts that guarantee and secure the cash flows, make PPP projects prime candidates for Project financing. A typical PPP example would be a hospital building financed and constructed by a private developer and then leased to the hospital authority. The private developer then acts as landlord, providing housekeeping and other non medical services while the hospital itself provides medical services.

1.6.1 Origins

Pressure to change the standard model of Public Procurement arose initially from concerns about the level of public debt, which grew rapidly during the macroeconomic dislocation of the 1970s and 1980s. Governments sought to encourage private investment in infrastructure, initially on the basis of accounting fallacies arising from the fact that public accounts did not distinguish between recurrent and capital expenditure.

The idea that private provision of infrastructure represented a way of providing infrastructure at no cost to the public has now been generally abandoned, interest in alternatives to the standard model of public procurement persisted. In particular, it has been argued that models involving an enhanced role for the private sector, with a single private sector organisation taking responsibility for most aspects of service provisions for a given project, could yield an improved allocation of risk, while maintaining public accountability for essential aspects of service provision.

Initially, most public-private partnerships were negotiated individually, as one-off deals. In 1992, however, the Conservative government of John Major in the United Kingdom introduced the private finance initiative (PFI), the first systematic programme aimed at encouraging public-private partnerships. In the 1992 programme, the main focus was on reducing the Public Sector Borrowing Requirement, although, as already noted, the effect on the public accounts was largely illusory. The Labour government of Tony Blair elected in 1997, persisted with the PFI sought to shift the emphasis to the achievement of "value for money" mainly through an appropriate allocation of risk.

A number of Australian state governments have adopted systematic programmes based on the PFI. The first, and the model for most others, is Partnerships Victoria.

1.6.2 Controversy

A common problem with PPP projects is that private investors obtained a rate of return that was higher than the government's bond rate, even though most or all of the income risk associated with the project was borne by the public sector.

A number of Australian studies of early initiatives to promote private investment in infrastructure reached the conclusion that, in most cases, the schemes being proposed were inferior to the standard model of public procurement based on competitively tendered construction of publicly owned assets (Economic Planning Advisory Commission (EPAC) 1995a,b; House of Representatives Standing Committee on Communications Transport and Microeconomic Reform 1997; Harris 1996; Industry Commission 1996; Quiggin 1996).

One response to these negative findings was the development of formal procedures for the assessment of PPPs in which the central focus was on "value for money" rather than reductions in debt. The underlying framework was one in which

value for money was achieved by an appropriate allocation of risk. These assessment procedures were incorporated in the private finance initiative and its Australian counterparts from the late 1990s onwards.

In 2009, the Treasury of New Zealand, in response to inquiries by the new National Party government, released a report into PPP schemes that came to the conclusion that "there is little reliable empirical evidence about the costs and benefits of PPPs" and that there "are other ways of obtaining private sector finance" as well as that "the advantages of PPPs must be weighed against the contractual complexities and rigidities they entail".

1.6.3 Product development partnerships

Product development partnerships (PDPs) are a class of public-private partnerships that focus on pharmaceutical product development for diseases of the developing world. These include preventive medicines such as vaccines and microbicides, as well as treatments for otherwise neglected diseases. PDPs were first created in the 1990s to unite the public sector's commitment to international public goods for health with industry's intellectual property, expertise in product development and marketing.

International PDPs work to accelerate research and development of pharmaceutical products for underserved populations that are not profitable for private companies. They may also be involved in helping plan for access and availability of the products they develop to those in need in their target populations. Publicly-financed, with intellectual property rights granted by pharmaceutical industry partners for specific markets, PDPs are able to focus on their missions rather than concerns about recouping development costs through the profitability of the products being developed.

These not-for-profit organizations bridge public- and private-sector interests, with a view toward resolving the specific incentive and financial barriers to increased industry involvement in the development of safe and effective pharmaceutical products.

International examples

International product development partnerships and public-private partnerships include:

- DNDi, the Drugs for Neglected Diseases Initiative was founded in 2003 as a not-for-profit drug development organization focused on developing novel treatments for patients suffering from neglected diseases.
- Aeras Global TB Vaccine Foundation is a PDP dedicated to the development of effective Tuberculosis vaccine regimens that will prevent TB in all age groups and will be affordable, available and adopted worldwide.
- The Global Alliance for Vaccines and Immunization is financed per 75% (750 Mio.US$) by the Bill and Melinda Gates Foundation, which has a permanent seat in the supervisory board of GAVI.
- The Global Fund to Fight AIDS, Tuberculosis & Malaria, a Geneva based UN connected organisation, established in 2002 to dramatically upscale global financing of interventions against the three pandemics.
- The International AIDS Vaccine Initiative (IAVI), a biomedical public-private product development partnership (PDP), was established in 1996 to accelerate the development of a vaccine to prevent HIV infection and AIDS. IAVI is financially supported by governments, multilateral organizations, and major private sector institutions and individuals.
- The International Partnership for Microbicides is a nonprofit product development partnership (PDP) founded in 2002, dedicated to the development and availability of safe, effective microbicides for use by women in developing countries to prevent the sexual transmission of HIV. See also Microbicides for sexually transmitted diseases.
- Medicines for Malaria Venture (MMV) are the not-for-profit drug discovery, development and delivery organization, established as a Swiss foundation in 1999, based in Geneva. MMV is supported by a number of foundations, governments and other donors.
- The TB Alliance is financed by public agencies and private foundations, and partners with research institutes and private pharmaceutical companies to develop faster-acting, novel treatments for Tuberculosis that are affordable and accessible to the developing world.

- A UN agency, WHO is financed through the UN system by contributions from member states. In recent years, WHO's work has involved more collaboration with NGOs and the pharmaceutical industry, as well as with foundations such as the Bill and Melinda Gates Foundation and the Rockefeller Foundation. Some of these collaborations may be considered global public-private partnerships (GPPPs); half the WHO budget is financed by private foundations.

Similar public-private partnerships outside the realm of specific public health goods include:

- Public Private Partnerships for Disaster Management brings together the Private sector for PPP models with a tool box of partnership opportunities towards Resilient & Sustainability Goals
- The Public Private Partnership for improving teaching and learning in schools in Abu Dhabi, United Arab Emirates.

1.6.4 Specific cases

While some PPP projects have proceeded smoothly, others have been highly controversial. Australian examples include: Airport Link, the Cross City Tunnel, and the Sydney Harbor Tunnel, all in Sydney; the Southern Cross Station redevelopment in Melbourne; and the Robina hospital in Queensland.

In British Columbia, Canada Public-private partnerships have become significant in both social and infrastructure development. PPP's exist in a variety of forms including the Canada Line rapid transit, the Abbotsford Hospital and Cancer Centre and run of river hydro-electric projects in Toba River

1.7 PUBLIC VS PRIVATE SECTORS

You often hear news analysts talk about the public and private sectors. Although most people generally have an idea what these two terms entail, there are intricate differences between the two, which are also useful to learn about.

Firstly, here's what the public sector is all about. It is basically composed of organizations which are owned and operated by the government. In the United States, the public sector includes government agencies like federal and state offices. When a private individual talks about the public sector, they are usually referring to a public authority, or

public body. Any federal institution which is associated with health care, police services, prison services, local and central government management, and all their departments, are also part of the public sector.

Secondly, there's the private sector. As the name implies, this is usually made up of organizations which are 'private', and this means that they are not owned by, nor part of, the government. All small businesses, corporations, profit and non-profit organizations, partnerships, charitable organizations and middle to large entrepreneurships, are considered to be part of the private sector. The specific examples are retail stores, credit unions, local businesses and non-government operated banks.

Now, what's the difference between the public and the private sector in terms of the way that they operate? Those who are in the public sector typically supply services to the public, and they are not competing with any other institution for profit. Private sectors, on the other hand, do have a goal of overtaking their competitors, and maximising their profit.

Most public sectors are managed under a larger chain of command and control, while private sectors mostly operate in a corporate setting. When it comes to policy decisions, the activities in the public sector have a goal of sticking to what is indicated by law, while the private sector is managed under the rules of shareholders and corporate owners.

Finally, the beneficiary of the services offered by the public sector, is the general public, while for the private sector, it is mostly the consuming public who uses the goods and services that they offer in return for profit.

In short we can say:

1. The public sector is made up of agencies and institutions owned and operated by the government, while the private sector is made up of small businesses, corporations, as well as profit and non-profit organizations.
2. The public sector is not profit-driven, while this is the case with the private sector.
3. The end beneficiary of the services offered by the public sector is the general public, while it is the general consuming public who take advantage of the goods and services offered for profit by the private sector businesses.

Activity 1

1. Discuss the role of government in society.
2. What do you understand by mixed economy? Is India a mixed economy? Justify your views.
3. Distinguish between public and the private sector.
4. Write a note on public private partnership.

1.8 SUMMARY

In this unit we seek to highlight the basic concepts of public economics. Public economics is discussed as a the study of economic issues concerning the public sector (including government) and its interface with the private sector (including households, businesses, and markets) in a mixed economy. After a brief introduction we discussed the role of government in organised and unorganized societies. Further the concept of mixed economy has been dealt in detail. In the next section we threw light on public sector and then on private sector. Public private partnership was another area of concern. Finally a brief discussion was there on public vs. private sector.

1.9 FURTHER READINGS

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- Stigler, George J. and Paul A. Samuelson, 1963. "A Dialogue on the Proper Economic Role of the State." Selected Papers, No.7. Chicago: University of Chicago Graduate School of Business. Samuelson portion reprinted in The Collected Scientific Papers of Paul A. Samuelson, 1966, MIT Press.

UNIT 2

ECONOMIC PLANNING AND DEVELOPMENT

Objectives

After studying this unit, you should be able to understand:

- The concept and approach to economic planning
- The role of government in economic planning
- The theory of public choice
- The rationale for public policy
- Public policy and provision of public goods
- Provision of infrastructure facilities in public planning
- Provisions for allocation of resources, balanced regional growth and regional imbalances in public policy

Structure

2.1 Introduction

2.2 Government as an agent of economic planning

2.3 Public choice theory

2.4 Rationale for public policy

2.5 Public policy and provision of public and local goods

2.6 Provision of infrastructure facilities

2.7 Public policy, allocation of resources and inequalities

2.8 Problems of regional imbalances and disparities

2.9 Policy initiatives for balanced regional growth

2.10 Summary

2.11 Further readings

2.1 INTRODUCTION

Planned economy (or *directed* economy) is an economic system in which the state or workers' councils manage the economy. It is an economic system in which the central government makes all decisions on the production and consumption of goods and

services. Its most extensive form is referred to as a command economy, centrally planned economy, or command and control economy. In such economies, central economic planning by the state or government controls all major sectors of the economy and formulates all decisions about the use of resources and the distribution of output. Planners decide what should be produced and direct lower-level enterprises to produce those goods in accordance with national and social objectives. Planned economies are in contrast to *unplanned economies*, such as a market economy, where production, distribution, pricing, and investment decisions are made by the private owners of the factors of production based upon their own interests rather than upon furthering some overarching macroeconomic plan. Less extensive forms of planned economies include those that use indicative planning, in which the state employs "influence, subsidies, grants, and taxes, but does not compel." This latter is sometimes referred to as a "planned market economy".

2.2 GOVERNMENTS AS AN AGENT OF ECONOMIC PLANNING

A planned economy may consist of state-owned enterprises, private enterprises directed by the state, or a combination of both. Though "planned economy" and "command economy" are often used as synonyms, some make the distinction that under a command economy, the means of production are publicly owned. That is, a planned economy is "an economic system in which the government controls and regulates production, distribution, prices, etc." but a command economy, while also having this type of regulation, necessarily has substantial public ownership of industry. Therefore, command economies are planned economies, but not necessarily the reverse.

Important planned economies that existed in the past include the economy of the Soviet Union, which, according to CIA Fact book estimates, was for a time the world's second largest economy, China before 1978 and India before 1991.

Beginning in the 1980s and 1990s, many governments presiding over planned economies began deregulating (or as in the Soviet Union, the system collapsed) and moving toward market-based economies by allowing the private sector to make the pricing, production, and distribution decisions. Although most economies today are market economies or mixed economies (which are partially planned), planned economies

exist in some countries such as Cuba, Libya, Saudi Arabia, Iran, North Korea, and Burma.

2.2.1 Stability

Long-term infrastructure investment can be made without fear of a market downturn (or loss of confidence) leading to abandonment of a project. This is especially important where returns are risky (*e.g.* fusion reactor technology) or where the return is diffuse (*e.g.* immunization programs or public education).

2.2.2 Meeting collective objectives by individual sacrifice

Planned economies may be intended to serve collective rather than individual needs: under such a system, rewards, whether wages or perquisites are to be distributed according to the value that the state ascribes to the service performed. A planned economy eliminates the individual profit motives as the driving force of production and places it in the hands of the state planners to determine what the appropriate production of different sets of goods is.

The government can harness land, labor, and capital to serve the economic objectives of the state. Consumer demand can be restrained in favor of greater capital investment for economic development in a desired pattern. The state can begin building a heavy industry at once in an underdeveloped economy without waiting years for capital to accumulate through the expansion of light industry, and without reliance on external financing. This is what happened in the Soviet Union during the 1930s when the government forced the share of GNP dedicated to private consumption from 80 percent to 50 percent. As a result, the Soviet Union experienced massive growth in heavy industry, at the expense of stifled growth of living standards.

It could be seen as the government deciding: Who produces what, where it is produced, how much it costs, and where it goes.

2.2.3 Comparison with capitalist corporations

Taken as a whole, a centrally planned economy would attempt to substitute a number of firms with a single firm for an entire economy. As such, the stability of a planned economy has implications with the Theory of the firm. After all, most corporations are essentially 'centrally planned economies', aside from some token intra-

corporate pricing. That is, corporations are essentially miniature centrally planned economies and seem to do just fine in a free market. As pointed out by Kenneth Arrow and others, the existence of firms in free markets shows that there is a need for firms in free markets; opponents of planned economies would simply argue that there is no need for a sole firm for the entire economy. Anarchist theorists like Kevin Carson however point to the numerous ways in which government intervention in the market magnify economies of scale, offsetting the natural inefficiencies of centrally planned economies by means of privileges and historical subsidies granted by force, and argues that in a truly free market corporations wouldn't exist.

2.2.4 Advantages over market economies

An advantage of a planned economy, one which was among the most important for socialist economists of the early 20th century, is that it is not subject to major pitfalls of market economies and marked-oriented mixed economies. A planned economy, in theory, does not suffer from business cycles; it does not experience crises of overproduction such as the one that was believed to have contributed to the Great Depression. From the modern perspective, it does not result in asset bubbles - massive misallocations of resources such as the dot-com bubble of the late 1990s or the housing bubble of mid-2000s.

The other aspect is that a centrally planned economy can provide public goods which would not have been available at all, or might require explicit government provision, in a market economy, resulting in a mixed economy. In a mixed economy, the government would have to achieve this goal through taxation or inflation. In a planned economy, state planners would allocate state resources toward public goods and state projects.

2.2.5 Economic planning versus the command economy

A centrally-planned economy is one in which most of the economy is planned by a central government authority. This is further contrasted with a command economy, in which the state allocates its resources as needed, without having to adhere to market principles. An example of this is the expropriation that took place in the Communist states compared to the nationalization that took place in the Western European countries.

Another key difference is that command economies are more authoritarian in nature whereas indicative economic planning controls the economy through incentive-based methods. Economic planning can be practiced in a decentralized manner through different government authorities. For example, in some predominately market-oriented and mixed economies, the state utilizes economic planning in strategic industries such as the aerospace industry. Another example of this is the utilization of indicative planning and dirigisme, both of which were practiced in France and Great Britain after the Second World War. Swedish public housing models were planned by the government in a similar fashion as urban planning. Mixed economies usually employ macroeconomic planning, while micro-economic affairs are left to the market and price system. The People's Republic of China currently has a socialist market economy in place. Within this system, macroeconomic plans are used as general guidelines and as government goals for the national economy, but the majority of state-owned enterprises are subject to market forces. This is heavily contrasted to the command economy model of the former Soviet Union.

2.2.6 Planned economies and socialism

In the 20th century, most planned economies were implemented by states that called themselves socialist. Also, the greatest support for planned economics comes from socialist authors. For these reasons, the notion of a planned economy is often directly associated with socialism. However, they do not entirely overlap. There are branches of socialism such as libertarian socialism, which reject a centralized state and all of these tendencies reject economic planning as well and instead favor decentralized collective ownership of the economy and property.

Furthermore, planned economies are not unique to Communist states. There is a Trotskyism theory of permanent arms economy, put forward by Michael Kidron, which leads on from the contention that war and accompanying industrialisation is a continuing feature of capitalist states and that central planning and other features of the war economy are ever present.

2.2.7 Transition from a planned economy to a market economy

The shift from a command economy to a market economy has proven to be difficult; in particular, there were no theoretical guides for doing so before the 1990s. One transition from a command economy to a market economy that many consider successful is that of the People's Republic of China, in which there was a period of some years lasting roughly until the early 1990s during which both the command economy and the market economy coexisted, so that nobody would be much worse off under a mixed economy than a command economy, while some people would be much better off. Gradually, the parts of the economy under the command economy decreased until the mid-1990s when resource allocation was almost completely determined by market mechanisms.

By contrast, the Soviet Union's transition was much more problematic and its successor republics faced a sharp decline in GDP during the early 1990s. One of the suggested causes is that under Soviet planning, price ceilings created major problems (shortages, queuing for bread, households hoarding money) which made the transition to an unplanned economy less easy. While the transition to a market economy proved difficult, many of the post-Soviet states have been experiencing strong, resource-based economic growth in recent years, though the levels vary substantially. However, a majority of the former Soviet Republics have not yet reached pre-collapse levels of economic development. Still, most of the economic hardship that struck many of the former eastern block countries and the post-Soviet states comes from the program of shock therapy that was invented by Milton Friedman. The idea behind this program is to convert from a centrally planned economy to a market economy in a short space of time. This means mass-scale privatization, budget cuts and liberalization of economy and finance regulations. This shock therapy program was implemented in several former communist states like Poland and Russia.

Iraq, after the fall of Saddam Hussein following the 2003 invasion of Iraq, is currently experiencing the transition from a command economy under Hussein to a free market economy. Iran is currently privatizing companies.

2.2.8 Disadvantages of economic planning

Inefficient resource distribution: surplus and shortage

Critics of planned economies argue that planners cannot detect consumer preferences, shortages, and surpluses with sufficient accuracy and therefore cannot efficiently co-ordinate production (in a market economy, a free price system is intended to serve this purpose). For example, even though the Soviet Union had its own passenger car manufacturing industry going back to 1940's, it was impossible for a Soviet citizen to simply walk into a store and buy a car - the entire output of all car manufacturing plants was allocated for years in advance. From the modern viewpoint, such a shortage indicates a mismatch between supply and demand - suggesting that planners have misjudged the demand for the product, the equilibrium price, or both. An imbalance, which would have been corrected naturally in a matter of years in a free-market economy, persisted for decades, while central planners turned a blind eye on it.

As the Soviet Union was collapsing, the system gradually became so unbalanced and shortages became so common that one could wait hours in a queue to buy basic consumer products such as shoes or bread.

This difficulty was first noted by economist Ludwig von Mises, who called it the "economic calculation problem". Economist János Kornai developed this into a shortage economy theory (advocates could claim that shortages were not primarily caused by lack of supply).

A problem of surpluses exists. Surpluses indicate a waste of labor and materials that could have been applied to more pressing needs of society. Critics of central planning say that a market economy prevents long-term surpluses because the operation of supply and demand causes the price to sink when supply begins exceeding demand, indicating to producers to stop production or face losses. This frees resources to be applied to satisfy short-term shortages of other commodities, as determined by their rising prices as demand begins exceeding supply. It is argued that this "invisible hand" prevents long-term shortages and surpluses and allows maximum efficiency in satisfying the wants of consumers. Critics argue that since in a planned economy prices are not allowed to float freely, there is no accurate mechanism to determine what is being produced in unnecessarily large amounts and what is being produced in insufficient

amounts. They argue that efficiency is best achieved through a market economy where individual producers each make their own production decisions based on their own profit motive.

Cannot determine and prioritize social goods better than the market can

Some who oppose comprehensive planned economies argue that some central planning is justified. In particular, it is possible to create unprofitable but socially useful goods within the context of a market economy. For example, one could produce a new drug by having the government collect taxes and then spend the money for the social good. On the other hand, opponents of such central planning say that "absent the data about priorities conveyed through price signals created by freely acting individuals, [it is questionable] whether determinations about what is socially important can even be made at all." Opponents do not dispute that something useful can be produced if money is expropriated from private businesses and individuals, but their complaint is that "it's far from certain that those monies could not have been spent better" if individuals were allowed to spend and invest as they wished according to their own wants.

It is possible to see things of value being produced by the state taxing and using those funds to undertake projects which are believed to be social goods, but not to see what social goods have *not* been produced due to wealth taken out of the hands of those who would have invested and spent their money in other ways according to their own goals. These opponents of central planning argue that the only way to determine what society actually wants is by allowing private enterprise to use their resources in competing to meet the needs of consumers, rather those taking resources away and allowing government to direct investment without responding to market signals. According to Tibor R. Machan, "Without a market in which allocations can be made in obedience to the law of supply and demand, it is difficult or impossible to funnel resources with respect to actual human preferences and goals.".

If the government in question is democratic, democratically-determined social priorities may be considered legitimate social objectives in which the government is justified in intervening in the economy. It must be noted that to date, most if not all countries employing command economies have been dictatorships or oligarchies – few or none were democracies. Many democratic nations, however, have a mixed economy,

where the government intervenes to a certain extent and in certain aspects of the economy, although other aspects of the economy are left to the free market.

Suppression of economic democracy and self-management

Central planning is also criticized by elements of the radical left. Libertarian socialist economist Robin Hahnel notes that even if central planning overcame its inherent inhibitions of incentives and innovation it would nevertheless be unable to maximize economic democracy and self-management, which he believes are concepts that are more intellectually coherent, consistent and just than mainstream notions of economic freedom. As Hahnel explains, "Combined with a more democratic political system, and redone to closer approximate a best case version, centrally planned economies no doubt would have performed better. But they could never have delivered economic self-management, they would always have been slow to innovate as apathy and frustration took their inevitable toll, and they would always have been susceptible to growing inequities and inefficiencies as the effects of differential economic power grew. Under central planning neither planner, managers, nor workers had incentives to promote the social economic interest. Nor did impending markets for final goods to the planning system enfranchise consumers in meaningful ways. But central planning would have been incompatible with economic democracy even if it had overcome its information and incentive liabilities. And the truth is that it survived as long as it did only because it was propped up by unprecedented totalitarian political power."

2.3 PUBLIC CHOICE THEORY

Public choice in economic theory is the use of modern economic tools to study problems that are traditionally in the province of political science. From the perspective of political science, it may be seen as the subset of positive political theory which deals with subjects in which *material* interests are assumed to predominate.

In particular, it studies the behavior of politicians and government officials as mostly self-interested agents and their interactions in the social system either as such or under alternative constitutional rules. These can be represented a number of ways, including standard constrained utility maximization, game theory, or decision theory. Public choice analysis has roots in positive analysis ("what is") but is often used for

normative purposes ("what ought to be"), to identify a problem or suggest how a system could be improved by changes in constitutional rules. Another related field is social choice theory.

2.3.1 Special Interests

Public Choice theory is often used to explain how political decision-making results in outcomes that conflict with the preferences of the general public. For example, many special interest and pork barrel projects are not the desire of the overall democracy. However, it makes sense for politicians to support these projects. It may make them feel powerful and important. It can also benefit them financially by opening the door to future wealth as lobbyists. The project may be of interest to the politician's local constituency, increasing district votes or campaign contributions. The politician pays little or no cost to gain these benefits, as he is spending public money. Special-interest lobbyists are also behaving rationally. They can gain government favors worth millions or billions for relatively small investments. They face a risk of losing out to their competitors if they don't seek these favors. The taxpayer is also behaving rationally. The cost of defeating any one government give-away is very high, while the benefits to the individual taxpayer are very small. Each citizen pays only a few pennies or a few dollars for any given government favor, while the costs of ending that favor would be many times higher. Everyone involved has rational incentives to do exactly what they're doing, even though the desire of the general constituency is opposite. (It is notable that the political system considered here is very much that of the United States, with "pork" a main aim of individual legislators; in countries such as Britain with strong party systems the issues would differ somewhat.)

2.3.2 Decision making processes and the State

One way to organize the subject matter studied by Public Choice theorists is to begin with the foundations of the state itself. According to this procedure, the most fundamental subject is the origin of government. Although some work has been done on anarchy, autocracy, revolution, and even war, the bulk of the study in this area has concerned the fundamental problem of collectively choosing constitutional rules. This work assumes a group of individuals who aim to form a government. Then it focuses on

the problem of hiring the agents required to carry out government functions agreed upon by the members.

The main questions are: (1) how to hire competent and trustworthy individuals to whom day-to-day decision-making can be delegated and (2) how to set up an effective system of oversight and sanctions for such individuals. To answer these questions it is necessary to assess the effects of creating different loci of power and decision-making within a government; to examine voting and the various means of selecting candidates and choosing winners in elections; to assess various behavioral rules that might be established to influence the behavior of elected and appointed government officials; and to evaluate alternative constitutional and legal rights that could be reserved for citizens, especially rights relating to citizen oversight and the avoidance of harm due to the coercive power of government agents.

These are difficult assessments to make. In practice, most work in the field of Public Choice has dealt with more limited issues. Extensive work has been done on different voting systems and, more generally, on how to transform what voters are assumed to want into a coherent "collective preference". Of some interest has been the discovery that a general collective preference function cannot be derived from even seemingly mild conditions. This is often called Arrow's impossibility theorem. The theorem, an economic generalization of the voting paradox, suggests that voters have no reason to expect that, short of dictatorship, even the best rules for making collective decisions will lead to the kind of consistency attributed to individual choice.

Much work has been done on the loose connection between decisions that we can imagine being made by a full contingent of citizens with zero collective decision-making costs and those made by legislators representing different voting constituencies. Of special concern has been logrolling and other negotiations carried out by legislators in exercising their law-making powers. Important factors in such legislative decisions are political parties and pressure groups. Accordingly, Public Choicer have studied these institutions extensively. The study of how legislatures make decisions and how various constitutional rules can constrain legislative decisions is a major sub-field in Public Choice.

2.3.3 Bureaucracy

Another major sub-field is the study of bureaucracy. The usual model depicts the top bureaucrats as being chosen by the chief executive and legislature, depending on whether the democratic system is presidential or parliamentary. (See also presidential system and parliamentary system.) The typical image of a bureau chief is a person on a fixed salary who is concerned with pleasing those who appointed him. The latter have the power to hire and fire him more or less at will. The bulk of the bureaucrats, however, are civil servants whose jobs and pay are protected by a civil service system against major changes by their appointed bureau chiefs. This image is often compared with that of a business owner whose profit varies with the success of production and sales, who aims to maximize profit, and who can hire and fire employees at will.

2.3.4 Rent-Seeking

A field that is closely related to public choice is "rent-seeking." This field combines the study of a market economy with that of government. Thus, one might regard it as a "new political economy." Its basic thesis is that when both a market economy and government are present, government agents are a source of numerous special market privileges. Both the government agents and self-interested market participants seek these privileges in order to partake in the monopoly rent that they provide. When such privileges are granted, they reduce the efficiency of the economic system. In addition, the rent-seekers use resources that could otherwise be used to produce goods that are valued by consumers.

Rent-seeking is broader than Public Choice in that it applies to autocracies as well as democracies and, therefore, is not directly concerned with collective decision-making. However, the obvious pressures it exerts on legislators, executives, bureaucrats, and even judges are factors that Public Choicer must account for in their effort to understand and assess collective decision-making rules and institutions. Moreover, the members of a collective who are planning a government would be wise to take prospective rent-seeking into account.

2.3.5 Political Market Failure: Undemocratic Governments

Public Choice Theory has been developed largely in the context of democratic political systems of the variety that exist in Europe and North America. A pioneering work - and, perhaps, the only work to-date of its kind - seeking to analyze collective decision-making based on rules and institutions that characterize the Less Developed Countries was undertaken by Muzaffar Ali Isani at Georgetown University in 1982. It focuses largely on the assumptions of a generation of development economists who have articulated the role of the state or political action as an efficient alternative to 'economic' market failures. Isani has suggested that once we introduce 'political' market imperfections as generally found in these countries, we may be confronted with the possibility that far from correcting market failures, political action may actually prove to be a source of further distortions in the economy. He then goes on to develop an essentially economic paradigm of politics appropriate to many developing countries and which is consistent with the axioms of economic theory.

2.3.6 Perspective

Prior to the emergence of public choice theory, many economists tended to consider the state as an agent outside the scope of economic theory, whose actions depend on different considerations than those driving economic agents? (The many *other* economists who *did* place the state and its agents within such theory include Vilfredo Pareto.)

Public choice theory attempts to look at governments from the perspective of the bureaucrats and politicians who compose them, and makes the assumption that they act based on Budget-maximizing model in a self-interested way for the purpose of maximizing their own economic benefits (e.g. their personal wealth). The theory aims to apply economic analysis (usually decision theory and game theory) to the political decision-making process in order to reveal certain systematic trends towards inefficient government policies. There are also Austrian variants of public choice theory (suggested by Mises, Hayek, Kirzner, Lopez, and Boettke) in which it is assumed that bureaucrats and politicians may be benevolent but have access to limited information. The assumption that such benevolent political agents possess limited information for making

decisions often results in conclusions similar to those generated separately by means of the rational self-interest assumptions. In another Austrian variant, developed by MacKenzie (2008a, 2008b), voters lack information on the opportunity costs of political choice, and expectation formation in politics is adaptive rather than rational. Randall Holcombe and Richard Wagner have also developed the notion of "Political Entrepreneurship".

2.4 RATIONALE FOR PUBLIC POLICY

Public policy can be generally defined as the course of action or inaction taken by governmental entities (the decisions of government) with regard to a particular issue or set of issues. Other scholars define it as a system of "courses of action, regulatory measures, laws, and funding priorities concerning a given topic promulgated by a governmental entity or its representatives." Public policy is commonly embodied "in constitutions, legislative acts, and judicial decisions."

In the United States, this concept refers not only to the end result of policies, but more broadly to the decision-making and analysis of governmental decisions. Public policy is also considered an academic discipline, as it is studied by professors and students at public policy schools of major universities throughout the country. The American (United States of America) professional association of public policy practitioners, researchers, scholars, and students is the Association for Public Policy Analysis and Management.

2.4.1 Government action

Shaping public policy is a complex and multifaceted process that involves the interplay of numerous individuals and interest groups competing and collaborating to influence policymakers to act in a particular way. These individuals and groups use a variety of tactics and tools to advance their aims, including advocating their positions publicly, attempting to educate supporters and opponents, and mobilizing allies on a particular issue.

In this context, advocacy can be defined as attempting to influence public policy through education, lobbying, or political pressure. Advocacy groups "often attempt to educate the general public as well as public policy makers about the nature of problems,

what legislation is needed to address problems, and the funding required to provide services or conduct research. Although advocacy is viewed as unseemly by some in the professional and research community, it is clear that public policy priorities are influenced by advocacy. Sound research data can be used to educate the public as well as policy makers, thereby improving the public policy process."

2.4.2 as an academic discipline

As an academic discipline, public policy brings in elements of many social science fields and concepts, including economics, sociology, political economy, program evaluation, policy analysis, and public management, all as applied to problems of governmental administration, management, and operations. At the same time, the study of public policy is distinct from political science or economics, in its focus on the application of theory to practice. While the majority of public policy degrees are masters and doctoral degrees, several universities also offer undergraduate education in public policy.

Different policy schools tackle policy analysis differently. The Harris School of Public Policy Studies at the University of Chicago has a more quantitative and economics approach to policy, the Heinz College at Carnegie Mellon uses computational and empirical methods, while the John F. Kennedy School of Government at Harvard University has a more political science and leadership based approach.

Public policy is an attempt by the government to address a public issue. The government, whether it is city, state, or federal, develops public policy in terms of laws, regulations, decisions, and actions. There are three parts to public policy-making: problems, players, and the policy.

The *problem* is the issue that needs to be addressed. The *player* is the individual or group that is influential in forming a plan to address the problem in question. *Policy* is the finalized course of action decided upon by the government. In most cases, policies are widely open to interpretation by non-governmental players, including those in the private sector. Public policy is also made by leaders of religious and cultural institutions.

Academics continue to contemplate the definition of public policy, since there is currently no consensus. The study of public policy began in 1922, when Charles Merriam, a political scientist, sought to build a link between political theory and its

application to reality. Numerous issues are addressed by public policy, including crime, education, foreign policy, health, and social welfare.

In 1993, due to ineffective healthcare policies, the Clinton administration sought to implement a policy that would bring about a national healthcare system. As part of the policies being considered, the US federal government would protect the healthcare consumer's rights, consumers would be able to form alliances to obtain better healthcare prices, and caregivers would be required to provide fair healthcare packages. Players involved in the policy-making process included lobbying groups and politicians. While some changes were made to healthcare provisions by legislators, the policies advocated by the Clinton administration were not put into effect as result of political differences.

The rational model for the public policy-making process can be divided into three parts: agenda-setting, option-formulation, and implementation. Within the agenda-setting stage, the agencies and government officials meet to discuss the problem at hand. In the second stage, option-formulation, alternative solutions are considered and final decisions are made regarding the best policy. Consequently, the decided policy is implemented in the final stage. Implied within this model is the fact that the needs of the society are a priority for the players involved in the policy-making process. Also, it is believed that the government will follow through on all decisions made by the final policy.

Unfortunately, those who frame the issue to be addressed by policy often exert an enormous amount of influence over the entire process through their personalities, personal interests, political affiliations, and so on. The bias is extenuated by the players involved. The final outcome of the process, as well as its implementation, is therefore not as effective as that which could result from a purely rational process. Overall, however, public policy continues to be vital in addressing social concerns.

2.5 PUBLIC POLICY AND PROVISION OF PUBLIC AND LOCAL GOODS

The term "local public goods" was introduced into the economics literature by Charles Tiebout in a still frequently cited 1956 paper. Previously, public or social goods were conceived of simply as goods that, if available to one person, were available to all. National defense was a commonly cited example. Richard Musgrave's somewhat

awkward 1969 characterization of such goods as exhibiting "non-rivalness" in consumption and "non-excludability" from consumption has remained in the literature.

The non-excludability of public goods has an important consequence, namely that a decentralized mechanism to achieve their optimal provision cannot be found; that is, it is not generally possible to find a way to get individuals to reveal their true valuation for public goods. This is the public goods problem, and it's one upon which Paul Samuelson laid considerable stress in a well known 1954 paper on public goods.

The public goods problem highlighted by Samuelson led to Tiebout's 1956 response. Tiebout argued that there was a class of public good, the local public good, for which a decentralized mechanism for achieving optimal allocations did indeed exist. His paper, along with others published in reaction to Samuelson's article, focused on the fact that many public goods are subject to congestion. This is especially true, it was argued, of public goods provided by local governments. A city park, a stretch of roadway, a fire department, a school; these are available to everyone in the community, but for any given level of infrastructure the more people who use the facility the more crowded it becomes and the less it is available or useful to others. Using Musgrave's terminology, local public goods exhibit non-excludability but not non-rivalness; they are partially rival (or partially non-rival).

Tiebout's model is one in which each local community or jurisdiction provides a mix of public goods. Those who live in the jurisdiction receive the benefits of these goods and pay for them through a tax levied equally on each taxpayer. There are no interactions between jurisdictions.

The key to Tiebout's mechanism lies in the assumed mobility of people. If people can costlessly move from one jurisdiction to another, they will move to the jurisdiction in which the mixture of services and tax level provides them with the greatest net benefit. Other location attributes, such as the availability of jobs, are ignored.

Those who like better schools and are prepared to pay more for them will be in one community; those who would prefer to pay less and make do with poorer schools will be in another community. Taxes are paid according to benefits received, a situation that has come to be called the "benefits" view of local taxation. With enough variety

among the jurisdictional offerings, each community will end up with people having identical preferences.

Because of congestion, there will be some optimum or least-cost size for each community. This size will occur where the benefit of sharing the infrastructure costs with another taxpayer will be just equal to the crowding cost imposed by the new person. If there are more people with a given preference pattern than can fit within an optimal community, then their needs will be met in another identical jurisdiction.

Within each jurisdiction, residents will pay the same tax, consume the same amount of public goods, and agree on the desirability of expanding or contracting any given service. The problem of providing a mechanism to achieve the efficient provision of public goods would appear to have been solved, at least for local public goods. In Tiebout's words, "Spatial mobility provides the local public-goods counterpart to the private market's shopping trip."

Tiebout's theory has a close counterpart in the theory of clubs, which was introduced in a 1965 paper by James Buchanan, and it is through the development of club theory that a number of aspects of local public goods have become better understood. Like Tiebout's communities that provide local public goods only to tax-paying members of the jurisdiction, clubs are able to restrict the provision of club services to those who are members. Club goods are thus excludable, like private goods, but like local public goods they are only partially rivalries.

One of the best known club theoretic results is that a group of individuals with heterogeneous preferences would be better off forming a separate club for each homogeneous preference group rather than forming one club for the larger group. In terms of the local public-goods model, this implies that if there were two types of people, the rich with one set of preferences and the poor with another set, both types would be better off in their own separate Tiebout jurisdiction than they would be together in a mixed jurisdiction.

The second assumption is that there must be no beneficial interaction among the different members of a heterogeneous group: there must be no benefit in having people of different skills or cultures together in one community.

The third assumption is that an integer number of optimally sized jurisdictions exist for each homogeneous group. If the best sized community for some set of local public goods is 50,000 and there are 75,000 people sharing a preference for this mix of public goods, then the Tiebout solution cannot exist.

This so-called "integer" problem may be less important than it at first appears. An optimally sized jurisdiction occurs at the bottom point on a U-shaped cost curve (where costs include congestion as well as infrastructure costs) where returns to scale are constant. Constant returns to scale in this case means, for example, that equal proportionate changes in infrastructure and in facility use would not change the degree of congestion. If the bottom part of the U-shaped cost curve were relatively flat, implying that constant returns to scale prevailed approximately for some distance to either side of the optimum, then a range of community sizes would be approximately optimal and so it would be easier to provide an integer number of communities for a group of like-minded people of any size. If constant returns to scale existed everywhere, then the integer problem would completely disappear: any person with a unique preference profile could have their own optimally sized jurisdiction of one.

The existence of constant returns to scale has another interesting implication, one first explored within the context of optimal road pricing. If exclusion is possible with respect to a local public good, so that a user fee may be charged, then a fee set optimally to equal the external congestion cost imposed on other users will generate exactly the amount of resources needed to cover the infrastructure cost, if the infrastructure is of optimum size.

Tiebout's article has generated an enormous and continuing literature, much of it dealing with two principal normative implications of his model: that smaller homogeneous local jurisdictions are better than larger integrated municipalities and that politics is unnecessary at the local level.

Some see the absence of politics as strength of the mechanism, while others are critical of the model precisely because it does not deal with the politics of municipal finance, The absence of politics leaves the Tiebout model with a gap on the supply side of local public goods. How do the optimal jurisdictions arise? The issue of supplying optimal clubs has been the subject of much club-theoretic literature, where reasonable

dynamics have proved difficult to establish. This difficulty carries over to the local public-goods model of Tiebout, although some argue that the maximization of land value in a local jurisdiction provides the proper signal for a developer of an urban community to achieve the Tiebout result.

The issue of smaller homogeneous jurisdictions versus larger integrated ones is currently in high relief, both in the theoretical literature and in practice. Those who favour smaller jurisdictions rely almost entirely on the arguments set forth by Tiebout, combined with the standard view of fiscal federalism that local governments should not engage in redistribution but should focus on supplying local public goods optimally. Those who argue differently do so for a variety of reasons. One is that local governments do and should have a redistributive role to play. Larger, heterogeneous jurisdictions are better positioned to play that role than smaller homogeneous ones.

A second reason for favoring larger jurisdictions is based on more theoretical considerations. Tiebout did not take into account the effect on land prices as more people try to access a local public good available only at a given geographic location. Recent research suggests that when land markets are taken into account, the Tiebout-type decentralization of local public good provision requires larger metropolitan governments supplying a range of goods and services.

2.6 PROVISION OF INFRASTRUCTURE FACILITIES

India is the seventh largest and second most populous country in the world. A new spirit of economic freedom is now stirring in the country, bringing sweeping changes in its wake. A series of ambitious economic reforms aimed at deregulating the country and stimulating foreign investment has moved India firmly into the front ranks of the rapidly growing Asia Pacific region and unleashed the latent strengths of a complex and rapidly changing nation. India's process of economic reform is firmly rooted in a political consensus that spans her diverse political parties. India's democracy is a known and stable factor, which has taken deep roots over nearly half a century. Importantly, India has no fundamental conflict between its political and economic systems. Its political

institutions have fostered an open society with strong collective and individual rights and an environment supportive of free economic enterprise.

India's time tested institutions offer foreign investors a transparent environment that guarantees the security of their long-term investments. These include a free and vibrant press, a judiciary that can and does overrule the government, a sophisticated legal and accounting system and a user-friendly intellectual infrastructure. India's dynamic and highly competitive private sector has long been the backbone of its economic activity. It accounts for over 75% of its Gross Domestic Product and offers considerable scope for joint ventures and collaborations.

Today, India is one of the most exciting emerging markets in the world. Skilled managerial and technical manpower that match the best available in the world and a middle class whose size exceeds the population of the USA or the European Union, provide India with a distinct cutting edge in global competition.

The road transport sector has been declared a priority and will have access to loans at favorable conditions. The Monopoly and Restrictive Trade Practices Act (MRTP Act) was passed in order to encourage large industry to enter the road sector.

The National Highways Act has been modified to help the reduction of tolls on national motorways, bridges and tunnels. Calcutta's Howrah Bridge is the world's busiest with a daily flow of 57,000 vehicles and innumerable pedestrians. Private participation in the energy sector has been encouraged with the reduction of import duties, a five-year tax exemption for new energy projects and a 16% return on equity.

The government is also following a new telecommunications policy that aims for the improvement of quality to a worldwide standard and, as a result, India could emerge as a major producer and exporter of telecommunication systems. Advantageous policies in this sector are encouraging private and foreign participation.

Previously, development of infrastructure was completely in the hands of the public sector and was plagued by corruption, bureaucratic inefficiencies, urban-bias and an inability to scale investment. India's low spending on power, construction, transportation, telecommunications and real estate, at $31 billion or 6% of GDP in 2002 had prevented India from sustaining higher growth rates. This has prompted the

government to partially open up infrastructure to the private sector allowing foreign investment which has helped in a sustained growth rate of close to 9% for the past six quarters.

Some 600 million Indians have no mains electricity at all. While 80% of Indian villages have at least an electricity line, just 44% of rural households have access to electricity. According to a sample of 97,882 households in 2002, electricity was the main source of lighting for 53% of rural households compared to 36% in 1993. Some half of the electricity is stolen, compared with 3% in China. The stolen electricity amounts to 1.5% of GDP. Almost all of the electricity in India is produced by the public sector. Power outages are common. Many buy their own power generators to ensure electricity supply. As of 2005 the electricity production was at 661.6 billion kWh with oil production standing at 785,000 bbl/day. In 2007, electricity demand exceeded supply by 15%. Multi Commodity Exchange has tried to get a permit to offer electricity future markets.

Indian Road Network is developing. Trucking goods from Gurgaon to the port in Mumbai can take up to 10 days. India has the world's third largest road network. Container traffic is growing at 15% a year. Some 60% of India's container traffic is handled by the Jawaharlal Nehru Port Trust in Mumbai. Internet use is rare; there were only 7.57 million broadband lines in India in November 2009, however it is still growing at slower rate and is expected to boom after the launch of 3G and wimax services.

Most urban cities have good water supply water 24 hours a day, while some smaller cities face water shortages in summer season. A World Bank report says it is an institutional

2.7 PUBLIC POLICY, ALLOCATION OF RESOURCES AND INEQUALITIES

Whether economic policies in India have lead to regional inequalities has been a source of debate. As far as the role of transfers are concerned, recent empirical evidence by Ghosh, Marjit and Neogi (1998) found that although the allocation of funds across the states have been in accordance with the level of income across the states, growth performances of states do not seem to be converging.

They attribute the rising disparity to the lower efficiency with which public capital is utilized particularly in the poorer states and also because of the infrastructural disparity between the states. Jha et. al. (1999) attempt to measure the pure tax efficiency of fifteen major Indian states for the period from 1980/81 to 1992/93 in a manner that allows efficiency of both to vary across time as well as across states. Their results revealed that there exists a moral hazard problem in the design of central grants in the sense that higher grants by central governments to the state governments reduce efficiency of tax collection by these states.

In a study on regional disparities, a study by Raman (1998), reveals that recent Finance Commissions (from the sixth commission onwards) have been more equitable and have benefited poorer states more than richer ones, while the same cannot be said for Planning Commission devolutions. However the type of funding and the share of transfers have changed in the last four commissions, in the sense that the type of automatic transfers have declined. That is finance commission transfers are declining in importance and that the portion of funds which come under the non-statutory type of distribution has increased. Amongst the poorer states, hill states of Manipur, Meghalaya, Nagaland, Mizoram and Arunachal Pradesh received higher than average level of funding. Among the subsequent finance commissions, the primary aim was to fill nonplan budgetary gaps of states, which are taken to be the financial needs of states. Typically, these estimates are incorrect and lead to further increases in budgetary gaps. The states are able to exploit the non-plan grants in aid, by presenting a set of data that shows the deficits in the states' budget. The nonplan grants are also harmful because the commission attaches no conditionality to the grants, thus, leaving no incentive for the states to improve their deficit situation. Moreover, the rates of return specified by the Finance Commission for state investments are very low and losses still made were covered by the Finance Commissions.

Alongside with the Finance Commission, the Planning Commission also disburses funds under the category of Plan expenditures. The funds are provided by the commission on the basis that states would be able to match this amount. This prompts all state governments to provide inflated estimates of expenditure and their revenue. The Planning Commission transfer of resources is done through loans and grants in the ratio 70:30. The

high share of loans component means that indebtedness of the states increases in successive plans. At the same time the ratio of grants to loans for the special category states have been in the ratio 90:10, which has meant that these states increasingly rely on central assistance for development expenditures. Plan transfers have been unequal with the special category states getting a much higher resource share than the national average, while other less developed states such as Bihar, Uttar Pradesh and Madhya Pradesh having received a much less share in all Plan periods.

Finally the proportion of discretionary transfers which the central government may decide by a formula of its own has risen to about 60% of the total disbursements. Goerge (1987) is critical of such transfers and is of the view that such transfers are open to political bargaining and horse-trading. Till now the discussion had focused on the problem of central government grant allocation and its impact on equity across states as well as policy distortions that it might induce.

It is also at the same time necessary to investigate as to how the duration of democratic governments might lead to distortions in fiscal policies. Dutta (1996) tries to explain the same using state election data from 1967 onwards for 15 major states. His main interest was to see the impact on the emergence of short lived coalition governments in the Indian case on their fiscal policies.

The main hypothesis being tested is, in a democratic setup, if political power alternates rapidly and randomly between competing parties or groups of parties, then each government will follow myopic policies since it assigns a low probability to being re-elected. Hard policy options whose benefits flow after a long gestation lag are unlikely to be adopted by such a government. Instead it may spend indiscriminately to satisfy the short term needs of its support groups. This will result in a policy of high debt to its successor.

Although this may constrain the next government, the current government does not care of the priorities of the next government. The analysis of data relating to the revenue budgets of major states in India during 1967/68 to 1992/93 does largely seem to support the fact that that unstable ruling coalitions tend to have a significantly higher ratio of revenue expenditure to state domestic product. Problems have also come up from the perspective of political representation of the states in the Lok Sabha. Till 1976, the

proportion of seats assigned to a state in the Lok Sabha was in the ratio of the states population to the total population of the country.

However, over the years, the southern states have performed very well on the area of population control, while this has not been so for the northern states, as a result in the first few decades after independence, the former were losing out on Lok Sabha seats to the north during the delimitation exercises. To prevent this anomaly, a freeze on Parliamentary seats was done in 1976 for a period of 25 years, which expires in 2001. Given the population projections, a revision based on 2001 census would mean U.P gaining 8 seats, Madhya Pradesh 3 and Haryana 1, while Tamil Nadu would loose 6 seats, Kerala 4 and Andhra Pradesh 1.

According to demographer Ashish Bose, a skewed distribution of central financial allocations to the states could also result from the expanding population growth differential. While the Central Plan funds will not be affected, distribution of revenue funds such as excise can run into problems. On the other hand continuing with the freeze, and not going in for delimitation would mean over-representation of small constituencies and under representation of large constituencies especially in urban areas, which is actually against the spirit of the constitution.

Apart from the political front, the widening disparity between the north and the south has also had significant economic fallouts. According to Goerge Mathew, southern states being more progressive and stable are attracting more investments and hence offering more job opportunities. In such a situation one cannot rule out the possibility better wages, better living conditions in the south attracting migrants from the north.

2.8 PROBLEM OF REGIONAL IMBALANCES AND DISPARITIES

The problem of regional imbalances is highly critical for almost all the countries of the world. There have always existed a variety of inter-regional and inter-state variations in terms of all macro indices linked with economic and social issues. There is what is known as 'declining areas' or 'special areas' within the frontiers of each country. These typical areas qualify for special government assistance to uplift them from a state of stagnation or near stagnation, resulting from local unemployment, industrial

imbalance, declining industries, over-population, and a variety of other economic and social 'pulling' factors.

The problem is highly alarming in developing countries most of which suffer from acute and lasting differences in prosperity between geographical regions. This phenomenon of regional income differentials is termed as 'regional dualism' or in American terminology as 'North-South problem'. India is no exception to this. The time series data set on various economic and social indices surely supports the hypothesis of regional imbalances in the country.

Such regional imbalances fall within the domain of what we term as 'regional economics'. In order to emphasize its inter-disciplinary nature it is also sometimes called 'regional analyses and also 'regional science'. Apart from economics, it also heavily draws on demography, history, geography, sociology and other disciplines.

The foremost problems of regional economics are concerned with (a) classifying regions, (b) measuring the inter-regional differences in prosperity/poverty, and (c) pulling, through economic and other measures, the declining areas so that are bestowed with equitable and balanced distribution of national prosperity and well being.

Let us first look at the first problem, which refers to identifying or defining 'regions'. Three different approaches are available. The first approach considers 'homogeneity' of regions with respect to either economic, social, geographic or other features, or their combinations. The homogeneity can also be in terms of statistical compilations.

The second approach is that of 'polarization' and defines regions on the basis of their being linked (in certain ways through say, trade, government help) with some central urban place.

There has been a continuous debate over globalization, income inequalities and regional disparities in India. While some scholars say that globalization has cast a favorable impact on the overall economic condition of the country, there are also lots of scholars who argue that factors such as poverty, income inequality and regional disparities have not been affected by globalization. In order to have an idea, one needs to deeply analyze various factors.

2.8.1 Globalization and income inequality

Although globalization has led to the economic development in the country, it has not really helped to minimize income inequalities across the country. Recent surveys say that lots of people across the country still live below the poverty line and their standard of living has gone down considerably. In fact, the poverty level in India is much more than that of China. One of the main causes of poverty in India is income inequality. While the effects of globalization, economic liberalization and market growth are being felt in the cities and urban sectors across the country, most of the rural areas are still not so developed and the condition has also not significantly improved. No doubt, there has been some improvement but still a lot needs to be done.

A significant portion of the rural mass does not have access to the basic amenities such as electricity, education, sanitation, drinking water, and infrastructure. The wealth distribution pattern is also uneven in the country. Recent surveys have shown that the top 10% of the income groups share around 33% of the total income of the country. Even after globalization and economic progress, around a quarter of the population of the country has a earning less than the minimum level of $0.40 per day.

2.8.2 Globalization and regional disparities

Globalization has also not done much good to reduce disparities between various regions and states across the country. While some states have a high earning, there are also some states which have a very low growth rate. Some of the states which have a high income are Gujarat with 8.8%, Delhi with 7.4% and Haryana with 8.7%. In comparison to these, Bihar with 5.1%, Uttar Pradesh with 4.4% and Madhya Pradesh with 3.5% are some of the lowest ranking states with very little socio economic growth.

To minimize the income inequalities and regional disparities across the country, the government has taken a number of steps. Lots of rural development programs have been initiated to make the rural mass self sufficient and financially stable. In this regard, the government has set up village cooperative banks, Regional Rural Banks and so on to help the poor and the villagers. The government also offers land for farming at cheap rates, tax relief and other incentives to minimize regional disparities and income inequality.

2.8.3 Growth and Regional Disparities

India saw an annual growth rate of GDP (Gross Domestic Product) of only 3.6% during the 3 decades, post-independence. It's a growth of only 1.4% in terms of per capita. The economy of the country only moved towards higher growth trajectory during 1980s, when it saw a growth rate of 5.4%.

The growth rate of GDP soared up to 7.3% by 2007-08, whereas the per capita GDP saw a growth of 5.7%. Due to sufficient foreign exchange reserves, moderate inflation, stable exchange rates and adequate food stocks, the country achieved a sustainable growth rate.

However, the gross state domestic product growth rates largely varied between states in India. The states like Assam, Uttar Pradesh, Madhya Pradesh and Bihar saw a growth rate of less than 5% in pre and post reform period. On the other hand, states like Andhra Pradesh, Tamil Nadu, Gujarat, Karnataka, Haryana saw a growth rate of less than 5% during 1980-93, which improved considerably during 1993-2006.

States	GSDP		Per Capita GSDP	
	1980-81 / 1992-93	1993-94 / 2005-06	1980-81 / 1992-93	1993-94 / 2005-06
Andhra Pradesh	5.72	6.53	3.50	5.41
Assam	3.98	3.54	1.75	2.14
Bihar	3.41	4.73	1.23	5.26
Gujarat	6.77	7.10	4.74	5.30
Haryana	5.75	6.98	3.24	4.81
Karnataka	5.57	6.88	3.59	5.50
Kerala	3.82	6.28	2.44	5.51
Madhya Pradesh	4.49	4.91	2.07	6.00
Maharashtra	6.32	6.17	3.97	4.42

Orissa	3.67	5.53	1.80	4.31
Punjab	5.21	4.53	3.23	2.93
Rajasthan	7.37	5.44	4.74	3.29
Tamil Nadu	5.46	6.12	4.03	5.16
Uttar Pradesh	4.47	4.19	2.17	2.59
West Bengal	4.57	6.61	2.35	5.23

Source: CSO

finally, globalization has had its effect on Indian economy. There also exist income inequalities and regional disparities. Yet, these shouldn't be treated as the inevitable outcomes of globalization. There are also some other factors like politics, political institutions, political mobilization, and policy frameworks etc. which play major role in creating income inequalities and regional disparities in the country. Political preferences often slow down the process of growing inequalities, which avert the movement from agriculture to service.

Disparities in economic and social development across the regions and intra-regional disparities among different segments of the society have been the major planks for adopting planning process in India since independence. Apart from massive investments in backward regions, various public policies directed at encouraging private investments in such regions have been pursued during the first three decades of planned development. While efforts to reduce regional disparities were not lacking, achievements were not often commensurate with these efforts. Considerable level of regional disparities remained at the end of the Seventies. The accelerated economic growth since the early Eighties appears to have aggravated regional disparities. The on-going economic reforms since 1991 with stabilization and deregulation policies as their central pieces seem to have further widened the regional disparities. The seriousness of the emerging acute regional imbalances has not yet received the public attention it deserves.

Most of the studies on inter-country and inter-regional differences in levels of living and income are done within the theoretical framework of neoclassical growth models. These models, under plausible assumptions demonstrate convergence of

incomes. Three notable recent studies[3], however, indicate that in the Indian context these convergence theories do not explain the ground realities.

The scope of analysis in this section is restricted to a comparative analysis of the emerging trends in fifteen major States[4] in respect of a few key parameters which have an intrinsic bearing on social and economic development. The variables chosen for examination include those which have a bearing on gender and equity issues. The fifteen States together account for 95.5 per cent of the population of India. The remaining 4.5 per cent of the population is spread out in 10 smaller States and seven Union Territories including the National Capital Territory of Delhi. Leaving out these States and UTs from detailed study is mainly due to non-availability of all relevant data and also to keep the data sets analytically and logistically manageable. The fifteen States taken up for the detailed study has been grouped into two - a forward group and a backward group. The forward group consists of Andhra Pradesh, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Punjab and Tamil Nadu. The backward group comprises of Assam, Bihar, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and West Bengal.

Geographically, the forward group of States falls in the Western and Southern parts of the country and are contiguous except for Punjab and Haryana which are separated by Rajasthan from the rest of the States in this group. The group of backward States is in the Eastern and Northern parts of the country and is geographically contiguous. Another notable geographical feature is that while six out of eight States, except Haryana and Punjab, in the first group have vast sea coasts, only two out of the seven in the second group viz., Orissa and West Bengal are littoral. While the forward group of States account for about 40.4 per cent of the national population, the backward group accounts for as much as 55.1 per cent of the population of the country according to 2001 census[5]. In terms of natural resources including mineral wealth, water resources and quality of soil, the latter has definite edge over the former.

A limitation of inter-regional analysis using States as units is the fact that this may not be able to capture the significant intra-State disparities in economic and social development, which exists today. The larger States in both the groups have regions within themselves, which are vastly different in terms of various indicators of development. There are identifiable distinct regions, at different stages of development,

in several States. After discussing the inter-regional disparities in development, treating States as units, we will take up intra-State disparities for a brief analysis in the latter part of the present study.

2.8.4 Income and Property

The most common indicator of the economic development of a society is the per capita annual income generated by it. The level of poverty or the share of population which do not have minimum income to meet its basic requirements is an indicator of the level of economic development as well as the inequality in the income distribution

Per capita gross state domestic product (GSDP) as a percentage of per capita GDP of the country at four time periods since 1980-81 for forward and backward group of States are presented in the table below:

Table 3

Per capita GSDP as a percentage of GDP

(Three-year average of incomes at current prices centered on)

States	1981-82	1985-86	1990-91	1997-98
Forward group				
Andhra Pradesh	87.4	82.4	92.5	92.9
Gujarat	125.3	124.4	118.8	137.4
Haryana	146.5	139.9	146.6	139.4
Karnataka	92.8	93.7	95.4	107.2
Kerala	90.5	90.9	87.8	116.4
Maharashtra	143.0	134.7	144.7	167.5
Punjab	168.6	165.0	169.7	146.5
Tamil Nadu	92.8	97.0	100.0	119.5
Backward group				
Assam	83.6	92.1	83.1	62.2
Bihar	58.8	60.6	53.5	44.2
Madhya Pradesh	80.8	74.8	78.1	73.5
Orissa	75.0	74.7	66.9	61.8
Rajasthan	76.6	74.0	79.3	81.1

Punjab	0.89	0.82	0.78	0.56
Tamil Nadu	8.05	7.53	6.31	5.01
Total for forward States	35.57	36.08	33.35	27.77
Backward Group				
Assam	2.41	2.47	3.01	3.63
Bihar	14.31	13.71	15.40	16.36
Madhya Pradesh	8.61	8.61	9.32	11.47
Orissa	5.62	5.40	5.01	6.50
Rajasthan	3.93	4.65	4.01	3.14
Uttar Pradesh	17.24	17.47	18.87	20.36
West Bengal	9.87	9.24	7.95	8.20
Total for Backward States	61.99	1.55	63.57	69.66
All India	100.00	100.00	100.00	100.00

Source: Planning Commission, Govt of India

The sharp decline in the share of poor population in the forward States since 1987-88, especially after 1993-94 is commendable. We have already noted that there was a steep fall in the share of poor in the country during the nineties. The two together imply that the main beneficiaries of the overall decline in poverty in the country have been the fast growing States in the forward group. This, in a sense, unequivocally establishes the close positive relationship between poverty reduction and economic growth.

In contract, the share of the poor in the seven States in the backward group has gone up significantly. Now they account for about 70 per cent of the poor in the country. As the table indicates, each one of the States in this group, except West Bengal, experienced considerable increase in the share of the poor. West Bengal's exceptional experience was mainly on account of the fast growth in agricultural production and the associated rural prosperity. Again, the positive association between poverty reduction and economic growth, especially agricultural growth is to be noted. It may, however, be mentioned that since the overall poverty in the country has come down substantially in the nineties, an increase in the State share in poverty need not imply an increase in the number of poor. Indeed, between 1993-94 and 1999-2000, the absolute numbers of poor in all the States have come down.

2.9 POLICY INITIATIVES FOR BALANCED REGIONAL GROWTH

We shall initiate the discussion on initiatives for balanced regional growth by illustrating two instances of initiatives in the past. One relates to agriculture and the other relates to industry, the two most important sectors of our economy. The strategy to boost agricultural production and to ensure food security was evolved in the mid-Sixties when the country faced a grim situation following two consequent years of severe draught. The strategy consisted of various incentives to farmers to adopt high yielding seeds of wheat and paddy along with complimentary inputs, assured minimum support prices for the output, buffer stocking of the foodgrains and supplying the same to the States to distribute through the public distribution system (PDS) to the consumers, especially in the deficit regions. To back up this strategy, institutions like Agricultural Prices Commission (APC), Food Corporation of India (FCI) and Warehousing Corporation of India and other ancillary institutions were established. Arrangements were made to spread the message of high yielding seeds and the associated package of inputs and practices.

The above strategy ushered in a green revolution, which resulted in doubling of wheat and rice production in the country over a short period. Adequate foodgrains surpluses were generated to build up the needed buffer stock. India was no more a 'basket case'.

The initial success of green revolution strategy was restricted to Punjab, Haryana and western Uttar Pradesh where assured irrigation networks already existed. Subsequently it was extended to a few irrigation commands in the South and West also. It was, however, expected that with the expansion of assured irrigation the green revolution would spread to other parts of the country soon. In the event this did not happen. Even today almost the entire foodgrain surpluses are generated by the small region, which benefited initially. Though massive public funds are spent on food subsidies, very little is spent on spreading irrigation. Besides food subsidies, large implicit subsidies to farmers for power, diesel, canal irrigation, fertilizer and credit are born by public exchequer at the Centre and in the States. Agricultural Price Policy which was evolved by APC to ensure adequate protection to the interests of the producers and

consumers has been 'high-jacked' to serve the interests of the large farmers who produce for the market. It hardly serves the interests of farmers in the emerging surplus regions. The distinction between support price and procurement price is no more there. Similarly, the Food Corporation of India and the associated procurement agencies operate, by and large, only in the traditional surplus regions and farmers in newly emerging surplus regions almost invariably end up selling their surpluses in distress.

Today the foodgrain management and the food security system is near collapse. As against a total requirement of 24 million tonnes of foodgrain for buffer stock and PDS together, the public stock is over 60 million tones as on July 1,2001. A substantial share of this is not even properly stored and may not be suitable for human consumption. On the other hand due to severe drought conditions large scale unemployment and hunger are reported from several States. Per capita net availability in the market has come down. PDS system has virtually collapsed. Poor people cannot afford the 'so called economic price' of foodgrains available in the PDS shops.

This is a classic case of a public policy evolved with much thought and resulted in significant gains for the country, as a whole, for several years initially but gone sore subsequently. Instead of adjusting the agricultural and food security policies to expand the scope of green revolution technology to the other regions of the country, they were allowed to be high-jacked by vested interests.

The other example of a major public policy, which had gone sore after initial success is the industrial policy. In the Fifties, when India initiated a policy of import substitution by starting various industries in key sectors there were very few critics both within the country and abroad. Indeed, the industrial policy embedded in the second Five Year Plan, giving emphasis to basic and heavy industries, was lauded equally by Russian experts as well as western experts. That policy enabled the country to lay the foundations of an industrial base.

Gradually the ills of public sector undertakings and the stifling effects of a market without competition became more and more evident. By late Sixties and early Seventies, several perceptive observers noted that there was need to deregulate the industrial sector to allow competition. Government, instead, went ahead with nationalization of more and more key sectors of the economy and also further throttling of private sector to control

concentration of wealth and industrial power. The result was further retrogression and immiserization of the economy.

The above two examples have been described in some detail to make the important point that major public policies initiated with thought and foresight and which initially yielded results, subsequently generated into fiefdom of powerful vested interests who will try all the trides in their trade to frustrate corrective measures. Kulaks and the so-called 'Deshi' industrialists who benefited from 'licence-permit raj' are not the only vested interests who stand in the way of programmes and reduction in regional disparities. The list includes politicians, trade unions, bureaucracy, various monopolists in the economy and the educated intelligent who occupy positions of power and patronage. Most of them collect one kind of 'rent' or other which they are not willing to give up only when there is crisis they will loosen their stranglehold, that too only a little which will suffice to defuse the crisis.

The economic reforms initiated in 1991 were also essentially crisis driven. It was the international payment crisis which forced the country to carry out deregulation of trade and industry. Again, once the crisis was overcome reforms also slowed down. There are several vital areas of reforms, which we have been talking about for the last one decade without doing much—public sector reforms, reform of labour laws, reform of the legal system, establishment of effective regulatory bodies and so on. Again, it is the politicians, the bureaucrats, the 'Deshi' industrialists and the trade union leaders who are standing in the way. They do not want to give up the powers, perks and monopoly profits, which they have been enjoying.

The main interest of the foreigners in India is its large potential market. Unless the rural incomes grow, especially in the backward regions this potential market will not be realized. Corporate India must realize that its future lies with the masses. Raising rural incomes should no longer be looked upon only as a philanthropic objective.

Also reduction of regional disparities should be looked upon as a national objective. The strength of a building depends on the strength of its weakest pillar. In a similar way the strength of the Indian economy depends on the strength of the economy of Bihar. Similarly, the bottom-line of India's human development will depend on the incomes and socio-demographic indicators of development in northern and eastern India.

While the development of depressed regions is a national responsibility, the solution mainly rests with the local leadership. Unless the local leadership—political, bureaucratic and intellectual—resolve to usher in development based on sharing the gains on egalitarian basis with the masses, results will be hard to come by. Resources are not the real constraint. It is the way resources are spent. Large sums are spent on education and health care in the backward States. But the results are not there. This happens because the teachers and medical personnel who are expected to provide the requisite services draw their salaries but provide poor services or no services. Unless this kind of work culture in public services changes, funds alone will not solve the problems.

Lastly, with divergent trends in various sectors of development, there emerges a resistance to vertical and horizontal fund transfers to the backward regions by forward regions. Immediately after the report of the Eleventh Finance Commission there was uproar from the so-called 'performing States' against increased tax revenue devolution to the backward States. One of the main arguments was that non-performing States are rewarded for their non-performance. It is imperative that Centre and the leadership of the backward States should evolve institutional arrangements to ensure that funds transferred result in the best use in terms of development.

Activity 2

1. Discuss briefly the role of government in economic planning.
2. What do you understand by public choice theory? Describe the rationale for public policy.
3. Write a note on provision of public goods in public policy.
4. Explain the problems of inequality and regional disparities in India.

2.10 SUMMARY

In this unit we highlighted the economic planning and development and role of government as an agent of economic planning. Planned economy is discussed as an economic system in which the central government makes all decisions on the production and consumption of goods and services. Another area of discussion was public choice and its theory in which public choice is described as economic theory is the use of modern economic tools to study problems that are traditionally in the province of political science. The next area of concern was rationale for public policy followed by

public policy and provision of public and local goods. Provision of infrastructure facilities and allocation of resources according to public policy were dealt in detail. Finally problems of regional imbalances and disparities were revealed.

2.11 FURTHER READINGS

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POST GRADUATE PROGRAMME

M.A. (FINAL) ECONOMICS

Paper - IV (A)

M.A. (FINAL) ECONOMICS

DISTANCE EDUCATION

PUBLIC ECONOMICS

BLOCK : II

Unit 1 Introduction to public expenditure

Unit 2 Public investment and government budgeting

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DISTANCE EDUCATION

SELF INSTRUCTIONAL MATERIAL

BLOCK : II

Unit 1 Introduction to public expenditure

Unit 2 Public investment and government budgeting

PAPER - IV (A) M.A. (FINAL) ECONOMICS

BLOCK - II

Public Economics

BLOCK 2. PUBLIC EXPENDITURE

This block comprises of two units. Unit 1 deals with the basic concepts of public expenditure. It discusses in detail, Samuelson's pure theory of public expenditure which is considered as a landmark in analysis of public expenditure in any country. Structure of public expenditure has been explained with various components of public expenditure. And finally the growth of public expenditure will be dealt in light of government policies.

Unit 2 highlight the concepts of public investment and government budgeting. Public investment and implications and initiatives pertaining to fiscal policy will be discussed in detail and Social cost benefit analysis will be explained in great detail. Government budgeting with different approaches to budgeting will be described. The final area of concern of this unit will be the budget reforms in India.

UNIT 1

INTRODUCTION TO PUBLIC EXPENDITURE

Objectives

After studying this unit you should be able to:

- Define the term public finance
- Understand the basic concepts of public finance.
- Analyze the Samuelson's theory of public expenditure
- Have the knowledge of structure and growth of public expenditure with special reference to India

Structure

1.1 Introduction

1.2 Basic concepts of public expenditure

1.3 Pure theory of public expenditure

1.4 Structure and growth of public expenditure

1.5 Summary

1.6 Further readings

1.1 INTRODUCTION

Government spending or public expenditure is classified by economists into three main types. Government acquisition of goods and services for current use to directly satisfy individual or collective needs of the members of the community is classed as government final consumption expenditure. Government acquisition of goods and services intended to create future benefits, such as infrastructure investment or research spending, is classed as government investment (gross fixed capital formation), which usually is the largest part of the government gross capital formation. Acquisition of goods and services is made through own production by the government (using the government's labour force, fixed assets and purchased goods and services for intermediate consumption) or through purchases of goods and services from market producers. Government expenditures that are not acquisition of goods and services, and instead just represent transfers of money, such as social security payments, are called transfer

payments. Government spending can be financed by seigniorage, taxes, or government borrowing.

The first two types of government spending, namely government final consumption expenditure and government gross capital formation, together constitute one of the major components of gross domestic product.

John Maynard Keynes was one of the first economists to advocate government deficit spending as part of the fiscal policy response to an economic contraction. In Keynesian economics, increased government spending is thought to raise aggregate demand and increase consumption.

Classical economists and Austrian economists, however, believe that increased government spending exacerbates a economic contraction by shifting resources from the private sector, which they consider productive, to the public sector, which they consider unproductive. According to Austrian economists, the reason the Great Depression lasted as long as it did was because of significant government spending and government regulation of the economy.

1.2 BASIC CONCEPTS OF PUBLIC EXPENDITURE

1.2.1 Significance

Public expenditure is the value of goods and services bought by the State and its articulations.

Public expenditure plays four main roles:

1. It contributes to current effective demand;
2. It expresses a coordinated impulse on the economy, which can be used for stabilization, business cycle inversion, and growth purposes;
3. It increases the public endowment of goods for everybody;
4. It gives rise to positive externalities to economy and society, the more so through its capital component.

With its prioritized structure and its peculiar decision-making processes, it substantiates the prevailing kind of State.

In democracy, public expenditure is an expression of people's will, managed through political parties and institutions. At the same time, public expenditure is

characterised by a high degree of inertia and law-dependency, which tempers the will of the current majority.

Public expenditure can be financed through taxes, public debt, money emission, international aid.

1.2.2 Composition

First, public expenditure can be classified in terms of the kind of goods and services bought, also with very general items:

1. Capital goods;
2. Consumption goods;
3. Personnel expenditure

By contrast, public expenditure in national accounts does not comprehend mere transfers among social groups, as it is the case of pension schemes. Payments of interest on public debt are not comprehended as well.

Second, public expenditure can be classified according to the official body and organization from which budget it is paid, as for example:

1. The central state and its ministries;
2. Regional and local authorities;
3. Separate public bodies;
4. International organizations.

Here we should note that public expenditure usually does not consolidate state-owned firms. Their capital goods expenditure is added to investment.

Third, public expenditure can be classified according to the **macro-function** at which it is directed:

1. Justice and public order;
2. Infrastructure (roads, railways...);
3. Military system;
4. Education system;
5. Health care;
6. Support for the poor, the old, the disadvantaged;
7. Support for firms, export and production in general;
8. Special policy expenditure (foreign aid, integrated fight against drugs...).

In different places and over time, those macro-functions have largely changed their level of priority and even the social acceptance of the idea that it is the State that must care of them.

In particular, as a very sketched framework, one may distinguish at least three general models of state to which public expenditure corresponds:

1. The **minimal state**, where only justice, public order, foreign policy and some other basic functions should be carried out by the state, relying on private initiative for the others;
2. The **welfare state**, where the State cares about the people's well-being directly, also through expenditure in schooling, health, support for the poor, the old, the disadvantages;
3. The **developmental state**, where the State takes the responsibility of fostering economic development, also through expenditure in infrastructure, support for firms, export and production in general.

Both the welfare and developmental state include the items of the minimal state. Military expenditure and special policies are common traits of the three models, maybe in different proportions.

Comparing macro-function shares in public expenditure, one can get insights in the kind of state under analysis.

Needless to say, the State does not exert its influence on economy and society through public expenditure only, but also for example through laws.

1.2.3 Determinants

Public expenditure is determined by political will of the leading forces in the state: their priorities, their desired state model, and their interpretation of current economic and political phase. Past choices have relevant impact on public expenditure because of inertia and incrementalism. Bureaucracy may play an important decision role for the actual expenditure.

Sometimes considered as a completely exogenous variable, the public expenditure would thus be fully in the hand of political decision-makers without dependency from the economic context. Yet, policy makers may turn out to follow an anti-cyclical broad control of public expenditure. Automatic stabilizers may be at work, as with the case of

support schemes for unemployment: in this case, higher unemployment and disappointing GDP growth would lead to higher public expenditure through unemployment benefits and financial support to firms.

In a different political and institutional context, public expenditure may, instead, positively respond to state revenues. Higher revenues (and maybe even a public surplus) may lead to higher public expenditure. Symmetrically, if there is an upper limit to public deficit and, because of a recession, tax revenue fall, the State may be forced to cut public expenditure. In this context, public expenditure would turn out to be pro-cyclical.

1.2.4 Impact on other variables

A GDP component as it is, public expenditure has an immediate impact on GDP. An increase of public expenditure rises GDP by the same amount, other things equal. Moreover, since income is an important determinant of consumption, that increase of income will be followed by a rise in consumption: a positive feedback loop has been triggered between consumption and income, exactly as in the case of shocks in export, investment or autonomous consumption.

The full extent of this mechanism will depend, however, by the reactions of the other economic agents. Firms have to decide whether to increase production or prices in response to demand.

Moreover, if consumers interpret the increase in public expenditure as a fall in their disposable income (i.e. after-tax income), consumption may fall accordingly. Public expenditure is also told to crowd-out investment, possibly through an interest rate increase, further leading, in a floating exchange rate regime, to a currency appreciation. Exports would then be displaced as well.

In more microeconomic terms, public expenditure may be directed to consumer goods and thus substitute families' expenditure, as with the case of health drugs. By contrast, in other cases, as with education, public expenditure may trigger further consumption (books and all the other goods whose consumption depend on culture levels).

1.2.5 Long-term trends

In developed countries, it has always grown, whatever the political orientation of the government. Just the tempo can change. With a few exceptions, only under extremely

strong constraints has public expenditure been cut in absolute terms. Wars are episodes of extremely high public expenditure, followed usually by a return to normality.

1.2.6 Business cycle behavior

Public expenditure may turn out to be pro-cyclical or anti-cyclical depending on the political and institutional attitude toward public deficit, as we said. Still, real world data show often little reaction of public expenditure to the cycle. Most cycles show public expenditure as a stabilizing tool just keeping the same dynamics when the rest "goes wrong".

1.3 PURE THEORY OF PUBLIC EXPENDITURE

In 1954 Paul Samuelson published his landmark paper *The Pure Theory of Public Expenditure*, which formalized the concept of public goods (which he called "collective consumption goods") -- i.e. goods that are non-rival and non-excludable. He highlighted the market failure of free-riding when he wrote: "it is in the selfish interest of each person to give false signals, to pretend to have less interest in a given collective consumption activity than he really has". His paper showed that "no decentralized pricing system can serve to determine optimally these levels of collective consumption".

Excludability is the ability of producers to detect and prevent uncompensating consumption of their products. Rivalry is the inability of multiple consumers to consume the same good. A public good is defined as a non-rival non-excludable good, such as national defense. Because public goods are not excludable, they get under-produced. The pricing system cannot force consumers to reveal their demand for purely non-excludable goods, and so cannot force producers to meet that demand.

The evidence for under-production of public goods is so overwhelming that, as anarcholibertarian professor Walter Block admits about the resulting justification for state intervention, "virtually all economists accept this argument. There is not a single mainstream text dealing with the subject which demurs from it." Exhibit 1 gives the clear understanding of the theory.

Exhibit 1

THE PURE THEORY OF PUBLIC EXPENDITURE

Paul A. Samuelson

1. *Assumptions.* Except for Sax, Wicksell, Lindahl, Musgrave, and Bowen, economists have rather neglected the theory of optimal public expenditure, spending most of their energy on the theory of taxation. Therefore, I explicitly assume two categories of goods: ordinary *private consumption goods* $(X_1, \cdots, X_n)$ which can be parcelled out among different individuals $(1, 2, \cdots, i, \cdots, s)$ according to the relations $X_j = \sum_1^s X^i_j$; and *collective consumption goods* $(X_{n+1}, \cdots, X_{n+m})$ which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good, so that $X_{n+j} = X^i_{n+j}$ simultaneously for each and every ith individual and each collective consumptive good. I assume no mystical collective mind that enjoys collective consumption goods; instead I assume each individual has a consistent set of *ordinal preferences* with respect to his consumption of all goods (collective as well as private) which can be summarized by a regularly smooth and convex utility index $u^i = u^i(X^i_1, \cdots, X^i_{n+m})$ (any monotonic stretching of the utility index is of course also an admissible cardinal index of preference). I shall throughout follow the convention of writing the partial derivative of any function with respect to its jth argument by a j subscript, so that $u^i_j = \partial u^i / \partial X^i_j$, etc. Provided economic quantities can be divided into two groups, (1) *outputs* or goods which everyone always wants to maximize and (2) inputs or factors which everyone always wants to minimize, we are free to change the algebraic signs of the latter category and from then on to work only with "goods," knowing that the case of factor inputs is covered as well. Hence by this convention we are sure that $u^i_j > 0$ always.

To keep production assumptions at the minimum level of simplicity, I assume a regularly convex and smooth production-possibility schedule relating totals of all outputs, private and collective; or $F(X_1, \cdots, X_{n+m}) = 0$, with $F_j > 0$ and ratios F_j/F_n determinate and subject to the generalized laws of diminishing returns.

Feasibility considerations disregarded, there is a *maximal* (ordinal) *utility frontier* representing the Pareto-optimal points — of which there are an $(s-1)$fold infinity — with the property that from such a frontier point you can make one person better off only by making some other person worse off. If we wish to make normative judgments concerning the relative ethical desirability of different configurations involving some individuals being on a higher level of indifference and some on a lower, we must be presented with a set of ordinal interpersonal norms or with a *social welfare function* representing a consistent set of ethical preferences among all the possible states of the system. It is not a "scientific" task of the economist to "deduce" the form of this function: this can have as many forms as there are possible ethical views; for the present purpose, the only restriction placed on the social welfare function is that it shall always increase or decrease when any one person's ordinal preference increases or decreases, all others staying on their same indifference levels: mathematically, we narrow it to the class that any one of its indexes can be written $U = U(u^1, \cdots, u^s)$ with $U_i > 0$.

2. *Optimal Conditions.* In terms of these norms, there is a "best state of the world" which is defined mathematically in simple regular cases by the marginal conditions

$$\frac{u^i_j}{u^i_r} = \frac{F_j}{F_r} \qquad (i = 1, 2, \cdots, s;\ r, j = 1, \cdots, n) \text{ or } (i = 1, 2, \cdots, s;\ r = 1;\ j = 2, \cdots, n) \qquad (1)$$

$$\sum_{i=1}^{s} \frac{u^i_{n+j}}{u^i_r} = \frac{F_{n+j}}{F_r} \qquad (j = 1, \cdots, m;\ r = 1, \cdots, n) \text{ or } (j = 1, \cdots, m;\ r = 1) \qquad (2)$$

$$\frac{U_i u^i_k}{U_q u^q_k} = 1 \qquad (i, q = 1, \cdots, s;\ k = 1, \cdots, n) \text{ or } (q = 1;\ i = 2, \cdots, s;\ k = 1). \qquad (3)$$

Equations (1) and (3) are essentially those given in the chapter on welfare economics in my *Foundations of Economic Analysis*. They constitute my version of the "new welfare economics." Alone (1) represents that subset of relations which defines the Pareto-optimal utility frontier and which by itself represents what I regard as the unnecessarily narrow version of what once was called the "new welfare economics."

The new element added here is the set (2), which constitutes a pure theory of government expenditure on collective consumption goods. By themselves (1) and (2) define the $(s-1)$-fold infinity of utility frontier points; only when a set of interpersonal normative conditions equivalent to (3) is supplied are we able to define an unambiguously "best" state.

Since formulating the conditions (2) some years ago, I have learned from the published and unpublished writings of Richard Musgrave that their essential logic is contained in the "voluntary-exchange" theories of public finance of the Sax-Wicksell-Lindahl-Musgrave type, and I have also noted Howard Bowen's independent discovery of them in Bowen's writings of a decade ago. A graphical interpretation of these conditions in terms of *vertical* rather than *horizontal* addition of different individuals' marginal-rate-of-substitution schedules can be given: but what I must emphasize is that there is a different such schedule for each individual at each of the $(s-1)$fold infinity of different distributions of relative welfare along the utility frontier.

3. *Impossibility of decentralized spontaneous solution*. So much for the involved optimizing equations that an omniscient calculating machine could theoretically solve if fed the postulated functions. No such machine now exists. But it is well known that an "analogue calculating machine" can be provided by competitive market pricing, (a) so long as the production functions satisfy the neoclassical assumptions of constant returns to scale and generalized diminishing returns and (b) so long as the individuals' indifference contours have regular convexity and, we may add, (c) so long as all goods are private. We can then insert between the right- and left-hand sides of (1) the equality with uniform market prices p_j/p_r and adjoin the budget equations for each individual

$$p_1X^i_1 + p_2X^i_2 + \cdots + p_nX^i_n = L^i \quad (i = 1, 2, \cdots, s), \qquad (1)'$$

where L^i is a lump-sum tax for each individual so selected in algebraic value as to lead to the "best" state of the world. Now note, if there were no collective consumption goods, then (1) and (1)' can have their solution enormously simplified. Why? Because on the one hand perfect competition among productive enterprises would ensure that goods are produced at minimum costs and are sold at proper marginal costs, with all factors receiving their proper marginal productivities; and on the other hand, each individual, in seeking as a competitive buyer to get to the highest level of indifference subject to given prices and tax, would be led as if by an Invisible Hand to the grand solution of the social maximum position. Of course the institutional framework of competition would have to be maintained, and political decision-making would still be necessary, but of a computationally minimum type: namely, algebraic taxes and transfers $(L^1, \ldots L^s)$ would have to be varied until society is swung to the ethical observer's optimum. The servant of the ethical observer would not have to make explicit decisions about each person's detailed consumption and work; he need only decide about generalized purchasing power, knowing that each person can be counted on to allocate it optimally. In terms of communication theory and game terminology, each person is motivated to do the signalling of his tastes needed to define and reach the attainable-bliss point.

Now all of the above remains valid even if collective consumption is not zero but is instead *explicitly set* at its optimum values as determined by (1), (2), and (3). *However no decentralized pricing system can serve to determine optimally these levels of collective consumption*. Other kinds of "voting" or "signalling" would have to be tried. But, and this is the point sensed by Wicksell but perhaps not fully appreciated by Lindahl, now it is in the selfish interest of each person to give *false* signals, to pretend to have less interest in a given collective consumption activity than he

really has, etc. I must emphasize this: taxing according to a benefit theory of taxation can not at all solve the computational problem in the decentralized manner possible for the first category of "private" goods to which the ordinary market pricing applies and which do not have the "external effects" basic to the very notion of collective consumption goods. Of course, utopian voting and signalling schemes can be imagined. ("Scandinavian consensus," Kant's "categorical imperative," and other devices meaningful only under conditions of "symmetry," etc.) The failure of market catallactics in no way denies the following truth: given sufficient knowledge the optimal decisions can always be found by scanning over all the attainable states of the world and selecting the one which according to the postulated ethical welfare function is best. The solution "exists"; the problem is how to "find" it.

One could imagine every person in the community being indoctrinated to behave like a "parametric decentralized bureaucrat" who *reveals* his preferences by signalling in response to price parameters or Lagrangean multipliers, to questionnaires, or to other devices. But there is still this fundamental technical difference going to the heart of the whole problem of *social* economy: by departing from his indoctrinated rules, any one person can hope to snatch some selfish benefit in a way not possible under the self-policing competitive pricing of private goods; and the "external economies" or "jointness of demand" intrinsic to the very concept of collective goods and governmental activities makes it impossible for the grand ensemble of optimizing equations to have that special pattern of zeros which makes *laissez-faire* competition even *theoretically* possible as an analogue computer.

4. *Conclusion.* To explore further the problem raised by public expenditure would take us into the mathematical domain of "sociology" or "welfare politics," which Arrow, Duncan Black, and others have just begun to investigate. Political economy can be regarded as one special sector of this general domain, and it may turn out to be pure luck that within the general domain there happened to be a subsector with the "simple" properties of traditional economics.

The Review of Economics and Statistics, Vol. 36, No. 4. (Nov., 1954), pp. 387-389.

1.4 STRUCTURE AND GROWTH OF PUBLIC EXPENDITURE

The best way to look at the structure of government expenditure is to examine the division of total expenditure between revenue expenditure and capital expenditure. From the time the economic reforms began, there has been a tendency to suppress capital expenditures in the face of the inability to control revenue expenditure. This state of affairs could not but raise extreme concern about the future growth prospects of the economy.

While disapproving spiralling revenue expenditures and bemoaning the decline in capital expenditures, it is being assumed that all capital expenditure is developmental in nature. Even though this standpoint may be generally true, it is important to remember that there can be, and has been, wasteful capital expenditure. Grandiose projects to satisfy the whims and fancies of the satraps in charge of ministries can be equally debilitating to the finances of the government.

Table 1 gives the details of total as well as revenue and capital expenditures of the current fiscal and the previous year.

TABLE 1: TOTAL EXPENDITURE

(Rs. Crore)

	2004-05 (BE)	2004-05 (RE)	2005-06 (BE)
TOTAL EXPENDITURE	477829	505791	514344
REVENUE EXPENDITURE	385493 (81%)	386069 (76%)	446512 (87%)
CAPITAL EXPENDITURE	92336 (19%)	119722 (24%)	67832 (13%)

Note: Figures in brackets give the percentage of expenditure to total expenditure.

It is evident from this data that l The percentage of Revenue Expenditure to Total expenditure (excluding State Plans) which, as per the revised estimates (RE) of 2004-05, was, at 76%, lower than the Budget Estimates (BE) of 81%, had once again risen sharply to 87% in 2005-06(BE). l The residual share of Capital Expenditure has been languishing at 13% of Total Expenditure l It is quite likely that the BE of 2005-06 will change as

the year progresses and, if the previous fiscal is any indication, the share of Capital Expenditure may well rise. Of course, this raises a different issue: how much faith should one have in the BE if these are subject to wide fluctuations as the year progresses? The divergence of the RE from the BE is an instance of poor fiscal marksmanship and destroys the credibility of the budgetary process. The relative importance of revenue and capital expenditure will not change unless significant expenditure reforms are carried out.

The Liberal Budget 2004-05 had made a number of suggestions towards this end. These included reforms on the administrative side, which would involve consolidation of some ministries and winding up of others. That this is not such a dramatic reform is evident from the fact that it has been suggested by the last Pay Commission and the Expenditure Reforms Commission. These reforms will also lead to a much flatter administrative process by which the movement of files from the lowest rung to the highest echelons will be much faster. Such reforms will save on administrative and salary expenditure.

Aggressive restructuring of public enterprises through right-sizing and privatisation can also cut down on revenue expenditures. At the same time vital revenues can be raised for use in productive purposes.

1.4.1 Important Components of Expenditure

Having examined the overall structure of government expenditure, we now look at some of its important components. This essentially involves looking at the quality of expenditure. In the first instance, we wish to look at how much of the total available revenue receipts are captured by committed expenditures. Committed expenditures are to be understood as those over which the government has little discretion. Such expenditure often arises as a legacy of the past. To illustrate: Debts raised in the past commit the government of the day to pay interest. There is some expenditure that must be incurred to provide protection to the country. Government cannot unilaterally change such expenditure and, consequently, the solution to reining in such expenditure is not in the realm of fiscal issues. Finally, a government committed to providing for the welfare of the poor is compelled to spend on subsidies. Table 2 shows such expenditure as a proportion of the total.

TABLE 2: COMMITTED EXPENDITURE

(%)

	2004-05 (BE)	2004-05 (RE)	2005-06 (BE)
TOTAL EXPENDITURE (Rs. Crore)	477829	505791	514344
INTEREST PAYMENT + DEFENCE + SUBSIDIES	70.00 (45.32)	71.76 (42.69)	65.49 (44.72)
INTEREST PAYMENT	41.87 (27.10)	41.84 (24.89)	38.14 (26.04)
DEFENCE	14.07 (9.11)	14.46 (8.60)	13.85 (9.45)
SUBSIDIES	14.07 (9.11)	15.46 (9.20)	13.51 (9.20)

Note: In columns 2, 3 and 4 the numbers outside brackets are ratios to Revenue Receipts; numbers inside brackets are ratios to Total Expenditure.

Table 2 shows the stranglehold those three items of expenditure. Interest payments, defense and subsidies have on the fiscal position of the Central Government. If one considers such expenditures as essentially nondevelopmental, an assumption that is not unreasonable, then barely 30% is left over for developmental purposes out of the revenue account.

From the point of view of total expenditure, almost 50% is devoted to the three items in Table 2. Assuming (unrealistically) that there are no other non-developmental expenditures, we can see that only about 50% of the expenditure is devoted for developmental purposes. Reforms to rectify this situation calls for bold and ruthless reforms, and these are necessary if the government is serious about helping development and not hindering it viz.,

- Curtailing interest payments requires a reduction in current deficits so that interest payments reduce in the future. Technically, only if the government is able to generate what are called primary surpluses can there be a reduction in debt and future interest payments. Unfortunately, the government has been running up primary deficits each year so that the debt levels continue to increase, only if some of the reforms suggested above are implemented will stop the debt growth.
- Subsidies represent a different problem altogether. The difficulty with reducing subsidies is that it.s political dynamite. Subsidies are dispensed not only explicitly i.e. through the budget, but also in a covert form by providing subsidised public sector services to the people. The numbers given in Table 2 refer only to explicit subsidies. Naturally, the level of implicit plus explicit subsidies will be much higher. The problem with most subsidies is that they are not well-targeted. The government had recently commissioned a study on subsidies, which offered certain suggestions to start to chipping away at the problem. It is a matter of great disappointment that the Finance Minister did not even refer to this study in his Budget speech in February this year.

1.4.2 Burden of Debt

The debilitating effect of debt is clear from the Table 3. Table 3 gives a truer picture of the capture of revenue and expenditures for non-developmental purposes. Almost 80% of total expenditure (excluding state plans) is hostage to past .sins. i.e. deficits created in the past, which now hang like a mill-stone around the neck of governments past, present and future.

TABLE 3. BURDEN OF DEBT

(Rs. Crore)

	2004-05 (BE)	2004-05 (RE)	2005-06 (BE)
TOTAL EXPENDITURE	477829	505791	514344
Repayment of debt	198380	224075	247984
Total Interest Payments (IP)	129500	125905	133945
Total debt servicing (TDS)	327880	349980	381929
Revenue Receipts (RR)	309322	300904	351200
IP as % of RR	41.90	41.80	38.10
TDS as % of Total Expenditure	68.62	69.20	74.26

1.4.3 Composition of Government Expenditure

Total Expenditure is one measure of the size of the government. Table 4 gives the ratio of expenditure to GDP. The numbers in Table 4.do not show any alarming rise in the size of the government. In fact, compared to many developed countries, which exhibit the above ratio in excess of 25%, the size of the government in India is more modest.

TABLE 4. SIZE OF GOVERNMENT : RATIOS TO GDP

(%)

	1999-2000	2003-04	2004-05	2005-06
Total Expenditure	13.46	15.30	14.51	13.62
Revenue Expendirure	11.86	12.17	11.45	11.70
Capital Expenditure	1.60	3.13	3.06	1.92

However, what is disturbing about India's expenditures is not so much its total level as its distribution across sectors. Table 5 gives some ratios of various categories of expenditures to GDP at market prices.·In the appendices, we also give the ratios of these categories of expenditures to total expenditures.

TABLE 5. COMPOSITION OF GOVERNMENT EXPENDITURE

[illegible]

	1999-2000	2003-04	2004-05 (RE)	2005-06 (BE)
Agriculture & Cooperation	0.31	0.09	0.11	0.13
Rural Development	0.37	0.57	0.45	0.52
RURAL SECTOR	[illegible]	[illegible]	0.55	[illegible]
Food & Public Distribution	0.51	0.93	0.84	0.76
Health	0.10	0.10	0.10	0.11
Family Welfare	0.16	0.16	0.17	0.18
Elementary Education	0.17	0.20	0.26	0.36
Secondary & Higher Education	0.26	0.17	0.17	0.17
Drinking Water Supply	0.09	0.10	0.11	0.14
WELFARE	[illegible]	[illegible]	[illegible]	[illegible]
Urban Development	0.08	0.13	0.10	0.09
Petroleum & Natural Gas	0.01	0.25	0.12	0.10
Power	0.14	0.07	0.08	0.09
Roads & Highways	0.30	0.26	0.25	0.35
Civil Aviation	0.01	0.01	0.01	0.02
Telecom	0.00	0.04	0.18	0.08
Railways	0.13	0.25	0.27	0.19
INFRASTRUCTURE	0.67	[illegible]	1.01	[illegible]
Other Expenditure	10.83	11.97	11.30	10.34

The Indian Liberal Group believes that governments must intervene in a market economy only if there are market failures and if welfare concerns demand such intervention.

Table 5 has identified those sectors of the economy in which the active role of the government can, not only be defended, but actively sought. The results reported in this table are disappointing, to say the least. The Rural sector, Welfare sector and Infrastructure stand at fewer than 3% of GDP while other expenditure. Some of which may be important, such as law and order, defense, etc. are as high as almost 11% of GDP. In terms of total expenditures (see Annexure Table), the same ratios are 20% and 80%

For all the grandiloquent verbiage in the last year about emphasising rural development, reforms with a human face (as if the reforms needed a human face!) and pushing for infrastructure, the reality is quite different.

1.4.4 Efficiency of Government Expenditure

For far too long, there has been a tendency to measure the efficiency of government machinery in terms of the amount that has been spent on specific activities. It must, however, be remembered that expenditures are inputs that must lead to desirable and measurable output. It is this that we seek to emphasise in this section.

In this connection, we have taken up two aspects in the social sector: Literacy Rates and Infant Mortality Rate. An effort is made to examine if any pattern emerges in the levels of government expenditure on elementary education and L.R. as well as between expenditure on public health and I.M.R. Table 6 considers L.R. at three points of time to see if any pattern emerges vis-à-vis government expenditure on education.

Table 6 shows that the ratios to expenditures have remained more or less constant over the decade 1991-2001 and yet L.R. has raised by 13 percentage points giving a growth rate of 25% over ten years. An optimistic assessment of this situation would state that for the same ratio of expenditure to GDP, the L.R. has raised significantly i.e. government expenditure is efficient. However, this would be misleading. If one looks at the actual levels of expenditure for the Centre and States combined, we find that the level was Rs.17401 crore in 1991 which had risen to Rs.62267 crore in 2001. This yields a

growth of 3.5 times over 1991 or a growth rate of 257% over the decade. Now it is not so clear that there is efficiency in government's provision of elementary education. Lest it be misunderstood this is not a call for privatisation of elementary education. The Liberal Position is that while the government will have to be the main provider of elementary education, private initiatives must also actively encourage. What our analysis calls for is greater accountability and transparency in the way elementary education is funded by the government. As for the quality of such education that is another though crucial issue.

TABLE 6. EXPENDITURE ON EDUCATION
Ratio of Expenditure to GDP (%)

	L.R. %	Centre: Elementary Education	Centre: Total Education	Centre + States: Education, etc.
1991	52.2	0.04	0.29	3.06
1996	58.4	0.12	0.31	2.74
2001	65.4	0.14	0.38	2.98

We also look at a similar table for health expenditure. Table 7 reports some data for one measure of public health namely Infant Mortality Ratio (I.M.R.). A more or less similar picture to that in Table 6 emerges once again. I.M.R. has dropped from 80 to 66, which is a sign of improvement in health, but the ratios of health expenditure to GDP have remained stagnant. However, the levels of health expenditure have been rising continuously. Total expenditure on public health and water supply by the Centre plus states has risen from Rs.6,539 crores in 1991 to Rs.24,447 crores in 2001. This represents a fourfold increase of about 275% while I.M.R. has fallen by 14 points.

TABLE 7 EXPENDITURE ON HEALTH
Ratio of Expenditure to GDP (%)

	I.M.R. (per 1000)	Centre: Health	Centre: Public Health	Centre + States: Public Health + Water Supply
1991	80	0.08	0.03	1.15
1996	72	0.09	0.04	1.05
2001	66	0.09	0.04	1.17

Reforms that emanate from our analysis are:

- Bearing in mind that most social expenditure is the responsibility of state governments, there should be no duplication of such expenditure at the level of

states. Even centrally initiated/implemented schemes must be handed over to state governments for better targeting. We also strongly suggest that much of these social sector spending be left to the states and preferably to the Panchayats for the efficient and effective management of these programmes.

- There must be a re-orientation of expenditure on education from higher education to basic and primary education. A strong rationale exists for subsidisation of elementary education but not higher education. The subsidy element in higher education must be reduced and diverted to elementary education.
- Similarly, emphasis must be placed on preventive health rather than curative health.
- Resources for such social sector activities must be garnered through the privatisation process. It has to be forcefully pointed that the stand of the Left parties is definitely anti-poverty reduction. By continuing to insist on keeping public enterprises free of any private participation they are depriving welfare-oriented activities much needed resources. Further, the opposition to privatisation betrays a bowing to the most important constituency of the .Left. viz., organised labour, which is a mere 3% of the total labour force of the country? The Left's obsession with organised labour has meant that unorganised labour and those without a job have been deprived of any chance to improve their lot. The UPA government which is in thrall of the Left would do well to aggressively privatise/disinvest public enterprises, especially in view of the fact that proceeds from disinvestments could well be earmarked for social sector spending.

The major points to emerge from our discussion are:

. The percentage of Revenue Expenditure to Total Expenditure (excluding State Plans) is at an alarming level and needs to be curtailed if India.s public finances are to be restored to health.

The problems with revenue expenditures also manifest themselves in the burgeoning and debilitating revenue deficits. It seems well-accepted that the major cause of India's fiscal problems is the inability to control revenue deficits. These deficits have to be hammered down to zero; in fact, prudence demands that there should be revenue

surpluses. The preceding two Liberal Budgets have constantly drawn attention to this fact and have called for drastically reducing revenue deficits.

The flip side of revenue deficits is the problem being experienced on the capital side of the budget. The residual share of Capital Expenditure has been languishing at less than 10% of Total Expenditure. In fact, revenue deficits have been funded for almost the last two decades by generating surpluses on the capital account. India has been borrowing to pay for the annual cost of running the government: the grocery bill is being paid fc by borrowing ever more.

The most significant drag on the finances of the government is interest payments and subsidies. The former is the direct outcome of past sins of profligacy and the latter is the outcome of political economy considerations. Interest payments will fall only if budgets from now on start to generate primary surpluses. Subsidies will not be reduced so long as the government is hostage to powerful interest groups clamouring for undeserved subsidies. It should be clarified that the Liberal position does recognise the need to promote genuine, subsidised welfare enhancing activities, such as basic education and basic health. What is being opposed is the dispensing of subsidies to those who do not deserve these.

- The current position of public finances has so constrained central and state governments that they are unable to meet their social obligations. Ideally, the Liberal position would advocate a re-orientation of subsidies from the undeserving to the deserving. This will generate resources for welfare improvement without an expansion in the size of the government. But a government that is not autonomous of interest groups would be hard-pressed to enforce the desired re-orientation of expenditures.
- The recommendation of the Liberal Budget is two-fold: One, an increase in the efficiency of government expenditures directed towards to the social sector so that the country .gets more bang for its bucks.. Two, there should be aggressive privatisation so that the revenues so generated could be deployed for welfare improvements.
- Obviously, we have reached a point where there are no easy options left. The UPA government which seems to be so completely in thrall of its communist

allies will have to distance itself from these so-called messiahs of the poor and honestly commit itself to work for the welfare of those who need it the most.

ANNEXURE TABLE

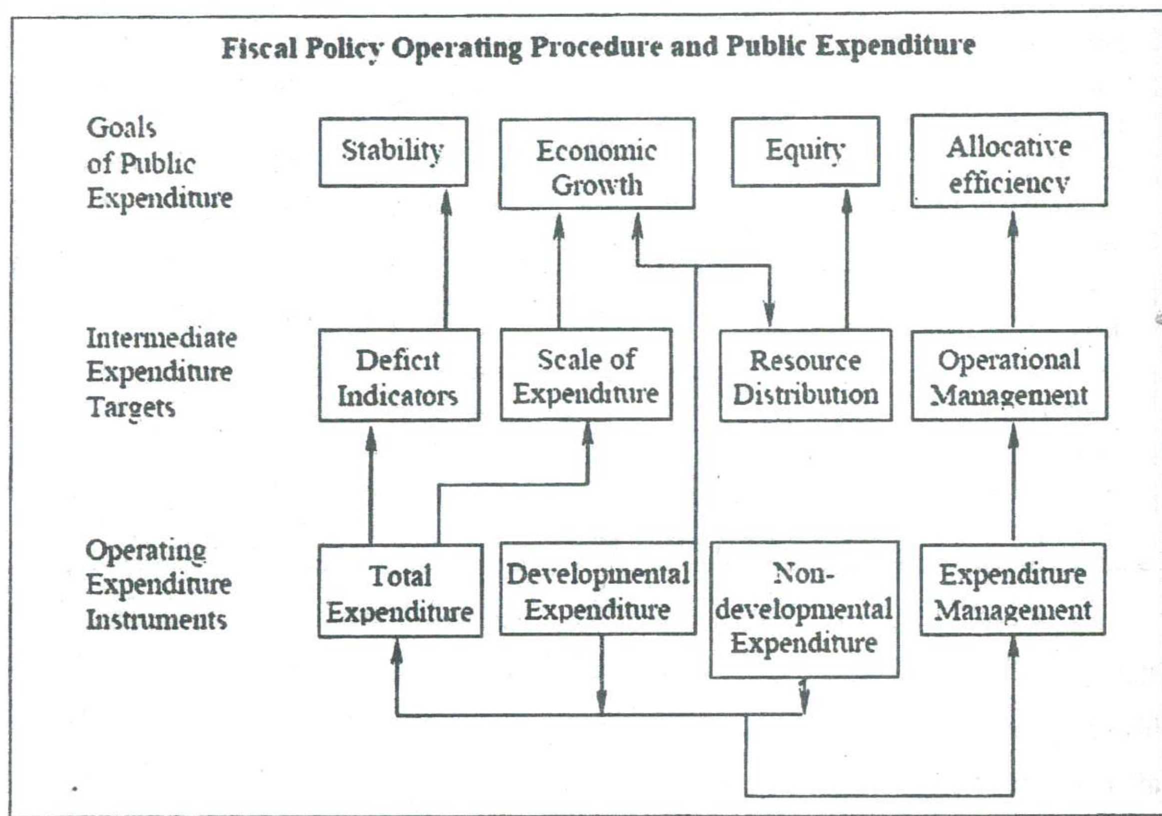
COMPOSITION OF GOVERNMENT EXPENDITURE

Ratios to Total Expenditure

	1999-2000	2003-04	2004-05 (RE)	2005-06 (BE)
Agriculture & Cooperation	2.31	0.58	0.73	0.95
Rural Development	2.77	3.70	3.09	3.84
RURAL SECTOR	5.08	4.28	3.82	4.79
Food & Public Distribution	3.77	6.07	5.82	5.56
Health	0.71	0.63	0.69	0.80
Family Welfare	1.19	1.06	1.19	1.35
Elementary Education	1.25	1.29	1.78	2.62
Secondary & Higher Education	1.95	1.13	1.16	1.21
Drinking Water Supply	0.69	0.66	0.74	0.99
WELFARE	9.56	10.84	11.38	12.53
Urban Development	0.58	0.87	0.69	0.66
Petroleum & Natural Gas	0.04	1 64	0.79	0.77
Power	1.01	0.45	0.55	0.64
Roads & Highways	2.21	1.73	1.71	2.59
Civil Aviation	0.07	0.06	0.08	0.13
Telecom	0.01	0.23	1.21	0.60
Railways	0.99	1.65	1.88	1.36
INFRASTRUCTURE	4.92	5.63	6.91	6.75
Other Exp.	80.43	78.24	77.87	75.93

The role of public expenditure in the fiscal policy goals of growth, equity and stability, has varied across different phases of economic development in India. The historical importance of public expenditure lies in the mixed economy model adopted after Independence in India whereby the government assumed the primary responsibility of building the capital and infrastructure base to promote economic growth. The concerns regarding equity and poverty alleviation after two decades of Independence added another important dimension to public expenditure in terms of redistribution of resources. The inadequate returns on capital outlays and the macroeconomic crisis of early Nineties arising out of high fiscal deficit shifted the focus of public expenditure to efficiency in its management for facilitating adequate returns and restoring macroeconomic stability. While the fiscal policy goal of stability could be achieved, the modus operandi of public

expenditure management through curtailing capital expenditure raised concerns about infrastructure investment and its impact on the long-term growth potential of the economy. Furthermore, stagnating revenue mobilisation in particular and some upward movements in expenditures led to a reversal of the fiscal stabilisation process since the second half of the Nineties. An improved fiscal performance during 2003-04 engendered by containment of the non-plan expenditures and supported by high revenue mobilisation on the back of buoyant real activity paved the way for renewed commitment towards fiscal consolidation in India.



It may also be noted that while greater centralisation improves revenue mobilisation, expenditure management tends to be more effective with greater decentralisation. It follows; therefore, that the imposition of expenditure constraint needs to be based on bottoms-up rather than top-down approach, although the former needs to be consistent with the overall framework of expenditure management. In terms of

sequencing, fiscal discipline or overall expenditure control needs to come first followed by resource allocation and operational efficiency objectives.

One of the strategies followed to institutionalise expenditure management is by setting formal rules such as fiscal responsibility legislations put in place in a number of countries. While expenditure management normally yearns to follow the formal rules, a key part of expenditure management is to also recognise informal rules. It may be noted in this context that the implementation of such rules may often pose a policy dilemma where cutbacks in capital expenditures may adversely affect economic growth which in turn contributes to reduction in revenue leading to larger deficit. It is important, therefore, to note that the policy formulations should not be such that remedy would be worse than the disease (Pattnaik, 1996).

Activity 1

1. Write a detailed note on basic concepts of public expenditure. What are the categories of its composition?
2. What do you understand by pure theory of public expenditure?
3. Give an account of structure of public expenditure in India.
4. Write short note on burden of debt.
5.

1.5 SUMMARY

Public expenditure and its basic concepts are highlighted in this unit which is classified by economists into three main types. Government acquisition of goods and services for current use to directly satisfy individual or collective needs of the members of the community is classed as government final consumption expenditure. Samuelson's pure theory of public expenditure was explained in the later section followed by the structure and growth of public expenditure. The analysis in this unit has shown the burden of debts over Indian government, components of public expenditure and efficiency of government expenditure that helps in overall growth of Indian economy.

1.6 FURTHER READINGS

Robert Barro and Vittorio Grilli (1994), European Macroeconomics, Ch. 15-16. Macmillan

Atkinson, A.B. and J. E. Siglitz (1980), lectures on public economics. Tata McGraw hill, New York

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Jha R. (1998), Modern public Economic. Rutledge, London.

UNIT 2
PUBLIC INVESTMENT AND GOVERNMENT BUDGETING

Objectives

After studying this unit you should be able to:

- Understand the approach to public investment and fiscal policy initiatives in reference of public investment
- Know the approach to cost benefit analysis in social context
- Appreciate the concept and strategies pertaining to government budgeting and its various approaches
- Be aware about the budget reforms in India

Structure

2.1 Introduction to public investment

2.2 Public investment and fiscal policy

2.3 Social Cost Benefit analyses

2.4 Government budgeting

2.5 Budget reforms

2.6 Summary

2.7 Further readings

2.1 INTRODUCTION TO PUBLIC INVESTMENT

Investment can be many things such as investment in machinery, buildings, facilities and computers. Operating expenditure on training, education and research is sometimes also regarded as investment. Physical investment is the most obvious, as it involves constructing new buildings, roads and facilities. This is the type of investment included in the public capital budgets, and it is also the focus area of the Government's strategic investment programme. However, this does not mean that operating expenditure on training, education and research is unimportant for the growth of a society. Expenditure in these areas is often, and rightly so, regarded as valuable investment for

both individuals and society as a whole. However, such expenditure is not covered here because it is not included in the investment budget.

Total public investment encompasses investment in physical infrastructure made by central government, local government and public corporations. Since 1993, considerable amounts have been invested in many areas of the public sector, such as new buildings, senior housing, transport installations, new equipment and much more. The improvements have been obvious to most.

Social services and health care have seen substantial improvements through investment in hospitals, senior housing and childcare facilities, for example. Investment in state-of-the-art equipment and new technology at hospitals has been a top priority, as has county investment in services provided to the mentally and physically disabled.

Housing investment has also been substantial, with a considerable rise in central-government grants to housing and urban renewal in particular.

Counties have invested in secondary schools, and the latest agreement with local authorities has given primary schools a much-needed lift. But still there are various loopholes in our country regarding public investment and budgeting.

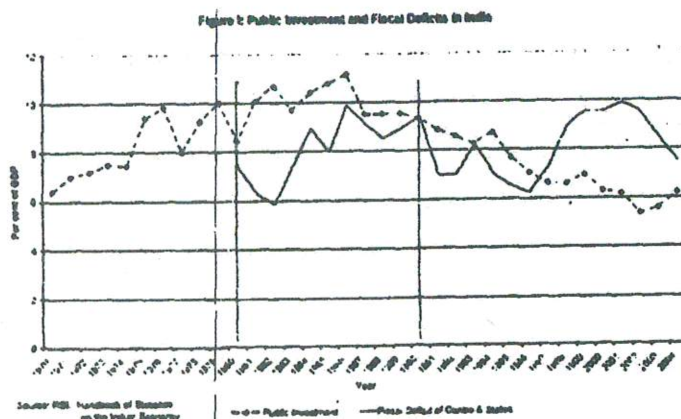
2.2 PUBLIC INVESTMENT AND FISCAL POLICY

India's fiscal deficit has deteriorated since the mid 1990s and now ranks amongst the worst in the world (Kochhar, 2006). Amongst emerging markets, only Turkey and Argentina have larger fiscal deficit to GDP ratios. The large fiscal deficit has been a persistent feature of the macro economy. Even though the balance of payments crisis of 1991 did result in the initiation of some fiscal restraint this was reversed in the mid 1990s. The deficit reduction reversed in part due to the low buoyancy of tax revenues as the tax system is narrowly based on indirect taxes and manufacturing and a few services, and customs revenues declined as trade has been liberalized (Rao, 2005). The deterioration in revenues was also accompanied by expenditure pressure after 1996-97 due to the substantial increase in the government pay and pension bill associated with the recommendation of the Fifth Pay Commission (Acharya, 2002).

However, even as early as 1994, the Indian government decided not to accept further IMF loans as it sought to increase current social expenditures (for example, cheap power to farmers and households) to politically consequential groups (Kohli, 2006, p.1363). Finally, expenditures surged on account of a rise in interest payments as financial repression was reduced and government borrowings took place at market rates of interests (Acharya, 2002).

The rise in fiscal deficits has given rise to concern about its macroeconomic impact and its sustainability (Lahiri and Kannan, 2004). Fiscal consolidation has become a salient policy objective and is sought to be achieved in India via the Fiscal Responsibility and Budget Management Act which became effective from July 2004. This Act specifies annual targets for fiscal correction and seeks to reduce the fiscal deficit to 3 per cent of GDP by March, 2008. A Task Force was also set up for drawing up the medium term framework for fiscal policies so as to achieve the targets as specified in the Act. With an adjustment path spelt out there is concern about whether the burden of adjustment will fall on public investment and other important items of expenditure such as operations and maintenance expenditures.

Given the pressure on current expenditures deficits have been reduced mainly by cutting public investment and especially social and physical infrastructure spending. As a decline in public investment constrains growth there have been concerns raised about the need to step up this component of expenditure (Ahluwalia, 2002;7 Kochhar, 2006; Lahiri and Kannan, 2004). In fact, Kohli (2006) argues that the decline of public investment (and the buoyancy of private investment) is a "key element of India's economic growth 'story' in the 1990s".



A significant feature of the pre-crisis 1980s is the growth in public investment that fueled the economic growth of that period. The 1990s and beyond by contrast has been associated with declining public investment (see Figure I). The decline in public investment at a time when more expenditure are required on power, water, and rural infrastructure, is growth constraining to the extent that public investment is known to crowd in private investment in India (Serven, 1996; Murty and Soumya, 2006).

Given that economic growth is a priority goal of the state (Kohli, 2006) this is a puzzle. The standard explanation which is an event driven one has been that the high levels of debt incurred in the 1980s and the subsequent balance of payments crisis of 1991 shifted the focus of fiscal policy towards the low level of government savings and resulted in the initiation of a fiscal restructuring and compression of public expenditures. As the cash flow stream associated with public investment in infrastructure is such that high costs are incurred in the present and the returns though high, accrue over the long run, postponing lumpy and costly public investment spending is far easier for a government than cutting current expenditures. Expenditure compression is therefore linked to investment expenditure cuts.

It is often argued that policy changes, stops, and reversals tend to be episodic. They are often triggered by discrete changes or shocks such as banking and balance of payments crises, changes in government, changes in global interest rates, and even leverage exercised by international financial institutions (Krueger, 1993). The event driven explanation has merit in ex post identifying the exact timing of a policy change. However, it does not interpret a policy change as part of a process – an event may be part of a larger process and identifying the structure of a process can offer an altogether different understanding of policy changes. The event or shock may then be a factor that hastens or hinders a policy change that would nevertheless have eventually occurred if the underlying economic processes had unfolded undisturbed. Our focus in this paper is on identifying the process behind public investment reversals in India.

In contrast to the event driven explanation the view that we put forward in this paper is that the distributive consequences of public investment spending are behind both the rising public investment of the 1980s and the decline in the 1990s and beyond. Though public investment raises the productivity of private factor endowments, those

with higher factor endowments benefit more from an increase in public investment than those with lower factor endowments. The wealth creating assets that households are endowed with unequally are various forms of capital – physical capital, financial capital, and human capital. Physical capital encompasses land, housing, livestock, implements and other production durables that constitute tangible assets which allow production and that have the potential of begetting income. Financial assets constitute assets with higher liquidity and lower carrying costs that allow households to make intertemporal adjustments of income that can be used for consumption, production, and investment10. Human capital includes health, education, and nutrition that are embodied in individuals and which translate into skills and abilities that are potential sources of labour, managerial and entrepreneurial incomes. Households have endowments of the various forms of capital identified at their disposal – their opportunities – which can be transformed into different forms of income that can be thought of as returns to these types of capital. In what follows we do not distinguish between these various forms of endowments and refer to the capital endowment quantity in the aggregate. Public investment as we demonstrate increases the returns to private capital endowments differentially and raises its productivity.

By disproportionately benefiting those with higher factor endowments public investment creates an incentive for such individuals to influence the government's expenditure policy. This influence effect increases public investment expenditure but at the same time since those with large factor endowments benefit more, inequality increases. The rise in inequality makes redistribution more attractive to the median voter and a government attentive to such preferences reallocates expenditures towards transfers and away from public investment. Public investment expenditure then declines when inequality has risen sufficiently.

Increases in public investment in the 1980s according to our view were accompanied by an increase in influence expenditures by those who were seeking to affect a policy variable – public investment – that impacted favourably on their incomes. However, a continued increase in such influence expenditure by raising inequality sufficiently eventually reduces the significance of this influence seeking group in state expenditure policy. The state still has the objective of promoting growth and turns

towards global integration with the world economy and the market to achieve this. Tax rates were accordingly moderated and the tax administration sought to be modernized. As tax rates were reduced the tax-GDP ratio declined. Public expenditures increasingly were required to be financed by borrowings and were accompanied by a rise in the fiscal deficit.

However, these borrowings were deployed towards transfer expenditures and redistribution in response to rising inequality. This reduced the emphasis of public expenditure policy on public investment which is tantamount to signaling a reduction in potential growth.

Lenders who witness the atrophying tax revenues and the constraints on economic growth associated with the increased emphasis of public expenditures on transfers would then have an incentive to impose a ceiling on borrowing by the government as a way of securing their returns. Inequality and the composition of public expenditures are accordingly the important underpinnings to the passage of a fiscal responsibility act which constrains the growth of government expenditure. For us transfer expenditure is a generic expression that includes not just those expenditures classified as transfers in an economic classification of government budgets but also implicit transfers.

Implicit transfers include for example the rent component of public sector wages. With income inclusive of the rent component in the public sector exceeding the alternative income in the private sector (and of course the alternative income if unemployed), the income is often not in synchrony with labour productivity. Public spending on wages of unproductive and surplus employees is akin to a transfer rather than government consumption expenditure. The Fifth Pay Commission of India recommendation of a 30 per cent staff cut in government which did not get implemented is indicative of the extent of implicit transfers in the salaries expenditures of the government. Similarly, not charging user fees on many public utilities such as electricity, water, etc., is a substantial form of transfer that does not necessarily get reported as an explicit subsidy or transfer payment in the accounts of the government. Directed credit programmes stipulating how much of a banks' portfolio goes into lending say to agriculture; also constitute a form of implicit transfers.

2.3 SOCIAL COST BENEFIT ANALYSIS

Cost-Benefit Analysis (CBA) estimates and totals up the equivalent money value of the benefits and costs to the community of projects to establish whether they are worthwhile. These projects may be dams and highways or can be training programs and health care systems.

The idea of this economic accounting originated with Jules Dupuit, a French engineer whose 1848 article is still worth reading. The British economist, Alfred Marshall, formulated some of the formal concepts that are at the foundation of CBA. But the practical development of CBA came as a result of the impetus provided by the Federal Navigation Act of 1936. This act required that the U.S. Corps of Engineers carry out projects for the improvement of the waterway system when the total benefits of a project to whomsoever they accrue exceed the costs of that project. Thus, the Corps of Engineers had create systematic methods for measuring such benefits and costs. The engineers of the Corps. did this without much, if any, assistance from the economics profession. It wasn't until about twenty years later in the 1950's that economists tried to provide a rigorous, consistent set of methods for measuring benefits and costs and deciding whether a project is worthwhile. Some technical issues of CBA have not been wholly resolved even now but the fundamental presented in the following are well established.

2.3.1 The social and governmental aspect of CBA

Cost–benefit analysis is typically used by governments to evaluate the desirability of a given intervention. It is heavily used in today's government. It is an analysis of the cost effectiveness of different alternatives in order to see whether the benefits outweigh the costs. The aim is to gauge the efficiency of the intervention relative to the status quo. The costs and benefits of the impacts of an intervention are evaluated in terms of the public's willingness to pay for them (benefits) or willingness to pay to avoid them (costs). Inputs are typically measured in terms of opportunity costs - the value in their best alternative use. The guiding principle is to list all parties affected by an intervention and place a monetary value of the effect it has on their welfare as it would be valued by them.

The process involves monetary value of initial and ongoing expenses vs. expected return. Constructing plausible measures of the costs and benefits of specific actions is often very difficult. In practice, analysts try to estimate costs and benefits either by using survey methods or by drawing inferences from market behavior. For example, a product manager may compare manufacturing and marketing expenses with projected sales for a proposed product and decide to produce it only if he expects the revenues to eventually recoup the costs. Cost–benefit analysis attempts to put all relevant costs and benefits on a common temporal footing. A discount rate is chosen, which is then used to compute all relevant future costs and benefits in present-value terms. Most commonly, the discount rate used for present-value calculations is an interest rate taken from financial markets (R.H. Frank 2000). This can be very controversial; for example, a high discount rate implies a very low value on the welfare of future generations, which may have a huge impact on the desirability of interventions to help the environment. Empirical studies suggest that in reality, people's discount rates *do* decline over time. Because cost–benefit analysis aims to measure the public's true willingness to pay, this feature is typically built into studies.

During cost–benefit analysis, monetary values may also be assigned to less tangible effects such as the various risks that could contribute to partial or total project failure, such as loss of reputation, market penetration, or long-term enterprise strategy alignments. This is especially true when governments use the technique, for instance to decide whether to introduce business regulation, build a new road, or offer a new drug through the state healthcare system. In this case, a value must be put on human life or the environment, often causing great controversy. For example, the cost–benefit principle says that we should install a guardrail on a dangerous stretch of mountain road if the dollar cost of doing so is less than the implicit dollar value of the injuries, deaths, and property damage thus prevented (R.H. Frank 2000).

Cost–benefit calculations typically involve using time value of money formulas. This is usually done by converting the future expected streams of costs and benefits into a present value amount.

2.3.2 Application and history

Cost–benefit analysis is used mainly to assess the monetary value of very large private and public sector projects. This is because such projects tend to include costs and

benefits that are less amenable to being expressed in financial or monetary terms (e.g., environmental damage), as well as those that can be expressed in monetary terms. Private sector organizations tend to make much more use of other project appraisal techniques, such as rate of return, where feasible.

The practice of cost–benefit analysis differs between countries and between sectors (e.g., transport, health) within countries. Some of the main differences include the types of impacts that are included as costs and benefits within appraisals, the extent to which impacts are expressed in monetary terms, and differences in the discount rate between countries. Agencies across the world rely on a basic set of key cost–benefit indicators, including the following:

NPV (net present value)

PVB (present value of benefits)

PVC (present value of costs)

BCR (benefit cost ratio = PVB / PVC)

Net benefit (= PVB - PVC)

NPV/k (where k is the level of funds available)

The concept of CBA dates back to an 1848 article by Dupuit and was formalized in subsequent works by Alfred Marshall. The practical application of CBA was initiated in the US by the Corps of Engineers, after the Federal Navigation Act of 1936 effectively required cost–benefit analysis for proposed federal waterway infrastructure. The Flood Control Act of 1939 was instrumental in establishing CBA as federal policy. It specified the standard that "the benefits to whomever they accrue [be] in excess of the estimated costs.

Subsequently, cost–benefit techniques were applied to the development of highway and motorway investments in the US and UK in the 1950s and 1960s. An early and often-quoted, more developed application of the technique was made to London Underground's Victoria Line. Over the last 40 years, cost–benefit techniques have gradually developed to the extent that substantial guidance now exists on how transport projects should be appraised in many countries around the world.

In the UK, the New Approach to Appraisal (NATA) was introduced by the then Department for Transport, Environment and the Regions. This brought together cost–

benefit results with those from detailed environmental impact assessments and presented them in a balanced way. NATA was first applied to national road schemes in the 1998 Roads Review but subsequently rolled out to all modes of transport. It is now a cornerstone of transport appraisal in the UK and is maintained and developed by the Department for Transport.

The EU's 'Developing Harmonised European Approaches for Transport Costing and Project Assessment' (HEATCO) project, part of its Sixth Framework Programme, has reviewed transport appraisal guidance across EU member states and found that significant differences exist between countries. HEATCO's aim is to develop guidelines to harmonise transport appraisal practice across the EU.

Transport Canada has also promoted the use of CBA for major transport investments since the issuance of its Guidebook in 1994.

More recent guidance has been provided by the United States Department of Transportation and several state transportation departments, with discussion of available software tools for application of CBA in transportation, including HERS, BCA.Net, StatBenCost, CalBC, and TREDIS. Available guides are provided by the Federal Highway Administration, Federal Aviation Administration, Minnesota Department of Transportation, and California Department of Transportation (Caltrans).

In the early 1960s, CBA was also extended to assessment of the relative benefits and costs of healthcare and education in works by Burton Weisbrod.[10][11] Later, the United States Department of Health and Human Services issued its CBA Guidebook.

2.3.3 Principles of Cost Benefit Analysis

One of the problems of CBA is that the computation of many components of benefits and costs is intuitively obvious but that there are others for which intuition fails to suggest methods of measurement. Therefore some basic principles are needed as a guide.

There Must Be a Common Unit of Measurement

In order to reach a conclusion as to the desirability of a project all aspects of the project, positive and negative, must be expressed in terms of a common unit; i.e., there must be a "bottom line." The most convenient common unit is money. This means that all benefits and costs of a project should be measured in terms of their equivalent money

value. A program may provide benefits which are not directly expressed in terms of dollars but there is some amount of money the recipients of the benefits would consider just as good as the project's benefits. For example, a project may provide for the elderly in an area a free monthly visit to a doctor. The value of that benefit to an elderly recipient is the minimum amount of money that that recipient would take instead of the medical care. This could be less than the market value of the medical care provided. It is assumed that more esoteric benefits such as from preserving open space or historic sites have a finite equivalent money value to the public.

Not only do the benefits and costs of a project have to be expressed in terms of equivalent money value, but they have to be expressed in terms of dollars of a particular time. This is not just due to the differences in the value of dollars at different times because of inflation. A dollar available five years from now is not as good as a dollar available now. This is because a dollar available now can be invested and earn interest for five years and would be worth more than a dollar in five years. If the interest rate is r then a dollar invested for t years will grow to be $(1+r)^t$. Therefore the amount of money that would have to be deposited now so that it would grow to be one dollar t years in the future is $(1+r)^{-t}$. This called the discounted value or present value of a dollar available t years in the future.

When the dollar value of benefits at some time in the future is multiplied by the discounted value of one dollar at that time in the future the result is discounted present value of that benefit of the project. The same thing applies to costs. The net benefit of the projects is just the sum of the present value of the benefits less the present value of the costs.

The choice of the appropriate interest rate to use for the discounting is a separate issue that will be treated later in this paper.

CBA Valuations Should Represent Consumers or Producers - Valuations As Revealed by Their Actual Behavior

The valuation of benefits and costs should reflect preferences revealed by choices which have been made. For example, improvements in transportation frequently involve saving time. The question is how to measure the money value of that time saved. The value should not be merely what transportation planners think time should be worth or

even what people say their time is worth. The value of time should be that which the public reveals their time is worth through choices involving tradeoffs between time and money. If people have a choice of parking close to their destination for a fee of 50 cents or parking farther away and spending 5 minutes more walking and they always choose to spend the money and save the time and effort then they have revealed that their time is more valuable to them than 10 cents per minute. If they were indifferent between the two choices they would have revealed that the value of their time to them was exactly 10 cents per minute.

The most challenging part of CBA is finding past choices which reveal the tradeoffs and equivalencies in preferences. For example, the valuation of the benefit of cleaner air could be established by finding how much less people paid for housing in more polluted areas which otherwise was identical in characteristics and location to housing in less polluted areas. Generally the value of cleaner air to people as revealed by the hard market choices seems to be less than their rhetorical valuation of clean air.

Benefits Are Usually Measured by Market Choices

When consumers make purchases at market prices they reveal that the things they buy are at least as beneficial to them as the money they relinquish. Consumers will increase their consumption of any commodity up to the point where the benefit of an additional unit (marginal benefit) is equal to the marginal cost to them of that unit, the market price. Therefore for any consumer buying some of a commodity, the marginal benefit is equal to the market price. The marginal benefit will decline with the amount consumed just as the market price has to decline to get consumers to consume a greater quantity of the commodity. The relationship between the market price and the quantity consumed is called the demand schedule. Thus the demand schedule provides the information about marginal benefit that is needed to place a money value on an increase in consumption.

Gross Benefits of an Increase in Consumption is an Area under the Demand Curve

The increase in benefits resulting from an increase in consumption is the sum of the marginal benefit times each incremental increase in consumption. As the incremental increases considered are taken as smaller and smaller the sum goes to the area under the marginal benefit curve. But the marginal benefit curve is the same as the demand curve

so the increase in benefits is the area under the demand curve. As shown in Figure 1 the area is over the range from the lower limit of consumption before the increase to consumption after the increase.

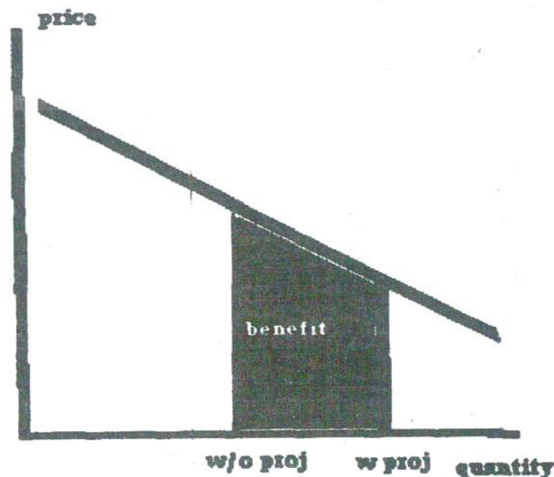


Figure 2

When the increase in consumption is small compared to the total consumption the gross benefit is adequately approximated, as is shown in a welfare analysis, by the market value of the increased consumption; i.e., market price times the increase in consumption.

Some Measurements of Benefits Require the Valuation of Human Life

It is sometimes necessary in CBA to evaluate the benefit of saving human lives. There is considerable antipathy in the general public to the idea of placing a dollar value on human life. Economists recognize that it is impossible to fund every project which promises to save a human life and that some rational basis is needed to select which projects are approved and which are turned down. The controversy is defused when it is recognized that the benefit of such projects is in reducing the risk of death. There are many cases in which people voluntarily accept increased risks in return for higher pay, such as in the oil fields or mining, or for time savings in higher speed in automobile travel. These choices can be used to estimate the personal cost people place on increased risk and thus the value to them of reduced risk. This computation is equivalent to placing an economic value on the expected number of lives saved.

The Analysis of a Project Should Involve a *With* Versus *Without* Comparison

The *impact* of a project is the difference between what the situation in the study area would be with and without the project. This that when a project is being evaluated the analysis must estimate not only what the situation would be with the project but also what it would be without the project. For example, in determining the impact of a fixed guide way rapid transit system such as the Bay Area Rapid Transit (BART) in the San Francisco Bay Area the number of rides that would have been taken on an expansion of the bus system should be deducted from the rides provided by BART and likewise the additional costs of such an expanded bus system would be deducted from the costs of BART. In other words, the alternative to the project must be explicitly specified and considered in the evaluation of the project. Note that the with-and-without comparison is not the same as a before-and-after comparison.

Another example shows the importance of considering the impacts of a project and a with-and-without comparison. Suppose an irrigation project proposes to increase cotton production in Arizona. If the United States Department of Agriculture limits the cotton production in the U.S. by a system of quotas then expanded cotton production in Arizona might be offset by a reduction in the cotton production quota for Mississippi. Thus the impact of the project on cotton production in the U.S. might be zero rather than being the amount of cotton produced by the project.

Cost Benefit Analysis Involves a Particular Study Area

The impacts of a project are defined for a particular study area, be it a city, region, state, nation or the world. In the above example concerning cotton the impact of the project might be zero for the nation but still be a positive amount for Arizona.

The nature of the study area is usually specified by the organization sponsoring the analysis. Many effects of a project may "net out" over one study area but not over a smaller one. The specification of the study area may be arbitrary but it may significantly affect the conclusions of the analysis.

Double Counting of Benefits or Costs Must be avoided

Sometimes an impact of a project can be measured in two or more ways. For example, when an improved highway reduces travel time and the risk of injury the value of property in areas served by the highway will be enhanced. The increase in property

values due to the project is a very good way, at least in principle, to measure the benefits of a project. But if the increased property values are included then it is unnecessary to include the value of the time and lives saved by the improvement in the highway. The property value went up because of the benefits of the time saving and the reduced risks. To include both the increase in property values and the time saving and risk reduction would involve double counting.

2.3.4 Decision Criteria for Projects

If the discounted present value of the benefits exceeds the discounted present value of the costs then the project is worthwhile. This is equivalent to the condition that the net benefit must be positive. Another equivalent condition is that the ratio of the present value of the benefits to the present value of the costs must be greater than one.

If there are more than one mutually exclusive project that have positive net present value then there has to be further analysis. From the set of mutually exclusive projects the one that should be selected is the one with the highest net present value.

If the funds required carrying out all of the projects with positive net present value are less than the funds available this means the discount rate used in computing the present values is too low and does not reflect the true cost of capital. The present values must be recomputed using a higher discount rate. It may take some trial and error to find a discount rate such that the funds required for the projects with a positive net present value is no more than the funds available. Sometimes as an alternative to this procedure people try to select the best projects on the basis of some measure of goodness such as the internal rate of return or the benefit/cost ratio. This is not valid for several reasons.

The magnitude of the ratio of benefits to costs is to a degree arbitrary because some costs such as operating costs may be deducted from benefits and thus not be included in the cost figure. This is called *netting out* of operating costs. This netting out may be done for some projects and not for others. This manipulation of the benefits and costs will not affect the net benefits but it may change the benefit/cost ratio. However it will not raise the benefit cost ratio which is less than one to above one. For more on this topic see Benefit/ cost Ratio Magnitude.

By reducing the positive and negative impacts of a project to their equivalent money value Cost-Benefit Analysis determines whether on balance the project is

worthwhile. The equivalent money value are based upon information derived from consumer and producer market choices; i.e., the demand and supply schedules for the goods and services affected by the project. Care must be taking to properly allow for such things as inflation. When all this has been considered a worthwhile project is one for which the discounted value of the benefits exceeds the discounted value of the costs; i.e., the net benefits are positive. This is equivalent to the benefit/cost ratio being greater than one and the internal rate of return being greater than the cost of capital.

2.4 GOVERNMENT BUDGETING

A government budget is a legal document that is often passed by the legislature, and approved by the chief executive-or president. For example, only certain types of revenue may be imposed and collected. Property tax is frequently the basis for municipal and county revenues, while sales tax and/or income tax are the basis for state revenues, and income tax and corporate tax are the basis for national revenues.

The two basic elements of any budget are the revenues and expenses. In the case of the government, revenues are derived primarily from taxes. Government expenses include spending on current goods and services, which economists call government consumption; government investment expenditures such as infrastructure investment or research expenditure; and transfer payments like unemployment or retirement benefits.

2.4.1 Approaches to Budgeting

A brief note on Systems Theory applied to Political Science: Inputs enter the governmental system that produces outputs which--in turn--are related to outcomes. The conversion of inputs to outputs is a measure of efficiency as the measurement of contributing inputs to impacting outcomes is a measure of efficacy.

1. Line Item Budgeting

Line Item Budgeting is arguably the simplest form of budgeting; this approach links the inputs of the system to the system. These budgets typically appear in the form of accounting documents that express minimal information regarding purpose or an explicit object within the system.

2. Program Budgeting

Program Budgeting takes a normative approach to budgeting in that decision making--allocating resources--is determined by the funding of one program instead of another based on what that program offers. This approach quickly lends itself to the PPBS budgeting approach. A program budget is a budget in which expenditures are based primarily on programs of work and secondarily on character and object. It is a transitional type of budget between the traditional character and object budget, on the one hand, and the performance budget on the other. The major contribution of PPBS lies in the planning process, i.e., the process of making program policy decisions that lead to a specific budget and specific multi-year plans.

PPBS Budgeting or--Program Planning Budgeting System--is the link between the line-item and program budgets and the more complex performance budget. As opposed to the more simple program budget, this decision making tool links the program under consideration to the ways and means of facilitating the program. This is meant to serve as a long-term planning tool so that decision makers are made aware of the future implications of their actions. These are typically most useful in capital projects. The planning portion of the approach seeks to link goals to objects or expected outcomes from specific outputs, which are then sorted into programs that convert inputs to outputs; finally, the budgeting of PPBS helps determine how to fund the program. A leader in the promotion of PPBS was Robert McNamara's use in the United States Government's Department of Defense in the 1960s.

3. Performance Based Budgeting

Performance Based Budgeting attempts to solve decision making problems based on a programs ability to convert inputs to outputs and/or use inputs to affect certain outcomes. Performance may be judged by a certain program's ability to meet certain objectives that contribute to a more abstract goal as calculated by that program's ability to use resources (or inputs) efficiently--by linking inputs to outputs--and/or effectively--by linking inputs to outcomes. A decision making--or allocation of scarce resources--problem is solved by determining which project maximizes efficiency and efficacy.

4. Zero-based budgeting

Zero-based budgeting is a response to an incremental decision making process whereby the budget of a given fiscal year (FY) is largely decided upon by the existing budget of FY-1. In contrast to incrementalism, the allocation of scarce resources--funding--is determined from a zero-sum accounting method. In government, each function of a department's section proposes certain objectives that relate to some goal the section could achieve if allocated *x* dollars.

Zero Base Budgeting is a management process that provides for systematic consideration of all programmes and activities in conjunction with the formulation of budget requests. It is a system whereby each governmental programme, regard less of whether it is new or existing programme must be justified in its entirety each time a new budget is formulated. It implies that, in defence of its budget request no department shall make reference to the level of previous appropriation. The analytical definition of Peter Sarant holds that

"Zero Base Budgeting is a technique which complements and links the existing planning, budgeting and review process. It identifies alternative and efficient methods of utilising limited resources in the effective attainment of selected re-allocating resources by focusing on the systematic review and justification of the funding and performance levels of current programmes or activities."

The objectives of Zero Base Budgeting according to the Department of Expenditure, Ministry of Finance, and Government of India are:

"Zero base budgeting requires identification and sharpening of objectives, examination of various alternative ways of achieving these objectives, selecting the best alternatives through cost-benefit and cost-effectiveness analysis, prioritisation of objectives and programmes, switching of resources from programmes with lower priority to those with higher priority and identification and elimination of programmes which have outlived their utility."

Zero Base Budgeting, thus, is an operating, planning and budgeting process which requires each manager to justify entire budget requests in detail from scratch, and shifts the burden of proof to each manager to justify why any money should be spent at all, as well as how the job can be done better. This approach requires that (i) all activities be

identified in decision packages (or programmes) that relate inputs (costs) with outputs (benefits), (ii) each one be evaluated by systematic analysis, and (iii) all programmes be ranked in order of performance.

Zero Base Budgeting aims at achieving a state of affairs whereby the whole of the budget needs to be justified in order to (a) combat waste and complacency (b) ensure that the relative tasks and activities remain under constant watch and review alternative levels of action in each sector periodically.

The concept of zero base budgeting is as old as the concept of budgeting. Since the first budget of any organisation is always prepared from zero, all the organisations experience this approach at least once. However, in zero base budgeting the idea is proposed to experience it year after year i.e. every time the budget for the next period is prepared. This does not mean that efforts made earlier are not taken into consideration at all. What it exactly means is that one must re-evaluate all activities to find out the level to which such activity should be funded; i.e. whether it should be eliminated or shall be funded at reduced level or increased level or similar level? It shall be determined by the priorities established by top management and by the availability of funds.

I. STEPS/ELEMENTS OF ZERO BASE BUDGETING

ZBB is a four step budgeting process which can be applied in a relatively simple way in any organisation. However, there are a number of conditions which must be fulfilled

- There must be a genuine need within the organisation.
- The management environment of an organisation should be objectively assessed.
- A competent management accountant should, occupy a senior budgeting position within the organisation.
- A ZBB programme must have the unqualified support and involvement of top management.
- ZBB must be tailored to the technical requirements of the organisation intending to implement it.
- A budget should be prepared for the organisation.
- The implementation of ZBB programme will be aided by a commitment to post implementation review and maintenance of the programmes.

The basic four steps are:

1) Review of organisational structure, and identification of decision units and their objectives.
2) Analysing the decision units, working and evolving documented decision packages.
3) Reviewing and ranking the decision packages on the basis of chosen criteria.
4) Allocation of organisation resources to rank decision packages and preparing detailed operating budgets.

Step 1. Decision Units

The first starting step in ZBB is the analytical review of the organisational structure and activities conducted. In every organisation there are meaningful interrelated hierarchical parts which are separated in order to verify the reporting relationships and functional responsibilities. This stage is intended to isolate key decision points in the organisation's hierarchy commencing with the lowest level and progressing to the top. The identification of the organisational entities (decision units) which will prepare budget requests for the organisation are accomplished through selection by higher level management. Selections are based on relationship to organisation, special analysis and re-organisation. Other factors are that units are not too low nor too high in the organisation to prevent meaningful review or analysis and the managers of these units make significant decisions on the amount of spending and the scope, direction, or quality of work to be performed. A decision unit is a distinct segment of an organisation for which budget is prepared.

Decision units are identified by segmenting the organisation into discrete functions, operations or activities for review and analysis. These are the lowest units in the organisational hierarchy which are headed by responsible managers having authority to make decisions on the activities under their control. These should be capable of carrying out different programmes or activities to achieve an objective.

The identification helps in deciding the levels in the organisation at which budgets should be formulated or ZBB ought to start first. Instead of considering the whole department as decision units, individual sections or performing units of each of these departments should be treated as separate decision unit. The location of decision unit

often is a difficult exercise. It is imperative that in the identification there should be a complete knowledge about the organisational structure, its management and objectives. Once the decision units have been identified, each of these must be analysed keeping in view (a) the functions of the department (b) whether any of the tasks are being performed due to some abnormal situations such as expansion, consolidation, (c) whether any of the tasks being performed be reduced or eliminated completely (d) the minimum staffing required to accomplish the normal functions of the decision units.

Step 2. Formulation and Development of Decision Package

Top level management completes two functions in the zero base budgeting process before decision packages (budget requests) are prepared. It decides as to which level of management develops the initial budget requests and budget guidance it needs to prepare the requests (decision packages). These two functions illustrate why ZBB is Zero Bare Budgeting.

First a "top-down" process before becoming a "bottom up" management process. A decision package includes comprehensive justification for budget estimates of an activity. Such a justification is built up by answering a number of questions. The first question to be answered is in regard to the need for the proposed expenditure as to what specific purpose it is serving. This would necessitate sharpening the objectives of the expenditure so that it could be evaluated by using the relevant evaluative techniques or measures of performance. In case the proposed expenditure is justified in the context of its objectives, a further question may be asked to know if there is a better alternative of incurring expenditure to achieve the specified objectives. To quote from Government of India's letter issued in 1986 on the subject of "Introduction of zero base budgeting in the Government of India" a decision package is a budget request which should contain the following:

- A description of the functions or activities of the decision unit.
- The goals and objectives of the various functions/activities of the unit.
- Benefits to be derived from financing the activity/project.
- Relevance of the activity / project to the overall objectives of the organisation/ department in the present context.
- The consequences of its non-funding.

- The projected/estimated cost.
- The yearly phasing of the proposed expenditure.
- Alternative ways of performing the same activity or same objective As Pyhrr defines it "the decision package is a document that identifies and describes a specific activity in such a manner that management can (a) evaluate it and rank it against other activities competing for the same or similar limited resources and (b) decide whether to approve or disapprove it.

One of the significant aspects of the decision packages is that it is used by a manager to define his or her objectives and responsibilities and how best to meet them at various levels of effectiveness. The manager also defines the methods for achieving the objectives. The manager can recommend elimination of some of the activities.

Step 3 Ranking of decision packages

After the construction of decision packages the next important step is to rank the decision packages. Ranking is the process of arranging the various service levels (decision packages) and benefits to be gained from the additional funds to be allocated. These are ranked in order of priority or decreasing benefits to the organisation. The process allows management to allocate scarce resources by concentrating on the following three key questions:

1) Where to spend the money first?

2) How much should be spent in pursuing these goals and objettives?

3) What are the consequences of non-implementing those decision packages which are not going to be approved?

The ranking is done on an ordinal scale (i.e. lst, 2nd and 3rd etc.) in order of priority. Because of the huge numbers involved the ranking process takes place at a number of levels depending on the size, geographical dispersion, levelsof management, volume of decision packages, unit managers, budget staff or by ranking committee.

Cut off level of funding

Ranking of decision packages in large organisations is more problematic as compared to smaller organisations. In large organisations identifying each discrete activity with several levels of effort could create a number of problems. If management

has to review in detail and rank every decision package with conflicting needs, it may take valuable time and effort of the top management.

This problem could be reduced to some extent by:

i) Concentrating management review on lower priority discretionary packages around which the funding levels or cut off levels will be determined.

ii) Limiting the number of consolidation levels through which the packages will be processed.

All packages presented for funding generally would fall into three categories

i) Those with higher priority and high probability of funding.

ii) Those with marginal priority and which may be funded or not funded depending on the resources available; and

iii) Those with low priority and low probability of funding.

The cut off level of funding is usually established arbitrarily as a percentage of current year budget or actual expenditure level or in absolute rupee value. It is important to note that cut off level has nothing to do with the ultimate allocation of resources. It is only a means to help the ranking managers to cut down the time and effort needed to review and rank packages. Each subordinate review level prepares a ranking sheet to submit to the next higher review level. This sheet serves primarily as a summary sheet to identify the order of priority placed on each decision package. Each time a ranking sheet is filled out by the ranking manager who sends it to the next ranking manager. It serves the following purposes:

1) It identifies cumulative funding level which helps top management to know whether the total budget request has exceeded the total available resources or is still below it.
2) It allows top management to decide which package it wants to review in detail.
3) It provides a work sheet to top management to make funding decisions among several rankings readily, adjust the funding levels etc.

The ZBB can be adopted by any organisation willing to aggressively eliminate its budgetary deficit. But only managers intimately acquainted with the organisation culture can make it work effectively. Although the process is ideally suited for cost effective planned growth, most managers probably will be initially interested in its enduring cost-

reduction aspects and the capability it provides for responding flexibility, to sudden shifts in an operating environment.

II. INTRODUCTION OF ZERO BASE BUDGETING IN INDIA

The concept of ZBB has been in use in Indian private industry since long. For example Britannia Industries Ltd. and Union Carbide have been using it since 1977-78 without calling it Zero base budgeting. However in government context, it is of recent origin. The first application of the system was in the Department of Science and Technology in 1983.

In view of the severe resource crunch for the seventh plan, several alternative steps were recommended to the government by the Eighth Finance Commission and the Planning Commission to prune the wasteful public expenditure and inefficiencies in implementation of government programmes. The Finance Ministry decided to introduce the system of ZBB in all departments of the Union Government in 1986-87, as it was important to control the government expenditure of the seventh plan which was showing a negative contribution. Unless the situation was remedied, the only alternative was to cut the plan outlay or to resort to more deficit financing than was envisaged in the plan document. Neither alternative was desirable and therefore the government, had launched a massive economy drive. On 10th July 1986, the Ministry of Finance issued a circular-cum-budget guidelines to all ministry departments, and State Governments and Public Sector Undertakings, impressing .upon them the need to apply ZBB to all schemes and programmes with over Rs. One Crore outlay from the fiscal year 1987-88. For this purpose, a Central monitoring cell was formed.

The Finance Ministry had identified around 150 redundant and low priority schemes with the estimated outlays over Rs. 1000 Crore which the Ministry wanted to eliminate. Among the State governments, Maharashtra has .been implementing ZBB in 42 departments. The budget for 1987-88 reflected a saving of Rs. 50 crore. Several, redundant and duplicative and low priority schemes have either been eliminated or merged. Similarly Karnataka Government experimented with ZBB in Public Health and Agriculture Sections and also had plans to apply it to all 45 departments. Among the public sector undertakings, Madras Refineries Ltd., HMT, BHEL, BEL, Indian

Telephone Industries, Indian Oil, Neyveli Lignite Corp., a few steel plants and nationalised banks have planned to implement ZBB.

5. Flexible Freeze

Flexible Freeze is a budgeting approach pioneered by President George H. W. Bush as a means to cut government spending. Under this approach, certain programs would be affected by changes in population growth and inflation.

6. Program Assessment Rating Tool

Program Assessment Rating Tool (P.A.R.T.) is an instrument developed by the United States OMB to measure and assess the effectiveness of federal programs that review the program's purpose and design, strategic planning, program management, and program results and accountability. The scores are rated from effective (ranging between 85 and 100 points), moderately affective (70-84 points), adequate (50-69 points), and ineffective (0-49 points).

2.4.2 Functions of a Budget Document

As a policy document, a government's budget is designed as a plan for implementing its policy. Traditionally, budgets served as a more rigid to implement policy in a retrospective setting. The functions associated with these values are listed under the Traditional Model and are control. management, and planning. With the age of information and its associated innovations, a more elastic and proactive model has emerged that is more reactive and less rigid. The Modern Model has replaced the control function with the monitoring function, the management function with the steering function, and the planning function with the strategic brokering function.

1. Traditional Model

Control: using the budget document to control expenditures to maximize accountability. This function is most commonly associated with line-item budgets.

Management:using the budget document to manage organizations and·personnel. This function is focused on performance and efficiency. This function is most commonly associated with performance budgets.

Planning: using the budget document as a plan to achieve some goal. The focus of this function is on the outcome and effectiveness of a program. This function is most commonly associated with program and PPBS budgets.

2. Modern Model

Monitoring: as a response to the traditional control function, the monitoring function focuses on the *consequences* of expenditures.

Steering: as a response to the traditional management function, the steering function serves as a *guide* for managing.

Strategic Brokering uses the budget document as a means of constantly looking for possible directions and reacting to the environment.

2.4.3 Values in Budgeting

Three values are generally discussed in the literature of public budgeting; accountability, efficiency, and efficacy.

Accountability focuses on the inputs going into the system or program in action and is best characterized by the Line-Item budgeting approach. It is best suited for the control and monitoring functions of a budget.

Efficiency focuses on the process of the system or program and its conversion of inputs (resources) into outputs (policy). It's focus on the process makes this value appropriate for performance budgets and most in-line with management and steering functions.

Efficacy focuses on outputs and outcomes, measuring the impact of policy. This value follows both the program budget and PPBS budget approaches and coinsides with the planning and strategic brokering functions.

2.4.4 Six Steps of the Budgetary Process; *simplified*

Typically, the budget cycles occurs in four phases. The first requires policy planning and resource analysis and includes revenue estimation. The second phase is referred to as policy formulation and includes the negotiation and planning of the budget formation. The third phase is policy execution which follows budget adoption is budget execution—the implementation and revision of budgeted policy. The fourth phase

encompasses the entire budget process, but is considered its fourth phase. This phase is auditing and evaluating the entire process and system. See the associated points below:

- **Revenue Estimation** performed in the executive branch by the finance director, clerk's office, budget director, manager, or a team.
- **Budget Call** issued to outline the presentation form, recommend certain goals.
- **Budget Formulation** reflecting on the past, set goals for the future and reconcile the difference.
- **Budget Hearings** can include departments, sections, the executive, and the public to discuss changes in the budget.
- **Budget Adoption** final approval by the legislative body.
- **Budget Execution** amending the budget as the fiscal year progresses.

2.4.5 Types of Public Budgets

- **Operating budgets** are those documents that describe the expenditures and revenues during a given period for the functioning of an organization.
- **Capital budgeting** is the process of planning for future purchases above a certain cost threshold or extended life span. This budget is typically accompanied by a Capital Improvement Plan that describes a timeline for acquisition and payment of debt.

Budgets have an economic, political and technical basis. Unlike a pure economic budget, they are not entirely designed to allocate scarce resources for the best economic use. They also have a political basis wherein different interests push and pull in an attempt to obtain benefits and avoid burdens. The technical element is the forecast of the likely levels of revenues and expenses.

2.4.6 India new budget – key features of budget 2009 2010

CHALLENGES

- To lead economy to high GDP growth rate of 9 per cent per annum at the earliest
- To deepen and broaden the agenda for inclusive development
- To improve delivery mechanisms of the government.

OVERVIEW OF THE ECONOMY

- Growth rate of Gross Domestic Product dipped from an average of over 9 per cent in the previous three fiscal years to 6.7 per cent during 2008-09.
- Whole sale price index rose to nearly 13 per cent in August, 2008 and had an equally sharp fall to zero per cent in March, 2009.
- The structure of India's economy changed over the last ten years with contribution of the services sector to GDP at well over 50 per cent and share of merchandise trade doubling to 38.9 per cent of GDP in 2008-09.
- Recognising economic recovery and growth as co-operative effort of the Central and State Governments, meeting with Finance Ministers of States held as part of preparation of the Budget. This is intended to become an annual feature.

TOWARDS ECONOMIC REVIVAL

Short-term Measures

- To counter the negative fallout of the global slowdown on the Indian economy, Government responded by providing three focused fiscal stimulus packages in the form of tax relief and increased expenditure on public projects along with RBI taking a number of monetary easing and liquidity enhancing measures.
- Fiscal accommodation led to an increase in fiscal deficit from 2.7 per cent in 2007-08 to 6.2 per cent of GDP in 2008-09.
- The fiscal stimulus at 3.5 per cent of GDP at current market prices for 2008-09 amounts to Rs.1,86,000 crore.
- Measures taken by the Government were effective in arresting the fall in GDP growth rate in 2008-09. 6.7 per cent growth rate recorded in 2008-09.

Infrastructure Development

- IIFCL to evolve a Takeout financing scheme in consultation with banks to facilitate incremental lending to infrastructure sector.
- IIFCL to refinance 60 per cent of commercial bank loans for PPP projects in critical sectors over the next fifteen to eighteen months. IIFCL and Banks are now in a position to support projects involving total investment of Rs.1,00,000 crore.

Highway and Railways

- Allocation to National Highways Authority of India (NHAI) for the National Highway Development Programme (NHDP) increased by 23 per cent over B.E. 2008-09 in B.E. 2009-10 and allocation for Railways increased from Rs.10,800 crore in Interim B.E. 2009-10 to Rs.15,800 crore in B.E. 2009-10.

Urban Infrastructure

- Allocation under Jawaharlal Nehru National Urban Renewal Mission (JNNURM) stepped up by 87 per cent to Rs.12,887 crore in B.E. 2009-10 over B.E. 2008-09. Allocation for housing and provision of basic amenities to urban poor enhanced to Rs.3,973 crore in B.E. 2009-10. This includes provision for Rajiv Awas Yojana (RAY), a new scheme announced.
- Brihan Mumbai Storm Water Drainage Project (BRIMSTOWA).
- Provision for the project BRIMSTOWA initiated in 2007 and funded through Central Assistance to address the problem of flooding in Mumbai, enhanced from Rs.200 crore in Interim B.E. 2009-10 to Rs.500 crore in B.E. 2009-10 to expedite completion of the project.

Power

- Allocation under Accelerated Power Development and Reform Programme (APDRP) increased by 160 per cent to Rs.2,080 crore in B.E. 2009-10 over B.E. 2008-09.
- **Gas**
- Blueprint to be developed for long distance gas pipelines leading to a National Gas Grid to facilitate transportation of gas across the length and breadth of the country.

Assam Gas Cracker Project

- Outlay for Assam Gas Cracker Project stepped up suitably in B.E. 2009-10.

AGRICULTURE DEVELOPMENT

- Target for agriculture credit flow set at Rs.3,25,000 crore for the year 2009-10. In 2008-09 agriculture credit flow was at Rs.2,87,000 crore.
- Interest subvention scheme for short term crop loans up to Rs.3 lakh per farmer at the interest rate of 7 per cent per annum to be continued. Additional subvention of

1 per cent to be paid from this year, as incentive to those farmers who repay short term crop loans on schedule. Additional allocation of Rs.411 crore over Interim B.E. 2009-10 made for this.

Debt Relief for Farmers

- Time given to the farmers having more than two hectares of land to pay 75 per cent of their overdues under Debt Waiver and Debt Relief Scheme extended from 30th June, 2009 to 31st December, 2009.
- Taskforce to be set up to examine the issue of debt taken by a large number of farmers in some regions of Maharashtra from private money lenders who were not covered by the loan waiver scheme announced last year.

Accelerated Irrigation Benefit Programme

- Allocation under Accelerated Irrigation Benefit Programme (AIBP) increased by 75 per cent over B.E. 2008-09.
- Allocation under Rashtriya Krishi Vikas Yojana (RKVY) stepped up by 30 per cent in B.E. 2009-10 over B.E. 2008-09.

RESTORING EXPORT GROWTH

- Adjustment assistance scheme to provide enhanced Export Credit and Guarantee Corporation (ECGC) cover at 95 per cent to badly hit sectors extended upto March 2010.
- Allocation for Market Development Assistance Scheme enhanced to Rs.124 crore in B.E. 2009-10.
- Interest subvention of 2 per cent on pre-shipment credit for seven employment oriented export sectors extended beyond the current deadline of September 30, 2009 to March 31, 2010.
- To facilitate flow of credit at reasonable rates, Rs.4,000 crore provided as special fund out of Rural Infrastructure Development Fund (RIDF) to Small Industries Development Bank of India (SIDBI). This will incentivise Banks and State Finance Corporations (SFCs) to lend to Micro and Small Enterprises (MSEs) by refinancing 50 per cent of incremental lending to MSEs during the current financial year.

- Stimulus package for print media comprising waiver of 15 per cent agency commission on DAVP advertisements and 10 per cent increase in DAVP rates to be paid as a special relief subject to documentary proof of loss of revenue in non-governmental advertisements, extended from 30th June, 2009 to 31st December, 2009.

MEDIUM-TERM SUSTAINABILITY

- To bring the fiscal deficit under control, institutional reform measures to be initiated during the current year itself.

Fertilizer Subsidy

- To ensure balanced application of fertilizers for increasing agricultural productivity, Government intends to move towards a nutrient based subsidy regime so as to cover larger basket of fertilizers with innovative fertilizer products available in the market at reasonable prices.
- It is intended to move to a system of direct transfer of subsidy to the farmers in due course.

Petroleum and Diesel pricing Policy

- With almost three quarters of our oil consumption met through imports, it is important to recognise that domestic prices of petrol and diesel are broadly in sync with global prices. Government to set up an expert group to advise on a viable and sustainable system of pricing petroleum products.

Taxation

- SARAL – II forms to be introduced early.

People's ownership of PSUs

- While retaining at least 51 per cent Government equity in Public Sector Undertakings, people's participation in disinvestment programmes to be encouraged.
- Public Sector Enterprises such as banks and insurance companies to remain in public sector and will be given full support including capital infusion to grow and remain competitive.

Financial Sector

- The threshold for non-promoter public shareholding for all listed companies to be raised in a phased manner.
- Scheduled commercial banks allowed to set up off-site ATMs without prior approval subject to reporting.
- A sub-committee of State Level Bankers Committee (SLBC) to identify and formulate an action plan for providing banking facilities in under-banked/unbanked areas in the next three years. Rs.100 crore set aside as one-time grant in-aid to ensure provision of at least one centre/Point of Sales (POS) for banking services in each of the unbanked blocks.
- Government has established Competition Commission of India, an autonomous regulatory body. An Appellate body headed by a retired judge of Supreme Court also constituted.

TOWARDS INCLUSIVE DEVELOPMENT

- National Rural Employment Guarantee Scheme (NREGS)
- Allocation under NREGS increased by 144 per cent to Rs.39,100 crore in B.E. 2009-10 over B.E. 2008-09.
- To increase productivity of assets and resources under NREGA, convergence with other schemes relating to agriculture, forests, water resources, land resources, rural roads initiated. In the first stage 115 pilot districts selected for convergence.

National Food Security Act

- National Food Security Act to be brought in to ensure entitlement of 25 kilo of rice or wheat per month at Rs.3 per kilo to every family living below the poverty line in rural or urban areas. Food Security Bill to be put on the website of the Department of Food and Public Distribution for public debate.

Bharat Nirman

- Allocation for Bharat Nirman increased by 45 per cent in 2009-10 over B.E. 2008-09. Allocations under Pradhan Mantri Gram Sadak Yojana (PMGSY) increased by 59 per cent over B.E. 2008-09 to Rs.12,000 crore in B.E. 2009-10. Under Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY), allocation increased by 27 per cent to Rs.7,000 crore.

- Allocation under Indira Awaas Yojana (IAY) increased by 63 per cent to Rs.8,800 crore in B.E. 2009-10. Allocation of Rs.2,000 crore made for Rural Housing Fund (RHF) in National Housing Bank (NHB) to boost the resource base of NHB for refinance operations in rural housing sector.

Pradhan Mantri Adarsh Gram Yojana (PMAGY)

- New scheme Pradhan Mantri Adarsh Gram Yojana (PMAGY) with an allocation of Rs.100 crore launched on pilot basis for integrated development of 1000 villages having population of scheduled castes above 50 per cent.

EMPOWERMENT OF WEAKER SECTIONS

- The Swarna Jayanti Gram Swarozgar Yojana (SGSY) restructured as National Rural Livelihood Mission to make it universal in application, focused in approach and time bound for poverty eradication by 2014-15. In addition to capital subsidy at enhanced rate, interest subsidy to poor households to be provided for loans upto Rs.1 lakh from banks.
- There are over 22 lakh Women's Self Help Groups linked with banks. Reach of SHGs to be widened to enrol at least 50 per cent of all rural women in India as members of SHGs over the next five years.
- Corpus of Rashtriya Mahila Kosh to be increased from Rs.100 crore to Rs.500 crore over the next few years.

Female Literacy

- National Mission for Female Literacy to be launched with focus on minorities, SC, ST and other marginalized groups with the aim to reduce level of female illiteracy by half in three years.
- Integrated Child Development Services (ICDS)
- All ICD Services to be extended to every child under the age of six by March, 2012.

Student Loans to Weaker Sections

- To enable students from economically weaker sections to access higher education, a scheme to provide full interest subsidy during the period of moratorium introduced to cover loans taken from scheduled banks to pursue any of the

approved courses of study in technical and professional streams from recognised institutions in India

Welfare of Minorities

- Plan outlay of Ministry of Minority Affairs enhanced from Rs.1,000 crore in B.E. 2008-09 to Rs.1,740 crore in 2009-10 registering an increase of 74 per cent. This includes Rs.990 crore for Multi-Sectoral Development Programme for Minorities, Grants-in-aid to Maulana Azad Education Foundation, National Minorities Development and Finance Corporation and pre and post matric scholarship for minorities.
- Allocations made for the new schemes of National Fellowship for Students from minority community and Grants-in-aid to Central Wakf Council for computerization of records of State Wakf Boards.
- Rs.25 crore each allocated for establishing new campuses at Murshidabad in West Bengal and Malappuram in Kerala by Aligarh Muslim University.

Welfare of workers in the unorganized sector

- Action initiated to ensure implementation of social security schemes for occupation like weavers, fishermen and women, toddy tappers, leather and handicraft workers, plantation labour, construction labour, mine workers, bidi workers and rickshaw pullers. Necessary financial allocation will be made for these schemes.

Employment Exchanges

- New project for modernization of Employment Exchange in public private partnership to be launched so that a job seeker can register on line from anywhere and approach any employment exchange.

Handloom

- One handloom mega cluster each in West Bengal and Tamil Nadu and one powerloom mega cluster in Rajasthan to be set up. New mega clusters for carpets to be also set up in Srinagar (J&K) and Mirzapur (UP).

Health

- Allocation under National Rural Health Mission (NRHM) increased by Rs.2,057 crore over Interim B.E. 2009-10 of Rs.12,070 crore.

- All BPL families to be covered under Rashtriya Swasthya Bima Yojana (RSBY). Allocation under RSBY increased by 40 per cent over previous allocation to Rs.350 crore in B.E. 2009-10.

Environment and climate change

- In furtherance to National Action Plan on Climate Change, eight national missions representing a multi-pronged long-term and integrated approach to be launched.
- National Ganga River Basin Authority set up. Budgetary allocation under National River and Lake Conservation Plans increased from Rs.335 crore in B.E. 2008-09 to Rs.562 crore in B.E. 2009-10.
- Special one-time grant of Rs.100 crore given to Indian Council of Forestry Research and Education, Dehradun.
- Rs.15 crore each to be allocated to Botanical Survey of India and Zoological Survey of India. An additional amount of Rs.15 crore to be allocated for Geological Survey of India.

TOWARDS BUILDING ACOUNTABLE INSTITUTIONS

- Improving Delivery of Public Services! Unique Identification Authority of India (UIDAI) to set up online data base with identity and biometric details of Indian residents and provide enrolment and verification services across country. Provision of Rs.120 crore made for this in the Budget.
- First set of unique identity number to be rolled out in 12 to 18 months.

National Security

- Additional amount of Rs.430 crore provided over Interim B.E. 2009-10 to modernise police machinery in the States.
- Additional amount of Rs.2,284 crore proposed over Interim B.E. 2009-10 for construction of fences, roads, flood lights on the international borders.
- Programme for housing to create 1 lakh dwelling units for Central Para-military Forces personnel to be launched through innovative financing model.

One Rank One Pension for Ex-servicemen (OROP)

- Based on the recommendation of the Committee headed by the Cabinet Secretary on OROP, government has decided to substantially improve the pension of pre

01.01.2006 defence pensioners below officer rank and bring pre 10.10.1997 pensioners on par with post 10.10.1997 pensioners. The decisions to be implemented from 01st July, 2009 and will cost more than Rs.2,100 crore annually.

Education

- Provision for the scheme 'Mission in Education through ICT' substantially increased to Rs.900 crore and the provision for setting up and up-gradation of Polytechnics under the Skill Development Mission enhanced to Rs.495 crore.
- Rs.827 crore allocated for opening one Central University in each uncovered State.
- Rs.2,113 crore allocated for IITs and NITs which includes a provision of Rs.450 crore for new IITs and NITs.
- The overall Plan budget for higher education is to be increased by Rs.2,000 crore over Interim B.E. 2009-10.
- Rs.50 crore allocated for Punjab University, Chandigarh. Plan allocation for Chandigarh to be suitably enhanced during the year to provide better infrastructure to the people of Chandigarh.

Commonwealth Games, 2010

- Outlays to be stepped up from Rs.2,112 crore in Interim Budget to Rs.3,472 crore in regular Budget 2009-10.

Srilankan Tamils

- Rs.500 crore allocated for rehabilitation of internally displaced persons and reconstruction of the northern and eastern areas of Sri Lanka. Ministry of External Affairs to work closely with the Sri Lankan Government.

Cyclone Aila

- Rs.1,000 crore allocated for programme for rebuilding the damaged infrastructure caused due to cyclone Aila in West Bengal.

BUDGET ESTIMATE 2009-10

- Budget Estimates provide for a total expenditure of Rs.10,20,838 crore consisting of Rs.6,95,689 crore under Non-plan and Rs.3,25,149 crore under Plan registering

an increase of 37 per cent in Non-plan expenditure and 34 per cent in Plan expenditure over B.E. 2008-09.

- Total expenditure in B.E. 2009-10 increased by 36 per cent over B.E. 2008-09.
- Increase in Non-plan expenditure is mainly due to implementation of Sixth Central Pay Commission recommendations, increased food subsidy and higher interest payment arising out of larger fiscal deficit in 2008-09.
- Interest payments estimated at Rs.2,25,511 crore constituting about 36 per cent of Non-plan revenue expenditure in B.E. 2009-10.
- Subsidies up from Rs.71,431 crore in B.E. 2008-09 to Rs.1,11,276 crore in B.E.2009-10.
- Outlay for Defence up from Rs.1,05,600 crore in B.E. 2008-09 to Rs.1,41,703 crore in B.E. 2009-10.
- Gross Budgetary Support for Annual Plan 2009-10 enhanced by Rs.40,000 crore over Interim B.E. 2009-10.
- State Governments to be permitted to borrow additional 0.5 per cent of their GSDP by relaxing the fiscal deficit target under FRBM from 3.5 per cent to 4 per cent of their GSDP. This will enable the States to borrow Rs.21,000 crore additionally over Interim B.E. 2009-10.
- Gross tax receipts budgeted at Rs.6,41,079 crore in B.E. 2009-10 compared to Rs.6,87,715 crore in B.E. 2008-09.
- Non-tax revenue receipts estimated at Rs.1,40,279 crore in B.E. 2009-10 compared to Rs.95,785 crore in B.E. 2008-09.
- Revenue deficit projected at 4.8 per cent of GDP in B.E. 2009-10 compared to 1 per cent in B.E. 2008-09 and 4.6 per cent as per provisional accounts of 2008-09.
- Fiscal deficit as a percentage of GDP is projected at 6.8 per cent compared to 2.5 per cent in B.E. 2008-09 and 6.2 per cent as per provisional accounts 2008-09.

TAX PROPOSALS

- Tax reform, like all reforms, is a process and not an event. Thrust of reforms has been to improve the efficiency and equity of our tax system. This is sought to be achieved by eliminating distortions in the tax structure, introducing moderate

levels of taxation and expanding the base and accompanied by requisite re-engineering of key business processes coupled with automation.

- Recent initiative, on direct taxes side, of the setting up of a Centralized Processing Centre (CPC) at Bengaluru where all electronically filed returns, and paper returns filed in entire Karnataka, will be processed.
- Centre's Tax-GDP ratio has increased to 11.5 per cent in 2008-09 from a low of 9.2 per cent in 2003-04. Share of direct taxes in the Centre's tax revenues has increased to 56 percent in 2008-09 from 41 percent in 2003-04, reflecting sharp improvement in equity of our tax system.
- Structural changes in direct taxes to be pursued by releasing the new Direct Taxes Code within the next 45 days and in indirect taxes by accelerating the process for the smooth introduction of the Goods and Services Tax (GST) with effect from 1st April, 2010.
- The Direct Taxes Code, along with a Discussion Paper, to be released to the public for debate. The Direct Taxes Code Bill will be finalised for introduction in Lok Sabha sometime during the Winter Session based on the inputs received.
- The Authorities for Advance Rulings on Direct and Indirect Taxes to be merged by amending the relevant Acts.
- Agreement has been reached on the basic structure of GST in keeping with the principles of fiscal federalism enshrined in the Constitution. Broad contour of the GST Model envisages dual GST comprising of a Central GST and a State GST. The Centre and the States will each legislate, levy and administer the Central GST and State GST, respectively.

Direct Taxes

- No changes made in the Corporate Tax rates.
- Exemption limit in personal income tax raised by Rs.15,000 from Rs.2.25 lakh to Rs.2.40 lakh for senior citizens; by Rs.10,000 from Rs.1.80 lakh to Rs.1.90 lakh for women tax payers; and by Rs.10,000 from Rs.1.50 lakh to Rs.1.60 lakh for all other categories of individual taxpayers.

- Deduction under section 80-DD in respect of maintenance, including medical treatment, of a dependent who is a person with severe disability being raised from the present limit of Rs.75,000 to Rs.1 lakh.
- Surcharge on various direct taxes to be phased out; in the first instance, by eliminating the surcharge of 10 percent on personal income-tax.
- Sun-set clauses for deduction in respect of export profits under sections 10A and 10B of the Income-tax Act being extended by one more year i.e. for the financial year 2010-11.
- Fringe Benefit Tax on the value of certain fringe benefits provided by employers to their employees to be abolished.
- Scope of provisions relating to weighted deduction of 150% on expenditure incurred on in-house R&D to all manufacturing businesses being extended except for a small negative list.
- Businesses to be incentivised by providing investment linked tax exemptions rather than profit linked exemptions. Investment linked tax incentives to be provided, to begin with, to the businesses of setting up and operating 'cold chain', warehousing facilities for storing agricultural produce and the business of laying and operating cross country natural gas or crude or petroleum oil pipeline network for distribution on common carrier principle. Under this method, all capital expenditure, other than expenditure on land, goodwill and financial instruments to be fully allowable as deduction.
- Minimum Alternate Tax (MAT) to be increased to 15 per cent of book profits from 10 per cent. The period allowed to carry forward the tax credit under MAT to be extended from seven years to ten years.
- New Pension System (NPS) to continue to be subjected to the Exempt-Exempt-Taxed (EET) method of tax treatment of savings. Income of the NPS Trust to be exempted from income tax and any dividend paid to this Trust from Dividend Distribution Tax. All purchase and sale of equity shares and derivatives by the NPS Trust also to be exempt from the Securities Transaction Tax. Self employed persons to be enabled to participate in the NPS and to avail of the tax benefits available thereto.

- Alternative dispute resolution mechanism to be created within the Income Tax Department for the resolution of transfer pricing disputes. Central Board of Direct Taxes (CBDT) to be empowered to formulate 'safe harbour' rules to reduce the impact of judgemental errors in determining transfer price in international transactions.
- Commodity Transaction Tax (CTT) to be abolished.
- Donations to electoral trusts to be allowed as a 100 percent deduction in the computation of the income of the donor.
- Deduction under section 80E of the Income-tax Act allowed in respect of interest on loans taken for pursuing higher education in specified fields of study to be extended to cover all fields of study, including vocational studies, pursued after completion of schooling.
- To mitigate the practical difficulties faced by charitable organisations, anonymous donations received by charitable organisations to the extent of 5 percent of their total income or a sum of Rs.1 lakh, whichever is higher, not to be taxed.
- Scope of presumptive taxation to be extended to all small businesses with a turnover upto Rs. 40 lakh. All such taxpayers to have option to declare their income from business at the rate of 8 percent of their turnover and simultaneously enjoy exemption from the compliance burden of maintaining books of accounts. As a procedural simplification, they are also to be exempted from advance tax and allowed to pay their entire tax liability from business at the time of filing their return. This new scheme to come into effect from the financial year 2010-11.
- Tax holiday under section 80-IB(9) of the Income Tax Act, which was hitherto available in respect of profits arising from the commercial production or refining of mineral oil, to be extended to natural gas. This tax benefit to be available to undertakings in respect of profits derived from the commercial production of mineral oil and natural gas from oil and gas blocks which are awarded under the NELP-VIII round of bidding. The section to be retrospectively amended to provide that "undertaking" for the purposes of section 80-IB(9) will mean all blocks awarded in any single contract.

Indirect Taxes

- Proposals on indirect taxes to seek to achieve stable framework by maintaining the overall rate structure for customs and central excise duties as well as service tax.

Customs Duties

- Customs duty of 5% to be imposed on Set Top Box for television broadcasting.
- Customs duty on LCD Panels for manufacture of LCD televisions to be reduced from 10% to 5%.
- Full exemption from 4% special CVD on parts for manufacture of mobile phones and accessories to be reintroduced for one year.
- List of specified raw materials/inputs imported by manufacturer-exporters of sports goods which are exempt from customs duty, subject to specified conditions, to be expanded by including five additional items.
- List of specified raw materials and equipment imported by manufacturer-exporters of leather goods, textile products and footwear industry which are fully exempt from customs duty, subject to specified conditions, to be expanded.
- Customs duty on unworked corals to be reduced from 5% to Nil.
- Customs duty on 10 specified life saving drugs/vaccine and their bulk drugs to be reduced from 10% to 5% with Nil CVD (by way of excise duty exemption).
- Customs duty on specified heart devices, namely artificial heart and PDA/ASD occlusion device, to be reduced from 7.5% to 5% with Nil CVD (by way of excise duty exemption).
- Customs duty on permanent magnets for PM synchronous generator above 500 KW used in wind operated electricity generators to be reduced from 7.5% to 5%.
- Customs duty on bio-diesel to be reduced from 7.5% to 2.5%.
- Concessional customs duty of 5% on specified machinery for tea, coffee and rubber plantations to be reintroduced for one year, upto 06.07.2010.
- Customs duty on 'mechanical harvester' for coffee plantation to be reduced from 7.5% to 5%. CVD on such harvesters has also been reduced from 8% to nil, by way of excise duty exemption.

- Customs duty on serially numbered gold bars (other than tola bars) and gold coins to be increased from Rs.100 per 10 gram to Rs.200 per 10 gram. Customs duty on other forms of gold to be increased from Rs.250 per 10 gram to Rs.500 per 10 gram. Customs duty on silver to be increased from Rs.500 per Kg. to Rs.1000 per Kg. These increases also to be applicable when gold and silver (including ornaments) are imported as personal baggage.

Customs duty on cotton waste to be reduced from 15% to 10%.

Customs duty on wool waste to be reduced from 15% to 10%.

Customs duty on rock phosphate to be reduced from 5% to 2%.

CVD exemption on Aerial Passenger Ropeway Projects to be withdrawn. Such projects will now attract applicable CVD.

Customs duty exemption on concrete batching plants of capacity 50 cum per hour or more to be withdrawn. Such plants will now attract Customs duty of 7.5%.

On packaged or canned software, CVD exemption to be provided on the portion of the value which represents the consideration for transfer of the right to use such software, subject to specified conditions.

Customs duty on inflatable rafts, snow-skis, water skis, surf-boats, sail-boards and other water sports equipment to be fully exempted.

Central Excise Duties

- Excise duty rate on items currently attracting 4% to be raised to 8% with following major exceptions:
- Specified food items including biscuits. sharbats, cakes and pastries
- Drugs and pharmaceutical products falling under Chapter 30
- Medical equipment
- Certain varieties of paper. paperboard and articles thereof
- Paraxylene
- Power driven pumps for handling water
- Footwear of RSP exceeding Rs.250 but not exceeding Rs.750 per pair
- Pressure cookers
- Vacuum and gas filled bulbs of RSP not exceeding Rs.20 per bulb

- Compact Fluorescent Lamps
- Cars for physically handicapped
- Specific component of excise duty applicable to large cars/utility vehicles of engine capacity 2000 cc and above to be reduced from Rs. 20,000/- per vehicle to Rs.15,000 per vehicle.
- Excise duty on petrol driven trucks/lorries to be reduced from 20% to 8%. Excise duty on chassis of such trucks/lorries to be reduced from '20% + Rs.10000' to '8% + Rs.10000'.
- Excise duty on Special Boiling Point spirits to be reduced to 14%.
- Excise duty on naphtha to be reduced to 14%.
- Duty paid High Speed Diesel blended with upto 20% bio-diesel to be fully exempted from excise duties.
- The ad valorem component of excise duty of 6% on petrol intended for sale with a brand name to be converted into a specific rate. Consequently, such petrol would now attract total excise duty of Rs.14.50 per litre instead of '6% + Rs.13 per litre'.
- The ad valorem component of excise duty of 6% on diesel intended for sale with a brand name to be converted into a specific rate. Consequently, such diesel would now attract total excise duty of Rs.4.75 per litre instead of '6% + Rs.3.25 per litre'.
- Excise duty on manmade fibre and yarn to be increased from 4% to 8%.
- Excise duty on PTA and DMT to be increased from 4% to 8%.
- Excise duty on polyester chips to be increased from 4% to 8%.
- Excise duty on acrylonitrile to be increased from 4% to 8%.
- The scheme of optional excise duty of 4% for pure cotton to be restored.
- Excise duty for man-made and natural fibres other than pure cotton. beyond the fibre and yarn stage, to be increased from 4% to 8% under the existing optional scheme.
- An optional excise duty exemption to be provided to tops of manmade fibre manufactured from duty paid tow at par with tops manufactured from duty paid staple fibre.

- Suitable adjustments to be made in the rates of duty applicable to DTA clearances of textile goods made by Export Oriented Units using indigenous raw materials/inputs for manufacture of such goods.
- Full exemption from excise duty to be provided on goods of Chapter 68 of Central Excise Tariff manufactured at the site of construction for use in construction work at such site.
- Excise duty exemption on 'recorded smart cards' and 'recorded proximity cards and tags' to be made optional. Manufacturers have the option to pay the applicable excise duty and avail the credit of duty paid on inputs.
- EVA compound manufactured on job work for further use in manufacture of footwear to be exempted from excise duty.
- Benefit of SSI exemption scheme to be extended to printed laminated rolls bearing the brand name of others by excluding this item from the purview of the brand name restriction.
- On packaged or canned software, excise duty exemption to be provided on the portion of the value which represents the consideration for transfer of the right to use such software, subject to specified conditions.
- Excise duty on branded articles of jewellery to be reduced from 2% to Nil.

Service Tax

- Service Tax to be imposed on the following services:
- Service provided in relation to transport of goods by rail
- Service provided in relation to transport of coastal cargo; and goods through inland water including National Waterways
- Advice, consultancy or technical assistance provided in the field of law (this tax would not be applicable in case the service provider or service receiver is an individual).
- Cosmetic and plastic surgery service
- Exemption from service tax being provided to inter-State or intra-State transportation of passengers in a vehicle bearing 'Contract Carriage Permit' with specified conditions.

- Exemption from service tax (leviable under Banking and other financial services or under Foreign exchange broking service) being provided to inter-bank purchase and sale of foreign currency between scheduled banks.
- Two taxable services, namely, 'Transport of goods through road' and 'Commission paid to foreign agents' to be exempted from the levy of service tax, if the exporter is liable to pay service tax on reverse charge basis. However, present cap of 10% on commission agency charges is retained. Thus there would be no need for the exporter to first pay the tax and later claim refund in respect of these services.
- For other services received by exporters, service tax exemption to be operated through the existing refund mechanism based on self-certification of the documents where such refund is below 0.25 per cent of FOB value, and certification of documents by a Chartered Accountant for value of refund exceeding the above limit.
- Export Promotion Councils and the Federation of Indian Export Organizations (FIEO) to be exempt from service tax on the membership and other fees collected by them till 31st March 2010.
- Tax proposals on direct taxes to be revenue neutral. On indirect taxes, estimated net gain to be Rs.2,000 crore for a full year.

2.5 BUDGET REFORMS

2.5.1 The Medium Term Budget Policy Statement

This Statement encapsulates the policy framework for the 1999 Budget. It provides a summary of the macroeconomic context within which the budget is prepared, it sets out the priorities, objectives and goals for the budget and it gives three year projections of resources available to meet Government's policy commitments. It describes key developments and trends in spending programmes, consistent with Government's response to the challenge of creating jobs and other reconstruction and development commitments.

The Medium Term Budget Policy Statement sets out the equitable division of nationally raised revenue between the three spheres of government. The Budget Policy

Statement explains the rationale underlying the division of revenue and projects spending for the next three years for the main components of government's social, economic, protection and administrative functions.

The Budget Policy Statement provides a point of departure for Government's medium term spending plans, which give practical expression and substance to the nation's shared reconstruction and development commitments. The detailed spending plans for the next three years will be published in the Budget on 17 February 1999.

Setting fiscal policy targets over the medium term – for the coming three years – has a number of advantages:

- Policy credibility is enhanced, contributing to economic confidence and a more stable financial environment;
- A transparent fiscal policy encourages investment by enhancing the predictability of taxes, interest rates and government spending;
- A medium term fiscal framework facilitates transformation by creating an integrated planning framework, indicating broad dimensions of budget reprioritisation and providing a baseline against which policy changes can be assessed;
- By planning spending over the medium term, government improves the allocation and efficiency of public spending; and
- The medium term framework encourages public discussion and debate of policy priorities within the context of consistent macroeconomic and budget projections.

2.5.2 Budget reform

The Medium Term Expenditure Framework is one of three broad reforms to the budget process. The 1999 Budget was the second to include spending projections for the next three fiscal years. The key features of the Medium Term Expenditure Framework were:

- Publication of three-year forward estimates when the Budget is tabled in Parliament;

- A focus on outputs and outcomes of government spending programmes as part of the budget review process;
- A cooperative approach to expenditure analysis and planning, involving national and provincial treasuries and spending departments;
- More detailed budget information to promote understanding and debate in Parliament and civil society; and
- A budget process aimed at informed political responsibility for budget priorities and spending plans.

The three-year projections of expenditure introduced in the 1998 Budget provide the baseline estimates for planning the 1999 Budget, and allow spending implications to be properly assessed when policy options come under consideration. Reviews of expenditure during the course of the budget process or shifts in priorities may lead political office-bearers to consider changes in the forward estimates. Policy changes will thus typically lead to specific adjustments to the baseline spending plan.

This three-year rolling budget framework means that departments can plan and reprioritise with greater certainty about future resource allocations than in the past. It also provides Parliament and civil society with clear signals of Government's spending intentions.

On Budget Day, Parliament is presented with a set of three-year spending plans, but is only asked to vote on the budget for the coming year. The three-year spending projections allow Parliament, institutions of civil society and particular interest groups to evaluate Government's reconstruction and development goals and objectives in relation to envisaged spending plans. While the vigour of public debate will no doubt remain undiminished, its substance and quality are enhanced by the transparency and extent of information Government provides in the new approach to expenditure planning.

The second key component of the budget reform process is the Treasury Control Bill. This gives effect to the Constitutional requirement for national legislation to:

- Establish a National Treasury;
- Introduce generally recognised accounting practices;
- Introduce uniform norms and standards;

- Prescribe expenditure control in all spheres of government; and
- Set the operational procedures for borrowing, procurement and look after the various National and Provincial Revenue Funds.

The Treasury Control Bill sets the stage for the introduction of further budget reforms by introducing an approach to the management of public finances that focuses on outputs and responsibilities. The Treasury Control Bill clarifies the respective responsibilities of the political head and the official head of a department or agency. In broad terms, the political head is responsible for policy matters, including the preparation of the Budget and ensuring that the administrative head is implementing the budget in line with policy objectives.

The administrative head is accountable to the political head for the implementation of the budget, and accountable to Parliament for financial management. The Bill includes provision for penalties or sanctions in the event of failure of accounting officers to discharge their responsibilities.

Four specific areas of responsibility of accounting officers are set out:

- Operation of basic financial systems;
- Ensuring that departments do not overspend their budgets;
- Regular financial reporting; and
- Publication of reports covering outputs and performance, in a prescribed format.

The Treasury Control Bill lays the basis for phasing in a major overhaul of financial management. This will include, amongst other things, the introduction of appropriation control and accountability arrangements for the management of budgets. As these principles take root, the emphasis will increasingly turn to oversight of the efficiency and effectiveness of programmes and qualitative improvements in financial management practice.

The budget reform process must deal in practical ways with the challenges of South Africa's fiscal environment:

- A cooperative governance framework, in which key policies and their implementation are managed jointly by national and provincial governments;
- The translation of agreed policy goals into delivery of public services;

- The need to make choices so that resources are used to maximize Government's reconstruction and development aims, meet basic needs and ensure redistribution;
- The promotion of democratic accountability and greater transparency and understanding of the nation's budget; and
- Greater effectiveness in the management of public resources to deliver services more efficiently and fairly.

These challenges underscore the need for a coherent vision of the budgeting system. The White Paper will set out proposals for greater devolution of powers of decision-making, empowering departments to allocate resources and manage their personnel and other inputs to improve service delivery. It will provide a clearer role for accounting officers in linking responsibility for resources to identified services, outputs and outcomes. It will outline tougher enforcement of controls, including improved financial accounting systems, more rapid audit and tougher penalties for over-spending or inappropriate use of funds.

These are inter-dependent reforms. If decision-makers are to be accountable for their actions, management responsibilities must be devolved to them. By the same token, devolution of decision-making requires a framework of accountability, and information systems to support decision-makers.

2.5.3 A revised budget framework

This Statement explains several significant shifts in the macroeconomic and fiscal environment since the publication of the 1998 Budget.. A slowdown in economic growth has led to adjustments in spending and tax plans. Higher interest rates have impacted sharply on resources available for service delivery. Government's commitment to effective policing and a revitalised justice system is outlined. Reforms aimed at better management of education, health and welfare services provided by provinces are noted.

In setting out these policy considerations, Government invites Parliament, citizens and the institutions of civil society to contribute to the making of sound budgets, honest evaluation of policies and programmes and steady progress in implementing improved public services.

Activity 2

1. What do you understand by public investment? What are the various areas of public investment?
2. What is Cost Benefit Analysis? Write different principles of CBA.
3. Describe government budgeting. What are various approaches to government budgeting.
4. Distinguish between program budgeting and Zero Base budgeting.

2.6 SUMMARY

Public investment as discussed in this unit encompasses investment in physical infrastructure made by central government, local government and public corporations. After brief introduction to public investment we threw light on public investment and fiscal policy initiatives and implications. Next area of discussion was the Cost benefit analysis in social context. Cost-Benefit Analysis (CBA) estimates and totals up the equivalent money value of the benefits and costs to the community of projects to establish whether they are worthwhile. These projects may be dams and highways or can be training programs and health care systems. Followed by CBA we discussed government budgeting. A government budget is a legal document that is often passed by the legislature, and approved by the chief executive-or president. Various approaches to government budgeting were explained and Zero base budgeting was dealt in detail. Finally budget reforms were revealed in great detail to give readers a broad spectrum.

2.7 FURTHER READINGS

- Joshi, P.L. & V.P. Raja, 1988. Techniques of Zero Base Budgeting: Text and Cases, Himalaya Publishing House: Bombay.
- Performance Budgeting: Linking Funding and Results, Marc Robinson (ed.). IMF, 2007
- From Line-item to Program Budgeting, John Kim, Seoul, 2007
- Micha Grau. 2008. Using a Model Municipal Performance Measurement System to Assess Mid-size Texas Cities' Systems.

POST GRADUATE PROGRAMME

M.A. (FINAL) ECONOMICS

Paper - IV (A)
M.A. (FINAL) ECONOMICS

DISTANCE EDUCATION
PUBLIC ECONOMICS

BLOCK : III

Unit 1	Theories and approaches to taxation
Unit 2	Governement revenue and tax reforms
Unit 3	Public debt

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SELF INSTRUCTIONAL MATERIAL

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PAPER - IV (A) M.A. (FINAL) ECONOMICS

BLOCK - III

Public Economics

BLOCK 3 TAXATION AND PUBLIC DEBT

This block discusses various aspects pertaining to taxation and public debt with special reference to Indian economy. Taxes consist of direct tax or indirect tax, and may be paid in money or as its labour equivalent (often but not always unpaid). A tax may be defined as a "pecuniary burden laid upon individuals or property owners to support the government a payment exacted by legislative authority. Similarly block reveals the concepts related to public debt. Public debt is, in effect, an extension of personal debt, since individuals make up the revenue stream of the government. Public debt accrues over time when the government spends more money than it collects in taxation.

Unit 1 focuses on theories and approaches to taxation. It describes tax incidence; alternative concepts of tax incidence; aspects of individual taxes; principles of taxation and the allocative and equity aspects; approaches to taxation; theory of optimal taxation and excess burden of taxation.

Unit 2 deals with the government revenue and tax reforms in India. Main concerns of this unit are non tax revenue and its distribution; revenue of Union, States and local bodies and tax reforms in India.

The last unit that is unit 3 three reveals the aspects of public debt in Indian context. Public debt in India will be discussed followed by compensatory aspect of debt policy. Other areas of discussion will remain burden of public debt and sources, debt through created money, public borrowings and price level objectives, interdependence of fiscal and monetary policy and budgetary deficits and their implications.

UNIT 1

THEORIES AND APPROACHES TO TAXATION

Objectives

After completing this unit, you should be able to:

- Understand the concept of taxation and its purpose
- Become aware of the theory of tax incidence and its alternative concepts
- Know the aspects of individual taxes
- Explain the principles of taxation and its various approaches
- Discuss the theory of optimal taxation
- Describe the excess burden of taxation

Structure

1.1 Introduction

1.2 Tax incidence

1.3 Alternative concepts of tax incidence

1.4 Aspects of individual taxes

1.5 Principles of taxation and the allocative and equity aspects

1.6 Approaches to taxation

1.7 Theory of optimal taxation

1.8 Excess burden of taxation

1.9 Summary

1.10 Further reading

1.1 INTRODUCTION

To tax (from the Latin *taxo*; "I estimate", which in turn is from *tangō*; "I touch") is to impose a financial charge or other levy upon a taxpayer (an individual or legal entity) by a state or the functional equivalent of a state such that failure to pay is punishable by law.

Taxes are also imposed by many sub national entities. Taxes consist of direct tax or indirect tax, and may be paid in money or as its labour equivalent (often but not always unpaid). A tax may be defined as a "pecuniary burden laid upon individuals or property owners to support the government a payment exacted by legislative authority." A tax "is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority" and is "any contribution imposed by government whether under the name of toll, tribute, tallage, gabel, impost, duty, custom, excise, subsidy, aid, supply, or other name."

In modern taxation systems, taxes are levied in money, but in-kind and *corvée* taxation is characteristic of traditional or pre-capitalist states and their functional equivalents. The method of taxation and the government expenditure of taxes raised is often highly debated in politics and economics. Tax collection is performed by a government agency such as Canada Revenue Agency, the Internal Revenue Service (IRS) in the United States, or Her Majesty's Revenue and Customs (HMRC) in the UK. When taxes are not fully paid, civil penalties (such as fines or forfeiture) or criminal penalties (such as incarceration) may be imposed on the non-paying entity or individual.

Taxes in India are levied by the Central Government and the State Governments. Some minor taxes are also levied by the local authorities such the Municipality or the Local Council.

The authority to levy a tax is derived from the Constitution of India which allocates the power to levy various taxes between the Centre and the State. An important restriction on this power is Article 265 of the Constitution which states that "*No tax shall be levied or collected except by the authority of law.*" Therefore each tax levied or

collected has to be backed by an accompanying law, passed either by the Parliament or the State Legislature.

1.1.1 Purposes and effects

Funds provided by taxation have been used by states and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order, protection of property, economic infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself. Governments also use taxes to fund welfare and public services. These services can include education systems, health care systems, pensions for the elderly, unemployment benefits, and public transportation. Energy, water and waste management systems are also common public utilities. Colonial and modernizing states have also used cash taxes to draw or force reluctant subsistence producers into cash economies.

Governments use different kinds of taxes and vary the tax rates. This is done to distribute the tax burden among individuals or classes of the population involved in taxable activities, such as business, or to redistribute resources between individuals or classes in the population. Historically, the nobility were supported by taxes on the poor; modern social security systems are intended to support the poor, the disabled, or the retired by taxes on those who are still working. In addition, taxes are applied to fund foreign and military aid, to influence the macroeconomic performance of the economy (the government's strategy for doing this is called its fiscal policy - see also tax exemption), or to modify patterns of consumption or employment within an economy, by making some classes of transaction more or less attractive.

A nation's tax system is often a reflection of its communal values or the values of those in power. To create a system of taxation, a nation must make choices regarding the distribution of the tax burden—who will pay taxes and how much they will pay—and how the taxes collected will be spent. In democratic nations where the public elects those in charge of establishing the tax system, these choices reflect the type of community that the public wishes to create. In countries where the public does not have a significant

amount of influence over the system of taxation, that system may be more of a reflection on the values of those in power.

The resource collected from the public through taxation is always greater than the amount which can be used by the government. The difference is called *compliance cost*, and includes for example the labour cost and other expenses incurred in complying with tax laws and rules. The collection of a tax in order to spend it on a specified purpose, for example collecting a tax on alcohol to pay directly for alcoholism rehabilitation centers, is called hypothecation. This practice is often disliked by finance ministers, since it reduces their freedom of action. Some economic theorists consider the concept to be intellectually dishonest since (in reality) money is fungible. Furthermore, it often happens that taxes or excises initially levied to fund some specific government programs are then later diverted to the government general fund. In some cases, such taxes are collected in fundamentally inefficient ways, for example highway tolls.

Some economists, especially neo-classical economists, argue that all taxation creates market distortion and results in economic inefficiency. They have therefore sought to identify the kind of tax system that would minimize this distortion. Also, one of every government's most fundamental duties is to administer possession and use of land in the geographic area over which it is sovereign, and it is considered economically efficient for government to recover for public purposes the additional value it creates by providing this unique service.

Since governments also resolve commercial disputes, especially in countries with common law, similar arguments are sometimes used to justify a sales tax or value added tax. Others (e.g. libertarians) argue that most or all forms of taxes are immoral due to their involuntary (and therefore eventually coercive/violent) nature. The most extreme anti-tax view is anarcho-capitalism, in which the provision of *all* social services should be voluntarily bought by the person(s) using them.

1.2 TAX INCIDENCE

Tax incidence is the analysis of the effect of a particular tax on the distribution of economic welfare. Tax incidence is said to "fall" upon the group that, at the end of the

day, bears the burden of the tax. The key concept is that the tax incidence or tax burden does not depend on where the revenue is collected, but on the price elasticity of demand and price elasticity of supply. For example, a tax on apple farmers might actually be paid by owners of agricultural land or consumers of apples.

The theory of tax incidence has a number of practical results. For example, United States Social Security payroll taxes are paid half by the employee and half by the employer. However, economists think that the worker is bearing almost the entire burden of the tax because the employer passes the tax on in the form of lower wages. The tax incidence is thus said to fall on the employee.

1.2.1 Example of tax incidence

Imagine a $1 tax on every barrel of apples an apple farmer produces. If the product (apples) is price inelastic to the consumer (where if price rose, a small demand loss will be accounted for by the extra revenue), the farmer is able to pass the entire tax on to consumers of apples by raising the price by $1: consumers are bearing the entire burden of the tax; the tax incidence is falling on consumers. On the other hand, if the apple farmer can't raise prices, because the product is price elastic (if prices rise, more demand will be lost than the extra revenue made) the farmer will have to bear the burden of the tax of face decreased revenues: the tax incidence is falling on the farmer. If the apple farmer can raise prices only $0.50, then they are sharing the tax burden. When the tax incidence falls on the farmer, this burden will flow back to owners of the relevant factors of production, including agricultural land and employee wages.

Where the tax incidence falls depends on the price elasticity of demand and price elasticity of supply. Tax incidence falls mostly upon the group that responds least to price (the group that has the most inelastic price-quantity curve).

1.2.2 Analysis

Inelastic supply, elastic demand

Because the producer is inelastic, he will produce the same quantity no matter what the price. Because the consumer is elastic, the consumer is very sensitive to price. A

small increase in price leads to a large drop in the quantity demanded. The imposition of the tax causes the market price to increase from *P without tax* to *P with tax* and the quantity demanded to fall from *Q without tax* to *Q with tax*. Because the producer is inelastic, the quantity doesn't change much. Because the consumer is elastic and the producer is inelastic, the price doesn't change much. The producer is unable to pass the tax onto the consumer and the tax incidence falls on the producer. In this example, the tax is collected from the producer and the producer bears the tax burden. This is known as *back shifting*.

Similarly-elastic supply and demand

Most markets fall between these two extremes, and ultimately the incidence of tax is shared between producers and consumers in varying proportions. In this example, the consumers pay more than the producers, but not all of the tax. The area paid by consumers is obvious as the change in equilibrium price (between *P without tax* to *P with tax*); the remainder, being the difference between the new price and the cost of production at that quantity, is paid by the producers.

Inelastic demand, elastic supply

Because the consumer is inelastic, he will demand the same quantity no matter what the price. Because the producer is elastic, the producer is very sensitive to price. A small drop in price leads to a large drop in the quantity produced. The imposition of the tax causes the market price to increase from *P without tax* to *P with tax* and the quantity demanded to fall from *Q without tax* to *Q with tax*. Because the consumer is inelastic, the quantity doesn't change much. Because the consumer is inelastic and the producer is elastic, the price changes dramatically. The change in price is very large. The producer is able to pass almost the entire value of the tax onto the consumer. Even though the tax is being collected from the producer the consumer is bearing the tax burden. The tax incidence is falling on the consumer, known as *forward shifting*.

1.2.3 Macroeconomic perspective

The supply and demand for a good is deeply intertwined with the markets for the factors of production and for alternate goods and services that might be produced or

consumed. Although legislators might be seeking to tax the apple industry, in reality it could turn out to be truck drivers who are hardest hit, if apple companies shift toward shipping by rail in response to their new cost. Or perhaps orange manufacturers will be the group most affected, if consumers decide to forgo oranges to maintain their previous level of apples at the now higher price. Ultimately, the burden of the tax falls on people—the owners, customers, or workers.

However, the true burden of the tax cannot be properly assessed without knowing the use of the tax revenues. If the tax proceeds are employed in a manner that benefits owners more than producers and consumers then the burden of the tax will fall on producers and consumers. If the proceeds of the tax are used in a way that benefits producers and consumers, then owners suffer the tax burden. These are class distinctions concerning the distribution of costs and are not addressed in current tax incidence models. The US military offers major benefit to owners who produce offshore. Yet the tax levie to support this effort falls primarily on American producers and consumers. Corporations simply move out of the tax jurisdiction but still receive the property rights enforcement that is the mainstay of their income.

Other Considerations of Tax Burden

Consider a 5% import tax applied equally to all imports (oil, autos, hula hoops, and brake rotors; steel, grain, everything) and a direct refund of every penny of collected revenue in the form of a direct egalitarian "Citizen's Dividend" to every person who files Income Tax returns. At the macro level (aggregate) the people as a whole will break even. But the people who consume foreign produced goods will bear more of the burden than the people who consume a mix of goods. The people who consume no foreign goods will bear none of the burden and actually receive an increase in utility. On the producer side, the tax burden distribution will depend on whether a firm produces its goods within the sovereignty or outside the sovereignty. Firms that produce goods inside the sovereignty will increase their market share and their profits when compared to firms who offshore their production. And if the current mix of firms is tilted toward offshore production then the owners of firms will be burdened more than the consumers while the workers/employees will benefit from greater employment opportunity.

Clarification

The burden from taxation is not just the quantity of tax paid (directly or indirectly), but the magnitude of the lost consumer surplus or producer surplus. The concepts are related but different. For example, imposing a $1000 per gallon of milk tax will raise no revenue (because legal milk production will stop), but this tax will cause substantial economic harm (lost consumer surplus and lost producer surplus). When examining tax incidence, it is the lost consumer and producer surplus that is important. See the tax article for more discussion.

1.2.4 Other practical results

The theory of tax incidence has a large number of practical results, although economists dispute the magnitude and significance of these results:

- Because businesses are more sensitive to wages than employees, payroll taxes, employer mandates, and other taxes collected from the employer end up being borne by the employee. The tax is passed onto the employee in the form of lower wages.
- If the go 'ernment requires employers to provide employees with health care, the burden of this is likely fall on the employee to a great degree because the employer may pass on the burden in the form of lower wages.
- Taxes on easily substitutable goods, such as oranges and tangerines, may be borne mostly by the producer because the demand curve for easily substitutable goods is quite elastic.
- Similarly, taxes on a business that can easily be relocated are likely be borne almost entirely by the residents of the taxing jurisdiction and not the owners of the business.
- The burden of tariffs (import taxes) on imported cars might fall largely on the producers of the cars because the demand curve for foreign cars might be elastic if car consumers may substitute a domestic car purchase for a foreign car purchase.

- If consumers drive the same number of miles regardless of gas prices, then a tax on gasoline will be paid for by consumers and not oil companies (this is assuming that the price elasticity of supply of oil is high, which is incorrect. In this case both the price elasticity of demand and supply are very low). Who actually bears the economic burden of the tax is not affected by whether government collects the tax at the pump or directly from oil companies.

1.2.5 Assessment

Assessing tax incidence is a major economics subfield within the field of public finance.

Most public finance economists acknowledge that nominal tax incidence (i.e. who writes the check to pay a tax) is not necessarily identical to actual economic burden of the tax, but disagree greatly among themselves on the extent to which market forces disturb the nominal tax incidence of various types of taxes in various circumstances.

The effects of certain kinds of taxes, for example, the property tax, including their economic incidence, efficiency properties and distributional implications, have been the subject of a long and contentious debate among economists.

The empirical evidence tends support different economic models under different circumstances. For example, empirical evidence on property tax incidents tends to support one economic model, known as the "benefit tax" view in suburban areas, while tending to support another economic model, known as the "capital tax" view in urban and rural areas.

There is an inherent conflict in any model between considering many factors, which complicates the model and makes it hard to apply, and using a simple model, which may limit the circumstances in which its predictions are empirically useful.

1.3 ALTERNATIVE CONCEPTS OF TAX INCIDENCE

1.3.1 Modern View of Tax Incidence or Musgrave's View

Suppose government imposes a new sales tax upon a spare part for a car. The seller shift that tax (by raising the selling price) to the shoulder of the buyer in the belief

that he will bear the burden of the tax. But the buyer may decide not to purchase that spare part from a shop. Instead he may decide to buy a similar one from second hand market or from black market. Thus as a result of sales tax, production in black market increases while the production that spare part in the legitimate market falls. As a result more workers may loose their job while some other find employment in the productive activity carried out for black market. Several other effects are also present. Anyway, every tax results in wide ranging changes in the economy. All the changes are mutually interdependent and intertwined with each other.

Traditional school analyses the effect of taxes by dividing the entire after effect of tax into 2 parts. First one is incidence of tax. The other, is all other remaining effects and changes, other than incidence. That is why, they considered incidence of tax as the eventual distribution of burden of tax. But Richard A Musgrave – The Theory of Public Finance – criticizes the traditional view. According to him, it is arbitrary and hence not correct to make a division between the total effect (or consequence) of a tax into two different parts, namely:

1) Direct incidence &

2) All other effects

The reason is that, all the various elements of the total change are mutually interdependent with each other. So it is not possible to divide the total effect into two parts. We have to consider all elements of the total effect in its wholeness. In this situation, Musgrave argues that, in order to examine and analyse the effects of taxation, we can follow a new approach. He says that, it is easy to identify different aspects of the total change rather than dividing the total change into two parts. He thus identifies three aspects to the total change. They are:

(i) Resource Transfer (RT) Aspect

(ii) Distributional Aspect or Incidence of Tax

(iii) Output Effect Aspect

(i) Resource Transfer (RT) means transfer of resources from private to public use by way of taxation.

(ii) Distributional aspect or incidence of taxation is the resulting change in the distribution of income available for private use as a result of a tax.

(iii)Output effect means, whenever there is a change in tax it will result in the level of output or real income.

Thus for the analysis of total consequence of a tax, instead of dividing the entire effect into two separate parts, Musgrave distinguishes three different aspects of the total change. Thus this approach recognizes the mutual interdependence between all elements of the total change. More specifically, the distributional aspect of the total economic consequence is considered as tax incidence by Musgrave. He says there are three different concepts of incidence of taxation. They are:

(i)-Specific Tax Incidence or Absolute Tax Incidence

When there is a change in a particular tax such as change in the personal income tax, it results in a change in the state of distribution of income. That change in the distribution of income is called as Specific tax incidence.

For example: Suppose government decides to cut income tax. Thus disposable income of the people increases and they began to demand more goods. As a result prices also began to rise and it in turn results in an inflationary process in the economy. Thus Specific tax incidence involves both the initial change in tax and distributional change in income due to this inflation. The major disadvantage of this concept is that it is very difficult to separate the distribution impact of initial change in tax and the inflationary process. Moreover, distribution effect of inflation / deflation makes the concept more complex to analysis.

(ii) Differential Tax Incidence

The distributional change that results as one tax is situated for another one is referred to as Differential tax incidence. For example: Suppose government replace income tax worth one billion US $ with a cigarette excise duty of same worth. This tax

change does not involve any increase in revenue to public use. Instead, it merely involves a re – distribution among households (HH). HH whose income tax is reduced will gain while other with high cigarette purchases will loss. Tobacco growers and cigarette workers will also loose as demand for cigarette falls. As disposable income of these people, who were earlier paying income tax, increases, they demand for products. Thus producers who are selling such products will gain. Due these interdependent changes, the state of distribution of income in the economy undergoes vast changes. This resulting change in distribution of income compared to the initial distribution of income is referred as Differential incidence.

(iii) Budget Incidence

To explain this concept we have to consider simultaneous change in Tax and Expenditure Policy of. government. In the analysis of Specific tax incidence and Differential tax incidence we considered changes in tax alone and assumed that there is no change in the public expenditure. But here, we consider changes in both tax and public expenditure. Changes in tax will bring sufficient revenue to undertake the proposed change in public expenditure.

Thus Budget incidence is that change in the distribution of income results from a simultaneous change in tax and expenditure policy. A good example is the imposition of 2% surcharge upon personal and corporate income tax by government to raise adequate revenue to meet additional expenditure of rehabilitation works in earthquake-hit areas of Gujarat. The resulting changes, due to the change in tax and added expenditure of rehabilitation in the state of distribution of income is referred as Balanced Budget incidence.

1.4 ASPECTS OF INDIVIDUAL TAXES

The "tax net" refers to the types of payment that are taxed, which included personal earnings (wages), capital gains, and business income. The rates for different types of income may vary and some may not be taxed at all. Capital gains may be taxed when realized (e.g. when shares are sold) or when incurred (e.g. when shares appreciate in value). Business income may only be taxed if it is significant or based on the manner

in which it is paid. Some types of income, such as interest on bank savings, may be considered as personal earnings (similar to wages) or as a realized property gain (similar to selling shares). In some tax systems, personal earnings may be strictly defined where labor, skill, or investment is required (e.g. wages); in others, they may be defined broadly to include windfalls (e.g. gambling wins).

Tax rates may be progressive, regressive, or proportional. A progressive tax taxes differentially according to how much has been earned. For example, the first $10,000 in earnings may be taxed at 5%, the next $10,000 at 10%, and any more income at 20%. Alternatively, a flat tax taxes all earnings at the same rate. A regressive income tax may tax income up to a certain amount, such as taxing only the first $90,000 earned. A tax system may use different taxation methods for different types of income. However, the idea of a progressive income tax has garnered support from economists and political scientists of many different ideologies, from Adam Smith in *The Wealth of Nations*[1] to Karl Marx in *The Communist Manifesto*.

Personal income tax is often collected on a pay-as-you-earn basis, with small corrections made soon after the end of the tax year. These corrections take one of two forms: payments to the government, for taxpayers who have not paid enough during the tax year; and tax refunds from the government for those who have overpaid. Income tax systems will often have deductions available that lessen the total tax liability by reducing total taxable income. They may allow losses from one type of income to be counted against another. For example, a loss on the stock market may be deducted against taxes paid on wages. Other tax systems may isolate the loss, such that business losses can only be deducted against business tax by carrying forward the loss to later tax years.

1.4.1 Types

Personal

A personal or individual income tax is levied on the total income of the individual (with some deductions permitted). It is often collected on a pay-as-you-earn basis, with small corrections made soon after the end of the tax year. These corrections take one of two forms: payments to the government, for taxpayers who have not paid enough during

the tax year; and tax refunds from the government for those who have overpaid. Income tax systems will often have deductions available that lessen the total tax liability by reducing total taxable income. They may allow losses from one type of income to be counted against another. For example, a loss on the stock market may be deducted against taxes paid on wages.

Corporate

Corporate tax refers to a direct tax levied by various jurisdictions on the profits made by companies or associations and often includes capital gains of a company. Earnings are generally considered gross revenue minus expenses. Corporate expenses that relate to capital expenditures are usually deducted in full (for example, trucks are fully deductible in the Canadian tax system, while a corporate sports car is only partly deductible)over their useful lives by using % rates based on the class of asset they belong to.Notably, accounting rules about deductible expenses and tax rules about deductible expenses will differ at times, giving rise to book-tax differences. If the book-tax difference is carried over more than a year, it is referred to as a temporary difference, which then creates deferred tax or future assets and liabilities for the corporation, which are carried on the balance sheet.

Payroll

A payroll tax generally refers to two kinds of taxes. Taxes which employers are required to withhold from employees' pay, also known as withholding, pay-as-you-earn (PAYE) or pay-as-you-go (PAYG) tax. These withholdings contribute to the payment of an employee's personal income tax obligation; if the payments exceed this obligation, the employee may be eligible for a tax refund or carryforward to future periods.

Other group of payroll taxes is paid from the employer's own funds, either as a fixed charge per employee or as a percentage of each employee's pay. Payroll taxes often cover government social insurance programs such as social security, health care, unemployment, and disability. These payments do not count towards income taxes of employees and employers, but are normally deductible by the employer.

Inheritance

The inheritance tax, estate tax and death duty are the names given to various taxes which arise on the death of an individual. In international tax law, there is a distinction between an estate tax and an inheritance tax: the former taxes the personal representatives of the deceased, while the latter taxes the beneficiaries of the estate. However this distinction is not always respected. For example, the "inheritance tax" in the UK is a tax on personal representatives, and is therefore, strictly speaking, an estate tax.

Capital gains tax

A capital gains tax is the tax levied on the profit released upon the sale of a capital asset. In many cases, the amount of a capital gain is treated as income and subject to the marginal rate of income tax. However, in an inflationary environment, capital gains may be to some extent illusory: if prices in general have doubled in five years, then selling an asset for twice the price it was purchased for five years earlier represents no gain at all. Partly to compensate for such changes in the value of money over time, some jurisdictions, such as the United States, give a favorable capital gains tax rate based on the length of holding. European jurisdictions have a similar rate reduction to nil on certain property transactions that qualify for the participation exemption. In Canada, 20–50% of the gain is taxable income. In India, Short Term Capital Gains Tax (arising before 1 year) is 10% [15 % from F.Y 2008-09 as per Finance Act 2008] flat rate of the gains and Long Term Capital Gains Tax is nil for stocks & mutual fund units held 1 year or more, provided the sale of shares involved payment of Securities Transaction Tax and 20% for any other assets held 3 years or more.

1.5 PRINCIPLES OF TAXATION AND THE ALLOCATIVE AND EQUITY ASPECTS

The Central Government shoulders the primary responsibility of discharging the key functions of stabilisation and growth in the arena of public finance. Maintaining a stable macroeconomic and fiscal environment, fostering increased rates of savings and investment, ensuring current account stability and maximizing growth are, thus, the main policy objectives. In addition, to ensure inclusive growth, the State must mobilise and

allocate resources in a manner that allows the poor, vulnerable and disadvantaged sections of the population access to the benefits of growth. In practice, this enlarges the equity or allocative aspect in the public finances of the Central Government.

1.5.1 Equity (Fairness) and allocative efficiency

Equity is in the eye of the beholder. Definitions and concepts of equity are numerous, and attitudes about it diverse. But it is clear that policymakers care about equity. Because equity debates are often emotionally charged and personalized, they provide more political drama than the more arcane notions of allocative efficiency.

Broadly defined, equity relates to the distribution of income and people's ability to buy things, especially necessities, in the marketplace.

In tax policy, there are two competing notions of equity, (1) benefits-received, and (2) ability to pay. The first of these forms the basis of many fees, but also can pay a role in the design of taxes. When benefits are less direct and more difficult to define, the case for more general taxation is strengthened.

In the evaluation of taxes, the ability-to-pay notion of equity takes on two dimensions, (1) horizontal equity, and (2) vertical equity. A tax is said to be horizontally equitable if the tax paid by two or more entities in the same economic circumstances (income, consumption, or wealth, depending on the tax) pay identical tax amounts. The Minnesota Department of Revenue, in its 1992 report entitled Model Revenue System for Minneso~ asserts that horizontal equity is achieved when tax bases are broad; deductions, exclusions and exemptions are minimized; and differential tax rates on essentially similar activities or tax bases are avoided. This particular notion of fairness is related to efficiency because when equals are treated equally, it's more likely that the tax will be economicall y neutral and hence less likely to disrupt private economic decisions.

Vertical equity looks at the other dimension of fairness-how tax burdens compare across people with different amounts of tax base (usually income). A tax is said to be progressive, regressive, or proportional if the tax burden as a percentage of income rises, falls, or stays constant, respectively, as income rises. Whether taxes should be progressive, regressive, or proportional requires a value judgement. Generally, some

amount of tax progressivity is widely accepted, particularly as it relates to the extremes of the income distribution. Regressivity can be a policy outcome, but it's rarely, if ever, a policy goal. It is important to note that while some taxes, like the gas tax and cigarette tax, have flat rates, their "incidence" with respect to income is progressive or regressive depending on how consumption (and hence taxes paid) varies by income class.

The Department of Revenue's *Tax Incidence Study* 1999 estimates that the incidence of Minnesota's state and local tax system is barely proportional-the personal income tax largely offsets the regressivity of the property, sales and excise taxes.26 A 50-state study of tax system incidence prepared for the Citizens for Tax Justice shows that most other state tax systems are markedly regressive.

1.5.2 Efficiency

The principle of efficiency relates directly to the condition of "economic efficiency" discussed at the beginning of this section. It is important that tax policy not distort private market decisions, unless distortion is an explicit goal (as might be the case with a cigarette tax increase enacted to reduce smoking, for example).

Market distortion can occur when taxes change the price of some products or inputs, relatively more than others, causing private decisions about production and consumption to change. Tax induced distortion (economic inefficiency) occurs when, for example, an employer elects to self –insure in order to avoid the increasing burden of MCHA assessments and state insurance regulation. To promote economic efficiency, the Department of Revenue generally recommends broad-based taxes with low rates, as opposed to narrow ones with high rates.

Taxes should also be administratively efficient, meaning they should be designed to minimize the cost of collection. Lower collection costs reduce government spending and taxes. Taxes should be designed to maximize voluntary compliance, and minimize taxpayer compliance costs.

1.5.3 Visibility

The important principle of visibility is often overlooked, particularly in legislative settings. The reasons are clear. Taxpayers rarely complain about hidden taxes. But if taxpayers don't know they're paying taxes they can't provide the important citizen oversight presumed by our founding fathers. Taxpayers need to be able to make informed judgements about the cost of government and how their tax burden will change as a result of personal and policy decisions. This principle is fundamental to the notion of accountability.

Because the principle of visibility is often overlooked, many taxpayers suffer from what can be called a "fiscal illusion." They're convinced that a tax diverted to business, health care providers, or insurance companies, is a tax avoided. I' In reality, taxes are paid by people, not entities. Through a process of "tax shifting", taxes on businesses or other organizations are eventually paid by people in the form of higher prices, lower wages or lower investment returns.

Hidden taxes mask the true cost of government and facilitate its growth beyond what taxpayers might knowingly support. Economic efficiency, accountability, and the health of democracy are ·improved when taxes are made more visible.

1.5.4 Simplicity

A good tax is also a simple tax. Taxpayers should know why the tax is'being levied, who's responsible for the tax, and how it's calculated and paid. Tax administrators should know the same. Besides reducing administrative and compliance costs, simplicity breeds an increased sense of fairness, better compliance and more accountability.

If over exercised, the simplicity principle can produce inequities. Equity and simplicity are two tax principles most in conflict. Blind pursuit of either can lead to too little of the other.

To further the goal of simplicity, the Department of Revenue recommends that tax systems minimize the use of deductions, exclusions, and exemptions. Simplicity is

particularly important for taxes in which taxpayers must initially determine their own tax assessment or when they are responsible for recognizing what constitutes a taxable transaction.

1.5.5 Stability and Adequacy

Taxes are assessed to meet public funding needs. As such, they should raise the required amount of revenue. This is usually no problem in the short run, since tax bases can generally be forecasted a short time ahead with sufficient accuracy.

The issues here are long run. The public finance literature generally says the demand for public services rises when incomes rise. Though the cost of income support and human service programs tend to fall in good times, public support for enhancing program benefits and enacting new spending commitments increases when the economy is strong. Consequently, tax collections that grow proportionately with income will more likely provide adequate revenues over time. Tax revenues dedicated to specific programs, like health care or transportation, must likewise grow as program expenditures grow.

The principle favoring stable and adequate taxes is understandable. No one likes disruption. Government employees like to get paid, the state has near contract-like arrangements with local governments and human service and health care providers, and businesses and other taxpayers hate the sudden, unexpected changes in the tax code that often accompany budget crises.

1.5.6 Competitiveness

New information technologies and other advances are reducing the significance of "place" in the conduct of economic activity. No state can afford to ignore this. John Shannon, a veteran public finance practitioner, compares the states to a convoy of ships. When the seas get rough, they stay closer together times of rapid change and uncertainty; he advises states not to fall too far behind in providing quality education and important public infrastructure like roads and telecommunications facilities. He' also warns states not to get too far ahead of the convoy in assessing new or unusually high tax burdens.

The Department of Revenue's Model Revenue report advises that Minnesota should "make the general tax structure competitive for all types of businesses and their employees, rather than to devise special targeted tax breaks for particular businesses or business expansions.

1.6 APPROACHES TO TAXATION

1.6.1 BENEFIT PRINCIPLE

A taxation principle stating that taxes should be based on the benefits received. The benefit principle works from the proposition that those who receive the greatest benefits should pay the most taxes. The benefit principle is commonly used for near-public goods such as highways, libraries, college, and national parks. This is one of two taxation principles. The other is the ability-to-pay principle, which states taxes should be based on income or the ability to pay taxes.

The benefit principle states that taxes should be based on the benefits received, that is, those who receive the greatest benefits should pay the most taxes. On the surface, this principle is quite logical and easily justified. The people who benefit from public goods are logically the ones who should pay for their provision. Drivers should pay for highways, library patrons should pay for libraries, students should pay tuition, camping enthusiasts should pay for national parks, and the list goes on.

However, the benefit principle does not work well for the efficient provision of public (and near-public) goods. Due to nonrival consumption, such goods are efficiently allocated with a zero price. If those who benefit directly from a public or near-public good pay a price equal to the value derived, as would be the case for private goods, then the "quantity demanded" declines and so too does the overall level of benefit generated. This is not efficient.

From the Market Side

The benefit principle is consistent with the market side of resource allocation, and is thus quite appealing to both economists and the general public. If Duncan Thurly never uses the Shady Valley Municipal swimming pool, then why should he pay for it?

This principle of tax fairness is most often applied to near-public goods that are characterized by nonrival consumption and the ability to exclude nonpayers, such as turnpikes, college education, and public parks. Because nonpayers can be excluded from consuming near-public goods, tax payments (entrance fees, tuition, etc.) can be based on the benefits received. It seems reasonable and fair that if nonpayers CAN be excluded from consumption, then they SHOULD be excluded. It seems reasonable and fair that those who benefit most from government services, those who are willing to pay for government services, should be the primary source of paying for these services.

What about Efficiency?

There is, however, a major problem with the benefit principle. It does not work well for the efficient provision of either public or near-public goods. Due to nonrival consumption, both public and near-public goods are efficiently provided at zero cost, at zero prices, to members of society. Just because governments CAN charge for near-public goods, doesn't mean they should. If those who benefit directly from a public or near-public good pay a price equal to the value derived, as would be the case for private goods, then according to the law of demand the "quantity demanded" declines and so too does the overall level of benefit generated. This is not an efficient outcome.

While the benefit principle is commonly used for near-public goods, taking this approach for public goods is exceedingly difficult. Due to the inability to exclude nonpayers from consuming public goods, identifying the benefits received, which would then be the basis for setting the amount of the tax, is virtually impossible. While everyone benefits from national defense, does everyone benefit equally? If not, then who benefits more? And can this be translated into different tax payments?

1.6.2 ABILITY-TO-PAY PRINCIPLE

A taxation principle stating that taxes should be based on the ability to pay taxes, is called as ability to pay principle. The ability-to-pay principle works from the proposition that those who have the greatest income should pay the most taxes. The ability-to-pay principle is the only reasonable way to finance the provision of public goods such as national defense, public health, and environmental quality. This is one of

two taxation principles. The other is the benefit principle, which states taxes should be based on the benefits received.

The ability-to-pay principle states that taxes should be based on the ability to pay taxes, that is, those who have more income should pay more taxes. This principle also makes a great deal of sense, especially for the provision of public goods that are consumed by all. If everyone benefits from public goods, without exclusion, then everyone should pay. However, not everyone CAN pay, so those who CAN afford to pay, need to bear the burden.

Fair and equitable application of the ability-to-pay principle also entails that those with the same income pay the same taxes and those with different incomes pay different taxes. These are termed horizontal equity and vertical equity, respectively.

A Transfer of Income

Taxes are a means of transferring the purchasing power of income from members of society to governments. Government is able to provide public goods and undertake government operations if it has command over resources. This command is achieved with taxes, with the transfer of income from members of society. Income can only be transferred from those who have income. This is the basis for the ability-to-pay principle.

Taking this notion a step further, those who have more income can afford to pay more taxes, that is, they have a greater ability to pay. In addition, even though taxes are imposed on a wide range of tax bases (sales, property, wealth), all taxes are ultimately paid with income. The ability-to-pay principle then implies that the best generate the revenue needed for government operations is collect taxes on income, ALL income without exclusion. All income should be included, not just wage earnings, or corporate profits, or income used for consumption, or just the income remaining after a myriad of special deductions or exemptions.

A Matter of Efficiency

In fact, the only efficient way to provide public goods, goods that are nonrival in consumption, is through the ability-to-pay principle. Because efficiency requires that public goods be provided at a zero price to members of society, tax payments cannot be

in any way attached to who benefits. If tax payments are perceived as a price based on benefits received, then efficiency is not achieved. The revenue generated to finance the provision of public goods must be based on some other criterion. The ability that members of society have to pay taxes is as good as any and better than most.

Equity: Horizontal and Vertical

The ability-to-pay principle has two additional criteria. It also seems "fair" and equitable that those with the same ability to pay should pay the same taxes and those with different abilities should pay different taxes. More specifically these are termed horizontal equity and vertical equity.

- Horizontal Equity: This tax equity principle states that people with the same ability to pay taxes should pay the same amount of taxes. Suppose, for example, that Jonathan McJohnson earns $50,000 of income as a junior executive at Omni Conglomerate, Inc. and pays $5,000 income taxes, a rate of 10%. Horizontal equity results if Manny Mustard, the proprietor of Manny Mustard's House of Sandwich, pays a like $5,000 of taxes on a like $50,000 of income earned from his sandwich-making business.
- Vertical Equity: This tax equity principle states that people with a different ability to pay taxes should pay a different amount of taxes. Once again, let's say that Jonathan McJohnson earns $50,000 of income as a junior executive at Omni Conglomerate, Inc. and pays $5,000 income taxes, a rate of 10%. Vertical equity results if Lisa Quirkenstone, a clerk at the Mega Mart Discount Warehouse Supercenter, pays $500 of taxes on $5,000 of income earned from her job, also 10%. Jonathan has greater ability and pays more taxes.

1.7 THEORY OF OPTIMAL TAXATION

Optimal tax theory is the study of how best to design a tax to minimize distortion and inefficiency subject to raising set revenues through distortionary taxation. A neutral tax is a theoretical tax which avoids distortion and inefficiency completely. Other things being equal, if a tax-payer must choose between two mutually exclusive economic projects (say investments) that face the same pre-tax risk and returns, the one with the

lower tax or with a tax break would be chosen by the rational actor. With that insight, economists argue that generally taxes distort behavior. For example, since only economic actors who engage in market activity of "entering the labor market" get an income tax liability on their wages, people who are able to consume leisure or engage in household production outside the market by say providing housewife services in lieu of hiring a maid are taxed more lightly. With the "Married filing jointly" tax unit in American income tax law, the second earner's income is placed on top of the first wage earner's taxable income and thus gets the highest marginal rate. This type of tax creates a large distortion disfavoring women from the labor force during years when the couple has great child care needs.

The incidence of sales taxes on commodities also leads to distortion if say food prepared in restaurants are taxed but supermarket bought food prepared at home are not taxed at purchase. If the taxpayer needs to buy food at fast food restaurants because he/she is not wealthy enough to purchase extra leisure time (by working less) he/she pays the tax although a more prosperous person who say enjoys playing at being a home chef is more lightly taxed. This differential taxation of commodities may cause inefficiency (by discouraging work in the market in favor of work in the household).

Ramsey (1927) developed a theory for optimal commodity sales taxes. The intersection on downward sloping demand curve and upward sloping supply curves implies that there is producer surplus and consumer surplus. Any sales tax reduces output and imposes a deadweight loss (DWL). If we assume nonvarying demand and supply elasticities, then a single uniform rate of tax on all commodities would seem to minimize the sum area of all such DWL triangles. Ramsey proposed that we assume suppliers were all perfectly elastic in their responses to price changes from tax and then concluded that taxes on goods with more inelastic consumer demand response would have smaller DWL distortions. Thus, we would tax MILK more heavily than PAPAYA JUICE if consumers were more inelastic in their demand for cow's milk. The DWL triangles are now called Harberger triangles (after Arnold Harberger).

Modern theory of optimal taxation looks for marginal deadweight losses, and can be used to evaluate the efficiency of tax reforms (Mayshar 1990, Slemrod & Yitzhaki 1996).

The standard theory of optimal taxation posits that a tax system should be chosen to maximize a social welfare function subject to a set of constraints. The literature on optimal taxation typically treats the social planner as a utilitarian: that is, the social welfare function is based on the utilities of individuals in the society. In its most general analyses, this literature uses a social welfare function that is a nonlinear function of individual utilities. Nonlinearity allows for a social planner who prefers, for example, more equal distributions of utility. However, some studies in this literature assume that the social planner cares solely about average utility, implying a social welfare function that is linear in individual utilities. For our purposes in this essay, these differences are of secondary importance, and one would not go far wrong in thinking of the social planner as a classic "linear" utilitarian.

To simplify the problem facing the social planner, it is often assumed that everyone in society has the same preferences over, say, consumption and leisure. Sometimes this homogeneity assumption is taken one step further by assuming the economy is populated by completely identical individuals. The social planner's goal is to choose the tax system that maximizes the representative consumer's welfare, knowing that the consumer will respond to whatever incentives the tax system provides. In some studies of taxation, assuming a representative consumer may be a useful simplification. However, as we will see, drawing policy conclusions from a model with a representative consumer can also in some cases lead to trouble.

After determining an objective function, the next step is to specify the constraints that the social planner faces in setting up a tax system. In a major early contribution, Frank Ramsey (1927) suggested one line of attack: suppose the planner must raise a given amount of tax revenue through taxes on commodities only. Ramsey showed that such taxes should be imposed in inverse proportion to the representative consumer's elasticity of demand for the good, so that commodities which experience inelastic demand are taxed more heavily. Ramsey's efforts have had a profound impact on tax

theory as well as other fields such as public goods pricing and regulation. However, from the standpoint of the optimal taxation literature, in which the goal is to derive the best tax system, it is obviously problematic to rule out some conceivable tax systems by assumption. Why not allow the social planner to consider all possible tax schemes, including nonlinear and interdependent taxes on goods, income from various sources, and even non-economic personal characteristics?

But if the social planner is allowed to be unconstrained in choosing a tax system, then the problem of optimal taxation becomes too easy: the optimal tax is simply a lump-sum tax. After all, if the economy is described by a representative consumer, that consumer is going to pay the entire tax bill of the government in one form or another. Absent any market imperfection such as a preexisting externality, it is best not to distort the choices of that consumer at all. A lump-sum tax accomplishes exactly what the social planner wants. In the world, there are good reasons why lump-sum taxes are rarely used. Most important, this tax falls equally on the rich and poor, placing a greater relative burden on the latter. When Margaret Thatcher, during her time as the Prime Minister of the United Kingdom, successfully pushed through a lump-sum tax levied at the local level (a "community charge") beginning in 1989, the tax was deeply unpopular. As the *New York Times* reported in 1990, "Widespread anger over the tax threatens Mrs. Thatcher's political life, if not her physical safety. And it may prove to be the last hurrah for her philosophy of public finance, in which the goals of efficiency and accountability take precedence over the values of the welfare state" (Passell, 1990). The tax was quickly revoked, and not coincidentally, Thatcher's term of office ended not long after.

As this episode suggests, the social planner has to come to grips with heterogeneity in taxpayers' ability to pay. If the planner could observe differences among taxpayers in inherent ability, the planner could again rely on lump-sum taxes, but now those lump-sum taxes would be contingent on ability. These taxes would not depend on any choice an individual makes, so it would not distort incentives, and the planner could achieve equality with no efficiency costs. Actual governments, however, cannot directly observe ability, so the model still fails to deliver useful and realistic prescriptions.

Practice

Despite the ambiguity of economic theory, public policy over the last three decades has steadily moved toward lower marginal tax rates on high earners. Figure 2 shows the top marginal tax wedge, which combines the top marginal income tax rate with the rate of value-added tax (or general sales tax) for OECD countries from 1983 to 2007. The average top marginal tax wedge in OECD countries has fallen steadily over this period, from nearly 80 percent to just above 60 percent. Most of this decline is due to a decline in top marginal income tax rates assessed by the central government, which has fallen to just above 50 percent over this period. Sub-central and payroll tax rates have remained essentially flat, while value-added and general sales taxes have increased somewhat.

The very top marginal rate shown in Figure 2, however, may be misleading because it tells us nothing about the range of incomes over which it applies. For instance, in 2006 the top marginal rate in the United Kingdom applied to a worker earning 134 percent of the average employee compensation, while in the United States the corresponding cutoff was 653 percent. If the minimum income to which top rates apply has fallen over time, then a wider range of high income workers are being taxed at a high marginal rate.

1.8 EXCESS BURDEN OF TAXATION

In economics, the excess burden of taxation, also known as the distortionary cost or deadweight loss of taxation, is the economic loss that society suffers as the result of a tax, over and above the revenue it collects. It is assumed that distortions occur because people or firms change their behaviour in order to reduce the amount of tax they must pay. Excess burdens can be measured using the average cost of funds or the marginal cost of funds (MCF). Excess burdens were first discussed by Adam Smith.

An equivalent kind of inefficiency can also be caused by subsidies (that are actually taxes with negative rates).

Economic losses due to taxes were evaluated to be as low as 2.5 cents per dollar of revenue, and as high as 30 cents per dollar of revenue (on average), and even much

higher at the margins. See Martin Feldstein, Tax Avoidance and the Deadweight Loss of the Income Tax, 81(4), Review of Economics and Statistics (1999). at p. 674; Charles L. Ballard, John B. Shoven and John Whalley, The Welfare Cost of Distortions in the United States Tax System: A General Equilibrium Approach, National Bureau of Economic Research Working Paper No. 1043. For a review of literature arguing that moving to a uniform taxation of investment will lead to 0.1% to 0.3% increase in GNP, see Lawrence H. Summers, Should Tax Reform Level the Playing Field?, National Bureau of Economic Research Working Paper No. 2132, Cambridge, MA, January 1987.

1.8.1 Measures of the excess burden

The cost of a distortion is usually measured as the amount that would have to be paid to the people affected by it, in order to make them indifferent to its presence. The excess burden of a tax depends upon two things. The first is the compensated demand or supply elasticity of the good being taxed: the more elastic the demand or supply, the greater the excess burden. The second is the tax rate: as a general rule, the excess burden of a tax increases with the square of the tax rate.

The average cost of funds is the total cost of distortions divided by the total revenue collected by a government. In contrast, the *marginal* cost of funds (MCF) is the size of the distortion that accompanied the last unit of revenue raised (ie. the rate of change of distortion with respect to revenue). In most cases, the MCF increases as the amount of tax collected increases.

The standard position in economics is that the costs in a cost-benefit analysis for any tax-funded project should be increased according to the marginal cost of funds, because that is close to the deadweight loss that will be experienced if the project is added to the budget, or to the deadweight loss removed if the project is removed from the budget.

1.8.2 Distortion and redistribution

In the case of progressive taxes, the distortionary effects of a tax may be accompanied by other benefits: the redistribution of dollars from wealthier people to poorer people who obtain more benefit from them.

In fact almost any tax measure will distort the economy from the path or process that would have prevailed in its absence (land value taxes are a notable exception). For example a sales tax applied to all goods will tend to discourage consumption of all the taxed items, and an income tax will tend to discourage people from earning money in the category of income that is taxed (unless they can manage to avoid being taxed). Some people may move out of the work force (to avoid income tax); some may move into the cash or black economies (where incomes are not revealed to the tax authorities).

For example, in Western nations the incomes of the relatively affluent are taxed partly to provide the money used to assist the relatively poor. As a result of the taxes (and associated subsidies to the poor), incentives are changed for both groups. The relatively rich are discouraged from declaring income and from earning marginal (extra) income, because they know that any additional money that they earn and declare will be taxed at their highest marginal tax rates. At the same time the poor have an incentive to conceal their own taxable income (and usually their assets) so as to increase the likelihood of their receiving state assistance. It can be argued that the distortion of incentives (the move away from a fiscally neutral stance that does not affect incentives) does more harm than good.

One of the main distortions sometimes said to have arisen in the USA and the UK as a result of tax policy is the creation of a permanent underclass, dependent on welfare and discouraged (by the tax system) from seeking work and betterment. In some countries the tax system can be badly designed to deal with such issues, e.g. sometimes the marginal tax rate that applies to earned income (as someone takes work attempting to escape from unemployment and welfare) is so high that the person's take-home income (post-tax and after taking account of any benefits or welfare receipts) does not increase as a result of taking work. This is known as the welfare trap.

There was an example of distortion of the economy by tax policy some years ago in the UK when cars supplied by employers to their employees were taxed at advantageous rates (e.g. encouraging the growth of company car fleets). Over several years the distortion grew to the point that the majority of cars used by working families

were company cars and the dealership structures, and even the types of cars used, altered to adjust to the tax regime.

1.8.3 Deliberate distortion

Not all distortions are bad: Pigovian taxes create distortions that correct for externalities and therefore have a negative MCF.

Here, the fiscal distortion is deliberate, so as to compensate for externalities. "Sin taxes" on alcohol, tobacco, pornography, etc. may be levied so as to discourage their consumption. Such an approach is often preferable to outright prohibition, since prohibition incites trafficking, often resulting in crime and other social costs, but no revenue. Similarly, taxes such as a carbon tax, may be levied on emission of pollutants, in order to encourage corporations to adopt cleaner methods of production.

Activity 1

1. Discuss the theory of tax incidence. What are the implications of tax incidence in practice?
2. Explain the aspects and principles of taxation.
3. What are various approaches to taxation? Discuss the theory of optimal taxation.
4. Give a brief account of excess burden of taxation.

1.9 SUMMARY

Funds provided by taxation have been used by states and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order, protection of property, economic infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself. Governments also use taxes to fund welfare and public services and hence taxation is an important part of economic development. Further in the unit the theory of tax incidence and alternative concepts of tax incidence have been discussed. Aspects of individual taxes had been focused and principles of taxation are revealed. Approaches of taxation were dealt in

detail followed by theory of optimal taxation. Finally excess burden of taxation is discussed in a detailed manner.

1.10 FURTHER READINGS

- BERNASEK, ANNA (February 13, 2010). "Should Tax Bills Be Public Information?". The New York Times.
- Lars Ljungqvist and Thomas J. Sargent (2000), Recursive Macroeconomic Theory, 2nd ed, MIT Press
- Zodrow GR, Mieszkowski P. "The Incidence of the Property Tax. The Benefit View vs. the New View". In: Local Provision of Public Services: The Tiebout Model after Twenty-Five Years—Zodrow GR, ed. (1983) New York: Academic Press.
- Zodrow, The Property Tax Incidence Debate and the Mix of State and Local Finance of Local Public Expenditures (2008), citing Fischel, Regulatory Takings: Law, Economics, and Politics (1995)
- Mayshar (1990), "Measures of Excess Burden," Journal of Public Economics

UNIT 2

GOVERNMENT REVENUE AND TAX REFORMS

Objectives

After reading this unit, you should be able to:

- Understand the concept of non tax revenue and its distribution among union, state and local governments
- Know various policy initiatives regarding distribution of revenues in India in the light of commission reports
- Identify the reforms related to taxation in India

Structure

2.1 Introduction

2.2 Non tax revenue and its distribution

2.3 Revenue of Union, States and local bodies

2.4 Tax reforms in India

2.5 Summary

2.6 Further readings

2.1 INTRODUCTION

Tax revenue is the income that is gained by governments because of taxation of the people.

Just as there are different types of tax, the form in which tax revenue is collected also differs; furthermore, the agency that collects the tax may not be part of central government, but may be an alternative third-party licensed to collect tax which they themselves will use.

Tax revenues on purchases can come from two forms: 'tax' itself is a *percentage* of the price added to the purchase (such as sales tax in US states, or VAT in the UK), while 'duty' is a *fixed amount* added to the purchase price (such as is commonly found on cigarettes). In order to calculate the total tax raised from these sales, we must work out the effective tax rate multiplied by the quantity supplied.

2.1.1 Changes in taxation level

The effect of a change in taxation level on total tax revenue depends on the good being investigated, and in particular on its price elasticity of demand. Where goods have a low elasticity of demand (they are price inelastic), an increase in tax or duty will lead to a small decrease in demand - not enough to offset the higher tax raised from each unit. Overall tax revenue will therefore rise. Conversely, for goods which are price elastic, an increase in tax rate or duty would lead to a fall in tax revenue.

Laffer curve

The Laffer curve theorises that, even price inelastic goods (such as addictive necessary items), there will be a tax revenue maximising point, beyond which total tax revenue will fall as taxes increase. This may be due to a number of causes:

- A cost limit on what can actually be afforded
- The existence of expensive substitutes (which become less expensive)
- An increase in tax avoidance (through the black market or similar)

Revenue Administration

Public Sector: A limiting factor in determining the size of a budget in the public sector is the capacity to tax. Per capita personal income is the most often used measure of relative fiscal capacity. But this measure fails to base tax capacity computation on other important tax bases like the sales and property tax and corporate income taxes. A representative tax system should assess the level of personal income, the value of retail sales and the value of property to compute fiscal capacity. To do so the average tax rate for each base is computed by dividing the total revenue derived by the total value of the

base. Thus, as an example, income taxes collected would be divided by total income to yield a rate of taxation.

Personal Income Tax	**Sales Tax**	**Property Tax**	**Corporate Tax**
Total revenue	Total revenue	Total revenue	Total revenue

The averages of each tax base can be used in comparison to other states or communities, that is, the average of other states or communities, to determine whether or not a government compares favorably regionally or nationally. A state or community's standing on these various bases may affect its ability to attract new industry. The resulting rates, high or low in comparison, can become targets for change. The mission of revenue administration is to provide prudent and innovative revenue, investment and risk management and to regulate the use of government capital.

There are four core responsibilities for the revenue administrator: 1. Manage and invest financial assets prudently. 2. Administer tax and revenue programs fairly and efficiently. 3. Manage risk associated with loss of public assets. 4. Regulate capital expenditures. Example of Balance: The Conflict of Economic Development and the Tax Base

New real estate development may not only enhance the economic base of a state or community, and it may also expand the tax base. It is not always the case, however, that new developments, especially if not properly planned, can in the aggregate, have a negative impact on the tax base. Economic development traditionally focuses on such things as job generation, the provision of affordable housing, and the creation of retail centers. Tax base expansion focuses primarily on maintaining and enhancing real estate values within the municipality. Municipalities tend to pursue economic development with almost a religious fervor, and often do not think strategically about the overall real estate impacts of their economic development initiatives. Yet the existing tax base in almost every municipality throughout the United States is an important source of revenue for funding municipal and school expenditures.

For public sector officials it is important to recognize the potential for a conflict between these two distinct, yet overlapping areas of public policy, and to establish

procedures to achieve the proper balance in this regard. For real estate investors it is important to recognize when public policy is not fully cognizant of the impact of its actions on the real estate market, because of the potential negative impact on property values.

In summary, the concept of tax base management is really one of asset management and is particularly important in States where municipalities derive much of their revenue from their real estate assessments. City officials in Concord, New Hampshire found that a five percent overall increase in the assessed value of existing property would have the same impact on the tax rate as the addition of 2,000,000 square feet (190,000 m^2) of new industrial property or 1,000,000 square feet (93,000 m^2) of new office/R&D development, both of which are likely to take fifteen or more years to realize.

In addition to being responsible for managing the tax base, a community should also be responsible for helping to ensure economic prosperity for its citizens. These two goals can be in conflict unless a long-term view is taken regarding public policy actions, and unless the impact of alternate development actions and programs and priorities are not carefully evaluated. Good tax base management may lead to even better economic development, because investors and businesses will want to be in a community. Instead of offering incentives to attract business, they may be willing to pay to come to a community because it's a good place to live, work, shop and play.

2.2 NON TAX REVENUE AND DISTRIBUTION

A. Interest Receipts

(a) Interest on loans to States

In pursuance of the recommendations of the Ninth Finance Commission (Second Report for the period 1990-95) as accepted by the Government, the State Plan loans advanced to States during 1984-89 and outstanding as at the end of 1989-90 have been consolidated for 15 years with 9% rate of interest. The Ninth/Tenth/Eleventh Finance Commission has not recommended any change in respect of the pre-1979 consolidated loans.

(In crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
(A) Interest Receipts	41578.00	37800.00	41660.01
(B) Dividends and Profits	16229.00	18291.61	18805.00
Total	**57807.00**	**56091.61**	**60465.01**
Interest Receipts			
(i) Interest on loans to-			
(a) States	31866.85	27761.87	27221.03
(b) Union Territories (with Legislature)	757.17	698.92	677.03
(c) Interest payable by Railways	1352.00	1367.88	2679.11
(d) Other Interest receipts	7601.98	7971.33	11082.84
Total	**41578.00**	**37800.00**	**41660.01**

(b) Interest on loans to Union Territory Governments

The interest receipts are estimated at Rs. 698.92 crore in Revised Estimate 2001-2002 and at Rs. 677.03 crore in Budget Estimate 2002-2003.

(c) Interest payable by Railways

The estimates of dividend for the year 2001-2002 have been framed on the basis of the Second Report of RCC (1999), which was adopted by the Lok Sabha on 23.2.2001. In absence of subsequent recommendations of the RCC, the estimates for the year 2002-2003 have been framed on the basis of the arrangements adopted for 2001-2002. These arrangements are:

(i) Except for the Capital cost of residential buildings which bears dividend at 3.5 per cent, Railways pay dividend at 7% on entire dividend-paying capital irrespective of the year of investment (inclusive of 1.5% on dividend bearing capital less subsidy capital invested upto 31.3.1964, for payment to States in lieu of Passenger fares tax).

(ii) The Railways do not pay dividend on capital in respect of:

(1) Strategic Lines - the annual loss in respect of working of such lines is borne by General Revenues and surplus, if any, in their working is transferred to General Revenue's upto the level of normal dividend.

(2) Unremunerative branch lines - the exemption of a particular branch line from payment of dividend on capital is based on annual review of the un-remunerativeness of the line, the remunerativeness being determined on the basis of the 'marginal cost' principle.

(3) Ferries, welfare buildings (hospitals, dispensaries, health units, clubs, institutes, schools and colleges, hostels and other welfare centres) and non-strategic portion of the Northeast Frontier Railway.

(4) Ore lines (Kiriburu-Bimlagarh and Sambhalpur-Titlagarh lines, which involve concessional rates of freight for the carriage of ore) provided that they are not remunerative, the remunerativeness being determined on the basis of the marginal cost' principle.

(5) 28 'new lines' taken up on or after 1st April, 1955 on 'other than financial' considerations, except those which become remunerative during the year adopting the 'marginal cost' principle; this arrangement applies also to Jammu-Kathua and Tirunelvelli - Trivandrum - Kanyakumari lines, which are known as 'national investments'.

On the 'new lines' other than those referred to above, dividend on capital invested is deferred during the period of construction as well as for the first five years after their opening. The deferred dividend is recoverable from the sixth year, provided the net income of the new lines leaves a surplus after payment of the current dividend. The account of the unliquidated deferred dividend on these lines is closed after a period of 20 years from the date of their opening, extinguishing any liability for deferred dividend not liquidated within that period.

(iii) 50 per cent of the outlay in a year on capital works-in-progress (which would otherwise be liable to payment of dividend) is exempted from payment of dividend for a period of three years.

(iv) The above dividend concessions (except losses in the working of strategic lines) are provided to Railways in the form of subsidy from General Revenues.

(v) In years in which the net revenue of the Railways is not adequate to meet the current dividend liability, the shortfall in the payment of the current dividend is treated as deferred dividend liability (on which no interest is charged) to be discharged by Railways from surplus in future years.

Based on the principles mentioned above, the estimates of dividend payable by Railways for Revised Estimates 2001-2002 and Budget Estimates 2002-2003 work out as follows:-

(In crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
(i) Dividend on Capital at charge(net of subsidy payable by General Revenues)	1628.72	1627.82	1778.18
(ii) Subsidy payable by General Revenues	912.91	965.82	1128.94
(iii) Payment by Railways in lieu of Tax on Railway Passenger Fares	23.12	23.12	23.12
(iv) Payment by Railways for assistance to States for railway safety works	...	...	...
Total	**2564.75**	**2616.76**	**2930.24**
Less-Loss on working of 'Strategic Lines'	212.75	248.88	251.13
Dividend payable by Railways taken as interest	**2352.00**	**2367.88**	**2679.11**
Less Dividend deferred	1000.00	1000.00	...
Net dividend payable by Railways taken as interest	**1352.00**	**1367.88**	**2679.11**

Out of the 1.5 per cent dividend paid by the Railways on the pre-1964-65 capital, an amount of Rs.23.12 crores is contributed by the Railways for being passed on to the States as grant in lieu of the repealed tax on railway passenger fares and the balance, which hitherto was contributed to the Railway Safety works fund, is from 2001-2002, credited to the newly created 'Railway Safety Works Fund' directly by the Railways with the approval of Ministry of Finance and the RCC (1999).

(d) Other Interest Receipts

The estimates under 'Other Interest Receipts' are in respect of interest on loans advanced to Public Sector Enterprises, Port Trusts and other Statutory Bodies, Cooperatives, Government servants, etc. and capital outlay on Departmental Commercial Undertakings.

The receipts also include interest from Railways against loans advanced to the Railway Development Fund.

B. Dividends and Profits:

The details are as follows:–

(in crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
(i) Dividends from Public Sector Enterprises and on other investments	5419.50	10295.78	8043.36
(ii) Dividend/Surplus profit of Reserve Bank of India, Nationalised Banks and Financial Institutions	10809.50	10254.22	10761.64
Total	**16229.00**	**20550.00**	**18805.00**

OTHER NON-TAX REVENUE

Broad details of revenue are as follows :-

(in crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
1. Fiscal Services	1317.20	1154.72	1077.72
2. Other General Services	6416.48	7198.03	7918.72
3. Social Services	220.64	235.01	254.73
4. Economic Services	14067.05	16183.33	13805.66
5. Grants-in-aid and Contributions	697.82	828.00	859.09
Total	**22719.19**	**25596.09**	**23915.92**
Less—			
Commercial Departments*	12256.45	11946.59	12748.78
Net-Other Non-Tax Revenue	10462.74	13649.50	11167.14

* Details of receipts of the commercial departments by sectors/sub-sectors are as follows:–

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
Fiscal Services	1010.90	890.64	811.30
Other General Services	3723.84	3726.86	4099.49
Economic Services	7521.71	7329.19	7837.99
Total	**12256.45**	**11946.59**	**12748.78**

FISCAL SERVICES

The estimates are as follows:

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
Fiscal Services	1317.20	1154.72	1077.72
Less-Receipts of Commercial Departments	1010.80	890.54	811.30
Net	**306.30**	**264.18**	**266.42**

Commercial Departments :

The details of the estimates of receipts by commercial departments are as follows:-

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
(a) Currency, Coinage and Mint:			
Currency Note Press	448.45	358.05	303.74
Bank Note Press	250.00	210.00	190.00
Security Paper Mill	92.85	108.09	86.06
Total	**791.30**	**676.14**	**579.80**
(b) Other fiscal services:			
India Security Press	181.60	176.49	191.50
Security Printing Press	38.00	38.00	40.00
Total	**219.60**	**214.49**	**231.50**

The net receipts comprise:-

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
(a). Currency, Coinage and Mint:			
(i) Profits from circulation of coins	280.00	200.00	200.00
(ii) Mints	8.45	8.25	7.59
Total	**288.45**	**208.25**	**207.59**
(b) Other Fiscal Services	17.85	55.93	58.83
Total Fiscal Services	***306.30***	***264.18***	***266.42***

(a) Currency, Coinage and Mint:- Profits from circulation of coins represents the difference between the face value of coins and their metal value. The receipts under 'Mints' relate mainly to refining and assaying charges. Receipts under 'Silver Refinery' mainly relate to sale proceeds of material auctioned.

(b) Other Fiscal Services:- The receipts mainly relate to contributions by Reserve Bank of India towards EFF charges payable to the International Monetary Fund, remunerations etc. received from IMF and penalties etc. realised against economic offences.

The receipts from the above commercial departments have been taken in reduction of expenditure and are dealt with in the Expenditure Budget.

OTHER GENERAL SERVICES

The estimates are as follows:-

(In crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
Other General Services	6416.48	7196.03	7918.72
Less- Receipts of Commercial Department	3723.84	3726.86	4099.49
Net	**2692.64**	**3469.17**	**3819.23**
The net receipts comprise:-			
(i) Administrative services			
Public Service Commission	14.81	14.04	16.04
Police	946.48	986.57	1024.16
Supplies and Disposals	43.02	48.32	48.02
Stationery and Printing	8.52	9.40	10.50
Public Works	70.70	100.20	87.20
Other Administrative Services	579.63	687.13	893.87
(ii) Contribution and recoveries towards pension and other retirement benefits	524.32	870.78	961.86
(iii) Miscellaneous general services	505.16	*752.73*	*777.58*
Total	**2692.64**	**3469.17**	**3819.23**

The Commercial Department receipts relate to Defence Services Canteen Stores Department (CSD) which are dealt with under net expenditure of Commercial Departments in the Expenditure Budget. The receipts of 'Public Service Commission' mainly represent examination fees, etc. of the Union Public Service Commission and Staff Selection Commission. The receipts of 'Police' are on account of Central Police Forces supplied to State Governments and other parties.

These receipts also include the receipts of Delhi Police. The receipts under 'Supplies and Disposals' mainly relate to the fees for purchase and inspection of stores;

and sale proceeds of surplus and obsolete stores disposed off through Directorate General of Supplies and Disposals. The receipts under 'Stationery and Printing' relate to government printing presses, sale of stationery, gazettes and government publications etc.

'Public Works' accommodates all receipts relating to Central Public Works Department other than rent of government residential buildings. The receipts under the head 'Other Administrative Services' mainly relate to audit fees, passport and visa fees, etc. The increase is mainly on account of larger receipts from Audit fees and passport and visa fees. The head 'Miscellaneous General Services' pertains, to receipts relating to unclaimed balances of postal certificates/ market loans written-off to revenue, guarantee fees etc.

SOCIAL SERVICES

The estimates are as follows:

(In crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
Social Services	**220.64**	**235.01**	**254.73**
The estimates of receipts, other than the commercial Departments, comprise the following:–			
Education, Sports, Art and Culture	22.12	26.14	20.43
Medical and Public Health	62.40	67.23	88.92
Family Welfare	17.05	18.30	20.40
Housing	57.96	61.13	62.24
Information and Publicity	58.37	57.47	57.97
Labour and Employment	2.22	4.03	4.05
Social Security and Welfare	0.52	0.71	0.72
Total	**220.64**	**235.01**	**254.73**

The receipts under 'Education, Sports, Art and Culture' mainly relate to tuition and other fees, and entry fees at museums and the ancient monuments. 'Medical' receipts include contributions for Central Government Health Scheme and charges realised from patients for hospital and dispensary services etc.

'Public Health' receipts include service fees, sale proceeds of sera and vaccine, etc. 'Family Welfare' receipts mainly relate to sale proceeds of material and supplies. 'Housing' receipts mainly relate to licence fees for Government residential buildings. 'Urban Development' receipts include licence fees and ground rent.

'Information and Publicity' receipts include charges from advertising and visual publicity, sale of publications and film rentals. 'Labour and Employment' receipts relate mainly to fees realised under labour laws, Factories and Mines Act, etc. The receipts under 'Social Security and Welfare' mainly relate to Central Government Employees Insurance Scheme.

ECONOMIC SERVICES

The estimates are as follows:-

(in crore of Rupees)

	Budget 2001-2002	Revised 2004-2002	Budget 2002-2003
Economic Services	**14067.05**	**16183.33**	**13805.66**
Less-Commercial			
Departments	*7521.71*	*7329.19*	*7837.99*
Net	**6545.34**	**8854.14**	**5967.67**

Commercial Departments

The details of the receipt estimates by commercial departments are given below:–

(In crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
Agriculture and allied activites:			
Delhi Milk Scheme	136.00	118.57	118.57
Industry and Minerals:			
Opium and Alkaloid Factories	353.00	305.00	335.00
Fuel Fabrication Facilities	659.63	772.72	770.96
Total	**1148.63**	**1196.29**	**1224.53**
Energy:			
Badarpur Thermal Power Station	970.00	992.00	1050.81
Rajasthan Atomic Power Station	154.35	75.30	161.20
Fuel Inventory	808.19	734.73	705.38
Heavy Water Pool Management	609.40	498.37	516.07
Total	**2541.94**	**2300.40**	**2433.46**
Transport:			
Lighthouses and lightships	78.68	80.00	80.00
Communications:			
Postal Services	3752.46	3752.50	4100.00
Total-Commercial Departments	***7521.71***	***7329.19***	***7837.99***

The receipts of these commercial departments have been taken in reduction of expenditure and are dealt with in the Expenditure Budget.

The estimates of the net receipts comprise as follows:–

(In crore of Rupees)

	Budget 2001-2002	Revised 2001-2002	Budget 2002-2003
(i) Agriculture and Allied Activities	73.31	108.73	108.43
(ii) Irrigation and Flood Control	10.20	10.20	10.62
(iii) Energy	3714.77	3526.33	2819.60
(iv) Industry and Minerals	245.08	83.41	73.57
(v) Transport	128.74	146.52	155.58
(vi) Communications	3725.59	7395.21	5245.82
Less contribution from BSNL	*2185.00*	*3103.00*	*3100.00*
Net	*1540.59*	*4292.21*	*2145.82*
(vii) Science, Technology and Environment	70.40	178.17	88.81
(viii) General Economic Services	762.25	508.57	565.24
Total	**6545.34**	**8854.14**	**5967.67**

NON-TAX REVENUE OF UNION TERRITORIES :

The estimates are as follows :-

Receipts of Union Territories (without legislature)	444.41	484.25	508.00

The receipts of the Union Territories (without legislature) mainly relate to administrative services, sale of timber and forest produce mainly in Andaman and Nicobar Islands, receipts from Chandigarh Transport Undertaking and receipts from shipping, tourism and power.

2.3 REVENUE OF UNION, STATE AND LOCAL BODIES

In line with cooperative federalism that characterizes harmonious Centre-State relations, the 13th Finance Commission (FC), headed by economist Dr Vijay L. Kelkar has come out with a slew of fiscal fillips and sharing of financial resources to States for the even development of the country.

The Union Finance Minister, Mr Pranab Mukherjee, has accepted most of the key recommendations including the share of States in the net proceeds of the Union taxes at 32 per cent and grants-in-aid of revenues of States for the period 2010-15, non-Plan revenue deficit grant, grant for elementary education and three tranche of environment-related grants of Rs 5,000 crore each comprising forest grant, promotion of renewable energy and for water sector, grants for improving outcomes and for maintenance of roads and bridges and State specific grants.

ON goods and services tax

The Commission proposal on Goods and Services Tax outlining a model GST structure and a grant of Rs 50,000 crore by way of compensation for loss in the implementation by the States has also been accepted in principle, pending the outcome of the ongoing discussions.

Gross domestic product

After assessing the finances of the Union and the States, it has specified a combined debt target of 68 per cent of Gross Domestic Product (GDP) to be met by 2014-15. A recent IMF working paper on what level of public debt could India target said that at 78 per cent of GDP in 2008-09, India stands out against the average for emerging markets at 45 per cent of GDP.

It has favoured a target of 60-65 per cent of GDP for India's public debt by 2015-16.

Resource transfer

Of course, many a State may not stomach this as it may not relish relinquishing its resource-transfer lever to local bodies!

In fact, the Commission makes no bones about its interest in local bodies as being key players in bringing about a development transformation when it said the advent of GST also needs to keep the local bodies in focus in the future. This is necessarily so since, being a consumption based and incentive compatible tax, it is well suited for direct allocation to the third tier, it said adding that such sharing of GST with local bodies will help in eliminating distortionary taxes such as octroi.

Revenue allocation

In yet another eye-popping teaser to the Union, the 13 {+t} {+h} Finance Commission proposes allocation of revenues arising from the 'fiscal commons' such as 'profit petroleum, profit gas and revenue shares from spectrum'. As these are national resources and ought to be the collective disposal of the Central and all State governments, there is a case to view such non-tax revenues that were exclusively in the domain of the Centre "as being sharable between the Centre and the States collectively". To do this, it

would be necessary to include these as a part of the divisible pool, requiring a constitutional amendment, it said.

While States may eye this bonanza with keenness, the Centre might shrink from taking it up as this abridges its right to arrogate the windfall. But cooperative federalism does entail costs and benefits, say fiscal experts wryly.

In the report of the Thirteenth Finance Commission covering the five year period commencing from April 1, 2010, following points have been recommended:

2.3.1 Sharing of Union Taxes

The Commission has recommended that for its award period, the share of States in the net proceeds of Union taxes may be fixed at 32%. The Commission has also recommended on the inter-se distribution of the States' share amongst the States. The details of the formula for inter -se distribution and the corresponding share of each State recommended by the Commission are indicated in Chapter 8 of the Report. It has also recommended that the total transfers to the States on the revenue account be subjected to an indicative ceiling of 39.5% of the gross tax revenues of the Centre.

Grants -in-Aid of Revenues of States under Article 275 of the Constitution

The Commission has recommended grants-in-aid of revenues of States for non plan revenue deficit, elementary education, environment related issues, improving outcomes, maintenance of roads and bridges, local bodies, disaster relief, GST implementation and state specific grants under Article 275 of the Constitution.

Non Plan Revenue Deficit Grant

The Commission has assessed the revenues and expenditure of the States for the period 2010-15 and has projected the deficit for each State after taking into account the amount of share in Central taxes for that State. The Commission has recommended a grant of Rs. 51800 crore to meet this deficit for eight States. The amount of grant recommended for each state year-wise is indicated in Chapter 12 of the Report. The Commission has also recommended a performance incentive grant of Rs. 1500 crore for

three special category States of Assam, Sikkim and Uttarakhand that have graduated out of Non Plan Revenue Deficit.

Elementary Education

The Commission has assessed the requirement of providing elementary education for each State based on the Sarva Shiksha Abhiyan norms and recommended to provide a grant of Rs. 24068 crore equivalent to 15% of the assessed requirement. The year -wise allocation for each State and the conditionality for release of this grant are given in Chapter 12 of the Report.

Environment Related Grants

The Commission has recommended three grants under this category of Rs. 5000 crore each aggregating to Rs. 15000 crore. The first grant of each of these Rs. 5000 crore grants is forest grant, the second is for promotion for renewable energy and the third is for water sector. The year-wise allocation for each State and the conditionalities for forest and water sector grants are indicated in Chapter 12 of the Report. The eligibility of each State for the grant for renewable energy is to be decided, based on the achievement of each state on this front in the first four years of the award period.

Grants for maintenance of Roads and Bridges

The Commission has assessed the requirement of ordinary repairs of roads in a State and has recommended grant of Rs. 19930 crore equivalent to 90% of the assessed requirement for PMGSY roads and 50% of the assessed requirement for other roads, for four years of the award period starting 2011-12.

State Specific grants

The Commission has recommended grants aggregating to Rs. 27945 crore for various state specific needs of the States. For monitoring and implementation of all the above grants at the State level, the Commission has recommended setting up a monitoring committee under the chairmanship of the Chief Secretary of the State. In addition to the grants mentioned above, the Commission has recommended grants for

GST implementation, local bodies and disaster relief which, alongwith the other recommendations relating to these areas, are explained below.

Goods and Services Tax

The Commission has recommended a model GST structure that includes features such as single rate, zero rating of exports, inclusion of various indirect taxes at the Central and State level in GST ambit, major rationalisation of the exemption structure, etc. The Commission has recommended a grant of Rs. 50000 crore for implementation of GST as per the recommended model. This grant is to be disbursed initially in the form of compensation for loss due to implementation of GST and residual amount to be distributed amongst States in the terminal year of the award period as per the devolution formula. It has also recommended administrative structure for implementation and monitoring of this grant.

The Government has accepted these recommendations in principle. However, in view of the ongoing discussions between Centre and States on this aspect, implementation of these recommendations alogwith modalities may await the outcome of the discussions.

Local Bodies

The Commission has recommended a basic grant and a performance grant for local bodies. Both these grants in any year have been quantified based on a percentage of the divisible pool of the preceding year. For every year of the award period, the Commission has recommended a basic grant amounting to 1.5% of the size of divisible pool in the preceding year. Similarly, for 2011-12 the Commission has recommended a performance grant of 0.5% of the divisible pool of the preceding year and for subsequent years in the award period, 1% of the divisible pool of the preceding year.

Disaster Relief

The Commission has reviewed the existing arrangement of financing relief expenditure in light of the Disaster Management Act, 2005 and has recommended merger of the National Calamity Contingency Fund (NCCF) into National Disaster Response Fund (NDRF) and merger of Calamity Relief Funds (CRF) into State Disaster Response

Fund (SDRF) with effect from 01.04.2010 and transfer of the balances in the existing funds into the new funds.

Fiscal Roadmap

The Commission has assessed the finances of the Union and States and specified a combined debt target of 68% of Gross Domestic Product (GDP) to be met by 2014-15. It has worked out a roadmap for Fiscal Deficit (FD) and Revenue Deficit (RD) for the award period. For Centre, it has recommended RD to be eliminated and FD to be brought down to 3% of GDP by 2013-14. For States, the Commission has worked out fiscal roadmap for each State depending on its current deficit and debt levels. The States are required to eliminate RD and achieve FD of 3% of their respective Gross State Domestic Product (GSDP) during the Commission's award period in stages, in a manner that all the States would eliminate RD and achieve FD of 3% of GSDP latest by 2014-15. The Commission has also recommended that the borrowing limits of the States should be fixed by the Centre in line with these targets.

Debt Relief to States

The Commission has recommended two debt relief measures to be extended to all States. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to States contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9%.

2.4 MAJOR TAX REFORMS IN INDIA

There have been major changes in tax systems of countries with a wide variety of economic systems and levels of development during the last two decades. The motivation for these reforms has varied from one country to another and the thrust of reforms has differed from time to time depending on the development strategy and philosophy of the times. In many developing countries, the immediate reason for tax reforms has been the need to enhance revenues to meet impending fiscal crises. As Bird (1993) states, "...fiscal crisis has been proven to be the mother of tax reform". Such reforms, however, are often ad hoc and are done to meet immediate exigencies of revenue. In most cases,

such reforms are not in the nature of systemic improvements to enhance the long run productivity of the tax system.

One of the most important reasons for recent tax reforms in many developing and transitional economies has been to evolve a tax system to meet the requirements of international competition (Rao 1992). The transition from a predominantly centrally planned development strategy to market based resource allocation has changed the perspective of the role of the state in development. The transition from a public sector based, heavy industry dominated, import substituting industrialization strategy to one of allocating resources according to market signals has necessitated systemic changes in the tax system. In an export-led open economy, the tax system should not only raise the necessary revenues to provide the social and physical infrastructure but also minimize distortions. Thus, the tax system has to adjust to the requirements of a market economy to ensure international competitiveness.

As in other countries, the systemic reforms in the tax system in India in the 1990s were the product of crisis but the reforms were calibrated on the basis of detailed analysis. The objective of this paper is to analyse the evolution of the India tax system with special reference to the systemic reforms in the design and implementation of the structure and operation of the taxes in Indian federal polity. In section I, the evolution of tax system reforms, alternative paradigms employed in reform exercises in different countries and the best practice approaches to reform are described to provide a framework for analysing the Indian tax reform experience.

Section II describes the Indian tax system and the reform initiatives undertaken until the comprehensive tax reform exercise was taken up in 1991. The salient features of comprehensive tax reform since 1991 and its impact on revenues are analysed in section III. The last section brings out the major shortcomings still persisting in the tax system and lists the challenges faced by the government in developing a coordinated tax system in the Indian federal polity.

The philosophy of tax reform has undergone significant changes over the years in keeping with the changing perception of the role of the state. With the change in the development strategy in favour of market determined resource allocation, the traditional

approach of raising revenues to finance a large public sector without much regard to economic effects has been given up. The recent approaches to reform lay emphasis on minimizing distortions in tax policy to keep the economy competitive.

Minimizing distortions implies reducing the marginal rates of both direct and indirect taxes. This also calls for reducing differentiation in tax rates to reduce unintended distortions in relative prices. To achieve this, the approach suggests broadening of the tax bases. Thus, over the years, emphasis has shifted from vertical equity in which both direct and indirect taxes are subject to high marginal rates with minute differentiation in rates, to horizontal equity in which, the taxes are broad-based, simple and transparent, and subject to low and less differentiated rates. Equity in general, is taken to mean improving the living conditions of the poor. This has to be achieved mainly through expenditure policy and human resource development rather than reducing the incomes of the rich as was envisaged in the 1950s and 1960s. Conventional wisdom on tax reforms provides us with at least three different model of tax reform. The optimal tax (OT) model (Ahmad and Stern 1991) is satisfactory in terms of its theoretical soundness, but has been found to be impractical in its applications. Besides the trade-off between efficiency and equity in tax policy, the information and administrative costs of designing an optimal tax model have been found to be prohibitive and, therefore, as a practical guide to tax policy this has not been useful.

2.4.1 IMPACT OF TAX REFORMS SINCE 1991 *Report of the Tax Reform Committee (TRC)*

Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practice approaches, the TRC adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms (see Bird 1989). There are three parts in the report. In the first interim report, the Committee set out the guiding principles of tax reform and applied them to important taxes namely, taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report was concerned mainly with the much-neglected aspect of reforms in administration and enforcement of both direct and indirect taxes. The second part of the report dealt with

restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations were to broaden the base, lower marginal tax rates, reduce rate differentiation, and undertake measures to make the administration and enforcement of the tax system more effective.

The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes. The important proposals put forward by the TRC included reduction in the rates of all major taxes, viz. customs, individual and corporate income taxes and excises to reasonable levels, maintain progressivity but not such as to induce evasion. The TRC recommended a number of measures to broaden the base of all taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and a thorough revamping and modernization of the administrative and enforcement machinery. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and this should be extended to the wholesale level in agreement with the states, with additional revenues beyond the post-manufacturing stage passed on to the state governments.

In the case of customs. the TRC recommendations were the weakest. The TRC recommended tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. The tariff rate was to vary directly with the stage of processing of commodities. and among final consumer goods, with the income elasticity of demand (higher rates on luxuries). Excessive rate differentiation (seven rates) and according varying degrees of protection depending on the stage of processing has been severely criticized by Joshi and Little (1996, p. 74) when they state, "....this is a totally unprincipled principle, for it has no foundation in economic principles". In addition to continued complexity, the proposed tariff structure creates very high differences in effective rates and provides a higher degree of protection to inessential commodities. The TRC recommendation also falls much short of developing a coordinated domestic trade tax system in the country. This, in

a sense, is understandable, as it had no mandate to go into the state level taxes. However, the Committee was aware of the serious problems of avoidance and evasion in respect of sales taxes levied by the states predominantly at the manufacturing stage. Therefore, it did recommend the extension of the central VAT to the wholesale stage with the revenues from the extended levy assigned to the states.

2.4.2 Implementation of reforms since 1991

The government accepted the recommendations of the TRC and has implemented them in phases. Although it did not entirely follow the recommendations and is yet to implement many of the measures to strengthen the administration and enforcement machinery, most of the recommendations have been implemented. It must also be noted that the pace and content of reforms have not been exactly true to TRC recommendations. As regards the personal income taxes, the most drastic and visible changes have been seen in the reduction in personal and corporate income tax rates. In the case of personal income taxes, besides exemption, the number of tax rates has been reduced to three and the tax rates were drastically reduced to 10, 20 and 30 per cent. At the same time, the exemption limit was raised in stages to Rs 50,000. Combined with the standard deduction, a salaried taxpayer up to an income of Rs 75,000 need not pay any tax. In addition, saving incentives were given by exempting investment in small savings and provident funds up to a specified limit. Attempts have also been made to bring in the self-employed income earners into the tax net. Every individual living in large cities covered under any of the specified conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel) is necessarily required to file a tax return. Empirical evidence shows that this drastic reduction in the marginal tax rates has improved the compliance index significantly.

Thus, revenues from personal and corporate income taxes have shown appreciable increases after the reforms were initiated in spite of the fact that the rates of tax have been reduced significantly. Voluntary disclosure scheme to allow a one time amnesty to tax defaulters by paying the necessary tax was introduced in 1997-98. In the case of corporate income taxes, the rates were progressively reduced on both domestic and foreign companies to 35 per cent and 48 per cent respectively. The dividend tax at the

individual income tax level has been abolished. However, very little has been done in terms of broadening the base of corporation tax. In fact, besides depreciation allowances and exemptions for exporters, generous tax holidays and preferences are given for investment in various activities (housing, medical equipment, tourism, infrastructure, oil refining, free trade zones, software development, telecommunication, sports etc.). Consequently, the tax base has not grown in proportion to the growth of corporate profits. As many corporate entities took generous advantage of all these tax preferences, there were a number of "zero-tax" companies. To ensure minimum tax payments by them, a Minimum Alternative Tax (MAT) was introduced in 1997-98.

In the case of tariffs, there has been a drastic reduction in both the average and peak tariff rates. In 1990-91, the unweighted average nominal tariff was 125 per cent and peak rate was 355 per cent. These were progressively reduced over the years. The peak rate of import duty in 1997-98 was 40 per cent and the average rate of tariff is just about 25 per cent. It is proposed to reduce the tariffs further to the levels prevailing in the South-East Asian countries in the next five years. In terms of rate differentiation, the number of tax rates continues to remain high. While in the initial years, there was an attempt to reduce the rate differentiation, in more recent years, the variations have, in fact, increased. Again, the pattern of tariffs with the rates varying with the stage of processing has resulted in very high incentives given to the assembly of consumer durables and luxury items of consumption.

There has been a considerable simplification and rationalization of union excise duties as well. Besides reduction in the number of rates, the tax has been progressively converted from a specific into *ad valorem* levy in respect of the majority of commodities. The facility of providing credit on input taxes under the MODVAT too has been progressively extended to a larger number of commodities. As of now almost 80 per cent of the goods covered under excise duties are provided with the MODVAT facility. The base of the tax was broadened by removing the exemptions and levying excise duty at the lowest rate (8 per cent). There has also been a simplification of the tax on the small-scale sector. As the government realized that there was considerable misuse, availability of MODVAT credit was reduced to 95 per cent instead of 100 per cent. Another important

change that has been brought about since 1991 is the introduction of a selective tax on services. The constitution does not assign this tax base specifically either to the centre or the states. However, the central government by invoking residuary powers has introduced a tax on services since 1994-95. Beginning with three services (telephones, non-life insurance and stock brokerage), the base of the tax has been broadened to cover a large number of services such as transporters, car rentals, air travel agents, architects, interior designers, management consultants, chartered accountants, cost accountants, company secretaries, credit rating agencies, market research agencies, underwriters, private security/detectives, real estate agencies and mechanized slaughter houses.

There have been significant attempts to improve the administration and enforcement of the tax as well, though progress in actual implementation has not been commensurate. Besides amnesties given from time to time, efforts have been made to reduce arrears by introducing simplified assessment procedures. A large number of pending cases in courts have been decided through out of court settlements. There have also been attempts to establish special tax courts to deal exclusively with tax disputes. With the assistance of the Canadian International Development Agency (CIDA), the government has started an ambitious programme of computerising tax returns and building a management information system.

2.4.3 State tax systems

While a good deal of progress has been made in the tax system reform of the central government, progress in the case of state tax systems has not been commensurate. The sales taxes, which account for over 60 per cent of states' revenues, have, over the years, become stagnant. The states prefer to levy the tax at the first point of sale, and this makes the tax base narrow. With as many as 16-20 rate categories introduced to fulfil a variety of objectives, the tax has become complicated. This has given rise to a large number of classification disputes as well. Taxation of inputs and capital goods, in addition, has contributed to cascading. In an imperfect market characterized by mark up pricing, the taxes on inputs and capital goods results in the phenomenon tax-on-tax, and mark up on the tax with consumers paying much more than the revenues collected by the government. In addition, there is a tax on inter-state sales, which not only causes severe

distortions but also results in inter-state tax exportation in favour of richer states. All these have combined to make the sales tax system complicated, opaque and distorting. Above all, with independent and overlapping commodity tax systems at the central and state levels, coordinated and harmonized development of domestic trade taxes has become difficult. The Government of India appointed a study group to recommend measures to harmonise and rationalize the domestic trade tax system in the country (India 1994). The study group made a thorough analysis of the distortions of the prevailing system of taxation and has recommended the gradual moving over to destination based, consumption type value added taxes at the state level. At the central level, the study group recommended complete switching over to the manufacturing stage VAT. At the state level, the existing sales taxes were to be transformed into retail stage destination type VAT.

In order to persuade the states to rationalise their tax systems on the lines recommended by the study group the Government of India appointed a state Finance Ministers' Committee. The Committee has made recommendations to switch over to the VAT in a given time frame through stages. Unfortunately, in spite of the consensus on the need for reforms in the sales tax systems at the state level, there has been very little action in terms of actual rationalization.

Activity 2

1. Differentiate between tax and non tax revenue.
2. Give a detailed account of non tax revenue and its distribution.
3. Write a short note on revenue of union, states and local bodies.
4. Discuss tax reforms in India since1991.

2.5 SUMMARY

This unit focuses on the non tax revenue received by Indian government and its distribution among union, state government and local bodies. Specifically the government reports are being referred in order to give readers a broad outlook of government revenues. Non tax revenue and its distribution under the head of interest Receipts was discussed and interest on loans to States; interest on loans to Union Territory

Governments; interest payable by Railways are discussed in great detail. Further dividends and Profits and their distribution according to currency, Fiscal Services were revealed. In the next section the revenue of union government, state government and local bodies were discussed with special reference to on goods and services tax, gross domestic product, and resource transfer and revenue allocation.

Sharing of Union Taxes was another area of concern with Grants -in-Aid of Revenues of States under Article 275 of the Constitution; Non Plan Revenue Deficit Grant; Elementary Education; Environment Related Grants; Grants for maintenance of Roads and Bridges; State Specific grants; Goods and Services Tax; Local Bodies; disaster Relief; Fiscal Roadmap and Debt Relief to States. Finally tax reforms in India were revealed in a great detail.

2.6 FURTHER READINGS

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UNIT 3

PUBLIC DEBT

Objectives

After reading this unit, you should be able to:

- Understand the concept of public debt
- Explain the compensatory aspect of debt policy
- Describe the burden of public debt on India
- Identify the approach to debt through created money
- Assess public borrowings and price level objectives of fiscal policy
- Know the interdependence of fiscal and monetary policy
- Discuss the budgetary deficits and their implications

Structure

3.1 Introduction

3.2 Public debt in India

3.3 Compensatory aspect of debt policy

3.4 Burden of public debt and sources

3.5 Debt through created money

3.6 Public borrowings and price level objectives

3.7 Interdependence of fiscal and monetary policy

3.8 Budgetary deficits and their implications

3.10 Summary

3.11 Further readings

3.1 INTRODUCTION

Public debt is also sometimes referred to as government debt. It is a term for all of the money owed at any given time by any branch of the government. It encompasses public debt owed by the federal government, the state government, and even the municipal and local government.

Public debt is, in effect, an extension of personal debt, since individuals make up the revenue stream of the government. Public debt accrues over time when the government spends more money than it collects in taxation

Public debt can be made up of all sorts of different types of debt. A great deal of public debt is external debt, which is money that is owed by the government to foreign lenders, either in the form of international organizations, other governments, or groups like sovereign wealth funds which invest in government bonds. Public debt is also made up of internal debt, where citizens and groups within the country lend the government money to continue operating. In some ways, this is a lot like lending to oneself, since ultimately the responsibility for public debt falls back on the very people lending money.

Governments with strong economies, who are well trusted in the world, are able to raise funds by issuing their own securities, usually called government bonds. Individuals, other nations, and groups buy these bonds, and the government promises to pay them back at a certain, usually fairly good, interest rate. Less robust governments, who do not have the trust from the world to be able to issue bonds and expect people to buy them, may turn to international institutions, or even normal banks, to give them loans, usually at less favorable rates.

Some people use the term public debt to refer not only to money directly owed, in the form of securities that can be collected on, by a government, but also on the pool of money owed in the form of services and payments promised. For example, pension payments the government may owe to its employees, or contracts the government has entered into but has not yet paid, may also be included in some calculations of public debt.

Public debt is usually broken down not only by an internal and external divide, but also by the length of the loan made. Short-term public debt is foreseen to last only one or two years, so the turnover rate is fairly high. Long-term public debt is designed to last more than ten years, with some long term debt lasting considerably longer than that. Mid-term public debt lasts anywhere between three and ten years.

As with all debt, public debt is sometimes defaulted on. In the case of nations defaulting on their debt, things get very complicated. Supranational organizations, most notably the International Monetary Fund, have a great deal of power granted them by the international community to ensure nations don't default on their debt, and to take control over a number of financial issues if it looks like they will. On levels lower than the national level, public debt is usually guaranteed by the nation they're a part of. So if a state or municipality were to default on their public debt, that cost would then be absorbed by the country itself. For example, in the 1960s the city of New York went effectively bankrupt, and both New York State and the federal government of the United States were required to help bail it out.

3.2 PUBLIC DEBT IN INDIA

Revenue receipts of the Union Government improved to 56.5 per cent of the budget estimates (BE) in April-November 2007 from 54.8 per cent in April-November 2006. As a proportion to BE, revenue expenditure at 61.8 per cent was comparable with 62.6 per cent a year ago. Within capital expenditure, Plan and non-Plan expenditure were 67.0 per cent and 20.5 per cent (net of transactions relating to transfer of the Reserve Bank's stake in the State Bank of India to the Government) of BE, respectively, as compared with 53.9 per cent and 32.6 per cent in the corresponding period of the previous year. As a proportion to BE, the revenue deficit was 97.9 per cent as compared with 99.7 per cent in the corresponding period of the previous year whereas the gross fiscal deficit decelerated to 63.8 per cent from 72.8 per cent a year ago. In recent months, there has been deceleration in mobilisation under small savings. On December 7, 2007 it was announced that the five-year post office time deposit accounts and the senior citizen savings scheme would enjoy the same tax treatment as bank deposits. The element of bonus on post office monthly income accounts has also been restored.

The gross market borrowings of the Central Government through dated securities at Rs.1,47,000 crore (Rs.1,30,000 crore a year ago) during 2007-08 so far (up to January 25, 2008) constituted 94.6 per cent of the BE. Net market borrowings at Rs.1,03,092 crore (Rs.91,432 crore a year ago) constituted 94.1 per cent of the BE. The weighted average yield and weighted average maturity of Central Government securities issued during 2007-08 so far were at 8.15 per cent and 14.57 years, respectively, as compared with 7.89 per cent and 14.72 years for those issued during 2006-07 (full year).

In addition, securities amounting to Rs.15,147 crore have been issued by the Central Government (excluding MSS) beyond the regular market borrowing programme for 2007-08 to fertiliser companies and to oil companies for partial compensation of under-recoveries, over and above issuances of such securities to the tune of Rs.40,321 crore during 2006-07. In addition to provisional net allocation of Rs.28,781 crore for 2007-08, additional allocations of Rs.2,834 crore were made to certain States and Rs.35,518 crore was allocated to meet the shortfall in receipt from the national small savings fund (NSSF). Accordingly, total net allocation for States stood at Rs.67,133 crore (gross Rs.78,687 crore) for 2007-08 against which they raised a net amount of Rs.35,895 crore (gross Rs.47,449 crore) during the current year up to January 25, 2008. During the third quarter of 2007-08, money, debt and foreign exchange markets remained generally stable, despite large movements in liquidity conditions.

Overnight interest rates, which averaged around 6.0 per cent in the first eleven days of November, rose to the upper end of the LAF corridor by mid-December and hardened further in the second half of December on account of reduction in liquidity with the banking system due to sizeable tax outflows and build-up of the Centre's cash balances. Thereafter, overnight rates have softened. The call money rate, which had declined from 14.07 per cent in March 2007 to 6.03 per cent in October, rose to 6.98 per cent in November and to a peak of 7.95 on December 26, averaging 7.50 per cent in December 2007. Thereafter, call rates remained within the informal LAF corridor and averaged 6.57 per cent in January 2008 (up to January 25, 2008). Overnight rates in other segments, viz., market repo and collateralised borrowing and lending obligations (CBLO)

ruled around the call money rate during the period. Market repo (other than LAF) declined from 8.13 per cent in March 2007 to 5.87 per cent in October 2007 and increased to 7.36 per cent in December 2007, before declining to 6.33 per cent in January 2008 (up to January 25, 2008). CBLO rates moved from 7.73 per cent in March 2007 to 5.61 per cent in October 2007, before increasing to 7.18 per cent in December 2007. However, they declined to 6.17 per cent in January 2008 (up to January 25, 2008). The daily average volume (one leg) in the call money market decreased from Rs.11,608 crore in March 2007 to Rs.8,124 crore in December 2007. The corresponding volumes in the market repo and CBLO segments increased from Rs.8,687 crore and Rs.17,662 crore, respectively, in March 2007 to Rs.13,354 crore and Rs.30,087 crore in December 2007. As on January 25, 2008, call, market repo and CBLO rates were 7.37 per cent, 7.40 per cent and 4.41 per cent, respectively.

The primary yields on 91-day Treasury Bills decelerated to 7.10 per cent on January 25, 2008 from 7.98 per cent at end-March 2007 and 7.31 per cent in end-October 2007. Yields on 364-day Treasury Bills moved to 7.39 per cent on January 25, 2008 from 7.98 per cent at end-March 2007 and 7.36 per cent in end-October 2007. The weighted average discount rate (WADR) on CP declined to 9.20 per cent by end-December 2007 from 11.33 per cent at end-March and the outstanding amount of CP increased from Rs.17,688 crore to Rs.40,231 crore over this period. In the market for certificates of deposit (CDs) also, WADR declined from 10.75 per cent at end-March 2007 to 8.81 per cent by December 21, 2007 accompanied by an increase of 32.4 per cent in the outstanding amount (i.e., from Rs.93,272 crore to Rs.1,23,466 crore).

3.3 COMPENSATORY ASPECT OF DEBT POLICY

3.3.1 The Current Global Capital Flows Paradox

Three aspects of global financial flows stand out as being without precedent:

First, the net flow of capital is substantially from developing countries and emerging markets towards the industrialized world. This broad pattern, which has been going on for several years now and on current projections will continue for quite some

time, runs very much counter to the traditional idea that core countries export capital to an opportunity rich periphery.

Second, the buildup in India net foreign debt is substantially mirrored in reserve accumulation by emerging markets. While claims flow in many directions, it is noteworthy that a large fraction of the buildup in foreign claims is represented by reserve accumulation. Global reserves of emerging markets are far in excess of any previously enunciated criterion of reserve need for financial protection.

Third, expected real returns on these reserves are very low. Assuming constant real exchange rates, reserves will earn the expected real return on primarily Dollar and secondarily Euro fixed income assets. Indexed bond yields or comparisons of interest rates and forecasted inflation rates would make 2% a somewhat optimistic estimate of expected real returns in international terms. If real exchange rates in emerging markets are likely to appreciate then domestic returns will be even lower and more risky.

These three elements, flow of capital from emerging markets to industrial countries, huge accumulation of reserves, and expected negative returns on reserves constitute what might be called the capital flows paradox in the current world financial system. While borrowing and consuming is functional for India and reserve accumulating and exporting is perhaps functional for many other countries, the sustainability and the desirability of the capital flows paradox seems to me to require careful thought.

Unsustainable and Problematic Dependence of India on Foreign Capital

The Indian current account deficit is unprecedented in our economic history or that of other major economic powers. Today, it is currently running at a rate approaching 7% of GDP. Barring some discontinuity, most knowledgeable observers expect it to increase. Imports substantially exceed exports; the rupee appreciated over the last year, the income elasticity of Indian imports exceeds that of Indian exports, and so forth. International debt accumulation at these rates cannot go on forever.

Moreover, most of the classic indicators for deciding how serious a current account deficit are worrying.

- First, 7% and growing is an unusually large deficit

- Second, the current account deficit is financing consumption rather than investment as the U.S. net national savings rate is now at a record low level of under 2%.
- Third, investment is tilted towards real estate and the non-traded goods sector rather than the traded goods sector and away from exportables.
- Fourth, the net flow of direct investment is out of India and the flow of incoming capital appears to be of shortening maturity and coming increasingly from official rather than private sources.

There is the hard-landing risk. This is not just an Indian risk, but a global risk at a time when the India external deficit is creating nearly a export stimulus demand of global GDP. And as we are seeing with increasing frequency, whether it is regarding ports or computers or automobile parts, the current situation is creating substantial protectionist pressures. In addition, it is hard not to imagine that there are geopolitical risks associated with reliance on what might be called a financial balance of terror to assure continued financial flows to the India.

To be sure India should be viewed differently from an emerging market and so there has been a certain amount of complacent commentary – commentary that has gained in strength as the India current account deficit has continued without evident ill effect. In general, thinking about past experience with tech stocks in India or with the Japanese stock market or with a range of emerging market situations is that the moment of maximum risk comes precisely when those concerned about sustainability lose confidence in their views as their warnings prove to have been premature and when rationalizations come to the forefront.

It is not to reflect at length on the commentaries of the complacent. Suffice it to say that intangible investment as well as tangible investment in India has also declined even as our dependence on foreign capital has increased. Even if home bias is declining, there are surely limits on the tolerance of foreign investors for increased claims on India. And while arguments about ';financial dark matter'; or the Indian ability to issue debt in its own currency probably have some force in thinking about what level of external debt

is sustainable for India, they surely do not make the case for indefinite continued expansion of debt.

3.4 BURDEN OF PUBLIC DEBT AND SOURCES

External debt (or foreign debt) is that part of the total debt in a country that is owed to creditors outside the country. The debtors can be the government, corporations or private households. The debt includes money owed to private commercial banks, other governments, or international financial institutions such as the IMF and World Bank.

PEP defines it as "Gross external debt, at any given time, is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to nonresidents by residents of an economy."

In this definition, IMF defines the key elements as follows; (a) Outstanding and Actual Current Liabilities: For this purpose, the decisive consideration is whether a creditor owns a claim on the debtor. Here debt liabilities include arrears of both principal and interest. (b) Principal and Interest: When this cost is paid periodically, as commonly occurs, it is known as an interest payment. All other payments of economic value by the debtor to the creditor that reduce the principal amount outstanding are known as principal payments. However, the definition of external debt does not distinguish between whether the payments that are required are principal or interest, or both. Also, the definition does not specify that the timing of the future payments of principal and/or interest need be known for a liability to be classified as debt. (c) Residence: To qualify as external debt, the debt liabilities must be owed by a resident to a nonresident. Residence is determined by where the debtor and creditor have their centers of economic interest - typically, where they are ordinarily located - and not by their nationality. (d) Current and Not Contingent: Contingent liabilities are not included in the definition of external debt. These are defined as arrangements under which one or more conditions must be fulfilled before a financial transaction takes place. However, from the viewpoint of understanding vulnerability, there is analytical interest in the potential impact of contingent liabilities on an economy and on particular institutional sectors, such as government.

Generally external debt is classified into four heads i.e. (1) public and publicly guaranteed debt, (2) private non-guaranteed credits, (3) central bank deposits, and (4) loans due to the IMF. However the exact treatment varies from country to country. For example, while Egypt maintains this four head classification, in India it is classified in seven heads i.e. (a) multilateral, (b) bilateral, (c) IMF loans, (d) Trade Credit, (e) Commercial Borrowings, (f) NRI Deposits,and (g) Rupee Debt. (h) NPR Debt

In context of India, Public debt has piled up because the Government has been indulging in excessive expenditures which had to be financed from borrowing. In the last two years alone debt shot up 24 per cent. Consequently, interest payments have swelled and consume 46 per cent of the tax revenue. Repayment of loans has to be made from fresh borrowings which accelerate the accumulation of debt.

Total debt at the end of March 2010 would be Rs.35 trillion. The external debt component, however, is small, only 4 per cent. As such the danger of default is not serious as in heavily indebted countries like Greece. Public debt has not been utilized to create productive assets. Most of the debt is against current expenditure. Only a part of the debt, about Rs.1.7 trillion, is invested in physical assets like roads, machinery, dams, etc., and another Rs.5.1 trillion given as loans to State Governments and PSUs. Against the rest of the debt there are no assets and consequently no income. In 2009-10, Government's interest payments were Rs.2.2 trillion while income from investment and loans was only Rs.711 million. That is why public debt becomes largely a dead burden.

Excessive government expenditure is not in the long term interest of economic growth or financial health of the Government. The FRBMA therefore required the Government to wipe out revenue deficit and restrict fiscal deficit to 3 per cent. It is necessary that Government trims expenditures funded from borrowing not only to reduce the interest burden but because that narrows the space for private sector to grow. Government borrowing results in over crowding and kicks up interest rates. Currently the rate on 10 year bond has crossed 8 per cent Growth is suppressed because Government borrows to spend much of the funds on non-productive uses forcing private sector to cut productive investment. According to budget papers, as against the target of Rs 1,00,000 crore (Rs 1 trillion), the government would end up raising Rs 2,62,000 crore (Rs 2,620

billion) during 2008-09, more than two and a half times the original estimate. Part of the increase in borrowings can be attributed to the stimulus packages raising expenditure and reducing revenues through slashing duties.

For the next fiscal, the government has pegged the market borrowing target at over Rs 3,00,000 crore (Rs 3 trillion), which is expected to be revised upwards at the time of the regular budget in July. India's public debt includes market borrowings, external debt and other liabilities like small savings and provident funds. Funds raised through market borrowing programmes and issuing treasury bills account for a major portion of the public debt. Of the total of Rs 34 lakh crore, about Rs 22.7 lakh crore will be internal debt, the amount raised through the borrowing programme. The external debt, which comprises funds raised from multilateral and bilateral lending agencies, is expected to be about Rs 1.38 lakh crore by the end of March 2010, while the other liabilities will account for the remaining Rs 10 lakh crore.

Viewed from an angle, the average debt of every Indian has been estimated to soar to about Rs 30,000 in about a year with the government Competitive economies stepping up it borrowing programme in the next fiscal to fund public expenditure and stimulate the economy. The average debt of a citizen would nearly be equal to his 10-month income, which on an annual basis has recently been estimated at Rs 38,000 by the Central Statistical Organisation (CSO) for a population of 115.4 crore (Rs 1.15 billion).

With the government adding about Rs 3,00,000 crore (Rs 3000 billion) to the public debt annually in the last few years, the total public debt is estimated to zoom to a whooping Rs 34,06,322 crore (Rs 34.06 trillion) by March 2010, nearly double the amount recorded seven years ago. In order to fight the impact of the global financial meltdown on the Indian economy, the government substantially increased its market borrowing programme in 2008-09.

3.4.1 Major Highlights of External Debt

(i) India's external debt, as at end-March 2009, was placed at US $ 229.9 billion (22.0 per cent of GDP) recording an increase of US $ 5.3 billion or 2.4 per cent over the level of the previous year mainly due to the increase in trade credits.

(ii) As per an international comparison of external debt of the twenty most indebted countries, India was the fifth most indebted country in 2007.

(iii) By way of composition of external debt, the share of commercial borrowings was the highest at 27.3 per cent as at end-March 2009 followed by short-term debt (21.5 per cent), NRI deposits (18.1 per cent) and multilateral debt (17.2 per cent).

(iv) The debt service ratio has declined steadily over the years, and stood at 4.6 per cent as at end-March 2009.

(v) Excluding the valuation effects due to appreciation of US dollar against other major currencies and Indian rupee, the stock of external debt would have increased by US$ 18.7 billion as compared with the stock as at end-March 2008.

(vi) The share of short-term debt in total debt increased to 21.5 per cent at end-March 2009 from 20.9 per cent at end-March 2008, primarily on account of rise in short-term trade credits.

(vii) Based on residual maturity, the short-term debt accounted for 40.6 per cent of the total external debt at end-March 2009 .

(viii) The ratio of short-term debt to foreign exchange reserves at 19.6 per cent in March 2009 was higher compared to 15.2 per cent in March 2008.

(ix) The US dollar continues to remain the dominant currency accounting for 57.1 per cent of the total external debt stock as at end-march 2009.

(x) India's foreign exchange reserves provided a cover of 109.6 per cent to the external debt stock at the end of March 2009 as compared with 137.9 per cent as at end-March 2008.

1. Stock of India's External Debt as at end-March 2009

(i) India's external debt, as at end-March 2009, was placed at US $ 229.9 billion (22.0 per cent of GDP) recording an increase of US $ 5.3 billion or 2.4 per cent over the

end-March 2008 level mainly due to the increase in trade credits. (Table 1 and Chart 1).

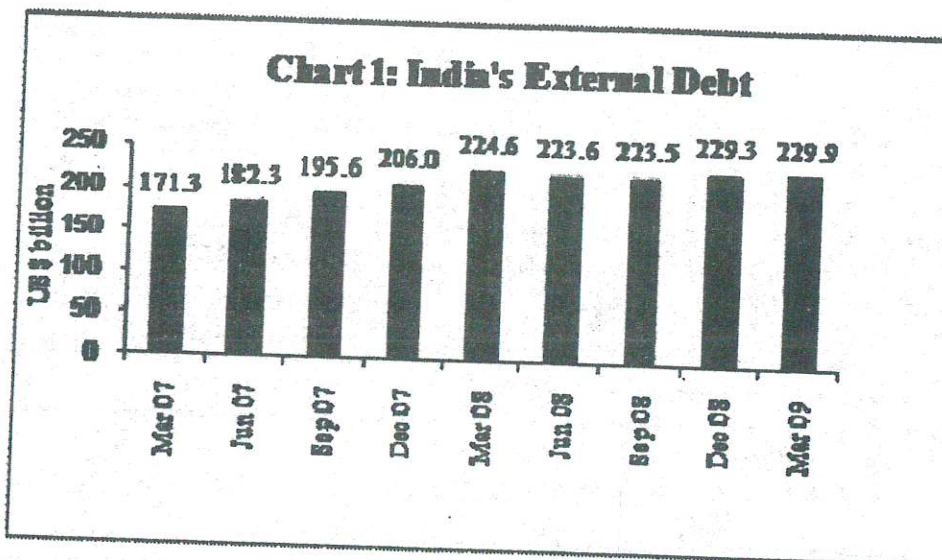
Table 1: External Debt Outstanding

(US $ billion)

At end of	Total External Debt	Variation: Over corresponding Quarter of Previous year		Variation: Over Previous Quarter	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
March 2007	**171.3**	**33.2**	**24.0**	**10.9**	**6.8**
June 2007	182.3	37.3	25.7	11.0	6.4
September 2007	195.6	45.0	29.9	13.3	7.3
December 2007	206.0	45.6	28.4	10.4	5.3
March 2008	**224.6**	**53.3**	**31.1**	**18.6**	**9.0**
June 2008	223.6	41.3	22.6	-1.0	-0.5
September 2008	223.5	·27.9	14.3	0.0	0.0
December 2008	229.3	23.3	11.3	5.7	2.6
March 2009 P	**229.9**	**5.3**	**2.4**	**0.6**	**0.3**

P: Provisional

Source: Ministry of Finance, Government of India and Reserve Bank of India.



2. Valuation Changes

(i) The valuation effect reflecting the appreciation of the US dollar against other major international currencies and Indian rupee resulted in a decline in India's external debt by US $ 13.4 billion. This implies that excluding the valuation effects, the stock of external debt as at end-March 2009 would have increased by US $ 18.7 billion over the level at end-March 2008.

3. Components of External Debt

(i) By way of composition of external debt, the share of commercial borrowings was the highest at 27.3 per cent as at end-March 2009 followed by short-term debt (21.5 per cent), NRI deposits (18.1 per cent) and multilateral debt (17.2 per cent) (Table 2).

(ii) The long-term debt at US$ 180.5 billion and short-term debt at US$ 49.4 billion accounted for 78.5 per cent and 21.5 per cent, respectively, of the total external debt as at end-March 2009.

Table 2: External Debt by Component

(US $ million)

Item	End- March							
	1991	1998	2004	2005	2006	2007	2008	2009 P
1	2	3	4	5	6	7	8	9
1. Multilateral	20,900	29,553	29,297	31,744	32,620	35,337	39,490	39,566
	(24.9)	(31.6)	(26.2)	(23.9)	(23.6)	(20.6)	(17.6)	(17.2)
2. Bilateral	14,168	16,969	17,277	17,034	15,761	16,065	19,701	20,587
	(16.9)	(18.1)	(15.5)	(12.8)	(11.4)	(9.4)	(8.8)	(9.0)
3. IMF	2,623	664	0	0	0	0	0	0
	(3.1)	(0.7)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
4. Trade Credit	4,301	6,526	4,697	5,022	5,420	7,165	10,358	14,604
	(5.1)	(7.0)	(4.2)	(3.8)	(3.9)	(4.2)	(4.6)	(6.4)
5. ECBs	10,209	16,986	22,007	26,405	26,452	41,443	62,337	62,676
	(12.2)	(18.2)	(19.7)	(19.9)	(19.1)	(24.2)	(27.8)	(27.3)
6. NRI Deposits	10,209	11,913	31,216	32,743	36,282	41,240	43,672	41,554
	(12.2)	(12.7)	(28.0)	(24.6)	(26.3)	(24.1)	(19.4)	(18.1)
7. Rupee Debt	12,847	5,874	2,720	2,302	2,059	1,951	2,016	1,527
	(15.3)	(6.3)	(2.4)	(1.7)	(1.5)	(1.1)	(0.9)	(0.7)
8. Long-term Debt (1to 7)	**75,257**	**88,485**	**1,07,214**	**1,15,250**	**1,18,594**	**1,43,201**	**1,77,574**	**1,80,514**
	(89.8)	(94.6)	(96.0)	(86.7)	(85.9)	(83.6)	(79.1)	(78.5)
9. Short-term Debt	**8,544**	**5,046**	**4,431**	**17,723**	**19,539**	**28,130**	**46,999**	**49,373**
	(10.2)	(5.4)	(4.0)	(13.3)	(14.1)	(16.4)	(20.9)	(21.5)
Total (8+9)	**83,801**	**93,531**	**1,11,645**	**1,32,973**	**1,38,133**	**1,71,331**	**2,24,573**	**2,29,887**

Table 4: External Commercial Borrowings

(US $ million)

Year	Approvals#	Gross Disbursement*	Amortisation*	Interest*	Total Servicing	ECB Debt Outstanding
1	2	3	4	5	6 (4+5)	7
1990-91	1,903	4,252	2,004	1,410	3,414	10,209
1995-96	6,286	4,252	3,868	1,380	5,248	13,873
2000-01	2,837	9,621	5,378	1,695	7,073	24,408
2001-02	2,653	2,684	4,107	1,456	5,563	23,320
2002-03	4,235	3,505	5,019	1,167	6,186	22,472
2003-04	6,671	5,225	8,045	2,119	10,164	22,007
2004-05	11,490	9,084	3,571	959	4,530	26,405
2005-06	17,175	14,343	11,584	3,015	14,599	26,452
2006-07	24,492	20,257	3,814	2,583	6,397	41,443
2007-08 PR	30,954	28,784	6,119	3,652	9,771	62,337
2008-09 QE	18,364	13,377	6,439	3,962	10,401	62,676

PR : Partially Revised ; QE: Quick Estimates.

*: Revised: based on Balance of Payments data.

: Based on date of agreement of the loan which may differ from the date of granting the loan registration number by the RBI. Ceiling on ECB approvals is fixed on the basis of the latter, which may either be after or before the date of agreement of the loan. Hence, there may be some difference between the amount shown under approvals in the table and the amount of ceiling fixed for a particular year.

Note: Disbursements during 1998-99 and 2000-01 include RIBs (US$ 4.2 billion) and IMDs (US $ 5.5 billion), respectively. Debt service payments during 2003-04 and 2005-06 include redemption of RIBs and IMDs, respectively.

4. Currency Composition

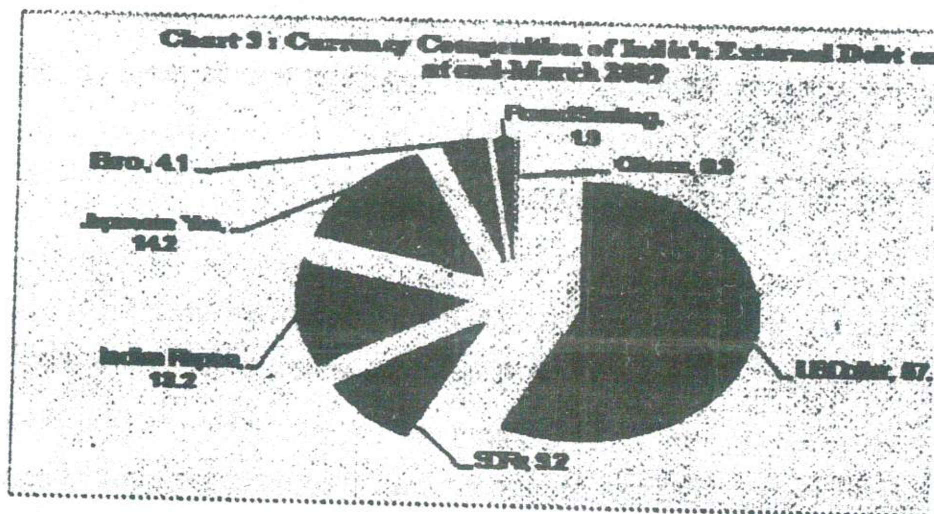
(i) The currency composition of India's external debt is generally disseminated in terms of major foreign currencies such as US dollar, Japanese Yen, Euro, Pound Sterling, Special Drawing Rights (SDR) and the domestic currency *i.e.*, Indian Rupee.

(ii) The US dollar continues to be the dominant currency accounting for 57.1 per cent of the total external debt stock as at end-March 2009, followed by the Japanese yen (14.2 per cent), Indian rupee (13.2 per cent) and SDR (9.2 per cent) (Table 5 and Chart 3). The share of Euro has been at around 4 per cent in the recent years.

Table 5: Currency Composition of External Debt
(Percentage share in total external debt)

	As at end March					
Currency	**2004**	**2005**	**2006**	**2007**	**2008**	**2009 P**
1	2	3	4	5	6	7
US Dollar	40.5	48.0	49.2	51.4	54.4	57.1
SDR	15.5	14.2	13.7	11.9	10.0	9.2
Indian Rupee	22.7	19.6	18.9	18.6	17.5	13.2
Japanese Yen	11.6	10.5	10.9	11.5	12.0	14.2
Euro	5.8	4.6	4.4	3.9	3.6	4.1
Pound Sterling	3.4	2.6	2.6	2.4	2.2	1.9
Others	0.5	0.5	0.3	0.3	0.3	0.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

P: Provisional
Source: Ministry of Finance, Government of India and Reserve Bank of India.



5. Instrument-wise Classification of External Debt

(i) The instrument-wise classification of India's external debt as at end-March 2009 reveals that 'loans' accounted for 51.8 per cent of total debt outstanding as compared to 49.5 per cent as at end-March 2008 (Table 6).

(ii)The group 'currency and deposits' and 'trade credits' together accounted for 50.6 per cent of the total non-Government debt as at end-March 2009 as against 52.6 per cent as at end-March 2008.

Table 6: Instrument-wise Classification of External Debt Outstanding

(US$ million)

Sr. No.	Borrower	End-March 2008	End-March 2009
1	2	3	4
A.	**Government (1+2)**	**56,947**	**54,856**
1.	Short-Term	615	939
	(i) Money Market Instruments	615	939
2.	Long-term {(i)+(ii)+(iii)}	56,332	53,917

	(i) Bonds and Notes	2,300	963
	(ii) Loans	52,740	51,680
	(iii) Trade Credits	1,292	1,274
B.	**Monetary Authority**	**1,115**	**764**
1.	Short-term	1,115	764
	(i) Currency and Deposits	1,115	764
C.	**Non-Government (1+2)**	**1,66,511**	**1,74,267**
1.	Short-Term {(i)+(ii)}	45,269	47,670
	(i) Money Market Instruments	2,107	1,695
	(ii) Trade Credits	43,162	45,975
2.	Long-term {(i)+(ii)+(iii)+(iv)}	1,21,242	1,26,597
	(i) Bonds and Notes	18,302	17,018
	(ii) Loans	58,484	67,310
	(iii) Currency and Deposits	43,672	41,554
	(iv) Trade Credits	784	715
	Total External Debt (A+B+C)	**2,24,573**	**2,29,887**
Source: Ministry of Finance, Government of India and Reserve Bank of India.			

6. Short-term Debt

(i) The short-term debt has become an important component for measuring the liquidity and refinancing risks. In the recent years, efforts have been taken to expand the coverage of short-term external debt. The data on short-term debt now includes suppliers' credit up to and above 180 days, FII investments in Government debt, investment by foreign central banks and international

institutions in Treasury Bills and external liabilities of central banks and commercial banks.

(ii) Short-term debt by original maturity has increased over the period mainly because of the increase in trade related credits due to growing imports. The share of trade related credits in total short-term debt increased from 91.8 per cent as at end-March 2008 to 93.1 per cent as at end-March 2009 (Table 7).

Table 7: Short-Term Debt by Original Maturity

(US $ million)

	Components	End-March						
		1991	2001	2005	2006	2007	2008	2009
	1	2	3	4	5	6	7	8
A	**Short-Term Debt**	8,544	3,628	17,723	19,539	28,130	46,999	49,373
	a) NRI Deposits (up to 1 year maturity) @	3,577	957	0	0	0	0	0
	b) FC (B&O) Deposits (up to 1 year maturity)	167	0	0	0	0	0	0
	c) Trade Related Credits#	4,800	2,671	16,271	19,399	25,979	43,162	45,975
	(i) Above 6 months and upto 1year	2,267	2,671	7,529	8,696	11,971	22,884	23,346
	(ii)Upto 6 months	2,533	0	8,742	10,703	14,008	20,278	22,629
	d) FII Investments in Government Treasury Bills & other instruments	0	0	1,452	140	397	651	2,065
	e) Investment in Treasury Bills by foreign central banks and international institutions etc.	-	-	-	-	164	155	105
	f) External Debt Liabilities of:	-	-	-	-	1,590	3,031	1,228
	(i) Central Bank	-	-	-	-	501.	1,115	764
	(ii)Commercial Bank	-	-	-	-	1,089	1,916	464
	Imports (during the year)*	27,915	57,912	1,18,908	1,57,056	1,90,670	2,57,789	2,94,587
	Trade Credits to Imports	17.2	4.6	13.7	12.4	13.6	16.7	15.6

	(%)								

@ Short-term deposits of less than one-year maturity under FCNR(A) were withdrawn with effect from May 15, 1993, such deposits under FCNR(B) and NR(E)RA were withdrawn effective October 1999 and April 2003, respectively.

#: Data on short-term Trade Credits of less than six months in respect of suppliers' credit and FII investment in debt papers are included since end-March 2005.

* On balance of payments basis.

Source: Ministry of Finance, Government of India and Reserve Bank of India

7. External Debt by Residual Maturity

(i) While external debt is generally compiled in terms of original maturity, analysing the external debt, in particular short term debt in terms of residual maturity is important from the point of view of foreign exchange liquidity management and to ascertain the total foreign exchange outgo on account of debt service payments in the immediate future.

(ii) The 'short-term debt by residual maturity' comprises the repayments due under medium and long-term debt by original maturity during one year reference period along with the short-term debt with original maturity. The balance constitutes the long-term debt by residual maturity. Based on residual maturity. the short-term debt accounted for 40.6 per cent of total external debt as at end-March 2009. The ratio of short-term debt by residual maturity to foreign exchange reserves worked out to 37.0 per cent at end-March 2009 (Table 8).

Table 8: Residual Maturity of External Debt Outstanding as at End-March 2009

(US $ million)

	Short-term	Long-term			Total (2) to (5)
Components	Up to one year	1 to 2 years	2 to 3 years	More than 3 years	
1	2	3	4	5	6
1. Sovereign Debt (long-term)	2,603	2,924	3,015	45,376	**53,917**
2. External Commercial Borrowings	9,189	10,839	14,521	50,494	**85,043**

(including trade credit)					
3. NRI deposits {(i)+(ii)+(iii)}	32,108	4,465	3,757	1,224	41,554
(i) FCNR(B)	9,944	2,085	1,075	107	13,211
(ii) NR(E)RA	18,649	2,015	2,041	865	23,570
(iii) NRO	3,516	365	641	252	4,773
4. Short-term Debt*	49,373	-	-	-	49,373
(Original maturity)					
Total (1 to 4)	**93,273**	**18,228**	**21,293**	**97,093**	**229,887**
Memo Items					
Short-term debt (Residual maturity as per cent of total debt	**40.6**				
Short-term debt (Residual maturity as per cent of Reserves)	**37.0**				

* Also includes short-term component of sovereign debt amounting to US$ 939 million.

Note: Residual Maturity of NRI Deposits is estimated on the basis of the Survey conducted by the Reserve

Bank on NRI deposits outstanding as on March 31, 2009.

Source: Ministry of Finance, Government of India and Reserve Bank of India.

8. Government and Non-Government External Debt

(i) Government (Sovereign) external debt stood at US$ 54.9 billion as at end-March 2009 while non-Government debt amounted to US $ 175.0 billion.

(ii) The share of non-Government debt in total external debt has increased steadily since March 2003. This trend continued during 2008-09 as the share of non-Government debt in total external debt increased further to 76.1 per cent as at end-March 2009 as against 74.6 per cent as at end-March 2008 (Table 9 and Chart 4).

Table 9: Government and Non-Government External Debt								
(US $ million)								
S. No.	Components	End-March						
		2003	2004	2005	2006	2007	2008	2009
1	2	3	4	5	6	7	8	9
A.	**Sovereign Debt (I+II)**	**43,612**	**44,674**	**46,668**	**45,346**	**48,330**	**56,947**	**54,856**
	(As a percentage of GDP)	*8.4*	*7.2*	*6.5*	*5.6*	*5.1*	*4.8*	*5.3*
I.	External Debt on Government Account under External Assistance	41,216	41,142	43,686	43,510	46,155	52,538	51,816
II.	Other Government External Debt @	2,396	3,532	2,982	1,768	2,175	4,409	3,040
B.	**Non-Government Debt #**	**61,302**	**66,971**	**86,305**	**92,787**	**1,23,001**	**1,67,626**	**1,75,031**
	(As a percentage of GDP)	*11.9*	*10.6*	*12.0*	*11.5*	*13.0*	*14.2*	16.8
C.	**Total External Debt (A+B)**	**1,04,914**	**1,11,645**	**1,32,973**	**1,38,133**	**1,71,331**	**2,24,573**	**2,29,887**
	(As a percentage of GDP)	*20.3*	*17.8*	*18.5*	*17.2*	*18.1*	*19.0*	*22.0*

@: Other Government external debt includes defence debt, investment in Treasury Bills/ Government securities by FIIs, foreign central banks and international institutions.

#: Includes external debt of Monetary Authority.

Source: Ministry of Finance, Government of India and Reserve Bank of India

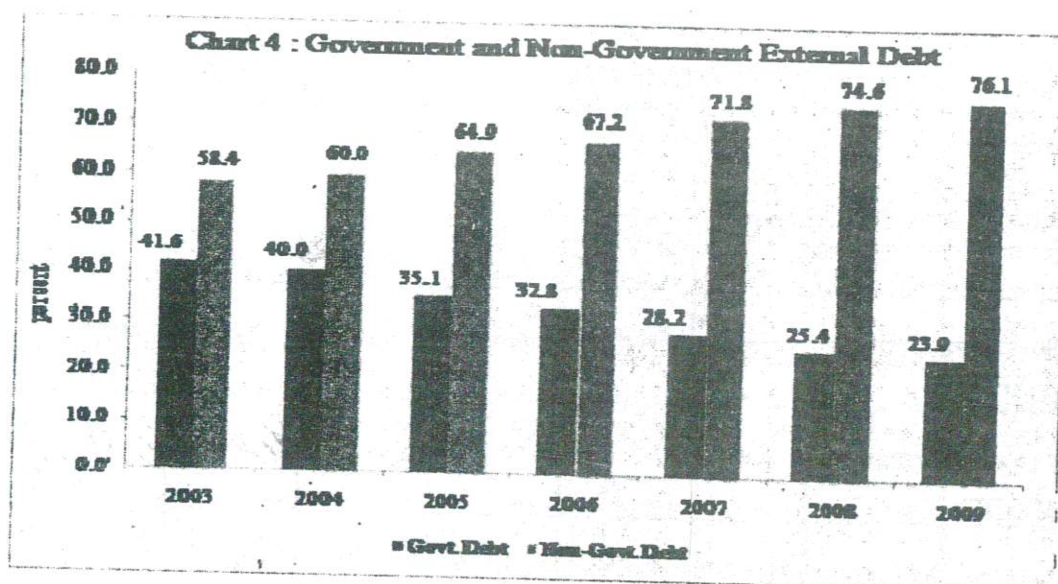


Chart 4 : Government and Non-Government External Debt

9. Debt Service Payments

(i) India's debt service payments amounted to US $ 15.4 billion during 2008-09 (April-March) as compared to US $14.9 billion during 2007-08 (April-March) (Table 10).

(ii) India's debt service ratio[1] has improved progressively over the years owing to the combined effect of moderation in debt service payments and growth in external current receipts. The debt service ratio had declined from a peak of 35.3 per cent in 1990-91 to 5.9 per cent in 2004-05 but increased to 10.1 per cent during 2005-06 due to repayments relating to the India Millennium Deposits. The debt service ratio declined to 4.6 per cent during 2008-09.

(iv) Servicing of External Commercial Borrowings (including principal and interest payments) accounted for 67.4 per cent of the total debt service during 2008-09.

Table 10: India's External Debt Service Payments (US$ million)									
Sr. No.	Item	1990-91	2000-01	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
1	2	3	4	5	6	7	8	9	10
1	External Assistance	2,315	3,444	6,983	2,855	2,652	2,942	3,241	3,381
	Repayment	1,187	2,338	6,193	2,129	1,945	1,960	2,099	2,372
	Interest	1,128	1,106	790	726	707	982	1,142	1,009
2	External Commercial Borrowings	3,414	7,073	10,164	4,530	14,839	6,331	9,771	10,401
	Repayment	2,004	5,378	8,045	3,571	11,824	3,814	6,119	6,439
	Interest	1,410	1,695	2,119	959	3,015	2,517	3,652	3,962
3	I.M.F.	778	26	0	0	0	0	0	0
	Repayment	644	26	0	0	0	0	0	0
	Interest	134	0	0	0	0	0	0	0
4	NRI Deposits Interest	1,282	1,661	1,642	1,353	1,497	1,969	1,813	1,547
5	Rupee Debt Service Repayments	1,193	617	376	417	572	162	121	101
6	Total Debt Service (1 to 5)	8,982	12,821	19,165	9,155	19,560	11,404	14,946	15,430
	Repayment	5,028	8,359	14,614	6,117	14,341	5,936	8,339	8,912
	Interest	3,954	4,462	4,551	3,038	5,219	5,468	6,607	6,518
7	Current Receipts #	25,479	77,467	1,19,239	1,54,123	1,94,170	2,42,811	3,14,014	3,37,095
	Debt Service Ratio (6/7) (%)	35.3	16.6	16.1	5.9	10.1	4.7	4.8	4.6

#: Current Receipts minus Official Transfers.
Source: Ministry of Finance, Government of India and Reserve Bank of India

(vi) At end-March 2009, the projected debt service payments for External Commercial Borrowings (ECBs) and Foreign Currency Convertible Bonds (FCCBs) revealed that the principal repayments between 2011-12 and 2012-13 would be higher (Table 11). Despite consolidation of high cost loans and lower interest rates on the current borrowings, interest payments would also increase during these years due to higher disbursement. The projections do not include future debt service obligations arising out of fresh borrowings.

Table 11: Projected Debt Service Payments for ECBs and FCCBs			
(US $ million)			
Year	**Principal**	**Interest**	**Total**
1	2	3	4
2009-10	8,633	2,057	10,690
2010-11	10,239	1,996	12,235
2011-12	13,877	2,367	16,244
2012-13	15,823	2,141	17,964
2013-14	10,256	961	11,217
2014-15	5,608	627	6,235
2015-16	3,786	465	4,251
2016-17	3,602	331	3,933
2017-18	2,285	212	2,497
2018-19	1,655	135	1,790

Note: Projections on debt servicing are based on the end-March 2009 debt outstanding position. The projections exclude NRI deposits and FII investment in government debt securities.

10. Sustainability of India's External Debt

(i) An assessment of sustainability of external debt is generally undertaken based on the trends in certain key ratios such as debt to GDP ratio, debt service ratio, short-term debt to total debt and total debt to foreign exchange reserves. India has managed its external debt successfully as reflected in the perceptible improvement in various external debt sustainability indicators (Table 12).

(ii) The ratio of external debt to GDP increased to 22.0 per cent as at end-March 2009 from 19.0 per cent as at end-March 2008.

(iii) The debt service ratio has declined steadily over the years, and stood at 4.6 percent as at end-March 2009

(iv) India's foreign exchange reserves provided a cover of 109.6 per cent to the external debt stock at the end of March 2009 as compared to 137.9 per cent as at end-March 2008 (Chart 5).

(v) The share of concessional debt in total external debt declined to 18.2 per cent as at end-March 2009 from 19.7 per cent at end-March 2008 reflecting the continuing increase in non-concessional private debt in India's external debt stock.

(vi) The ratio of short-term debt to foreign exchange reserves at 19.6 per cent as at end-March 2009 was higher than that of 15.2 per cent in the previous year.

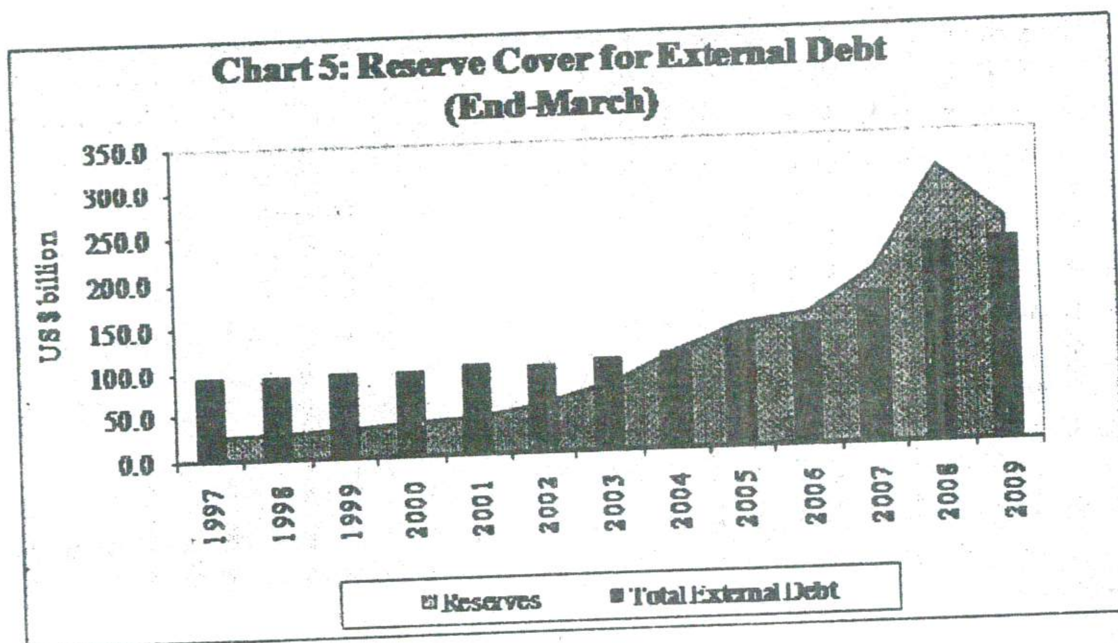
(vii) The share of short-term debt in total debt increased to 21.5 per cent at end-March 2009 from 20.9 per cent at end-March 2008.

Table 12: India's Key External Debt Indicators

Year	External Debt (US $ billion)	Ratio of External Debt to GDP (per cent)	Debt Service Ratio (per cent)	Ratio of Foreign Exchange Reserves to Total Debt (per cent)	Ratio of Concessional Debt to Total Debt (per cent)	Ratio of Short-Term Debt to Foreign Exchange Reserves (per cent)	Ratio of Short-Term Debt to Total Debt (per cent)
1	2	3	4	5	6	7	8
1990-91	83.8	28.7	35.3	7.0	45.9	146.5	10.2
1995-96	93.7	27.0	26.2	23.1	44.7	23.2	5.4
2000-01	101.3	22.5	16.6	41.7	35.4	8.6	3.6
2001-02	98.8	21.1	13.7	54.7	35.9	5.1	2.8
2002-03	104.9	20.3	16.0*	72.5	36.8	6.1	4.5
2003-04	111.6	17.8	16.1**	101.2	36.1	3.9	4.0
2004-05	133.0	18.5	5.9^	106.4	30.9	12.5	13.3
2005-06	138.1	17.2	10.1#	109.8	28.6	12.9	14.1
2006-07	171.3	18.1	4.7	116.2	23.1	14.1	16.4

2007-08	224.6	19.0	4.8	137.9	19.7	15.2	20.9
2008-09P	229.9	22.0	4.6	109.6	18.2	19.6	21.5

P: Provisional
* Works out to 12.4 per cent, with the exclusion of prepayment of external debt of US $ 3,430 million.
** Works out to 8.2 per cent with the exclusion of pre payment of external debt of US $ 3,797 million. and redemption of Resurgent India Bonds (RIBs) of US $ 5,549 million.
^ works out to 5.7 per cent with the exclusion of pre payment of external debt of US $ 381 million.
# works out to 6.3 per cent with the exclusion of India Millennium Deposits (IMDs) repayments of US $ 7.1 billion and pre payment of external debt of US $ 23.5 million.
Source: Ministry of Finance, Government of India and Reserve Bank of India



11. Cross Country Comparison

(i) According to the latest data available on Global Development Finance Online Database, World Bank, the international comparison of external debt of the twenty most indebted countries indicates that India was the fifth most indebted country in 2007 as compared with third position in 1990 (Table 13).

(ii) The element of concessionality in India's external debt portfolio was the third highest after Indonesia and Philippines.

(iii) India's debt service ratio was third lowest with China and Malaysia having first and second lowest debt service ratio, respectively.

(iv) In terms of ratio of external debt to Gross National Income (GNI), India's position was sixth lowest, with China having the lowest ratio of external debt to GNP.

(v) India's position with respect to short-term debt to total external debt was eighth lowest with Mexico having the lowest ratio of short-term debt to total external debt.

(vi) In terms of reserves to total debt, India's position was fourth as China, Malaysia and Thailand had higher reserves to debt ratio than India.

Table 13: International Comparison of Top Twenty Debtor Countries, 2007

	External debt stocks, total (US $ billion)	Concessional debt/Total debt (EDT) (per cent)	Debt service ratio (per cent)	External Debt to GNI (per cent)	Short-term debt/ Total debt (EDT) (per cent)	Forex Reserves to Total Debt (per cent)
1	2	3	4	5	6	7
China	373.6	10.1	2.2	11.6	54.5	413.9
Russian Federation	370.2	0.4	9.1	29.4	21.4	129.1
Turkey	251.5	2.1	32.1	38.8	16.6	30.4
Brazil	237.5	1.0	27.8	18.7	16.5	75.9
India	**224.6**	**19.7**	**4.8**	**19.0**	**20.9**	**137.9**
Poland	195.4	0.4	25.6	47.7	30.9	33.6
Mexico	178.1	0.6	12.5	17.7	5.1	49.0
Indonesia	140.8	26.2	10.5	33.9	24.8	40.4

Argentina	127.8	1.3	13.0	49.7	29.8	36.1
Kazakhstan	96.1	1.0	49.6	103.7	12.2	18.4
Romania	85.4	1.6	19.1	51.5	35.7	46.8
Ukraine	73.6	2.2	16.9	52.9	31.1	44.1
Philippines	65.8	20.0	13.7	41.9	10.8	51.2
Thailand	63.1	9.6	8.1	26.5	34.3	138.7
Chile	58.6	0.4	14.2	40.3	22.7	28.7
Malaysia	53.7	6.1	4.6	29.4	28.4	189.9
Croatia	48.6	2.1	33.0	97.7	10.5	28.1
Colombia	45.0	2.1	22.0	22.5	11.9	46.6
South Africa	43.4	0.0	5.9	15.8	38.2	75.9
Venezuela, RB	43.1	0.5	7.4	18.7	27.1	78.2

Source: Data for India as published by national authorities for 2007-08 and those for other countries as at end-December 2007 as available in World Bank's Global Development Finance Online Database.

(vii)The Quarterly External Debt (QEDS) database, jointly developed by the World Bank and the International Monetary Fund, brings out detailed external debt data of countries that are subscribing to IMF's Special Data Dissemination Standard/ General Data Dissemination System. The position in respect of the reporting countries for the third and fourth quarters of the calendar year 2008, which has been published by the World Bank is given at Annex I.

Annex I: Gross External Debt Position of QEDS Reporting Countries for End-September and End-December 2008

(US$ million)

Sr. No.	Countries	2008 Q3			2008 Q4		
		Short-	Long-	Total	Short-	Long-	Total

		term	term		term	term	
1	2	3	4	5	6	7	8
1	Argentina	53,660	75,277	1,28,937	56,253	71,859	1,28,112
2	Armenia	429	2,748	3,177	465	2,962	3,427
3	Australia	2,73,741	5,65,950	8,39,691	2,28,190	5,35,482	7,63,671
4	Austria	3,03,048	5,61,405	8,64,453	2,65,533	5,61,961	8,27,494
5	Belarus	8,755	5,802	14,557	7,253	7,565	14,818
6	Belgium	12,02,725	4,20,123	16,22,848	9,64,129	3,82,388	13,46,517
7	Bolivia	317	5,484	5,801	267	5,656	5,923
8	Brazil	47,507	2,25,459	2,72,966	36,466	2,26,466	2,62,931
9	Bulgaria	18,913	32,909	51,822	18,493	32,624	51,117
10	Canada	2,99,552	5,10,854	8,10,406	3,01,712	4,49,599	7,51,311
11	Chile	18,616	50,426	69,042	14,251	50,517	64,768
12	Colombia	5,616	39,793	45,409	5,684	40,708	46,392
13	Costa Rica	3,509	5,297	8.805	3,864	5,218	9,082
14	Croatia	4,123	47,721	51,843	6,620	47,830	54,450
15	Czech Republic	28,553	61,187	89,740	25,941	54,487	80,428
16	Denmark	2,88,064	3,00,587	5,88,651	2,99,226	2,84,127	5,83,353
17	Ecuador	0	0	0	0	0	0
18	Egypt	2,651	29,831	32,481	2,842	29,281	32,123
19	El Salvador	1,497	8,873	10,369	1,542	9,149	10,691
20	Estonia	9,982	17,077	27,059	10,623	16,778	27,401

21	Finland	1,17,488	2,26,735	3,44,223	1,09,624	2,18,935	3,28,559
22	France	22,47,510	28,90,585	51,38,095	21,38,532	28,63,164	50,01,696
23	Georgia	1,062	6,081	7,143	972	6,330	7,302
24	Germany	19,78,058	34,50,105	54,28,163	17,23,723	35,26,777	52,50,499
25	Greece	1,29,621	3,70,543	5,00,164	1,56,216	3,48,397	5,04,612
26	Hong Kong, China	5,10,248	1,67,531	6,77,779	4,83,877	1,76,053	6,59,931
27	Hungary	26,422	1,83,990	2,10,412	26,111	1,83,523	2,09,634
28	**India**	**50,675**	**1,72,856**	**2,23,531**	**46,625**	**1,82,646**	**2,29,271**
29	Indonesia	20,264	1,31,475	1,51,739	20,488	1,34,578	1,55,067
30	Ireland	10,81,982	13,08,683	23,90,665	11,10,636	12,01,087	23,11,724
31	Israel	35,512	53,423	88,935	32,956	52,312	85,268
32	Italy	9,44,407	16,07,011	25,51,418	8,09,594	15,49,516	23,59,110
33	Japan	12,51,745	8,02,838	20,54,583	14,66,347	8,78,336	23,44,683
34	Kazakhstan	10,946	95,117	1,06,064	10,174	97,639	1,07,813
35	Korea	1,89,598	2,35,918	4,25,516	1,51,056	2,29,439	3,80,495
36	Kyrgyz Republic	292	3,060	3,352	385	3,082	3,467
37	Latvia	15,014	27,452	42,466	14,091	27,963	42,054
38	Lithuania	9,066	24,426	33,492	8,169	24,299	32,469
39	Malaysia	38,796	43,355	82,151	30,892	44,399	75,292
40	Mexico	28,679	1,83,493	2,12,172	24,218	1,76,175	2,00,393
41	Moldova	1,299	2,596	3,895	1,429	2,696	4,125

42	Netherlands	12,57,438	14,31,377	26,88,815	10.68,222	13,71.643	24,39,864
43	Norway	3,02,466	2,56,742	5,59,208	2,74,891	2,76,705	5,51,596
44	Paraguay	710	2,653	3,363	735	2,772	3,507
45	Peru	8,934	26,931	35,865	6,148	28,440	34,587
46	Poland	62,275	2,03,832	2,66,107	50,809	1,91,248	2,42,057
47	Portugal	1,95,715	3,08,391	5,04,106	1,80,351	3,04,359	4,84,710
48	Russian Federation	1,15,759	4,26,322	5,42,082	79,779	4,04,948	4,84,726
49	Slovak Republic	20,255	32,791	53,045	20,102	32,424	52,527
50	Slovenia	17,842	39,257	57,100	16,170	38,240	54,409
51	South Africa	27,978	49,547	77,525	25,462	46,349	71,811
52	Spain	7,12,137	16,93,443	24,05,580	6,91,557	16,22,086	23,13,643
53	Sweden	0	0	0	0	0	0
54	Switzerland	9,99,466	4,31,423	14,30,890	9,12,796	3,92,161	13,04,956
55	Thailand	21,201	44,023	65,224	20,317	44,529	64,846
56	Tunisia	4,602	16,010	20,612	4,330	16,442	20,773
57	Turkey	57,804	2,32,911	2,90,715	50,714	2,26,120	2,76,834
58	Ukraine	29,345	75,494	1,04,839	21,983	81,253	1;03,236
59	United Kingdom	80,71,790	26,77,095	1,07,48,884	69,80,002	24,08,010	93,88,012
60	United States	53,47,436	82,80,023	1,36,27,459	54,14,396	82,27,411	1,36,41,807
61	Uruguay	351	10,863	11,214	115	10,626	10,742

[1] Debt service ratio is defined as total repayments of principal and interest on debt as a ratio of current receipts.

3.5 DEBT THROUGH CREATED MONEY

Modern central banking allows multiple banks to practice fractional reserve banking with inter-bank business transactions without risking bankruptcy. The process of fractional-reserve banking has a cumulative effect of money creation by banks, essentially expanding the money supply of the economy.

There are two types of money in a fractional-reserve banking system operating with a central bank:

1. Central bank money (money created or adopted by the central bank regardless of its form (precious metals, commodity certificates, banknotes, coins, electronic money loaned to commercial banks, or anything else the central bank chooses as its form of money)
2. Commercial bank money (demand deposits in the commercial banking system) - sometimes referred to as chequebook money

When a deposit of central bank money is made at a commercial bank, the central bank money is removed from circulation and added to the commercial banks reserves (it is no longer counted as part of m1 money supply). Simultaneously, an equal amount of new commercial bank money is created in the form of bank deposits. When a loan is made by the commercial bank (which keeps only a fraction of the central bank money as reserves), using the central bank money from the commercial bank's reserves, the m1 money supply expands by the size of the loan. This process is called deposit multiplication.

3.6 PUBLIC BORROWINGS AND PRICE LEVEL OBJECTIVES OF FISCAL POLICY

Governments use fiscal policy to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment, and economic growth. Keynesian economics suggests that adjusting government spending and tax rates are the best ways to stimulate aggregate demand. This can be used

in times of recession or low economic activity as an essential tool for building the framework for strong economic growth and working towards full employment. The government can implement these deficit-spending policies to stimulate trade due to its size and prestige. In theory, these deficits would be paid for by an expanded economy during the boom that would follow; this was the reasoning behind the New Deal.

Governments can use budget surplus to do two things: to slow the pace of strong economic growth and to stabilize prices when inflation is too high. Keynesian theory posits that removing funds from the economy will reduce levels of aggregate demand and contract the economy, thus stabilizing prices.

3.6.1 Fiscal Policy Overview

The Union Budget 2008-09 was presented in the backdrop of impressive growth in the Indian economy which clocked about 9 per cent of average growth in the last four years.

This striking performance coupled with significant improvement in fiscal indicators, during the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 regime definitely put the country on a higher growth trajectory inspiring confidence in the medium to long term prospects of the economy. The process of fiscal consolidation during these years has resulted in improvement in fiscal deficit from 5.9 per cent of GDP in 2002-03 to 2.7 per cent of GDP in 2007-08. During the same period, revenue deficit has declined from 4.4 per cent to 1.1 per cent of GDP.

In tune with the philosophy of equitable growth, the process of fiscal consolidation was taken forward without constricting the much-required social sector and infrastructure related expenditure. This improvement in the state of public finances was achieved through higher revenue buoyancy, driven by efficient tax administration and improved compliance which is evident from increase in the tax to GDP ratio from 8.8 per cent in 2002-03 to 12.5 per cent in 2007-08. Riding on the path of fiscal consolidation, the Union Budget 2008-09 was presented with fiscal deficit estimated at 2.5 per cent of GDP and revenue deficit at 1 per cent of GDP.

However after the presentation of the Union Budget in February 2008, the world economy was hit by three unprecedented crises -- first, the petroleum price rise; second, rise in prices of other commodities; and third, the breakdown of the financial system. The combined effect of these crises of these orders is bound to affect emerging market economies and India was no exception. The first two crises resulted in serious inflationary pressure in the first half of 2008-09. The focus of the monetary as well as fiscal policy shifted from fuelling growth to containing inflation, which had reached 12.9 per cent in August, 2008.

Series of fiscal measures both on tax revenue and expenditure side were undertaken with the objective of easing supply side constraints. These measures were supplemented by monetary initiatives through policy rate changes by the Reserve Bank of India, and contributed to the softening of domestic prices. Headline inflation fell to 4.39 per cent in January, 2009. However, the fiscal measures undertaken through tax concessions and increased expenditure on food, fertiliser and petroleum subsidies along with increased wage bill for implementing the Sixth Central Pay Commission recommendations significantly altered the deficit position of the Government.

3.6.2 Fiscal Policy for the ensuing financial year.

The Interim Budget 2009-2010 is being presented in the backdrop of uncertainties prevailing in the world economy. The impact of this is seen in the moderation of the recent trend in growth of the Indian economy in 2008-09 which at 7.1 per cent still however makes India the second fastest growing economy in the World.

The measures taken by Government to counter the effects of the global meltdown on the Indian economy, have resulted in a short fall in revenues and substantial increases in government expenditures, leading to a temporary deviation from the fiscal consolidation path mandated under the FRBM Act during 2008-09 and 2009-2010.

The revenue deficit and fiscal deficit for R.E.2008-09 and B.E.2009-2010 are, as a result, higher than the targets set under the FRBM Act and Rules.

The grounds due to which this temporary deviation has taken place, are detailed in the Fiscal Policy Overview above and also in the Macro-economic Framework Statement

being presented in the Parliament. The fiscal policy for the year 2009-2010 will continue to be guided by the objectives of keeping the economy on the higher growth trajectory amidst global slowdown by creating demand through increased public expenditure in identified sectors.

However, the medium term objective will be to revert to the path of fiscal consolidation at the earliest, with improvement in the economic situation.

3.6.3 Tax Policy

Indirect Taxes

During the first half of the fiscal year, the global spurt in commodity prices (crude petroleum, food items and metals) led to increases in domestic prices of essential items and industrial inputs, putting a severe inflationary pressure on the economy.

Hence, the Government took several measures after the presentation of the Union Budget 2008-09, particularly on the Customs side, to contain the rising inflation, as detailed below:-

Customs

- On 21.3.2008, to curb the inflationary trends in the economy arising out of a rise in prices of food items, a sharp reduction was effected in the import duty rates on various food items such as semi-milled or wholly milled rice (70% to nil) and crude and refined edible oils (from 40%-75% to 20%-27.5%). On 01.04.2008, a further reduction was effected in the import duty rate- on all crude edible oils duty was reduced to nil, and on refined edible oils duty was reduced to 7.5%.
- Export duty of Rs 8,000 PMT was imposed on exports of Basmati rice with effect from 10.5.2008.
- With effect from 10.5.2008, import duties on crude petroleum was reduced to nil and on petrol and diesel to 2.5% (earlier 7.5%). Customs duty on other petroleum products was reduced from 10% to 5% on 04.06.2008.
- Import duties were reduced to nil on many iron and steel items as well as on specified inputs for this sector (zinc, ferro-alloys, metcoke) on 29.4.2008. Further,

carrying administered interest rates, (iii) elongation of the maturity profile and consolidation of the debt portfolio and (iv) development of a deep and wide market for Government securities to improve liquidity in secondary market.

In the first half of the current financial year, the government borrowing was in line with the indicated auction calendar decided upon in consultation with the Reserve Bank of India. However, due to the need to provide the fiscal stimulus to counter the situation created by the effects of the global financial crisis, the borrowing calendar of the government had to be revised in the second half of the current financial year.

The gross and net market borrowings (dated securities and 364- day Treasury Bills) of the Central Government during 2008-09 (up to February 9, 2009) amounted to Rs 2,40,167 crore and Rs 1,68,710 crore, respectively. As part of policy to elongate maturity profile, Central Government has been issuing securities with maximum 30--year maturity.

The weighted average maturity of dated securities issued during 2008-09 (up to February 9, 2009) was 14.45 years which was marginally lower than 14.90 years during the corresponding period of the previous year. The weighted average yield of dated securities issued during 2008-09 (up to February 9, 2009) was 7.91 per cent and was lower than 8.12 per cent during the corresponding period of last year.

Consequent to the transition to the FRBM Act mandated environment, recourse to borrowing from RBI under normal circumstances is prohibited. During the year 2008-09 (up to February 7, 2009) the Central Government resorted to ways and means advance to meet the temporary mismatch in receipts and expenditure for 77 days as compared with 91 days a year ago.

The daily average utilization of ways and means advance by the Central Government was Rs 7,383 crore as compared with Rs 14,498 crore a year ago. The Central Government also availed of Overdraft (OD) for 24 days up to February 7, 2009. The daily average of OD was Rs.11,233 crore as compared with Rs 6,381 crore a year ago.

The outstanding balance under Market Stabilization Scheme (MSS) on 1st April, 2008 was Rs 1,70,554 crore. Notwithstanding fresh issuance of Rs 43,500 crore during 2008-09, the outstanding balance under the MSS declined to Rs 1,05,773 crore mainly reflecting the change in policy and unwinding MSS through buyback of Rs 47,544 crores. This was done in order to ease liquidity in the system in the backgrounds of the additional borrowing plan during the second half of 2008-09 to finance the increased deficit.

In order to have prudent management of debt and greater focus on carrying cost as well as meeting secondary market liquidity, the government has set up a Middle Office which in due course will merge with the proposed Debt Management Office. Central Government has stopped playing the role of financial intermediary for State Government for domestic market borrowings and the trends in the current year shows that this transition has been very smooth resulting in reduction in cost for the State Governments while at the same time bringing in a sense of market discipline.

Government has set up National Investment Fund (NIF) to which the disinvestment proceeds from Central PSUs are being transferred. This fund is being managed by professional fund managers. The receipts in the Fund are not reckoned as resources for the purpose of financing the fiscal deficit. The income from investments under NIF is used to finance social infrastructure and provide capital to viable public sector enterprises without depleting the corpus of NIF.

3.7 INTERDEPENDENCE OF FISCAL AND MONETARY POLICY

Even as the sub-prime mortgage bubble burst and the economic crisis dawned, the Central Banks across the world, after some initial hesitation, were quickly off the blocks and resorted to aggressive monetary policy actions - lowering rates to almost zero bound, direct cash injections into financial institutions, purchases of troubled or distressed assets, liquidity infusions through auctions and Central Bank lending windows, relaxation of collateral standards for lending, blanket insurance on deposits etc. In the US alone, the balance sheet of the Federal Reserve has burgeoned from $900 bn to nearly $3 trillion in the space of a few months.

However, all these have had limited effect in reining in the steep slide downwards. There are ofcourse, those who claim that without these aggressive monetary loosening, the results would have been worse still. Even if this is true (and it surely is), it is a small consolation. The apparent ineffectiveness of the monetary policy in preventing a slide into an economic recession set in motion calls for a fiscal stimulus package to bail out the economy and its various sections.

Fiscal policy and monetary policy have significant differences. The government oversees fiscal policy while the Fed oversees monetary policy. The Fed is the central bank of the United States and controls the money supply. Supply and demand is not the only ways in which the economy is affected. Both fiscal policy and monetary policy play their part. Each has the ability to affect the economy in its own way, with its own advantages and disadvantages.

The Fed has the greatest ability to slow down the economy in order to promote full employment and counter inflation with monetary policy. The Fed increases interest rates to defer people from borrowing money. In this case, monetary policy is more effective then fiscal policy. In order for fiscal policy to have an affect on slowing down the economy, the government must raise taxes or decrease spending, neither of which is very appealing and politically costly. Since the government runs fiscal policy, they must adhere to all aspects of democracy, which can lead to delays and slows down the process.

The Fed has the advantage of being independent of the normal political process. They are able to make decisions quickly without the time consuming checks and balances associated with the political process. They are also at a disadvantage because they do not have all the support of that same political process. Perhaps the checks and balances system the government uses could be somewhat effective in the Fed without hindering the speed they are accustomed to.

As opposed to monetary policy, fiscal policy refers to expenditure (used to provide goods and services), taxation (to finance the various government expenses) and government borrowing. The main point of fiscal policy is to keep the surplus or deficit swings in the economy to a minimum by reducing inflation and recession.

There are two types of expenditures – money spent on the delivery of goods and services and the transfer of funds to other levels of government. Government expenditure can be both, planned, as well as non-planned. Planned capital expenditure is like government expenditure on social sectors and planned non-capital expenditure means normal government expenses. The latter means sudden expenses on, say, durable disaster management and mounts to government expenses on government officials, including VIPs.

Taxation takes many forms (direct and indirect), including taxation of personal and corporate income, so-called value added taxation and the collection of royalties or taxes on specific sets of goods. Government revenue is categorised into revenue receipts – like tax revenue and non-tax revenue – and capital receipts (say, through borrowing). Through borrowing, a government means to provide a great deal of goods and services to its people, while not having the immediate tax revenue to fund that expenditure. This is done primarily by issuing securities, such as Treasury Bills or Treasury Bonds. All levels of government borrow money at some point or the other. Fiscal Policy has two main tools – the changing of tax rates, and changing of government expenditure. The government has been focusing on both of these to provide a boost to the economy.

Existing Measures – As we know, the on-going global recession has also hit India. According to the International Monetary Fund (IMF) and World Bank, apart from many Central and Eastern European economies, a large number of developing countries across the five continents are facing a financial meltdown. This would seriously affect the rate of economic growth and the related equity issues, especially poverty levels. It is estimated that an additional 90 million people's income may fall below the poverty line in most of these countries.

Another problem is that capitalism rules the world but is surviving only because stimulus packages. India is fortunate in the sense that both the public and private e active, and both are equally aware of the crisis. They are, in fact, going hand get the country out of this crisis. Let us briefly see what the public sector is Fiscal and Monetary Policies in this context:

Looking at the global financial and economic conditions, the RBI has taken many measures since mid-September 2008, to augment domestic liquidity and to ensure that credit continues to flow to productive sectors of the economy. Since then, the RBI has reduced the Cash Reserve Ratio (CRR) from 9.0 per cent to 5.0 per cent and the Statutory Liquidity Ratio (SLR) from 25.0 per cent to 24.0 per cent.

The various fiscal stimulus packages as announced by the government during the last few months or so, have raised the market borrowing programme of the government for the year 2008-09. In terms of the amendment to the memorandum of understanding on 'Market Stabilisation Scheme' (MSS) on February 26, 2009, an amount of Rs 45,000 crore was transferred from the MSS cash account to the normal cash account of the Government of India by March 31, 2009. An equivalent amount of government securities issued under the MSS would also form part of the normal market borrowing of the government. This arrangement has surely given a boost to the market.

Furthermore, the RBI has conducted purchase of government securities under its open market operations. The Government has given liquidity support to the housing sector and particularly to Housing Finance Companies (HFC), which have been adversely affected by the recent financial market developments. The government is also helping the overseas financial companies in many ways for financing imports to India. Attempts are being made to ensure adequate liquidity in order to maintain the flow of credit for all productive purposes in the housing, export and small and medium industry sectors.

3.8 BUDGETARY DEFICITS AND THEIR IMPLICATIONS

In general, RBI follows the Government of India's approach/methodology for compilation in respect of various deficits/fiscal indicators. Details of methodology followed in budget 2006-07 are presented in Annex-8.1. The definitions of various defi indicators used in compilation of fiscal statistics are as follows: *Revenue Deficit* the difference between revenue receipts and revenue expenditure. *The co deficit (budgetary deficit)* is the difference between all receipts and exper revenue and capital. *The gross fiscal deficit (GFD)* is the excess of to including loans net of recovery over revenue receipts (including ext

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Unit 1	Introduction to fiscal federalism
Unit 2	Fiscal relations among various levels of Government in India

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BLOCK - VI

Public Economics

BLOCK 4 FISCAL FEDERALISM

This block comprises two units. The first unit deals with introduction to fiscal federalism. Fiscal federalism in India will be discussed in detail and multi unit finance including finance of MSMEs will be focused. Fiscal imbalances in India and assignment of functions and sources of revenue will be described. Functions and working of finance and planning commissions of India will finally be taken into consideration.

The second unit gives you the understanding of financial relationship between union, state and local bodies. devolution resources and grants; theory of grants and resource transfer from union to state and its criteria are some main areas of discussion of this unit similarly problems of state resources and indebtness and resource transfer from union to state and local bodies will also be dealt in a detailed manner.

UNIT 1

INTRODUCTION TO FISCAL FEDERALISM

Objectives

On successful completion of this unit, you should be able to:

- Appreciate the concept of fiscal federalism with special reference to Indian economy
- Identify the multi unit finance in India
- Analyse fiscal imbalances include vertical and horizontal imbalances
- Determine the assignment of functions and sources of revenue
- Recognize the finance commission of India
- Know the planning commission of India

Structure

1.1 Introduction

1.2 Fiscal federalism in India

1.3 Multi unit finance

1.4 Fiscal imbalance

1.5 Assignment of functions and sources of revenue

1.6 Finance commission of India

1.7 Planning commission of India

1.8 Summary

1.9 Further readings

1.1 INTRODUCTION

As a subfield of public economics, fiscal federalism is concerned with "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government" (Oates, 1999). In other words, it is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration. An important part of its subject matter is the system of transfer payments or grants by which a central government shares its revenues with lower levels of government. Federal governments use this power to enforce national rules and standards. There are two primary types of transfers, conditional and unconditional. A conditional transfer from a federal body to a province, or other territory, involves a certain set of conditions. If the lower level of government is to receive this type of transfer, it must agree to the spending instructions of the federal government. An example of this would be the Canada Health Transfer. The second type of grant, unconditional, is usually a cash or tax point transfer, with no spending instructions. An example of this would be a federal equalization transfer.

It may be noted that the ideas of fiscal federalism is not relevant for all kinds of government *via* unitary, federal and confederal. The concept of fiscal federalism is not to be associated with fiscal decentralization in officially declared federations only; it is applicable even to non-federal states (having no formal federal constitutional arrangement) in the sense that they encompass different levels of government which have defacto decision making authority. This however does not mean that all forms of governments are 'fiscally' federal; it only means that 'fiscal federalism' is a set of principles, which can be applied to all countries attempting 'fiscal decentralization'. In fact, fiscal federalism is a general normative framework for assignment of functions to the different levels of government and appropriate fiscal instruments for carrying out these functions

The questions arise: (a) How federal and non-federal countries are different with respect to 'fiscal federalism' or 'fiscal decentralization' and (b): How fiscal federalism and fiscal decentralization are related (similar or different)? Chanchal Kumar Sharma

clarifies: While *fiscal federalism* constitutes *a set of guiding principles, a guiding concept* that helps in designing financial relations between the national and subnational levels of the government, *fiscal decentralization* on the other hand is *a process of applying such principles*. Federal and non-federal countries differ in the manner in which such principles are applied. Application differs because unitary and federal governments differ in their political & legislative context and thus provide different opportunities for fiscal decentralization.

1.2 FISCAL FEDERALISM IN INDIA

India has a federal form of government, and hence a federal finance system. The essence of federal form of government is that the Centre and the State Governments should be independent of each other in their respective, constitutionally demarcated spheres of Action. Once the fundamentals of the government are spelt out, it becomes equally important that each of the government should be provided with sources of raising adequate revenues to discharge the functions entrusted to it. Sales taxes are most important revenue for the state sin India. While the taxes vary in their design, they are generally levied in the first point of sale within the State.

Hamilton in his federalist papers stated that Multileveled government permits various functions to be assumed by different levels, potentially improving efficiency since different activities have different optimal scales and hence in India with respect to Sales Tax Federalism, The Constitutional amendment in 1956, gave the States power to impose sales tax the Central Sales Tax Act, 1956,enacted by the Sixth Constitutional Amendment which introduced Entry 92A in List I of the Seventh Schedule authorizing Parliament to levy tax on the sale or purchase of goods (other than newspapers) in the course of inter-State trade.

The revenue from this tax was assigned to the States by amending Article 269 of the Constitution. Thus, sale within the State (Intra-State sale) is within the authority of State Government, while sale outside State (Inter-State sale) is within the authority of Central Government. Accordingly, the Central Sales Tax (CST) is levied on sale or purchase of goods in the course of inter-State trade and commerce. The power to levy the

CST and revenue from this tax is, however, assigned to the State occasioning the movement of goods from one State to another (i.e., the exporting State)

An attempt has been made hereby to study the Distribution of Power and Tax federalism in India with respect to Sales Taxation in India Keeping in view the Central Sales Tax Act and the Individual States Sales Tax Acts.

The federal character of public finance in India has its origin as far as the seventies of the last century. Although at that time the country had a unitary form of government, some division of functions and financial powers between the Center and the state was found administratively desirable. Ever since then the arrangements have been revised and improved from time to time. Fiscal federalism entails the division of responsibilities in respect of taxation and public expenditure among the different layers of the government, namely the Center, the states and the local bodies. Fiscal federalism helps governmental organization to realize cost efficiency by economies of scale in providing public services, which correspond most closely to the preference of the people. From the point of view of economy, it creates a unified common market, which promotes greater economic activity.

India has a federal form of government, and hence a federal finance system. The essence of federal form of government is that the Centre and the State Governments should be independent of each provided with sources of raising adequate revenues to discharge the functions entrusted to it. For the successful operation of the federal form of government financial independence and adequacy form the backbone

The Seventh Schedule (Article 246) delineates 'the subject matter of laws made by the Parliament and by the Legislatures of the states' and indicates the Union List (List I), states List (List II) and the Concurrent List (List III). List I invests the union with all functions of national importance such as defence, external affairs, communications, constitution, organization of the Supreme Court and the high courts, elections etc, List II invests the states with a number of important functions touching on the life and welfare of the people such as public order, police, local government, public health, agriculture, land etc. List III is a concurrent List, which includes administration of justice, economic and social planning, trade and commerce, etc.

According to Article 246, Seventh Schedule, Parliament has exclusive powers to make laws regarding matters enumerated in List I. not withstanding the provisions of the other clauses of this Article. On the other hand, the Legislature of any state has exclusive power to make laws for the state regarding any of the matters enumerated in List II, subject to other clauses. With regard to List III, both the Parliament and a State Legislature can make laws but the law listed in I or III, vests with the Union. Thus, the Union has supremacy over a wide range of the legislative field.

These lists include the powers of taxation also. The union List includes among others, taxes on income other than agricultural income, excise duties, customs and corporation tax. The State list includes land revenue, excise on Alcoholic liquors, tax on agricultural incomes, estate duty, taxes on sale or purchase of goods, taxes on vehicles, on professions, on luxuries, on entertainment, on stamp duties, etc. the concurrent list does not include any important taxes.

Accordingly there are both mandatory and enabling provisions in the Constitution for facilitating a wide-ranging transfer of resources, arranged in a systematic manner, through

1) Levy of duties by the Center but collected and retained by the States.
2) Taxes and duties levied and collected by the Center but assigned in whole to the states
3) Mandatory sharing of the proceeds of income tax
4) Permissible participation in the proceeds of the Union excise duties
5) Statutory grants –in-aid of the revenues of states
6) Grants for any public purpose and
7) Grants of loans for any public purpose

Thus, having provided for a certain division of powers of taxation between the union and the states, the Constitution gives the States a share in the resources available to the Center. Any amendment of the lists from the Union and the States derive their power of taxation is covered by the Provision to Article 368. This requires ratification by the Legislatures of not less than one half of the States. On the other hand, if any provisions of

the Part XII are to be amended, this can be done under Article 368(2), which requires the approval of only half of the members of each house of the Parliament. This means that the share of the Union resources that the states are entitled to, can be altered by Parliament by its power of amendment.

Though considerations of national policy and administrative convenience require that some of the more elastic taxes should be assigned to the Union Governments, these considerations themselves require that some of the most expansive expenditure heads apart from defense should be undertaken by the States. Consequently, a salient characteristic of federal government is legislative autonomy with financial dependence. This feature is accentuated in a developing economy where the functions of the States develop by leaps and bound with no corresponding increase in the sources of revenue.

1.2.1 The Concept of Sales Taxation In India

Sales tax is the most important revenue for the States in India. It can be defined as a tax on sale of goods. The liability to pay sales tax arises on making sales of goods. Sales tax is levied on the sale of a commodity, which is produced or imported and sold for the first time. If the product is sold subsequently without being processed further, it is exempt from sales tax.

According to John Due, "A sales Tax is levy imposed upon the sales, or element incidental to sales, such as receipts from them, of all or a wide range of commodities." A sales tax may be levied upon all the transactions through which the commodities pass or upon one or a small number of stages only. It is presumed that the tax will be shifted forward to the consumers, the selling firm being regarded as merely an agent to collect tax.

The present day sales taxes may be classified into three major groups:

- **Multiple-stage taxes**: they apply to all the stages in production and distribution, in other words all the transactions from initial production to final sale to the consumers.
- **Single-stage taxes**: they apply to commodities only once in production and distribution channels.

Value Added taxes: it bears the characteristics of both multi stage taxes and single stage taxes, since "it involves the multiplication of the tax rate but produces the same overall distribution on commodity as a single stage tax.

Sales taxation differs in different countries according to the breadth of the coverage. In the United States of America there are at least six different types of sales tax. In some countries the sales tax is on the sale of the manufacturer only, or on the whole seller or the retailers only. In many countries the retailers were not taxed until recently.

In India, the law for levying sales tax is provided in the Central Sales Tax Act, 1966. This act was passed by the Parliament and applies to the entire country. The main objects of this act are:-

1. To formulate the principles for determining as to when sale or purchase of goods takes place (i) in the course of inter-state trade or commerce or (ii) outside a state or (iii) in the course of import into or export from India.
2. To provide for the levy, collection and distribution of taxes on sales of goods in the course of inter-state trade or commerce
3. To declare certain goods to be of special importance in interstate trade or commerce.

To specify the restrictions and conditions in respect of State laws which impose taxes on the sale or purchase of such goods of special importance? Sales tax can be levied either by the Central or State Government, Central Sales tax department. Also, 4 per cent tax is generally levied on all inter-State sales. Depending on the type of sales, this can be classified into three categories:

- Intra-state sales
- Sales during import and export
- Inter-state sales

State sales taxes that apply on sales made within a State have rates that range from 4 to 15 per cent. Sales tax is also charged on works contracts in most States and the

value of contracts subject to tax and the tax rate vary from State to State. However, exports and services are exempt from sales tax. Sales tax is levied on the seller who recovers it from the customer at the time of sale.

1.2.2 Central Sales Tax Act and Tax Federalism in India

The period following the adoption of the Constitution up to 1955 could be described as a transitory phase for sales taxation. It was only with the Supreme Court judgment in 1955 and through the resultant. Constitutional amendment in 1956, that the States power to impose sales tax was clearly demarcated. Thus, the taxes on sale or purchase of goods in the course of inter-State trade or commerce were brought expressly within the purview of the legislative jurisdiction of Parliament.

As a result, the Central Sales Tax Act, 1956,enacted by the Sixth Constitutional Amendment which introduced **Entry 92A** in List I of the Seventh Schedule authorizing Parliament to levy tax on the sale or purchase of goods (other than newspapers) in the course of inter-State trade. The revenue from this tax was assigned to the States by amending Article 269 of the Constitution. Thus, sale within the State (Intra-State sale) is within the authority of State Government, while sale outside State (Inter-State sale) is within the authority of Central Government. Accordingly, the Central Sales Tax (CST) is levied on sale or purchase of goods in the course of inter-State trade and commerce. The power to levy the CST and revenue from this tax is, however, assigned to the State occasioning the movement of goods from one State to another (i.e., the exporting State)

In addition, section 15 of the Central Sales Tax Act laid down certain restrictions on the powers of the States in regard to the levy of inter - State sales tax on goods declared as of special importance within their respective territories.

In addition to the above, since 1975, the Union Government entered into an agreement with the States to abolish sales tax on textiles, sugar and tobacco including manufactured tobacco.

According to the agreement, the Union Government levies an additional Excise Duty in lieu of Sales tax (IDEALIST) on these 3 commodities. In recompense, the entire proceeds of the IDEALIST are assigned to the States. Thus, the Union Government

entered into a tax-rental arrangement with the States who were given the Constitutional right to cancel the agreement and impose sales tax on these commodities, whenever they so desired. But the right of States to levy sales tax on these commodities was restricted by including these three items under the of "Good of Special Importance",

Hence, the rate of sales tax on these commodities can't exceed the rate of the Central Sales Tax which, at present, is four percent If the product is sold subsequently without being processed further, it is exempt from sales tax. Sales tax can be levied either by the Central or State Government, Central Sales tax department.

1.2.3 Sales Tax and the Division of Taxing Power

In federal constitution the powers of taxation are distributed between the Union and the States as a part of the overall distribution of the Legislative Powers. In India it is under Article 246, it is mentioned in Part XII of the Constitution that makes some of the taxes that are within the exclusive power of the Union, under this article are divisible. between the Union and the States. One can argue that the Intention is to strengthen the states and this can be achieved by increasing their powers of taxation. It is the power to tax that strengthens the States and not merely the proceeds from a tax.

Various procedures for framing the rules under the Central sales tax Act can be broadly divided under the following three heads:

(a) Rules framed by the Central Government

(b) Rules framed by the State Government

(c) rules as prescribed in the State Sales tax laws of each state

It may be noted that though the tax is levied as the Central Sales Tax, it is administered by respective State Governments.

(a) **Rules Framed by the Central Government**: Section 13 (1) authorizes the Central Government to make rules for different purposes. Some of these rules have already been discussed in the preceding paras.

(b) **Rules Framed by the State Governments**: with Section 13(3), the State Governments are authorized to make rules for different purposes. These rules should not be inconsistent with the CST Act or rules made by the Central

Government under the CST Act. The State Governments can make these rules for the following purposes. In view to the aforesaid power, all the State Governments have framed their rules and prescribe their forms.

(c) **Rules Prescribed in the State Sales Tax Laws:** Section 9(2) provides that all provisions of the local sales tax law of each state (other than those provided in the Central Sales Tax and rules made there in) in respect of the following shall be applicable to any person under the CST Act in that state. If in any state there is no general sales tax law in force, the Central Government may take necessary provision for all or any matters specified in the CST Act.

It is pointed out that the tax on the interstates-State sales had originally been included in Art. 269, the power to administer the tax and retain the revenue was delegated to the originating state. It was pointed out that original provision of the Constitution was based on the 'destination' principle whereas after the Constitutional Amendment under the Central Sales Tax Act, 1956, the origin rule, paving the way for tax exportation, displaced this, somewhat inadvertently.

Herein, it can be clearly seen that the structure of sales taxation clearly fits in the bracket for a federal structure. The sales of a variety of goods of general use are more or less confined to the individual areas or states. Therefore, the allocation of general sales tax to the states is quite appropriate. There are, however, certain commodities, which enter inter-state trade. Different rates in different states on the sale of these goods, therefore, may adversely affect the trade. To avoid this difficulty, sometimes, Central co-ordination in the management and rates of these taxes is introduced.

Sometimes sales taxes on certain commodities are substituted by special excise duties imposed by the Centre, the proceeds of which are distributed to the States on some well-defined basis.

1.2.4 Determination Of Imposition And Collection Of Sales Tax "Another View to the Federal Scheme of Distribution"

A sale or purchase of goods, which is not within the state as per the above provisions, will be treated as taking place outside the state. The purpose of determining

whether the sales have taken place within the state or outside the state is very important for levying central sales tax since under the CST Act, tax is leviable only on sales in the course of inter-state trade or commerce, while the state sales tax laws apply on the sales that are made within the state.

Vide section 9(1), tax under the CST Act shall be levied by the Central Government but can be collected and retained by the State Government where the movement of the goods have been commenced.

I. Inter-state trade or commerce

Section 3 of Central Sales Tax Act defines Inter-State sale or purchase as a sale or purchase of goods shall be deemed to take place in the course of interstate trade or commerce if the sale or purchase—

a) Occasions the movement of goods from one state to another.

b) Is effected by a transfer of documents of title to the goods during their movement from one state to another

In **CST v. Suresh Chand Jain** it was held that a sale can be said to be in the course of inter-state only if two conditions concur viz. **(i)** sale of goods and **(ii)** a transport of those goods from one State to another. If in case, Inter-state sales involve two or more states. It is necessary to determine the state in which the sale or purchase of goods takes place since that becomes the appropriate state for the purpose of levying and collecting central sales tax. Not all dispatches of goods from one state to another result in inter state sales rather the movement must be on account of a covenant or incident of the contract of sales.

In case of Inter- State Sale there are certain essential ingredients which includes that the transaction must be a completed sale, moreover, in Balabhgas Hulaschand v. State of Orissa it was held that for inter state sale to be complete, there should be an agreement to sale which contains a stipulation (express or implied) regarding movement of goods from one State to another. In the case of CST, UP v. Bakhtawar Lal Kailash Chand Arhtiit was held that it is immaterial whether a completed sale precedes the movement of goods or follows the movement of goods or takes place while the goods are

in transit. What is important is that movement of goods and the sale must be inseparably connected, moreover the movement shall be physical and such movement must be inextricably connected with sale. This Sale need not precede the inter-State movement. Sale can be either before the movement or after the movement.

There are some instances wherein the goods are moved out of the selling state and yet they are not considered inter state sales: -

- Intra-state sales
- Stock transfer from head office to branch & vice versa
- Import and Export sales or purchases
- Sale through commission agent / on account sales
- Delivery of Goods for executing works contract

II. Intra State Trade or commerce

A sale or purchase of goods shall be deemed to take place inside the state if the goods are within the state.

- In case of specific or ascertained goods, at the time the contract of sale is made (Specific or ascertained goods means goods which are identified and agreed upon at the time when contract of (sale is made) and
- In case of unascertained or future goods, at the time of appropriation of contract of sale by the seller or by the buyer, whether the ascent of the other party is prior or subsequent to such appropriation (eg agreement to buy mangoes which are still growing on the trees at a future date)

III. Sale or purchase of goods in the course of import or export

The Constitution of India prohibits imposition of sales tax on import and exports and authorizes Parliament to formulate principles for determining when sale is in the course of import/export. Under these powers, section 5 of CST Act has been enacted.

A sale or purchase of goods shall be deemed to take place in the course of exports of goods out of the territory of India only if: - 1. The sale or purchase results in such exports; or

2. It is affected by the transfer of documents of title after the goods have crossed the customs of India.

In other words, location of goods when contract of sales is made is very important for determining where the sale took place.

1.2.5 Procedure for Imposition of Sales Tax

Section 6 of the Central Sales Tax is the charging section i.e. it creates a liability for a dealer to pay Sales Tax on all sales of goods other than sale of electrical energy affected by him in the course of inter-state trade or commerce during any financial year.

A sale or purchase of goods is said to take place when the transfer of property in the existing goods or future goods takes place for consideration of money. The goods have been divided into different categories and different rates of sales tax are charged for different categories of goods.

In most of the cases related to the sales tax, the tax on the sale or purchase of goods is at single point. Under the provisions of some state laws the assesses are divided into several categories such as manufacturer, dealer, selling agent etc. and such as assess is required to obtain a registration certificate to that effect. The sales tax or the purchase tax is levied on that assesses on the basis of his category such as dealer, manufacturer etc. on production of certain forms or certificates (and differential rates of sales tax are levied). Generally, a quarter return of sales or purchases is insisted upon and the assesses is required to furnish the return in the prescribed form.

At the time of assessment, the assessee has to furnish all the documentary evidence and satisfy the concerned sales tax / commercial tax officer. The sales tax laws of the states prescribe the procedure to be followed in case an assessee prefers to make an appeal. Every dealer should apply for registration and obtain a registration certificate to that effect. The registration certificate number should be quoted in the entire bill / cash memos.

1.2.6 The Theory of Territorial Nexus

It is a well known that neither the sale of goods Act nor the Central sales tax has so far tried to fix the situs of sale. This is because the localization of a sale in many cases is a difficult problem when different stages of the transaction of sale are reached in different places, as when the contract of sale is made in one state while the transfer of ownership of goods takes place in another, the payment of price in the third state and the delivery in yet another state .in such cases, there might be a real danger of different states claiming to tax the same transaction on the basis of sufficient territorial nexus. Between the state and what it sought to tax. The purpose of Article286 of the Constitution of India was to avert such danger. The power of provincial legislature to make a law imposing sales tax was granted by section 100 (3) of the Government of India Act read with entry 48 of the List II of the seventh schedule and such a law could be made for the province or for any part thereof: basing themselves on the doctrine of territorial nexus, the legislature of different provinces enacted sales tax laws adopting one or more of the nexi as the basis of taxation.

When the states power to tax sales on territorial nexus theory was challenged, it was decided by the Supreme Court in **Poppatial Shah v. State of Bombay** that it would be quite competent to enact a legislation imposing taxes on the transactions concluded outside the province provided that there was a sufficient and real territorial nexus between such transactions and the taxing province. This principle, which is based on the decision in **Wallace Broyhers and C. v. Commissioner of Income Tax, Bombay** has been held by the Supreme Court to be applicable in sales Tax Legislation.

It thus appears, that the state legislature has within its allotted field of legislation covered by the Entry 54 of list II by reason of **Article 246 (3)**, exclusive power to make laws for the state with regard to taxes on sales or purchases of goods other than newspapers, subject of course, to restrictions placed by **Article 286**.

All that is necessary is that the taxing law must be for the purpose of the state. That being the case, in absence of any constitutional limitation it was not necessary. for levy of sales tax that all the component parts of the sale, such as the contract of sale,

passing of title, payment of price, delivery of goods, must take place within the borders of the taxing state. The doctrine of nexus is applicable to sales tax legislation was further affirmed in United motors Case on this point has not been, in any way shaken by the subsequent decision of the Supreme court in **Bengal Immunity Company's Case**

The Supreme Court on **Tata Iron and Steel Company vs. State of Bihar** also recognized the Theory of territorial nexus. It is stated in the case "the presence of goods at the date of agreement for the sale in the taxing state or the production or manufacturing in the state of goods the property wherein eventually passed as a result of the sale wherever it might have taken place, constituted a sufficient nexus between" he taxing state and the sale.

In **State trading corporation v. State of Mysore**, the company made various sales of cement, which were supplied from the factories outside the state of Mysore to purchasers within the State. The State of Mysore levied tax on these sales under the two sales tax acts passed by the Mysore legislature. The company applied Art.32 of the Constitution to squash the assessment order on the ground that the State had no power to tax the sales they had taken place in the course of inter-state trade.

The Court held that the sale occasions the movement of goods from one state to another within Section 3(a) of the Central Sales tax Act when the movement is the resultant of the covenant or the incident of the contract of sale. In that case, the contract of sale was deemed to have contained a covenant that the goods would be supplied in Mysore from place situated outside the borders and the sales were therefore, interstate sales within Section 3 (a) of the Central sales tax Act.

From the consideration of the decisions of the Supreme Court cited above one principle that has clearly emerged out is the theory of territorial nexus has not ceased to operate and facilitates the machinery of taxation and enables tax Federalism.

1.3 MULTI UNIT FINANCE

Micro, Small and Medium enterprises (MSME) constitute the dominant form of business organisation worldwide. For instance, 99% of enterprises in European Union and about 80% in USA were small enterprises. In India too, SSIs share is as high as

97%. Out of 42.12 million non-farm enterprises, 0.58 million are factory units. (Source: 5th Economic Census Provisional result. June 2006). It is estimated that out of 5.8 lakh factory units, about 5 lakh are factory SSIs and Medium Enterprises as per the new definition of MSMEs adopted by the Government of India in June 2006. Finance forms the most critical input for a business enterprise whether large or small. All firms require financing to grow and survive Sources may be external, such as loans, equity infusions, subsidies and government grants, or internal such as generated cash flows.

Many firms are self-financed in the beginning. Once the firms reach certain degree of maturity in the development of their product line and customer base, external finance becomes available. The flow of institutional finance is linked with the creditworthiness of the enterprise.

Small enterprises, due to their small size and low capital base, generally find it difficult to satisfy the conditions laid down by the banks, particularly, in establishing the viability of the project, meeting collateral requirements and making timely repayment of loans. Hence, they do not find a place among the preferred clients of the banks. Institutional Credit Structure a multi-level institutional structure exists for financing of small enterprises and non-farm enterprises in India. This consists of commercial banks. cooperative banks, RRBs, State Financial Corporations. Credit to small enterprises comes under priority sector lending programme of banks.

The Reserve Bank of India (RBI) constantly reviews the flow of credit to this sector. To improve the flow of credit, the RBI has constituted several committees and working groups since 1991. Notable among the committees are Nayak Committee. Kapur Committee and Ganguly Committee. Appropriate measures are taken by the RBI and Government from time to time based upon the decision of the Standing Committee on SSI set up at the RBI.

An exclusive refinancing bank, called Small Industries Development Bank of India (SIDBI) was set up in 1990. The issue of providing micro credit to micro-enterprises through development of SHG-Banks Linkage rests mainly with National Bank for Agricultural and Rural Development (NABARD). However, major part of SHG-Bank Linkage credit is in the form of micro credit to meet production and consumption

needs and not for micro enterprises. Status of Credit Flow to MSMEs Major complaints of the MSME sector relating to bank finance are that it is inadequate, delayed and costly. The status of SSI sector and flow of credit to the sector from scheduled commercial banks and public sector banks could be obtained from the Table 1.

TABLE – 1

Status and Contribution of SSIs in India

Year	No. of Units registered (in lakh)	Un-registered (in lakh)	Total Units (in lakh)	Production (Rs. in crore) (Constant price Base 1993)	Employment (in lakh)	Export (Rs. in crore)
2000-01	13.10	88.00	101.10	184428	239.09	69797
2001-02	13.75	91.46	105.21	195613	249.09	71244
2002-03	13.68	94.81	108.49	210636	260.13	86013
2003-04	15.54	98.41	113.95	228730	271.36	97644
2004-05	16.38	102.15	118.53	245747	282.82	NA

(Source: Annual Report 2005 – 06, Ministry of SSI)

During the five year period, number of SSIs has increased from 101.1 lakh in 2000- 01 to 118.5 lakh in 2004-05 and employment from 239 lakh to 283 lakh during the same period. The sector recorded an annual growth of 4.4% in units, 8.2% in output and 5.2% in employment during 2000-01 to 2004-05.

Currently it contributes 39% of industrial production and 30% of national export. In view of the important role played by SSIs, it is essential to look into the status of credit flow to SSIs from the scheduled commercial banks which is the prime source of credit to the sector. It may be clarified here that in banking parlance, SSI sector covers both modern SSIs eligible for registration at DICs and traditional industries like khadi and village industries, handloom, handicraft, coir, sericulture, etc.

TABLE – 2

Flow of Credit from Commercial Banks to SSI Sector

Year	Net Bank Credit (Rs. in crore)	Annual Growth (%)	Credit to SSI (Rs. in crore)	Annual Growth (%)	SSI as % of Net Bank Credit
1994-95	192424	—	29175	—	15.17
1995-96	228198	18.75	34246	17.12	14.98
1996-97	245999	17.89	38196	11.40	15.52
1997-98	297265	21.20	45771	19.60	15.40
1998-99	339477	14.14	51679	12.66	15.22
1999-00	398205	17.40	57035	10.46	14.31
2000-01	467206	17.33	60141	5.43	12.86
2001-02	535063	14.56	67107	11.65	12.53
2002-03	668576	25.04	64707	(-) 3.60	9.67
2003-04	763855	14.20	71209	10.04	9.32
2004-05	971809	27.22	83179	16.71	8.55

(Source – RBI Statistical Tables Relating to Banks in India 2004 - 05)

The pace of growth in SSI credit has not kept pace with the growth in net bank credit (NBC) (see Table 2 and 3). While NBC grew by 17.33% in 2000-01, SSI credit grew by only 5.43% that year and while NBC grew by 25.04% in 2002-03, SSI credit recorded a negative growth of 3.60%. Though SSI loans come under priority sector lending programme of the scheduled commercial banks, the most disturbing trend to note is the decline in flow of credit to SSI in percentage terms in relation to NBC. It has declined from 15.52% in 1996-97 to 8.55% in 2004-05.

In the absence of any quantitative restriction to SSI lending within the priority sector, the commercial banks have enough scope for deploying funds to other priority sectors like housing, retail trade, education, consumption and transport purposes, etc. and thus, try to meet the overall target.

TABLE - 3

Credit Flow to SSI Sector from Public Sector Banks (PSBs)

(Rs. Crore)

S. No.	Year	As at the end of March		
		Net Bank Credit (NBC)	Credit to SSI	% to NBC
1.	1998	218219	38109	17.5
2.	1999	265554	42591	16.0
3.	2000	316427	46045	14.6
4.	2001	341291	48400	14.2
5.	2002	396954	49743	12.5
6.	2003	477899	52988	11.1
7.	2004	558849	58278	10.4
8.	2005	718722	67634	9.4
9.	2006	966452	82275	8.5

(Source: RBI)

Further, while the absolute amount of advances from the public sector banks to SSIs had increased from Rs. 38109 crore in 1998 to Rs.82275 crore in 2006 (Table. 3), the share of the credit to the SSI sector in the NBC had declined from 17.5% as at the end of March,.1998 to 8.5% as at March, 2006. The continuing decline of credit to SSI sector is a matter of serious concern as adequate credit flow is vital for achieving 12% annual growth rate for the SSI sector as envisaged in the 10th Plan.

1.3.1 Tiny Units

Sixty per cent of the total SSI credit is earmarked for tiny units, (now micro enterprises) as per the guidelines of the RBI. The flow of credit to tiny sector since 2000 is as under:

TABLE – 4

Credit Flow to Tiny Units from Public Sector Banks

(Rs. Crore)

Net Bank credit to tiny sector	24742	26019	27030	26937	30826	28062	33314
Credit to tiny sector as % of net SSI credit	54.0	53.7	54.3	50.8	52.9	41.5	40.5

(Source: RBI)

There had also been a decline in the credit flow to the tiny sector as a percentage of SSI advances from 54.3% in March, 2002 to 50.8% in March, 2003. This somewhat improved at the end of March, 2004 (52.9%). However, thereafter it declined sharply and as against the target of 60%, actual credit was only 40.5% of total SSI credit by the end of March, 2006. Some other disturbing trends noticed with regard to bank credit to MSMEs are: (i) inadequate working capital which is currently ranging between 10-13% against RBI norm of 20% of projected turnover to be given as working capital, (ii) high cost of credit normally ranging between 13-16% as against relatively lower rate of interest of 6 to 9% charged from large units on the ground of latter.s better creditworthiness and 7% from agricultural sector, (iii) insistence on collaterals even on loan upto Rs. 5 lakh in spite of the RBI guidelines to this effect (loans without collateral out of total loan below Rs. 5 lakh to SSI was 25.9% in 2004-05), and (iv) neglect of small

Loan as the share of loan below Rs. 25000 had declined from 21% of total outstanding of banks. Credit in June 1985 to 3.7% in March, 2005. Scheduled commercial banks Credit to the large and medium industries was of the order of Rs. 290186 crore in the year 2004-05 which was 30% of the gross bank credit for that year.

Though separate figure for medium industries is not available, it is assumed that about 20% this credit, amounting to Rs. 58083 crore might have gone to medium enterprises. Thus, the total credit from the scheduled commercial banks for the year 2004-05 was Rs. 141217 crore, including Rs. 83179 crore for SSI. To this, we may add Rs. 34313 crore being the credit to small business, retail trade, transport operation, etc in 2003 – 04 in addition, a sum of Rs. 37483 crore flowed to small enterprises including traditional industries and small business from sources like regional rural banks (Rs.

14393 crore), cooperative banks (Rs. 15117 crore), SIDBI direct finance (Rs. 2695 crore), SFCs (Rs 864 crore) and SIDCs and NSIC (Rs. 4414 crore) in the year 2003-04. Cooperative banks credit is mostly going to handloom, handicraft and traditional cooperative industries.

Thus it is expected that entire MSME Sector received a total credit of over Rs. 2 lakh crore (rough estimate) by the end of March 2005. Banks, it seems, are not favourably inclined to finance the small enterprises, particularly, smaller among the small enterprises for various reasons. Notable among them are (i) inability of small entrepreneurs to meet collateral requirement (ii) high non-performing assets in SSI sector which is currently at 15% as against 8% for large industries (iii) high incidence of sickness (though official RBI data indicates a decline in the number of sick SSI units from 3.04 lakh in 2000 to 1.39 lakh in 2004 (iv) higher transaction cost to banks in processing large number of small loan applications. Normally, the cost of processing small loans has been found in the range of 18 to 21% whereas the rate of interest on small loans below Rs. 25,000 is 12% and other loans upto Rs. 5 lakh is 15 to 16% (v) difficulty in establishing the creditworthiness of the project proposals. Poor borrowers do not require project finance; instead they need production, consumption and housing loan.

Among the measures taken by the Government in recent years to improve the flow of credit to MSME Sector, two measures deserve special mention. (1) Launching of Credit Guarantee Scheme in the year 2000 to enhance the confidence of banks in SSI lending. Credit Guarantee Scheme provides for collateral free loan upto Rs. 25 lakh by member lending institutions. Government guarantees 75% of the loan which is made available to borrowers at nominal service charge of 1.5%. Initially the progress of the scheme was slow but now the scheme has started picking up. Loans of more than Rs. 1100 crore have been guaranteed by now.

(2) One of the most important components of the SME credit package announced in August 2005 is the direction to banks to achieve a minimum of 20% year-on-year growth in credit to the SME sector. The objective is to double the flow of credit from public sector banks to SME Sector from Rs. 67500 crore in 2004-05 to Rs135000 crore by 2009-10 i.e. within a period of 5 years. The policy package, it seems has started

showing results since at the end of March 2006, credit to SSI Sector from public sector banks stood at Rs. 82275 crore as against Rs. 67634 crore at the end of March 2005. This gives an annual growth of over 21% thus exceeding the target of 20%.

1.3.2 Micro Finance

A notable development in recent years has been the phenomenal growth of micro-credit to the poor and needy segment considered as altogether non-bankable segment by the banking sector. This has been possible by the initiative of the RBI and the lead role played by NABARD and SIDBI. Though there are 3 accepted models in micro financing in India namely (1) SHG-Bank Linkage model (II) Grameen model (based on Grameen Bank of Bangladesh and (III) Individual Banking Model operated through Micro Financing Institutions (MFIs), the first model is most popular in India.

90% of the micro credit is being disbursed through the SHG-Bank Linkage Model. In fact, with emphasis on capacity building of MFIs and intermediaries, micro credit has transformed to micro financing. The phenomenal growth of micro financing is evident from the fact that the number of SHGs which was 4757 in 1995-96, had increased to 1.83 million by the end of December, 2005 and the volume of credit had increased from Rs. 6 Crore to Rs. 8319 crore during the same period. However, in spite of this phenomenal growth, micro financing has not attained the shape of a movement. There exists a vast gap in demand and supply of credit. As per one study, micro credit requirement was assessed at Rs. 50000 crore for the year 1999-2000. By adding other requirements such as housing loan, education loan and micro-enterprise loan, the upper ceiling of loan requirement was assessed at Rs. 2 lakh crore of micro credit. At present rate of cost escalation and taking the base at Rs.50000 crore, it is estimated that the present minimum requirement of micro credit may be Rs. 70000 crore. As against this, the supply is not more than Rs. 10000 crore.

1.3.3 Innovative Financing

The small enterprises have, so far, depended mostly on banks and traditional modes of financing namely term loan and working capital from banks. Micro finance through MFIs and SHGs, no doubt an innovative means of financing, is

only in its initial stage and at best only an indirect form of bank finance. Unlike large enterprises which raise finance from capital market and external sources like foreign financial investors besides commercial banks, small enterprises and other non-farm enterprises are solely dependent on banks.

With the growing financial need, emergence of new product lines, emergence of risky and untried ventures, it is high time that some innovative means of financing for the non-farm unorganized enterprises are explored. The possibility of linking SMEs, with capital market needs to be explored. Capital market has huge amount of money and institutions like SIDBI will have to design instruments to link SMEs with capital market. The emergence of clusters and with emphasis on making them as the strategy of SME development would make it possible to rope in capital market to SME financing. This will bring new capital to this sector.

Another, innovative instrument to be tried for newly emerging ventures like bio-tech, food processing, IT, pharmaceutical and other knowledge based sectors in India is creation of venture capital funds to meet the equity requirements of these units in the initial phase of their working and the knowledge sector including BPO, KPO, Life sciences, on-line business, technology-enabled design and manufacturing as well as in emerging areas of nano-technology and environmental technology. Some venture funds, have already been set up by SIDBI, SBICAP, etc. Third area of innovative financing, which needs popularization in India, is the development of factoring services. This is necessary since a major problem faced by MSMEs, is delayed payment from the units to whom they have supplied goods. Banks can work as factors on behalf of MSMEs. to collect the dues on their behalf by discounting the bills at nominal service charge. Likewise, other means of financing SMEs, such as lease finance, hire-purchase finance and propagation of incubation centers could be undertaken to inject additional fund to the MSMEs in order to bridge the financial gap.

1.4 FISCAL IMBALANCE

Fiscal imbalance is the term used by governments to describe a monetary imbalance between the national government and smaller, subordinate governments, such as those of states or provinces.

A **vertical fiscal imbalance** occurs when the revenues of different levels of government do not match their expenditure responsibilities. This will necessitate transfer payments from the over endowed party to the under endowed party (vertical fiscal equalization).

A **horizontal fiscal imbalance** occurs when different regions of a country have different abilities to provide services due to different abilities to raise funds. This can occur if regions are able to raise more funds through their tax bases than other regions and/or the cost of provision of services is higher in some regions than in others.

This is usually rectified by weighting transfer payments toward the needier regions (horizontal fiscal equalization).

The discussion of horizontal fiscal imbalance and equalisation was of particular importance in the drafting of the new Iraqi constitution. It was a sticking point for the drafting process—with the oil rich regions seeking to minimise the reallocation of revenue while other regions sought to maximise equalisation payments.

Let us have a deep look into the concept.

"Fiscal imbalance," a term economists invented to describe two conditions in transfers between governments in federal countries, means different things to different people.

The first condition is "vertical imbalance," when one level of government collects more revenue than it spends while another spends more revenue than it collects. The federal government addresses vertical imbalance when it collects revenue from all parts of the country and then returns it in the form of grants to all provinces. A good example is the payment agreed at the recent first ministers' meeting on health. Vertical imbalance and the transfers that address it are normal features of virtually all federal countries.

The second condition is "horizontal imbalance," when richer provinces have the ability to raise more per-capita revenue, and provide more or better services, than poorer provinces. In this case, the federal government transfers additional revenue to poorer provinces to allow them to provide comparable services at tax rates comparable to their richer neighbours. Equalization is a good example of addressing horizontal imbalance.

When people talk of fiscal imbalance, they are mostly referring to vertical rather than horizontal imbalance.

As politicians became involved, the meaning of fiscal imbalance changed. Once the federal government started running surpluses, provinces claimed that an imbalance existed because they had bigger spending needs (especially for health care) than the federal government. Some argued that the federal government should increase transfers to all provinces. Ironically, the approach supported by most provinces, financing increased provincial spending by increasing federal transfers, would actually enlarge the vertical imbalance as economists define it.

Until the recent election, the federal government responded by arguing that it needed its surpluses to increase spending on its own priorities (including health care and child care), reduce taxes and pay down the large federal debt. Given that provincial governments can levy most of the same taxes that the federal government can.

So how are we to judge the actions of the new federal government and the provinces in addressing fiscal imbalance? A good start would be to be clear about what the issue is and is not about.

It is not about whether a vertical imbalance exists. The real question concerns the best way to divide up the taxes Canadians pay. Should the federal government increase transfers to provinces or reduce taxes and let provinces increase them? Alternatively, perhaps the current level of taxation and the way revenues are divided is about right and provinces should look at controlling their spending to keep things in balance.

It is not about whether all Indians should help solve any individual province's deficit problem. It is not about EI or Old Age Security or other federal transfers to individuals or businesses.

1.5 ASSIGNMENT OF FUNCTIONS AND SOURCES OF REVENUE

It was the theoretical framework of the neo-classical economists that had justified the creation of multi-level governments in a country, on the ground that such a system of government would provide optimum level of goods and services at each territorial level, in accordance with the needs and aspirations of the people. Fiscal federalism is a

necessary adjunct of the concept of multi-level government in a federal set-up. Since in a federation, there are several levels of government functioning in their respective jurisdictions, there is the need for creating such an optimum institutional arrangement which combines the advantages of decentralisation as well as economies of scale, associated with centralised form of government. Such an arrangement has to undergo revision from time to time, depending upon the experience of running the federation, changing relationships between different layers of government, reflecting changes in social, political and economic conditions in the country.

1.5.1 Principles of division of functions and finances

All forms of federations are based on compromises, and inter-governmental relations between them are the result of give and take, because in the ultimate analysis, both the federal government and the constituent units have to collect taxes from the same body of tax-payees. Fiscal federalism applies cost-benefit analysis to allocate governmental functions to different territorial levels. Accordingly, that level of government which provides public services at the least cost may be entrusted such functions, and public services where supply does not involve economies of scale, should be decentralised. Such a division of functions ensures economic efficiency in the provision of public goods, accountability of money spent and fiscal autonomy of lower level governments.

Wherever such clear-cut demarcations are not possible and wherever benefits accrue beyond the jurisdiction of local governments, resulting in spill over of benefits and costs, the federation has to work out a system of transfer of resources from the higher to lower levels of government. The general experience is that when functions and resources are divided between different layers of government, the more elastic and productive sources of revenue with nation-wide base, tend to be allocated to the national government and less elastic with immobile and localised base to the lower layers of government. Such a division results in vertical fiscal imbalances between expenditure needs and own-revenue of the local governments.

Despite evolving a scheme of division of functions and finances, there are bound to be tax and expenditure over-lapping which require coordination and harmonisation of expenditure and taxation policies of different layers of governments. Every federation has to face this problem and also frequent encroachments of the higher level government in the legitimate domain of lower level governments. For example, a large number of centrally sponsored programmes in India, numbering more than 250, particularly in such areas which legitimately belong to the domain of local governments, do not find any theoretical support but tantamount to encroachment of the Union government in the legitimate domain of state governments and local bodies. Such conflicts are bound to arise in every federation and have to be resolved through dialogue, mutual understanding and interaction.

1.5.2 Principles of Federal Finance

In every federation, different layers of government should have considerable freedom and initiative to raise and manage their resources, but some degree of control and regulation by higher levels become necessary to ensure coordination between different bodies and also to promote sound financial management. Division of functions leads to division of resources. Local bodies are generally allocated three sources of revenue: (i) Independent sources of revenue - tax and non-tax. (ii) Sharing of specific taxes and other revenues raised by higher levels of governments. (iii) Grants-in-aid. In the absence of independent sources of revenue, local bodies would become the spending departments of the central and state governments. In the allocation of sources of revenue to local bodies, it is necessary to see that the base is local and their collection does not involve elaborate machinery. Resources allocated to different units in a federation must be adequate to meet needs and should be capable of expansion with growing needs. There has to be a balance between direct and indirect taxes, to promote equity in taxation. Prof. B.P. Adarkar has laid down three essential tests of a good federal finance set-up.

(i) Independence and responsibility;

(ii) Adequacy and elasticity, and;

(iii) Administrative economy.

But no cut-and-dried method can solve the problem of fiscal incoherence which all federations have to face.

Tax revenue sharing is the most important element of inter-governmental fiscal relations. This issue has three major dimensions: tax assignment between the federal and sub-national governments, vertical tax sharing between the federal and sub-national governments, and horizontal redistribution of shared tax revenue among the subnational governments.

1.6 FINANCE COMMISSION IN INDIA

The *Constitution of India* provides for the establishment of a **Finance Commission** for the purpose of allocation of certain resources of revenue between the Union and the State Governments. The Finance Commission is established under Article 280 of the *Constitution of India* by the President.

The qualifications, powers and procedures of the Commission itself are regulated by the *Finance Commission (Miscellaneous Provisions) Act* 1951. Such Commissions are deemed to be civil courts for the purposes of the *Code of Criminal Procedure* 1898.

The Finance Commission is constituted to define financial relations between the Center and the States. Under the provision of Article 280 of the constitution, the President appoints a Finance Commission for the specific purpose of devolution of non-plan revenue resources.

The Finance Commission of India came into existence in 1951. The Finance commission is established under article 280 of the Indian Constitution of India by the President of India. The Indian Finance Commission Act was passed to give a structured format to the Finance Commission of India as per the world standard. The need for the Finance Commission was felt by the British for guiding the finance of India. The structure of the modern Act was laid in the early 1920's. The Finance Commission is formed to define the financial relations between the centre and the state. The Finance Commission Act of 1951 tells about the qualification, appointment, term, eligibility, disqualification, powers etc of the Finance Commission.

1.6.1 Functions of the Finance Commission

Under Article 280 of the Constitution the Finance Commission is required to make recommendations to President in respect of:

1. The distribution of net proceeds of taxes to be shared between the Centre and the States, and the allocation between the States, the respective share of such proceeds.
2. The principles which should govern the grants-in-aid by the Centre to States out of the Consolidated Fund of India.
3. The measures needed to augment the consolidated fund of a State to supplement the resources of the Panchayats and the Municipalities in the state on the basis of the recommendations made by the State Finance Commission.
4. Any other matter referred to it by the President in the interests of sound finance.

1.6.2 Implementation of the Recommendation of Finance Commission

The recommendation of the Finance Commission are implemented

- By an order of the President or by executive orders.

1.6.3 Powers of the Commission:

The Finance Commission has the following powers:

- The Commission shall have all the powers of the Civil Court as per the Code of Civil Procedure, 1908.
- It can call any witness, or can ask for the production of any public record or document from any court or office.
- It can ask any person to give information or document on matters as it may feel to be useful or relevant.
- It can function as a civil court in discharging its duties.

1.6.4 Qualifications for appointment and the manner of selection

The Chairman of the Finance Commission is selected among persons who have had the experience of public affairs, and four other members are selected among persons who

- Are, or have been, or are qualified as judges of High Court, or
- Have knowledge of finance, or
- Have vast experience in financial matters and are in administration, or
- Have knowledge of economics

1.6.5 Term of Office of the members

Every member of the commission shall be in the office as specified by the President. He can also be reappointed, provided that he has already addressed a letter to the President for his resignation.

1.6.6 Conditions of service and salaries and allowance of members

- Each member should provide whole time or part time service to the Commission as the President with respect to each case might specify.
- Each member shall receive salaries according to the provisions made by the central government.

1.6.7 Disqualification

A member may be disqualified if:

- He is of unsound mind.
- He is involved in a vile act.
- If his interests are likely to affect the smooth functioning of the Commission.

1.7 PLANNING COMMISSION IN INDIA

India Planning Commission was set up in March, 1950 by the resolution of the Indian government. The Commission for India Planning was established in order to bring about a steady and swift rise in the living standards of Indian citizens.

The government sought to uplift the condition of India's teeming millions by exploiting the country's rich resources (natural and otherwise) efficiently, providing employment opportunities to all, and by increasing the production levels in the agricultural as well as industrial sectors.

The composition of the India Planning Commission has changed a lot since its inception. At the head is the Prime Minister of the country who acts as the ex-officio chairman. The India Planning Commission has a deputy chairman who is nominated and the cabinet members who act as part- time members. The full-time members of the Indian Planning Commission are experts from various fields such as industry, science, general administration, and economics.

In 1951, the 1st 5 year plan was announced and the then Prime Minister, Jawaharlal Nehru was the chairman of that India Planning Commission. Till 1965, 2 consecutive 5 year plans had been formulated. After that, there was a pause in the launch of 5 year plans in India due to the Indo-Pakistan war. Again, in 1969, the 4th five year plan was launched and by 1992, the 8th five year plan was started. In all these 8 plans emphasis has been laid on the public sector, with huge investments being made in heavy and basic industries. But in 1997, with the launch of the 9th five year plan, the emphasis shifted from the public sector and became more indicative in nature.

India Planning Commission has helped in the better utilization of the country's resources for the common good of the citizens. The Planning Commission is considered by many as the backbone of the country's progress and all-round development.

1.7.1 Organisation

The composition of the Commission has undergone a lot of change since its inception. With the Prime Minister as the ex-officio Chairman, the committee has a

nominated Deputy Chairman, who is given the rank of a full Cabinet Minister. Mr. Montek Singh Ahluwalia is presently the Deputy Chairman of the Commission.

Cabinet Ministers with certain important portfolios act as part-time members of the Commission, while the full-time members are experts of various fields like Economics, Industry, Science and General Administration.

The Commission works through its various divisions, of which there are three kind:

- General Planning Divisions
- Programme Administration Divisions

The majority of experts in the Commission are economists, making the Commission the biggest employer of the Indian Economic Services.

1.7.2 Functions of planning commission

The 1950 resolution setting up the Planning Commission outlined its functions as to:

a. Make an assessment of the material, capital and human resources of the country, including technical personnel, and investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation's requirement;

b. Formulate a Plan for the most effective and balanced utilisation of country's resources;

c. On a determination of priorities, define the stages in which the Plan should be carried out and propose the allocation of resources for the due completion of each stage;

d. Indicate the factors which are tending to retard economic development, and determine the conditions which, in view of the current social and political situation, should be established for the successful execution of the Plan;

e. Determine the nature of the machinery which will be necessary for securing the successful implementation of each stage of the Plan in all its aspects;

f. Appraise from time to time the progress achieved in the execution of each stage of the Plan and recommend the adjustments of policy and measures that such appraisal may show to be necessary; and

g. Make such interim or ancillary recommendations as appear to it to be appropriate either for facilitating the discharge of the duties assigned to it, or on a consideration of prevailing economic conditions, current policies, measures and development programmes or on an examination of such specific problems as may be referred to it for advice by Central or State Governments.

Evolving Functions

From a highly centralised planning system, the Indian economy is gradually moving towards indicative planning where Planning Commission concerns itself with the building of a long term strategic vision of the future and decide on priorities of nation. It works out sectoral targets and provides promotional stimulus to the economy to grow in the desired direction.

Planning Commission plays an integrative role in the development of a holistic approach to the policy formulation in critical areas of human and economic development. In the social sector, schemes which require coordination and synthesis like rural health, drinking water, rural energy needs, literacy and environment protection have yet to be subjected to coordinated policy formulation. It has led to multiplicity of agencies. An integrated approach can lead to better results at much lower costs.

The emphasis of the Commission is on maximising the output by using our limited resources optimally. Instead of looking for mere increase in the plan outlays, the effort is to look for increases in the efficiency of utilisation of the allocations being made.

With the emergence of severe constraints on available budgetary resources, the resource allocation system between the States and Ministries of the Central Government is under strain. This requires the Planning Commission to play a mediatory and facilitating role, keeping in view the best interest of all concerned. It has to ensure

smooth management of the change and help in creating a culture of high productivity and efficiency in the Government.

The key to efficient utilisation of resources lies in the creation of appropriate self-managed organisations at all levels. In this area, Planning Commission attempts to play a systems change role and provide consultancy within the Government for developing better systems. In order to spread the gains of experience more widely, Planning Commission also plays an information dissemination role.

1.7.3 Divisions

1. Agriculture Division	18. Monitoring Division
2. Backward Classes Division	19. Perspective Planning Division
3. Communication & Information Division	20. Programme Outcome & Response Monitoring Division
4. Development Policy Division	21. Plan Coordination Division
5. Education Division	22. Power & Energy Division
6. Environment & Forest Division	23. Programme Evaluation Organisation
7. Financial Resources Division	24. Project Appraisal & Management Division
8. Health, Nutrition & Family Welfare Division	25. Rural Development Division
9. Housing, Urban Development & Water Supply Division	26. Science & Technology Division
10. Industry & Minerals Division	27. Social Development & Women's Programme Division
11. International Economic Division	28. Social Welfare Division
12. Secretariat for Infrastructure	29. State Plans Division
13. Labour, Employment and Manpower Division	30. Transport Division
14. Multi-level Planning Division	31. Village & Small Enterprises Division
o Border Area Development Programmes	32. Water Resources Division
o Western Ghat Development Programme	33. Administration & Services Division
	34. Socio-Economic Research Division

Activity 1

1. Give a detailed account of fiscal federalism in India.
2. What do you understand by multi unit finance? Throw light on finance of tiny units in India.
3. Differentiate between vertical and horizontal fiscal imbalance.
4. Write short notes on finance commission and planning commission of India.

1.8 SUMMARY

Fiscal federalism has been introduced in the unit as the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration. After a brief introduction, the prevailing scenario of fiscal federalism was revealed. Multi unit finance which is a great challenge for Indian government was discussed in the later section followed by discussion on fiscal imbalance including vertical and horizontal imbalances. Assignment of functions and sources of revenue were dealt in the next section. The Finance Commission is explained as constituted to define financial relations between the Center and the States. And finally planning commission was described as it bring about a steady and swift rise in the living standards of Indian citizens by effective planning in all areas of economy.

1.9 FURTHER READINGS

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UNIT 2

FISCAL RELATIONS AMONG VARIOUS LEVELS OF GOVERNMENT IN INDIA

Objectives

Upon successful completion of this unit, you should be able to:

- Understand the financial relationship between centre and state
- Know devolution resources and grants
- Explain the theory of grants
- Appreciate the resource transfer from union to state and the criteria of that transfer
- Describe the problems of state resources and indebtness
- Have a quick review of resource transfer from union to state and to local bodies

Structure

2.1 Introduction

2.2 Devolution resources and grants

2.3 Theory of grants

2.4 Resource transfer from union to state and its criteria

2.5 Problems of state resources and indebtness

2.6 Resource transfer from union to state and local bodies

2.7 Summary

2.8 Further readings

2.1 INTRODUCTION

Division of financial powers and functions among different levels of the federal polity are asymmetrical, with a pronounced bias for revenue taxing powers at the Union level while the States carry the responsibility for subjects that affect the day to day life of the people entailing larger expenditure than can be met from their own resources. On an average, the revenue of States from their own resources suffices only for about 50 to 60 percent of States' current expenditure. Since the insufficiency of the States' fiscal resources had been foreseen at the time of framing the Constitution, a mechanism in the shape of Finance Commission was provided under article 280 for financial transfers from the Union. Its function is to ensure orderly and judicious devolution that is deemed necessary from the point of view of avoiding vertical or horizontal imbalances.

The Finance Commission is only one stream of transfer of resources from the Union to the States. The Planning Commission advises the Union Government regarding the desirable transfer of resources to the States over and above those recommended by the Finance Commission. Bulk of the transfer of revenue and capital resources from the Union to the States is determined largely on the advice of these two Commissions. By and large, such transfers are formula-based. Then there are some discretionary transfers as well to meet the exigencies of specific situations in individual States.

These institutional arrangements served the country well in the first three decades after independence. Testifying to the strength of these institutions neither the Union nor the States suffered from any large imbalance in their budgets, although the size of the public sector in terms of proportion of government expenditure to Gross Domestic Product had nearly doubled during this period.

Imbalances have become endemic during the last two decades and have assumed alarming proportions recently. For this state of affairs, the constitutional provisions can hardly be blamed. Broadly, the causes have to be sought in the working of the political institutions. There are shortcomings in the transfer system. For example, the 'gap-filling' approach adopted by the Finance Commission and the soft budget constraints have

provided perverse incentives. The point, however, is that these deficiencies are capable of being corrected without any change in the Constitution.

The institution of the Finance Commission has been one of the major success stories of the Constitution. The broad terms of reference as laid down in article 280(3) are unexceptionable. However, other matters in the interest of sound finance can also be referred to the Finance Commission. These would constitute additional terms of reference. It has been suggested that it would be desirable to associate the States more actively in deciding the additional terms of reference, preferably by having the National Development Council (comprising the Prime Minister and the Chief Ministers of States) to endorse the additional terms of reference. The Commission is not in favour of an amendment of article 280(3)(d) to enable such enlargement of the scope of the Finance Commission. However, it is recommended that terms of reference of the Finance Commission should be broader and comprise of matters which would take care, in a comprehensive way, aspects of the financial relations between the Union and the States. The broadening of such terms of reference could also be discussed earlier by the National Development Council.

Under article 281, the recommendations of the Finance Commission are laid before the Houses of Parliament along with an explanatory memorandum as to the action taken on them. The recommendations are not theoretically binding, although there has been no case so far when the Government of India has deviated from recommendations of successive Finance Commissions. It has been suggested that the Constitution itself should describe the recommendations as an award binding on both the Union and the States. This has been urged in the context of the mechanism of the State Finance Commissions which are set up under articles 243-I and 243-Y which too make only recommendations and not awards. The State Finance Commissions are a comparatively new constitutional mechanism. They would take some time to strike roots in the constitutional soil. Politicians at the Sate level have also to find their bearings in the new landscape where the old landmarks of patronage at the State level have yielded place to a non-discriminatory passage of resources from the State exchequer to the local government institutions. Keeping in view the factors pointed out above the Commission

does not consider it necessary to recommend the amendment of the Constitution to provide for the recommendations of either the Finance Commission constituted under article 280 or of the State Finance Commissions constituted under articles 243-I and 243-Y being treated as awards.

2.2 DEVOLUTION RESOURCES AND GRANTS

It is often said that "India lives in its states". This is obviously true, but it is also increasingly becoming a means of passing on governmental responsibility from central to state levels. Under the Constitution. State governments have always had very significant responsibilities (for law and order. infrastructure development, health, education, agriculture – to name just a few). However, at the same time they have not had commensurate powers either to raise resources or to influence broader trends that create the context or enabling conditions for fulfilling these responsibilities.

The assigning of responsibility to states particularly for economic outcomes is now becoming even more pronounced in the central government. Thus, in the past week Ministers in the Central Government Cabinet have argued that the recent rise in the rate of inflation is the problem of state governments and must be dealt with by them. Yet inflation is so clearly a macroeconomic process that it is obviously determined by aggregate national forces and policies. These include not only fiscal and monetary policies, which are the sole preserve of the central government, but also trade policies and other features that state governments cannot determine but must only respond to.

A wide range of other actions – for example, enactment and enforcement of a Right to Education Bill for the entire country – are being held up or undermined on spurious concerns about federalism. At the same time, it is now common to hear central government spokesmen argue that "the states are now flush with funds" because of the increase in sales taxes and therefore do not require further transfer of financial resources from the Centre. The basic difference between Centre and States – that state governments necessarily face a hard budget constraint unlike the central government – is forgotten in this context. Also, since the state governments cannot impose service taxes, and therefore must exclude the fastest growing segment of the economy from their resource raising

efforts, means that they are at a significant disadvantage compared to the central government in this regard.

The basic means of financial transfer is through the successive Finance Commissions, which are supposed to ensure a fair and equitable devolution of fiscal resources from the Centre to States. However, the terms of reference of recent Finance Commissions have gone beyond the simple allocation of tax revenues between Centre and different States according to a given formula, to allowing and even proposing conditional transfers, even if this goes against the basic principle of federal devolution. Thus, the Eleventh Finance Commission proposed a system of debt relief to states which required them to first pass fiscal responsibility legislation according to parameters laid down by the Centre.

For all the talk of decentralisation, this actually amounts to a greater centralisation of government finances. Direct central allocations to states are increasingly covered by conditionalities, even if they are egregious or unsuitable to the state in question. A case in point is the transfer of funds under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), which requires problematic measures such as the elimination of stamp duty by recipient state governments. Or they are so rigid as to make it difficult to adjust the funding to local requirements, as in the case of the Sarva Shiksha Abhiyan (SSA) where exactly the same norms for expenditure are laid down for all states regardless of differing contexts.

Another attempt to undermine federalism and the authority of elected state governments comes in the arguments for fiscal provisions by the Centre directly to panchayats at district level. With norms for expenditure determined by the Centre, as well as "capacity building" of panchayat members by the Centre. this amounts to an extremely centralised notion of decentralisation, where the real decisions are made at the very top of national government rather than being delegated to states and then to panchayats.

The Thirteenth Finance Commission has proposed to award up to 2.50 per cent of the divisible pool of resources during 2009-14 as grants to local bodies. which includes panchayati raj institutions (PRI) and urban local bodies (ULB).

The basic grant is to comprise 1.5 per cent, whereas up to 1 per cent would be a performance-based component. All states would be eligible. The performance grant is to be effective from 2011-12 and will be 0.5 per cent for 2011-12 and 1 per cent for the next three years. The total recommended grant for local bodies is Rs 87,519 crore.

To ensure proper utilisation, the Finance Commission has proposed that state governments be eligible for general performance grant and special areas performance grant only if they comply with some stipulations.

The performance-based component is to available only to those states who comply with Finance Commission guidelines by 2011-12. This is aimed at improving the functioning of local bodies, ensuring predictability and transparency in transfer of funds, and enhancing the functioning of State Finance Commissions.

The Finance Commission also showed concern on non-utilisation of funds allocated to local bodies by previous commissions. While there was some improvement over 2005-09, compared to those of the 10th and 11th Finance Commissions, still ULBs and PRIs were unable to use 10.6 per cent and 7.4 per cent, respectively, of the money in 2005-09.

In the 12th Finance Commission period, the amount allocated for PRIs and ULBs were Rs 18,000 crore and Rs 4,500 crore, respectively. The amount drawn by PRIs and ULBs in the same period was Rs 16,664.8 crore and Rs 4,024.5 crore.

On property tax collection, the Finance Commission said only about Rs 4,500 crore on this head is collected in a year, the total across 36 cities. It says large cities take in no more than 63 per cent of the total assessment. It suggested local bodies do more to exploit this potential; it wants the collection level in all states to reach at least 85 per cent, which would translate to an addition of Rs 22,000-32,000 crore in a year.

It also wants every state to establish a Central Valuation Board, on the lines of the West Bengal Central Valuation Board, to standardise property assessment and valuation. It also suggested the states institute a geographic information system (GIS) for mapping all properties in cities, which will result in increased coverage.

The Finance Commission also urged states to incentivise revenue collection by local bodies, including mandating some or all local taxes as obligatory. And, that states strengthen their local fund audit departments.

To ensure accountability in states, the Commission said recommendations of any State Finance Commission (on devolution within a state) be implemented without delay and the Action Taken Report be placed before the legislature at the earliest.

2.3 THEORY OF GRANTS

Intergovernmental grants are payments from one level of government to another, such as from the federal government to a state government or from a city to a school district. Intergovernmental grants are widely used in India across a range of policy functions and are an important tool for redistribution in a federalist context. Under the Tiebout hypothesis, providing public goods locally rather than centrally improves match quality between individual preferences and local provision levels and generates competition in efficiency of public goods provision across communities, limiting bureaucratic capture. In a purely local system, however, any spillovers to public spending across local jurisdictions generate inefficient levels of public spending, and the ability to redistribute is limited to within local borders. Intergovernmental grants provide a mechanism to retain some benefits of local provision, while allowing for more optimal levels of public spending in the presence of inter jurisdictional spillovers and increasing the capacity for redistribution.

The economic literature on intergovernmental grants investigates both their fiscal and their non-fiscal effects. Research on the fiscal impact of intergovernmental grants focuses on the extent to which they supplement local revenue formerly dedicated to the programme area, rather than supplanting it. Because intergovernmental grants are used in such a variety of policy functions, they have the capacity – especially if they do not crowd out local revenue – to affect a wide range of non-fiscal outcomes.

2.3.1 Block grants and matching grants

The most important distinction between block grants and matching grants is that matching grants change the relative prices facing the receiving jurisdiction, making the

publicly provided good or service in question relatively cheaper, while block grants provide income but do not change prices. Both types of grant typically are directed to particular agencies or programmes. Block grants transfer funds from one jurisdiction to another, and are theoretically equivalent to the receiving jurisdiction facing a positive income shock from any source. A conditional block grant requires that the receiving jurisdiction spend at least the grant amount on the governmental activity targeted by the grantor jurisdiction. The extent to which the condition is binding depends on the preferences of the receiving jurisdiction. Despite this constraint, the fungibility of grant income makes it difficult to force receiving jurisdictions to increase spending by the full grant amount. Grantor jurisdictions often attempt to address this issue through 'maintenance of effort' requirements, by which receiving jurisdictions are required to

Continue funding the programme to which the grant is dedicated at some set percentage of previous years' levels in order to receive the grant. When a grantor jurisdiction offers matching grants, it sets a rate at which it will match contributions from the grantee jurisdiction. These rates may vary depending on the level of contributions.

Economic theory predicts that a jurisdiction receiving an intergovernmental lump-sum grant targeted to a particular function of government will view the grant as income and spend it as such, with a fraction going to the targeted function, and the remainder going to other projects or to private consumption through reductions in tax rates. Many empirical studies, however, have observed that the marginal propensity to spend an intergovernmental grant on public expenditures is higher than the marginal propensity to spend other income on public expenditures. Arthur Okun called this phenomenon the flypaper effect, because the money 'sticks where it hits' (see Gramlich, 1977). There are three main categories of explanation for these observed effects: (*a*) they are real and reflect the preferences of bureaucrats but not of voters; (*b*) they are real and reflect but are generated by econometric misspecification. Hines and Thaler (1995) describe more specific cases within these categories in detail.

Given the current and historical prevalence of such grants, whether they ultimately supplement, or 'stick to'; local spending is, unsurprisingly, the subject of a lengthy empirical literature, of which Hines and Thaler provide an excellent review.

Studies included typically find that intergovernmental grants increase expenditures on the targeted programme by 25 to 100 per cent of the grant amount, with most estimates clustered at the high end of the range. This is much more than the receiving government's estimated propensity to spend on public programmes out of regular income (here Hines and Thaler estimate that only five to ten per cent of new non-grant income would be spent on public programmes), corresponding to a strong flypaper effect. One of the most convincing studies in their review is that of Ladd (1992), which shows that plausibly exogenous increases in state tax bases (stemming from the fact that some states link their tax base definition to the federal one, and exploiting changes in the federal income tax base following the Tax Reform Act of 1986) generate increases of about 40 per cent in state revenue. Many other studies simply correlate intergovernmental grants with spending, often in a cross-sectional context, without regard to potential bias from the fact that the same factors which make some jurisdictions receive more intergovernmental payments in a particular policy area may also make them have higher demand for public spending in that area.

Several recent additions to this literature have focused more explicitly on isolating exogenous variation in grant levels, and in doing so have yielded much less 'sticky' results. Knight (2002) accounts for political endogeneity in the amount of federal highway aid received by states by exploiting variation in legislative bargaining power due to seniority of state representatives in the US House. His technique reveals significant crowd-out of states' own support of their highway programmes. A number of recent papers focus on the heterogeneity of flypaper effects.

Gordon (2004) shows that governments receiving intergovernmental grants may need time to adjust other revenue sources in response. Federal Title I grants to school districts for compensatory education, based largely on child poverty counts, appeared to stick completely to school spending in the first year following a shock to grant amount after the release of new census poverty data. Three years after the shock, however, there appears to be no effect on spending. Baicker and Staiger (2005) highlight the importance of institutional factors in determining how much receiving jurisdictions are capable of crowding out. In examining state responses to federal Medicaid Disproportionate Share

Hospital (DSH) grants, they find that states which allow different levels of government to transfer funds directly between one another crowded out about half the federal grants. In states without this institutional capacity, the DSH funds were much stickier. Strumpf (1998) shows that the share of local spending on administrative overhead (a proxy for bureaucratic power) predicts the extent to which intergovernmental payments stick to local budgets, supporting a bureaucratic capture explanation of the flypaper effect.

2.3.2 Evidence of non-fiscal impacts

Intergovernmental grants have a wide range of effects, intended and unintended, on non-fiscal outcomes. The intended effects of intergovernmental grants may be due to the productive use of the grant. For example, Baicker and Staiger (2005) go on to show that federal DSH grants have significant impacts on mortality, despite the substantial crowd-out observed. Their findings suggest that the effects on mortality are due to the sticky part of the grant, which improves quality of hospital care. More often, studies evaluate the effect of the total intergovernmental grant amount rather than the effective or sticky grant amount on the outcome targeted by the grant. Such studies may conclude that public spending in that area is not effective, when in fact other revenue was crowded out so that total public spending in that area did not rise.

Jurisdictions making intergovernmental grants may do so to create incentives for the receiving governments that differ from simply spending the payment as designated. For example, Title I of the Elementary and Secondary Education Act of 1965 strengthened incentives for school districts to desegregate in compliance with the Civil Rights Act of 1964, and school districts responded accordingly (Cascio et al., 2005), though Title I funded compensatory education activities rather than desegregation-related costs. The current incarnation of this programme, the No Child Left Behind Act of 2001, similarly uses the threat of losing compensatory education funds as an incentive for schools to meet criteria for academic achievement growth benchmarks.

Finally, intergovernmental grants may create incentives that generate consequences unintended by the granting jurisdiction. For example, Cullen (2003)

attributes 40 per cent of the significant rise in the special education classification of Texas public (government) school students from 1991 to 1996 to increased payments from the state to districts on a per-classified-student basis.

2.4 RESOURCE TRANSFER FROM UNION TO STATE AND ITS CRITERIA

The constitution of India provides independent revenue raising and spending power to both the central and the state governments. It also admits the existence of vertical imbalances in taxing power. The expenditure responsibilities of the state governments on the other hand are higher. The constitution thus directs the central government to transfer resources. Transfers by the central government are meant to bridge the gap between resources required by states to meet their assigned responsibilities and the resources they can raise themselves. Three-tier transfer mechanism exists in India. The central government transfers funds in India via Finance Commission, Planning Commission and discretionary transfers through various union ministries and agencies. Low taxing power and high expenditure responsibilities make the state governments dependent on the central government for resources. Transfer from the centre covers large part of revenue of the state governments. In this chapter we have studied the impact of intergovernmental transfer on the state fiscal performance.

The review of literature (Rao and Singh (1998a), Rao (1998b), Rao (2000), Bajpai and Sachs (1999), Sen and Trebesch (2004)) on state finances and the intergovernmental transfer mechanism in India indicates that most of the studies have examined the vertical and horizontal imbalances in the federal transfer mechanism and how the design of transfer system can be improved to distribute resources equitably. Ma (1997) evaluated the intergovernmental transfer mechanism of different countries and suggested methods of determining fiscal capacities of provinces.

2.4.1 Rules applied in transferring resources in India

In analyzing intergovernmental transfer mechanism in India it is very important to know the criteria used by different finance and planning commissions. In India, Finance Commission (FC), Planning Commission and different central ministries transfers resources to the states on the basis of a few criteria. In this section we have discussed

about the criteria used by different Finance and Planning Commissions. Finance Commission's (FC) transfer criteria used by different finance commissions in giving grants in aid and sharing income tax and excise tax are summarized in the following table.

The federal grants create some fiscal effects on the budgets of the unit government. Though different types of grants create different effects, all grants in general increase the fiscal resources available to the unit government to finance public servicc_ or to lower their tax/revenue effort. Hence, the federal resource transfer policy in any multi-tier Government needs to be designed to strengthen the resource position of the sub-central units. The extent of own effort of a sub-central unit in meeting their expenditure requirements or the tax effort criterion must play a significant role in this regard. Theories on fiscal federalism argue that expenditure assignment must precede tax assignment. 'This is because tax assignment would in general be guided by expenditure requirements and these can't be worked out in advance of expenditure assignment. However in India tax assignment was undertaken independently of expenditure assignment. Moreover the basic framework of tax and expenditure assignment is based on the government of India Act 1935 which becomes irresponsive to meet the changing developmental needs of the States and suffer from relative inadequacy, inelasticity, stickiness and lack of buoyancy. The 1935 Act was designed to cater to the requirements of administrative consolidation than of developmental acceleration. Economic and Social

Planning inaugurated in 1950 to accelerate the growth process in India. All the expanding developmental functions were assigned to the States. Different strategies have been followed during the plan era. Then liberalisation policy has been proposed and implemented since 1991. However, the Indian federal system assumes a fairly rigid bifurcation of power and resources between the Union and States curbing any flexibility to meet the changing requirements. Under such rigid institutional arrangement, there are three types of Union resource transfers to States, mainly to correct vertical and horizontal imbalances via. Finance Commission, Planning Commission and discretionary transfers through various Union Ministries and agencies. While recommending the resource transfers from the Union to States, the statutory as well as nonstatutory bodies like

Finance Commission and Planning All the Finance Commissions have laid emphasis on the tax efforts of the States. Fifth Finance Commission went to the extent of measuring tax effort for devolution purpose and the Sixth Finance Commission went against the use of it and the rest showed their sincerity somewhere in between these two extremes.

Generally, States are dependent on resources which flow from the Union. But both the current mechanisms of the resource transfer, either by way of plan assistance from Planning Commission or States' share in the Divisible Pool of Taxes, little weightage is accorded to revenue generation and prudent management. Both these mechanisms seem to put a premium on inefficiency and backwardness. It may be desirable to give greater weightage to developmental efforts and efficiency in use in resource transfers. Economists like Dr. Montek Singh should find an appropriate remedy for this thorny issue which is likely to cause heart-burning among performing States. Constitution of a Revolving Fund – a mix of grant and soft loan – for augmenting resources of some of the States who get adversely affected in the current dispensation of resource transfer from Centre, may be considered

1st FC	Grants	(i)For seven states to cover their deficits during the period 1951-56; (ii) For eight states to improve their primary education facilities
	Share in taxes	Income taxes were shared in the following way: 80 percent on the basis of population and 20 percent on the basis of revenue collection of the state. 40 percent of the net proceeds of excise duties were to be distributed among the states on the basis of population.
2nd FC	Grants	Larger grants in aid for meeting development needs of states
	Share in taxes	Income taxes are to be distributed in this way-90 percent pf tax collection was to be distributed on the basis of population and 10 percent on the basis of revenue collection. 25 percent of the net proceeds from excise duties were to be distributed among states.
3rd FC	Grants	(i) Rs. 550 crores to all states except Maharashtra to cover part of their revenue expenditure; (ii) Rs. 45 crores for improvement of communications
	Share in taxes	For income taxes, 80 percent was distributed on the basis of population and 20 percent on the basis of revenue collection of the state. In case of excise tax there is an increase in the number of commodities in the divisible pool from 8 to 35 by including all commodities on which duties were collected in 1960-61 but reduced the state's share from divisible pool from 25 percent to 20 percent.
4th FC	Grants	Rs. 610 crores to cover deficits during the period 1966-71
	Share in taxes	80 percent on the basis of population and 20 percent on the basis of revenue collection of the state income taxes were shared. In case of excise tax the number commodities had been increased to 45. The share of commodities was retained at 20 percent.
5th FC	Grants	Rs. 638 crores to cover deficits during the period 1969-74
	Share in taxes	Population was the major criterion of devolution of income tax. Did not make any change for excise taxes.

6th FC	Grants	Rs. 2510 crores for fourteen out of twenty one states to cover their non-plan revenue deficit
	Share in taxes	Population became the major criterion of devolution of income tax Did not make any change for excise taxes.
7th FC	Grants	Rs. 1600 crores to cover deficits of a few poor states during the period 1980-85 and also to upgrade the standard of administration
	Share in taxes	Population became the major criterion of devolution of income tax. For excise taxes, 7th FC raised the state's share to 40 percent of the net proceeds. 25 percent weightage was equally given to population, increase in per capita income of the state, the percentage of poor in each state, a formula for income equalization between states.
8th FC	Grants	(i) A small grant of Rs. 1556 crores for the period 1985-90 to cover deficit; (ii) A grant of Rs. 915 crores to certain states to upgrade the standard of administration
	Share in taxes	For income taxes, (i) 10 percent on the basis of income tax collection. (ii)Out of remaining 90 percent, 25 percent on the basis of population,25 percent on the basis of inverse of per capita income of the state multiplied by population. 50 percent on the basis of the distance of per capita income of a state from the highest per capita income state multiplied by population of the state. For excise tax 8th FC raised state share to 45 percent and introduced the same formula as 7th FC for 40 percent of proceeds and retained 5 percent share to distribute that among deficit sates.
9th FC	Grants	(i) Grant of Rs. 15017 crores to cover deficits of plan and non-plan revenue account during 1990-95. (ii) A special annual grant of Rs. 603 crores towards centre's contribution o the calamity relief fund-totaling Rs. 3015 crores for five year period, 1990-95. (iii) A grant of Rs. 122 crores to Madhya Pradesh towards expenditure on rehabilitation and relief of victims of Bhopal gas leak.
	Share in taxes	For income tax, 9th FC basically followed the above formula with minor modification. Ninth FC added one more criterion, that is, backwardness

		of sates based on population of scheduled castes and scheduled tribes, number of agricultural labourers in different states as revealed in 1981 census. According to NFC the composite index would correctly reflect poverty and backwardness of a state in large measure. The states having larger share of these components were required to bear substantial expenditure responsibilities. For excise taxes, 9th FC proposed to distribute the entire amount of 45 percent as a consolidated amount. The formula used was: 25 percent on the basis of 1971 census, 12.5 percent on the basis of index of backwardness, 33.5 percent on the basis of per capita income of the state from highest per capita income state. 12.5 percent on the basis of income adjusted total population, 16.5 percent among states with deficits, after taking into account their shares from all sharable taxes.
10th FC	Grants	(i) Grant of Rs. 15017 crores to cover deficits of plan and non-plan revenue account during 1990-95. (ii) A special annual grant of Rs. 603 crores towards centre's contribution to the calamity relief fund-totaling Rs. 3015 crores for five year period. 1990-95. (iii) A grant of Rs. 122 crores to Madhya Pradesh towards expenditure on rehabilitation and relief of victims of Bhopal gas leak.
	Share in taxes	For income taxes, 10th FC proposed (i) 20 per cent on the basis of population of 1971. (ii) 60 per cent on the basis of distance of per capita income of a state from that of state having highest per capita income.(iii)5 per cent on the basis of area adjusted. (iv) 5 percent on the basis of index of infrastructure. (v) 10 percent on the basis of tax effort. 9th FC distributed 47.5 percent of net proceeds from excise taxes among states. Using the same formula as used in sharing of income taxes. 40 percent of excise taxes were distributed among major states. Remaining 7.5 percent taxes were distributed among deficit states.
11th FC	Grants	(i) Rs. 35,359 crores was provided among states facing revenue deficit after devolution of grants. (ii) For upgradation of administration and special problems associated with certain states Rs. 4793 crores was

		provided. (iii) A total grant of Rs. 10000 crores has been provided to support local bodies at the panchayat level and municipalities at the urban level. To panchayats Rs. 8000 cores and to municipalities Rs. 2000 crores for the five year period (2000-05) were provided.
	Share in taxes	(i) 10 percent on the basis of population. (ii) 62.5 percent on the basis of distance of per capita income from that of state having highest per capita income. (iii) 7.5 percent on the basis of are. (iv) 7.5 percent weight is given to index of infrastructure. (v) 7.5 percent weight is given to fiscal discipline.

2.5 PROBLEMS OF STATE RESOURCES AND INDEBTNESS

Poverty has many dimensions and stems from several factors – economic, social and cultural. Although lack of opportunities for livelihood (economic) and denial of opportunities (social) are largely seen as a major causal factor for poverty, indebtedness is considered as important manifestation of household poverty in India. Related to this are issues of economic growth, socio-economic equity, access to and control over productive resources, gainful employment and income, and lack of implementation of labour standards. Indebtedness impacts differently on various classes of household and also has a bearing on intra household differences. Given the varied inter linkages between indebtedness and other socio-economic welfare dimensions; it has come to be seen as a crucial variable that must be addressed by policy makers. Despite a multitude of measures taken in this regard, chronic indebtedness and a structural inability to overcome bondage continues to plague poor households in rural India. Indebtedness has clearly become a way of life but over a certain threshold of debt repayment/income, it prevents families to access basic amenities and has an important disempowering effect on them. It is accentuated in the Indian context by lack of access to affordable credit and has now been recognised as another significant contributory factor.

The poor like the proverbial Indian farmer is born with debt, lives with and dies with debt. It is not so much debt per se, but the price paid for the debt, which makes them poorer. The predatory lending practices of indigenous moneylenders charging usurious rate of interest have been perpetuating the legacy of poor's debt bondage.

ii) A minimum revenue collection from the Panchayat taxes be insisted;

iii) Incentive grants related to revenue collection beyond a prescribed minimum be introduced by the State government;

iv) User charges be made obligatory levies;

v) All common property resources vested in the village Panchayats may be identified, listed and made productive of revenue;

vi) Valuation of taxable lands and buildings should be done by a separate cell in the Panchayati Raj Department of the State Government and not left to the panchayats;

vii) Powers to levy a tax/surcharge/cess on agricultural holdings should be given to the intermediate or district Panchayats;

viii) Revenue transfers from the States to Panchayats in the form of revenue sharing/revenue assignment be made statutory in nature;

ix) State Governments should desist from unilaterally taking decisions in regard to revenues whose proceeds are to be transferred either in full or in part to the panchayats;

x) The quantum of revenue that a Panchayat can reasonably expect under the revenue sharing mechanism should be predictable;

xi) State Government should adhere to its commitment in regard to the grants-in-aid; all untied grants to the panchayats should be made statutory in nature;

xii) SFC should be constituted for a lifespan of 18 months and a time limit of six months is prescribed for a State government to act on the SFC recommendations;

xiii) The maintenance of accounts by the Panchayats be standardized; Panchayat department officials should not be made statutory auditors of the village Panchayats; the accounts of the intermediate and district Panchayats be subjected to audit by Comptroller and Auditor General (C&AG);

xiv) A performance audit system is adopted.

MONITORING AGENCIES

- Every State shall constitute a High Level Committee (HLC) to ensure proper utilisation of Local Bodies Grants.
- This HLC shall be headed by the Chief Secretary to the State Government and will include Finance Secretary and Secretaries of the concerned Departments as members.
- HLC shall be responsible for the following:
  - a. Approval of the projects at the beginning of every year to be undertaken in each sector, quantify the targets, both in physical and financial terms and lay down a time-table for achievement of specific milestones;
  - b. Monitoring both physical and financial targets and ensuring adherence to the specific conditionalities in respect of each grant, wherever applicable;
- HLC shall meet at least once in every quarter to review the utilisation of grants and to issue directions for mid-course correction, if considered necessary. Minutes of HLC meetings shall be provided to the Department of Expenditure (Finance Commission Division), Ministry of Finance, Government of India for information.
- A Central Review Committee will be constituted in the Government of India, headed by Secretary to Government of India, Ministry of Finance, Department of Expenditure to review the releases and utilisation of grants. The Committee will include representatives from the Ministry of Panchayati Raj, Ministry of Urban Development and Poverty Alleviation, Ministry of Home Affairs and Ministry of Finance (Department of Expenditure). The Committee shall meet at least once in a year.
- Given the much higher quantum of grants and larger number of rural local bodies, a separate Committee for Panchayati Raj Institutions (PRIs) will be constituted to monitor the mode of release of local body grants to Panchayats as mentioned in

the guidelines from para 6.1 to para 7. The Committee will be chaired by Secretary to Government of India, Ministry of Panchayati Raj with the Joint Secretary (State Finances) and Financial Adviser (Panchayati Raj) as Member and Jt. Secretary (Panchayati Raj) as Member Secretary. The Committee shall meet at least once in a quarter. This Committee shall bring out the points for intervention by Government of India in Ministries of Panchayati Raj and Finance to ensure smooth and uninterrupted flow of funds to PRIs.

2.6.4 MODE OF RELEASE OF LOCAL BODY GRANTS TO STATES

Local bodies grants will be released in two equal installments in July and January every year. States have to mandatorily transfer the grants released by the Centre to the PRIs and ULBs within 15 days of the same being credited to the State's account. Also, Panchayats as defined in the Constitution can exist only when they are constituted as per the mandatory provisions of Articles 243B and 243 C. Hence, grants will not be provided to a State (which is covered under Part IX of the Constitution) where elections for constituting these Panchayats have not been held for the period for which there were no elected panchayats as per the provisions of the Constitution.

Two sets of details, one on allocation of funds and another on release of funds, will be reported by the State Government in the format prescribed at Annex – II for the purpose prior to the release of each installment by the Government of India. However, the first six monthly installment for 2005-06 shall be released to a State after receiving only the details (in the above said format) of the allocation of these funds to the PRIs and ULBs in that State. All subsequent installments shall be released after receiving both sets of details – the certificate of the release of funds to the PRIs and ULBs for the previous installment and the information about allocation of funds for the subsequent installment. For the first installment for 2005-06, information on allocation upto district level alone

needs to be sent by the State. For the subsequent releases, the breakup of the allocation to each PRI and ULB at the three levels should be provided.

The States are advised to inform Government of India about allocated share of each PRI and ULB at all levels before October 31, 2005. The certification and allocation information (as per the format) may please be sent to the Ministry of Finance both in hard copy as well as on a magnetic media (e.g. floppy or CD). State Finance Secretary would be required to providé a certificate within 15 days of the release of each installment by Government of India under his signature certifying the dates and amounts of local grants received by the State from the Government of India, and the dates and amounts of grants released to the PRIs and ULBs. This certification and information will be in the above mentioned format.

State Finance Secretary would also be required to provide a certificate every year of the percentage of grants spent by the ULBs on schemes of solid waste management and on schemes of water supply and sanitation by the PRIs. States would also be required to provide details of recurring O&M cost recoverable by the PRIs on schemes of water supply. The second installment of local bodies grants for the year 2005-06 shall be released upon receipt of the release certificate for the previous installment and allocation information for the subsequent installment referred to in para 6.2 . In case of delayed transfer to PRIs / ULBs beyond the specified period of 15 days, the State Government shall transfer to PRI / ULB amount of interest at the rate equal to the RBI Bank rate along with such delayed transfer of grants.

The second installment from the year 2006-07 would be released on receipt of the certificate referred to in para 6.3 in addition to the release certificate and allocation information referred to in para 6.2. Government of India will withhold the amount short spent on the schemes of solid waste management by the ULBs and on schemes of water supply and sanitation by the PRIs. The withheld amount will be subsequently reimbursed upon confirmation that the short spending has been compensated in the subsequent period.

2.6.5 AUDIT BY THE COMPTROLLER AND AUDITOR GENERAL OF INDIA

Comptroller and Auditor General of India would be expected to audit the release and use of the local body's grants within the time and for the purposes mentioned by the TFC, reproduced above. Government of India may take appropriate decision about withholding grants of a State if the Comptroller and Auditor General of India reports that the State has either not transferred the grants to the local bodies or has allowed the grants to be used for purposes other than for which these are being provided or that local bodies have not been able to give priority to spend on the O&M of water supply and sanitation for the rural areas and on schemes of solid waste management in the urban areas.

Annex- I

Shares of States in Allocation (2005-10)

Sl.No.	STATE	Panchayats		Municipalities	
		Per cent	(Rs. Crore)	Per cent	(Rs. Crore)
1	Andhra Pradesh	7.935	1587.00	7.480	374.00
2	Arunachal Pradesh	0.340	68.00	0.060	3.00
3	Assam	2.630	526.00	1.100	55.00
4	Bihar	8.120	1624.00	2.840	142.00
5	Chhattisgarh	3.075	615.00	1.760	88.00
6	Goa	0.090	18.00	0.240	12.00
7	Gujarat	4.655	931.00	8.280	414.00
8	Haryana	1.940	388.00	1.820	91.00
9	Himachal Pradesh	0.735	147.00	0.160	8.00
10	Jammu & Kashmir	1.405	281.00	0.760	38.00
11	Jharkhand	2.410	482.00	1.960	98.00
12	Karnataka	4.440	888.00	6.460	323.00
13	Kerala	4.925	985.00	2.980	149.00
14	Madhya Pradesh	8.315	1663.00	7.220	361.00

15	Maharashtra	9.915	1983.00	15.820	791.00
16	Manipur	0.230	46.00	0.180	9.00
17	Meghalaya	0.250	50.00	0.160	8.00
18	Mizoram	0.100	20.00	0.200	10.00
19	Nagaland	0.200	40.00	0.120	6.00
20	Orissa	4.015	803.00	2.080	104.00
21	Punjab	1.620	324.00	3.420	171.00
22	Rajasthan	6.150	1230.00	4.400	220.00
23	Sikkim	0.065	13.00	0.020	1.00
24	Tamil Nadu	4.350	870.00	11.440	572.00
25	Tripura	0.285	57.00	0.160	8.00
26	Uttar Pradesh	14.640	2928.00	10.340	517.00
27	Uttaranchal	0.810	162.00	0.680	34.00
28	West Bengal	6.355	1271.00	7.860	393.00
	Total	100.000	20000.00	100.000	5000.00

Activity 2

1. Write a note on devolution resources. What do you understand by theory of grants?
2. Discuss in brief, problems of state resources and indebtness.
3. Write a short essay on resource transfer through different levels of Indian government.

2.7 SUMMARY

The unit revolves around the notion that fiscal federalism is a necessary adjunct of the concept of multi-level government in a federal set-up. Since in a federation, there are several levels of government functioning in their respective jurisdictions, there is the need for creating such an optimum institutional arrangement which combines the advantages of decentralisation as well as economies of scale, associated with centralised form of government. Such an arrangement has to undergo revision from time to time, depending upon the experience of running the federation, changing relationships between different layers of government, reflecting changes in social, political and economic conditions in the country. In this light unit discusses the devolution resources and grants

followed by theory of grants. It further explains the problems of state resources and indebtness and finally discusses resource transfer from union to state to local bodies.

2.8 FURTHER READINGS

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