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Principles of Public Finance

1. PUBLIC FINANCE– DEFINITION

Public finance deals with the process of raising public revenue and spending public funds. Public revenue has to be properly adjusted with public expenditure. Therefore, in Dalton's view "public finance deals with the income and expenditure of public authorities and with the manner in which the one is adjusted with the other." There are definite principles governing the mobilisation of public finance and their spending. These principles are the subject-matter of public finance.

Public finance deals with the financial aspects of the conduct of government. There are three different levels of government–federal government, state government and local government. In Harlod Grove's view, public finance is a field of enquiry that treats of the income and outgo of governments (federal, state and local). In modern times, this includes four major divisions- "public revenue, public expenditure, public debt and certain problems of fiscal system as a whole, such as fiscal administration and fiscal policy."

In modern times governments are concerned with the satisfaction of public wants such as those of public health, recreation, means of transport and communication etc. Money has to be collected for these purposes. Thus, Ursula Hicks says that "The main content of public fund (finance) consists of examination and appraisal of the methods by which governing bodies provide for the collective satisfaction of wants and secure the necessary funds to carry out their purpose."

2. PUBLIC FINANCE VERSUS PRIVATE FINANCE

Private finance is concerned with the income and expenditure of an individual person while public finance deals with the revenues and expenditures of public institutions and their mutual relationships.

If we have a simple look at both, there does not seem to be any fundamental difference between public finance and private finance. Both public finance and private finance are based on similar principles. Both require some type of management. First, both are concerned with income and expenditure and the problem of adjustment between the two. Secondly, lack of proper management can lead to serious consequences in both. Thirdly, both are concerned with the achievement of maximum satisfaction. Just as an individual consumer wants to obtain the maximum satisfaction from spending his income, the government tries to promote the maximum social advantage. In other words, we can say that both private institutions and public institutions spend according to the law of Equi-marginal utility.

In spite of these broad similarities between private finance and public finance, we cannot say that the two operate on identical lines. Both have their own peculiar features. There are marked differences between the two. These differences are as under :

1. *Compulsory character of public finance.* An important feature of public finance is the element of compulsion which the government can impose on the tax-payers. Nobody can say no to a tax. The government has the authority to recover the taxes by attaching the property of a person. On the other side, private finance is without an element of compulsion. No person can force another person or institution to give a loan.

2. *Relation between income and expenditure.* In private finance, an individual adjusts his expenditure to his income. In public finance a government plans to raise revenue according to the planned expenditure. There is an old saying that one must cut one's coat according to one's cloth. Therefore, individuals try to live within their means. But there is no such rigid limit for a government. This is because a government has the authority to impose additional taxes to raise more revenue. Even then, if the revenues are less than the expenditure, the finance minister can raise a public loan.

3. *Possibility of change in income and expenditure.* A government can bring about the desired change in its income and expenditure, but a person cannot do it. Every person wants to raise his income and standard of living but how many are really able to do it immediately ? But a government can successfully change the income and expenditure radically if the national interest so demands it. If the political power is in the hands of a socialist party, revolutionary changes in revenue and expenditure of the government are brought about.

4. *Possibility of raising the loans.* A government has much better possibilities of raising loans from within the country and from outside than an individual. This is because people in the country and outside have great confidence in a government and little confidence in a company. Public finance can rely on internal financing through public loans or even by printing additional notes called deficit financing. But an individual has no such possibilities of internal financing.

5. *Deficit financing.* If an individual has more expenditure than his income, then he has to find the means of overcoming the deficit. He has to spend sleepless nights. But in Public finance, there is an easy way out of a deficit. This is what is called deficit financing. The deficit can be covered by printing the paper currency notes equal to the difference between revenue and expenditure. This is also the way government can avoid direct taxation of the general public and yet obtain finance.

6. *Public nature of public finance.* Private finance is generally kept a secret. This is because it is helpful for an individual if others do not know his real financial position. But public finance is an open book. The government has to publish its annual accounts, present it to parliament and obtain its approval. The budget is debated and criticised. It is only when the budget is voted and passed that the government is able to spend money.

7. *Preference between the present and the future.* In public finance, the finance minister has to be farsighted. The State is considered to be as much considered to the next generation as to the present generation. Government spends huge amounts on public welfare schemes, public works and social security schemes on which there is little or no immediate return. The return comes in the long period. As against this, an individual is keen to use his property and other wealth in his life time only. Life is so uncertain for him that he is concerned only with the present. But a society has a long life. Therefore, the government has to draw long-term plans for its welfare.

8. *Budgeting period.* In public finance, an annual budget is prepared on systematic lines. The budget contains revenue account and capital account. But in private finance, a monthly budget is prepared with some saving for the annual and long-term purchases. There is a regular organisation or government department dealing with public finance. Private finance has no such organisation.

9. *Surplus budgeting.* A wise person is supposed to have less expenditure than his income. Saving is considered a virtue for him. But a surplus budget is not considered to be wise policy for a government. A surplus budget may be criticised on two grounds. One, that there is unnecessary taxation which is resulting in a surplus. Second, that expenditure is not properly planned and that important schemes of social welfare and national construction are not being properly implemented. Therefore, most of the budgets are either balanced or deficit.

10. *Pre-determined policy.* Public finance is based on a specific economic policy. In developed countries of the world, the goal of public expenditure is achieving full employment. In less developed countries, the objective of public expenditure is to promote production and employment. Thus, public finance is used to promote national welfare. In private finance, there is no such pre-determined policy. The nature of expenditure of a person depends upon his habits, customs, his economic and his social conditions.

11. *Difference in motives.* Private finance is used to obtain more and more profit. Public finance is meant to promote the maximum good of the maximum number of persons. Private finance is profit motivated. Public finance is public welfare- motivated. The efficiency of a firm is judged by the profit it earns. The performance of public finance is measured by the improvement in the lot of the people.

12. *Possibility of Using the Law of Equi-marginal utility.* In private finance, the expenditure of a person is based on the law of equi-marginal utility. This ensures the maximisation of utility for him. In public finance, the ideal is to obtain the maximum social advantage by equating the social marginal productive of the items of public expenditure. But in practice, the rule is not easy to enforce. First, it is not easy to measure and compare the marginal productivities of different items of expenditure in public finance. Public health, defence, public education and public recreation are widely different activities whose social productivities cannot be easily compared. Secondly, governments incur public expenditures on items which are not having top priority from the national viewpoint. As a result, it is not possible to maximise social productivity of public expenditure.

On the basis of the study of the similarities and differences in private finance and public finance made above, we can say that public finance has to be studied through principles and policies concerning the nation as a whole. The similarities between private finance and public finance are only superficial. The differences are material and real. Therefore, public finance has built up its own method of study.

3. PUBLIC GOODS AND PRIVATE GOODS

The distinction between public goods and private goods is of great importance in public finance. A simple distinction between public goods and private goods is that the public goods are consumed by people at large jointly while private goods are consumed alone by an individual or a family. A bridge on a river built by the government and open to the general public is an example of a public good. A private house in a beautiful locality is an example of a private good. From these examples, we can conclude that public goods have a peculiar nature. Public goods have characteristics which are not to be found in private goods. To be more clear about public goods we can give the following definition.

Public goods are those goods whose consumption is necessarily joint and equal. In other words, public goods are jointly-used goods and their consumption by one individual is not at the cost of consumption of the good by another individual. For a good to be called a public good, two conditions must apply :

(*a*) **Non rivalry in consumption.** This means that a public good is always open to enjoyment of the general public. If the good is provided to one person, the others automatically come to enjoy. For example, a link road built to join a milk plant with a city is open to use of the general public also. There is no-rivalry in consumption because the milk vans are not always and fully using the road.

(*b*) **Non-excludability.** This means that the public goods are such that the general public cannot be excluded from the benefit of the good. For example, if defence services are provided to the rich, the poor people also get the benefit.

Against this background, we can define a *private good as that good whose consumption by one person in necessarily rival to the consumption of that good by another person and whose use can be exclusively made by one person easily.* An example of a private good is a private house which has no other user. And, secondly, the owner is able to keep others out by a boundary wall and gate.

Failure of the Market Mechanism in the Case of Public Goods

Public goods are sharply distinguished from private goods by the fact that normal market mechanism fails to the needed supply of the public goods for the consumers. Since public goods are jointly demanded, the market mechanism fails to induce consumers to reveal their preferences for such goods. If the citizens of a locality are asked as to how much they are individually willing to pay if a road is constructed for their benefit, then they will not reveal their true preferences. This is simply because everyone benefits from the road whether he pays or not. As a result, it is very difficult to recover the cost of public good from those who benefit from it. As a result, public goods are much short in supply. Everyone enjoys the benefits of such things are national defence, noise and smoke reduction, clearance of areas that produce infectious diseases and building of parks, no matter who pays for it. But everyone tries to evade the cost of paying for these. So the supply of these public goods is much less than needed.

Another reason for the failure of the market mechanism in the case of public goods is that there is no market test to establish the "proper" quantity of public goods. It is only through a political decision with the help of voting that the quantity of public goods which ought to be provided can be determined. Thus, it is clear that much of the problem of public finance is that of the supply of public goods.

Types of Public Goods

Public goods can be classified into three types : (*a*) pure public goods, (*b*) quasi-public goods, and (*c*) public bads.

Pure public goods are those which have a joint consumption and every consumer has equal consumption whether one pays or not. Moreover, there must be no rationing of supply of a pure public good because limitations on quantity supplied is just like charging a price. There are hardly any examples of pure public goods. Only defence or police come close to being pure public goods.

Quasi-public goods are those which do not fulfil both the conditions of a pure public good. Roads, police protection, parks, playgrounds, educational institutions and health centres are all examples of quasi-public goods. Take the case of education. The economic benefits of education are largely personal and divisible. The inputs into the educational system such as teachers, buildings and equipment are bought and sold in private markets. Yet education is surely a public good because the benefits of education also go to those who have not paid for it and it is not possible to exclude the less educated from getting the benefits of highest education. We therefore call education a quasi-public good.

Public 'bads' are the converse of public goods. An example of a public bad is pollution from smoke. Take the case of factory located in a residential area. The smoke from the factory chimney fouls the air around. It is harmful to the health of the residents in the area. Everyone has to bear it. So the smoke is jointly consumed. Secondly, no one resident will be prepared to pay for the movement of the factory to an industrial area. If a group of citizens agrees to pay the cost those not paying for it cannot be excluded from enjoying the benefit. Thus, air pollution from factories is a public bad.

From the discussion given above, we can conclude that the distinction between public goods and private goods is not so easy as it seems at first sight. There are many goods which are of a mixed type. They are of partly public and partly private nature. This fact has important effects on public finance and public policy. These days governments are having public enterprises which compete with private enterprises and are expected to earn a profit.

3A. THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

The principle of Maximum Social Advantage was introduced in public finance by Professor Pigou and Dalton. *The principle states that the state should collect revenue and spend the money so as to maximize the welfare of the people.* Collection of revenue through taxes gives disutility to people . It involves a social cost. On the other side, public expenditure creates social utility. Professor Pigou wanted the government to so adjust the size of the budget that the social advantage (total utility-total disutility) is maximized.

According to Professor Dalton, public expenditure in every direction should be carried just so far that the advantage to the community of a further small increase in any direction is just counter balanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other source of public income. This gives the ideal total both of public expenditure and public income. This principle implies that with every additional unit of tax raised, the burden of sacrifice will go on increasing and the amount of benefit obtained from additional public expenditure goes on diminishing. Thus, a point is reached where the benefit derived from a unit of money spent by the state will be just equal to the sacrifice imposed in rasing that unit of revenue. At this point the state must stop collecting more revenue and incurring more expenditure because this is the optimum size of the public finances.

Professor Pigou went farther to say that the distinction of public expenditure on different heads must be so planned as to give the same social marginal utility in all uses *i.e.* the principle of equi-marginal utility should be applied to public finances also. On the taxation side, Prof. Pigou advocated that the burden of taxation on different sources should be distributed according to the principle of least aggregate sacrifice. He wanted that the burden of taxation should be so distributed on different sources that the marginal sacrifice of each source is the same.

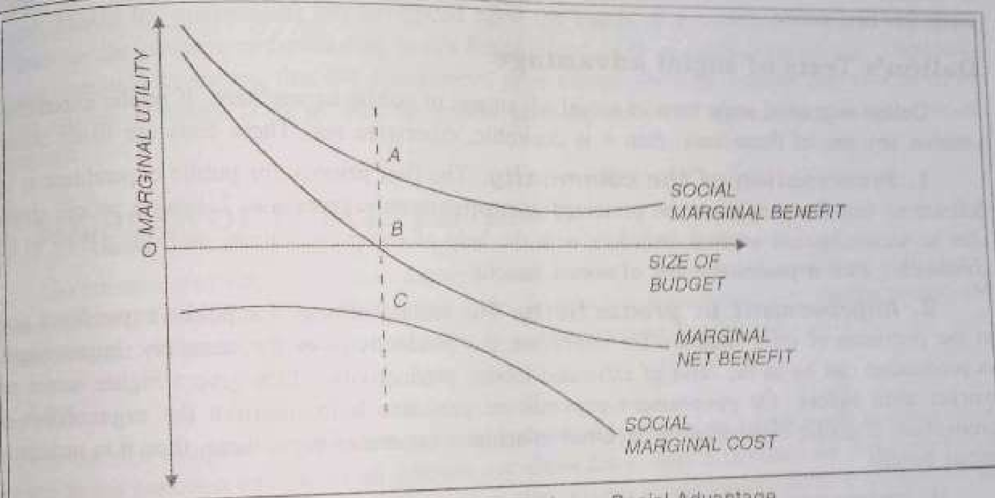


Fig. 28.1 The Principle of Maximum Social Advantage

Musgrave's views on the Principle

Professor R.A. Musgrave further developed the Principle of Maximum Social Advantage. He explained the principle with the help of a diagram.

Figure 28.1 shows in the upper portion the marginal utility of the successive dollars of public expenditure allocated optimally between public uses and in the lower position it shows the marginal disutility of taxes imposed. In the upper quadrant, the social marginal benefit curve shows the diminsihing social marginal utility of public expenditure. In the lower quadrant, the social marginal cost curve is also falling from the right to the left ; of course the curve is inverted in the diagram so as to make it comparable with the social marginal benefit curve in the upper quadrant. The vertical distances of these curves from each other, such as *AB* and *BC* measure the benefit and cost of spending the budget along *OB*. The net benefit is positive upto *B*. For example, at the point *B* the social marginal benefit *AB* is equal to the social marginal cost *BC*. The points to the left of *B* show higher benefit than costs. The points to the right of *B* show a lesser social benefit compared to the social cost of taxation. We can trace out the points showing the *net* benefit in the diagram which give us a curve that passes through the point B. The curve is labeled 'marginal net benefit' in the diagram. The optimum size of the budget is determined at OB where the marginal net social benefit is zero. Professor Musgrave has in this way combined the minimum sacrifice approach with the maximum benefit approach for obtaining the level of public finances. These two approaches have been utilised to formulate the general theory of budget planning.

Musgrave has, however, expressed some difficulties in the practical use of this principle. The fundamental difficulty is in determining the preferences on which the values of the social benefit and cost schedules are to be based. Even when these have been decided, there is the further problem of choice among alternative solutions. It is almost impossible to obtain a consumers evaluation of social benefits and costs if everybody's preference is considered. If we can assume the social utility function as given to us through the political process, there remains the problem of social choice. Thus, the principle of maximum social advantage is not so easy to apply as it seems on first notice.

Dalton's Tests of social advantage

Dalton suggested some tests of social advantage of public expenditure. If public expenditure satisfies any one of these tests, then it is desirable, otherwise not. These tests are listed below.

1. ***Preservation of the community.*** The first priority for public expenditure is for defence so that the people can be protected against external aggression. Likewise people should also be secure against internal disorders with the help of the preservation, and integration of the community, then it passes the test of social benefit.

2. ***Improvement in productivity.*** The second priority for public expenditure goes to the provision of infra-structure for improving the productivity of the economy. Improvements in production can be in the form of enhanced labour productivity which give a higher output per worker than before. Or government expenditure can also help improve the organisation of production. If public expenditure is incurred to achieve anyone of these three, then it is increasing social benefit.

3. ***Improvement in distribution.*** Public expenditures are also justified if these ensure better distribution of the national income. This is the test of 'equity'. In any community, there are income inequalities which cannot be justified on grounds of economic efficiency alone. Some groups obtain high, unearned incomes or get rentals of property which they have monopolized. These groups must be taxed to earn revenue. On the opposite side are the really poor people who are not able to obtain the basic necessities of size because they have neither the skills nor the capital assets to earn enough incomes. These groups must be provided the basic needs and amenities of life through subsidisation by the government. If public expenditure for this purpose is increased, it enhances social benefit.

4. ***Stability and increased employment.*** If business conditions in the country can be stabilised through government expenditure, it is a social advantage. Stability means reduced unemployment through reduction of economic fluctuations. Experience has shown that fiscal operations can reduce the effects of recession by increasing public expenditure to boost up private investment. Similarly, public borrowing and heavy taxation of unearned incomes during the period of inflation may help to bring the price level down.

5. Provision for the future. The state is a guardian of the interest of future generations also. Therefore, it has to see that the present generation does not exploit the country's resources so much as to give any disadvantage to the future generation. The state has to choose between the present generation and the future generation when it decides to exploit its natural, non-reproducible resources like petroleum and coal. Public expenditure has to be increased in ensuring conservation of these resource for the future.

Limitations

The principle of maximum social advantage has limitations of its own.

In the first place, it is difficult for the state to balance the marginal disutilities created by the imposition of a tax with the marginal utility of public expenditure. Even an individual finds it difficult to do so in his private life. Since government consists of a number of interested groups it cannot apply the principle in details. Secondly, the state can only speculate on the future benefits and costs of its public finances. There is an element of uncertainly in every public project. Hence the government has to depend upon the vision of a number of experts employed by them for the purpose of forecasting future benefits and costs of public expenditure. Therefore, we can conclude by saying that the government must recruit planners, experts and executives of a high calibre at every level so that the public economy works to obtain the maximum social advantage.

4. SOURCES OF PUBLIC REVENUE

Government can obtain revenue through many sources. From the viewpoint of individuals, households and firms, there are four major ways in which a government can charge people and obtain revenue. We study these four sources of public revenue one by one.

1. Tax

A tax is a compulsory contribution by an individual, a family or a firm made to government for use in the common interest of all without any claim for a service in return for the contribution made. In the words of Seligman, "Tax is a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."

From the definition given above, we can note the characteristics of a tax. First, tax is a compulsory contribution. Nobody can question it. It has to be paid in time. Second, it is a contribution to the revenue of the government so that they can provide the necessary administrative services for governing the country. Third, the tax contribution has no relation whatever to the extent of benefit which a tax-payer has from the government. A tax differs from the other changes made by a government by the fact that there is no direct *quid pro quo* (exchange) between the tax-payer and the public authority. Fourth, tax is levied according to a legal procedure. The person who is to pay tax and the amount of the tax is well-defined. If the person fails to obey, be can be penalised for it.

Taxes are generally classified into two types : (*a*) Direct taxes, and (*b*) indirect taxes. *A direct tax is really paid by the person on whom it is legally imposed.* Income lax is a direct tax. It has to be paid by the person who earns a particular income. He cannot pass the tax on to another person. Similarly, wealth tax has also to be paid by the person owning the wealth. So it is a direct tax.

An indirect tax is one which the tax payer is required to pass on to others for actual payment while the tax payer deposits the proceeds in the government treasury. Sales tax is an example of an indirect tax. The shop-keeper who sells, charges the sales tax from the buyer of the goods and deposits the proceeds regularly as directed by the government. Similarly, an excise duty is an indirect tax. The producer of a television set pays the excise duty to the government and charges the same from the buyer in the price of the set itself.

The basic difference between a direct tax and an indirect tax is that the former cannot be shifted by a person to another person while the latter can be. In the case of income tax, the person whose income is found to be taxable has to pay tax himself. He cannot shift it. In economics, we say that for an income tax, the impact as well as, the incidence of the tax is on the same person. In the case of an indirect tax such as sales tax, the impact of the tax is on the shopkeeper while the incidence of the tax is on the customer. Thus, we can say that *an indirect tax is one whose impact and incidence are on different persons.*

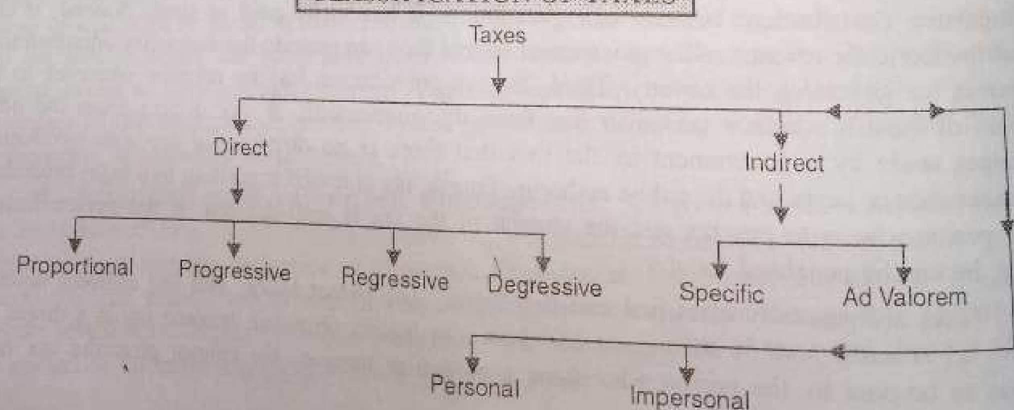
Taxes are said lo be of four types from the point of view of the rate of taxation (*a*) Proportional, (*b*) Progressive, (*c*) Regressive and (*d*) Degressive.

A *Proportional tax* is that which is imposed at the same rate for all the slabs of income wealth or property. The rate remains the same even when income goes up or down. A proportional tax is simple to calculate and is understandable easily.

A *progressive tax* is one whose rate goes on increasing with income. Higher slabs of income have higher percentages of tax. Take the case of income tax. The first 18,000 rupees are tax free. The rate of taxation is say 30% upto Rs. 25,000 and 35% on the income slab ot Rs. 25,001 to Rs. 50,000 and 40% after that. Then this is case of a progressive tax. It is clear that a progressive tax places a greater burden on the rich people than on the poor. A progressive tax can be used to reduce too high incomes and obtain revenue for helping the poor, aged and infirm people.

A tax is said to be regressive in nature if the rate of taxation falls with the rise in income. A regressive tax is the opposite of progressive tax. The regressive tax places a greater burden on the poor as compared to that on the rich. For example, taxes on salt and foodgrains place a greater tax burden on the poor because the poor people use these commodities much more than the rich people. The poor spend a much greater proportion of their incomes on salt and food than the rich people. It is clear, therefore, that a regressive tax is unjust.

CLASSIFICATION OF TAXES



Those taxes which are less progressive and whose rate increases at a very slow rate as income rises are called *degressive taxes*. In case of such taxes, the rate of increase of the tax is not much. A degressive tax is something in between a proportional and a progressive tax as compared to the poor people. Therefore, a degressive tax is not justified socially.

Indirect taxes can be imposed in two different ways : (1) on the value of a commodity, (2) on the weight or volume of a commodity. When the rate of tax is based on the value of a good, the tax is called ad valorem. For example, printing paper is sold with a sales tax of 7% of the value of the paper purchased. In this case, the higher is the value of commodity, the higher is the amount of sales tax collected. Similarly, customs duty is also charged according to the value of an imported item.

A specific tax is one which is imposed on a commodity according to its weight, volume or form. For example, octroi charges for things coming into a city are Rs. 5 per quintal. The rate for carrying a bicycle on a bus is one half of passenger ticket. The railway transport charges for a box or a table are according to its volume. These are instances of a specific tax.

Sometimes a distinction is also made between a personal and an impersonal tax. A personal tax is that which is imposed on people having particular attributes, that is having particular property . For example, bus passengers going to a hill station are charged toll box. They are considered to be tourists having the capacity to pay a small amount for the development of the hill station.

The taxes which are imposed on things without considering whether a poor man or a rich man shall purchase them are known as impersonal taxes. For example, a radio set is having the same licence fee whether a poor man purchases it or a rich man buys it. Similarly, the licence fee for a black and white television is the same as that for a colour television. This is a clear case of impersonal tax. We can say, in short, that all direct taxes are personal taxes and all indirect taxes are impersonal taxes.

2. Fee

Fees are the charges made by a government to bear the cost of administrative services from individuals who get special benefits from these services even though these are rendered primarily in the public interest. According to Seligman, a fee is a "payment to defray the cost of each recurring service undertaken by the government, primarily in the public interest, but conferring a measurable special advantage on the fee buyer." Examples of fees are the fees charged in educational institutions run by the government from the students. Similarly, court fee have to be paid by those who want to seek justice from a particular court.

There are some examples of fees which are charged simply for giving a permission to do something in a way allowed by the government. These fees are known as the licence fees. The registration fee for automobiles, the payment for permits to operate these vehicles and the licence fee for keeping a gun or pistol are charged from individuals who want to enjoy a privilege which others do not have. The nature of the benefit of the licence fees are directly linked to the obtainable benefit from the licence. For example, the licences for running liquor shops in particular are auctioned to get the maximum amount of revenue for the government. The auction bids are directly related to the profitability of running the shops.

A fee differs from a tax. First, a tax is a compulsory collection from people who may not or may obtain a benefit from it. A fee is a special charge made only from those who apply for particular benefits of permission to carry on particular activities. Secondly, fees are charged in the course of administration. These are administrative revenue. Taxes are charged simply for governing a country. Thirdly, fees are charged for regulation or control of activities in the public interest. Taxes have no such role to play.

3. Special Assessment

Seligman has defined special assessment as "a compulsory contribution, levied in proportion to the special benefits derived, to defray the cost of a specific improvement to property undertaken in the public interest." A special assessment is charged only from the direct beneficiaries of a government scheme of development. For example, when a network of canals was constructed to irrigate particular areas through the multi- purpose river valley projects in India, a large number of land owners in these areas got a special benefit of irrigation at very low rates. As a result, the land value in these areas suddenly rose up. The state governments were directed to impose 'betterment levy' on those lands which had benefited from canal irrigation. They levy was based on a special assessment of the rise in land values.

Another example of a special assessment is the development charges which town-improvement trusts impose on the residents of a colony they develop. The improvement trusts construct roads, provide drainage, street lighting etc. The charges for these are based on a special assessment.

We can point out the following features of special assessments.

(1) These are linked with a special purpose of developing an area ;

(2) The special benefit of public activity to the beneficiaries is measurable ;

(3) Special assessment charges are proportional to the benefit received.

4. Commercial Sources of Revenue

The revenue obtained by a government from its commercial enterprises such as iron and steel plants depends directly on the price of the good or service provided by the enterprise. Generally, the commercial undertakings of government are not supposed to earn the maximum possible profit. They are run in accordance with the public interest these are supposed to serve. However, all commercial enterprises are supposed to cover their costs if not earn a surplus. The surplus of revenue receipts over costs of a commercial undertaking depends upon the price charged.

Public undertakings are of various types : railways, passenger transport undertakings, electric supply, milk plants, iron and steel factories and water supply. No one policy about pricing of these undertakings can be determined. They serve different purposes. Therefore, surpluses from commercial undertakings are not considered an important source of income.

In short, we find that the characteristics which distinguish commercial revenues from the other categories are : (1) direct receipt of a commodity or service in return for payment, and (2) adjustment of the amount of payment at least roughly to cost-benefit of the service.

5. CHARACTERISTICS OF A GOOD TAX SYSTEM

A good tax system is that which is framed according to the cannons of taxation so that it has the least obstructive effect in the achievement of national aims. In Dalton's view, "The best system of taxation from the economic point of view is that which has the best or the least bad economic effects." Both theory and practice of public finance tell us that a sound tax system has the following features :

1. *Judicious Combination of Direct and Indirect taxes.* A good tax system does not depend too much on direct or indirect taxes alone. It has a judicious combination of both. An important canon of taxation is that the tax system must involve equal marginal sacrifice from all the sections of society. The richer sections have to contribute more to tax revenue than the poorer sections. Direct taxes generally put the burden of payment on the rich, for example, income tax, estate duty, gift tax etc. The poorer sections go out of the net of direct taxes through exemptions. Therefore, the middle income groups and the lower income groups have also to contribute to the state exchequer. They do so through indirect taxes such as sales tax, excise duties and octroi etc. In less developed countries, the major part of the population bear heavy and disproportionate burden of indirect taxes. This is because the number of the rich is limited. Direct taxes have a narrow base. The tax system is thus unbalanced.

2. *Productivity.* A good tax system is that which brings adequate income to the government with as few taxes as possible. At any time, the government's needs of revenue are given. These needs must be fulfilled through the tax revenue. As Adams has said, the best system of taxation from the economic point of view is that which is adequate for the just wants of the state. Too many taxes irritate the tax-payers and some of them are likely to not contribute much to the revenues. It is better to concentrate on relatively limited number of taxes which are productive and which do not have any adverse effect on the will to save or invest.

3. *Elasticity.* A good tax system must he elastic in the sense that with changes in tax rates, tax revenues must also change proportionately. If the tax rates are raised 25% the tax revenue must also go up adequately. If the tax revenues lag behind the rise in the tax rate the tax system is inelastic. Of course, some taxes are more elastic than the others. For example, land revenue is an inelastic tax while excise duties on consumer durables like electric fans are quite elastic. Therefore, the overall tax system must be fairly elastic so as to meet the rising needs of revenue.

4. *Buoyancy.* A good tax system must also be buoyant in the sense that as the national income rises, the tax revenues must also rise accordingly. In developed countries, the tax revenues automatically rise with the economic growth rate because their tax system has the required buoyancy. But this is not the case in India. The tax system in this country is not buoyant because of tax evasion and tax exemption on a large scale.

5. *Progressivity.* As far as possible, the tax system should be progressive. A progressive tax system puts more and more burden on the richer groups as their incomes rise. A government which is committed to bring about a socialistic pattern of society must have a good number of progressive taxes. At least its taxes should not be regressive. Most of the progressive taxes are direct taxes. Most indirect taxes are regressive in nature because their burden on the poor is more than on tho rich. In less developed countries like India, the government has to depend more and more on indirect taxes for certainty and adequacy of revenues. This makes the tax system regressive.

6. *Efficiency.* A tax system is efficient if the overall costs of collection of taxes are not above a particular percentage of the revenue. If the tax-collection machinery is corrupt or the tax laws are complex, the costs of collection are unusually high. This makes the tax system inefficient. If the tax laws are simple and clear, the tax-payers feel convenient in assessing and paying their taxes. As an example of an inefficient tax, we can cite the case of the expenditure tax in India.

This tax was introduced in India to encourage saving. But the collection costs were so heavy in relation to the revenue collected that it had to be abandoned soon. If the tax system has to be progressive, then it must be organised on systematic principles of public finance.

7. *Sectoral balance.* A good tax system must have a sectoral balance of revenue mobilisation. The industrial sector, the agricultural sector and foreign trade sector must all contribute their due in the tax revenues. In India, this sectoral balance has not been established. The agricultural sector is comparatively lightly taxed. The industrialists complain that they are over-taxed. The importers complain of unusually heavy customs duties. The tax system needs reform so as to have the sectoral balance of taxation.

Conclusion

We can conclude by saying that a good tax system conforms to the basic canons of taxation while making compromises of various types with the realities of the institutional set up in a country. In a developed economy having varied production, it is easily possible to have elasticity and buoyancy in the tax system. Tax assessment is easier and tax compliance surer. Tax evasion is minimal. The economy being balanced, the tax system can be made progressive and yet simple. But in less developed countries, there are limitations of the finance minister in imparting such virtues to the tax system. There has not been shortage of tax-reform advice in less developed countries. Not all such advice has proved fruitful in such countries.

6. PUBLIC BUDGET – MEANING

According to Bustable, "The budget has come to mean the financial arrangements of a given period, with the usual implication that they have been submitted to the legislature for approval." Thus public budget is or document containing a preliminary approval plan of public revenue and expenditure. (1) It contains a statement of the estimated receipts and expenses during a fixed period, usually a year. (2) It is a comprehensive table giving the amounts of the receipts to be realised and the expenses to be incurred. (3) It is furthermore on authorisation or command given by the proper authorities to incur the expenses and collect the revenue.

The three elements of a budget are :

(A) Finance Plan

(B) A procedure formulating authorising, executing and controlling.

(C) Some government authority responsible for each successive step in this procedure.

The budget proposals should be clear and easily understandable. The anticipation of revenue and expenditure should make positive contribution to the economic goals of the nation.

Purpose of the Public Budget

The main purposes of a budget are :

1. It is a worthwhile exercise for putting an annual plan in action.

2. It is necessary for drawing up plans for mobilisation of revenue and executing programmes of public expenditure.

3. A budget is required for the purpose of informing the legislature and the people so that they can support the over-all programmes for a year.

ficant purpose of the budget is to study the generation of saving, investment
d capital formation in the economy. For this purpose, an Economic Survey is
the budget.

c budget serves to account for the allocation of funds for the previous year and
ocations for the coming year. The reports of the public auditing authorities usually
budget.

ue and Capital Budgets

budget contains two accounts–a current account and a capital account.

nue budget is concerned with current financial transactions of the government
ecurrent nature. It gives a detail of the revenue receipts–both tax revenue and non-
d the expenditure incurred in collecting the revenue receipts. The non-tax revenues
es from currency, coinage, mint, interest receipts, profits, from general services,
social and community services (education, housing, broadcasting etc.) and revenue
c services (agriculture, allied services, transport and communication).

budget is concerned with such transactions as acquisition and disposal of capital
sists of receipts from market loans, borrowing from the Reserve Bank of India,
ale of treasury bills and long-term securities, loans from foreign governments and
ions. The capital budget also incorporates the transactions in the Public Account.

ak-up of the budget into two parts in justified on the following grounds.

stinguishes between the routine administrative work of the government and its
respect of building and management of asserts in the public sector.

lps in analysing the economic effects of the revenue raising and expenditure of the

classification helps in tracing the effect of government proposals on current
, capital formation and the price level.

O-FUNCTIONAL CLASSIFICATION OF THE BUDGET

aditional classification of the budget was primarily guided by the objectives of establishing
e legislative control over the executive management of the budget and provision of
nformation for fiscal management. To this end, budget accounts were classified into
tegories corresponding to each department of the government. The traditional approach
esigned to have better legislative control and an effective check against misappropriation
But that did not yield the requisite information for economic analysis. Secondly, as the
tor expanded and had been given a prominent role in stabilising the economy, the
classification proved to be inadequate for formulation of economic policies. There was
o have functional classification of the budget.

unctional classification refers to be breaking down of government expenditure directed
different purposes. A Report of the United Nations says, "It classifies government
re by specific governmental function such as defence, health, education, promotion of
e etc."

Since the resources of the government are limited while the functions of the government are many, the latter are essentially competing objectives. Therefore, there is need to determine the extent of budgetary resources which can be earmarked for each of these purposes of public expenditure. This is what the functional classification does. In the functional classification of the budget, the allocation of public expenditure among different functions may be based on such criteria as future needs, present set up or past performance in the particular area of development. For example, the decision to spend specific amounts between primary education and health will be based on the study of the present level of attainment, the rate of benefit from past expenditure, the expected level to be reached in the budget year, the extent of regional disparity etc.

The allocation of different amounts of expenditure among the various purposes signifies the priorities of the policy-makers. The assumption is that they already have an idea about the relative benefit which the people should expect from the public outlays. Thus, a cost-benefit notion shapes the eco-functional classification. The programmes are made cost-effective in as much as the objectives are set in measurable terms. For example, in the case of teachers' Training Programmes, the target may be set in terms of additional enrolment in schools. Another example in the case of public health expenditure may be a targeted fall in the death rate within a specified period.

The eco-functional classification of the budgets does have specific advantages for policy planning but it is not immediately applicable in the developing countries. This is because of the time and expenses required for such an exercise. In India, we have only partly introduced this classification.

Among the requirements of a good tax system is the principle of equity. There are two aspects of equity : horizontal and vertical. According to horizontal equity, people *in the same circumstances* should be taxed equally. In other words, taxes should be levied impartially. For example, people earning the same level of income and with the same personal circumstances (for example, number and type of dependants, size of mortgage etc.) should pay the same level of income tax.

According to vertical equity, taxes should be fairly apportioned between the rich and the poor. What constitutes fairness here is highly controversial. No one likes paying taxes and thus a rich person's concept of a fair tax is unlikely to be the same as a poor person's. This whole question of using taxes as a means of redistributing incomes is debatable.

There should also be equity between recipients of benefits. Under the *benefit principle*, it is argued that those who receive the most benefits from government expenditure ought to pay the most in taxes. For example, it can be argued that roads should be paid for from fuel tax. That way those who use the roads the most will pay the most towards their construction and maintenance.

In most cases, the benefit principle would be difficult to put into practice. There are two reason for this : First, a specific tax would have to be devised for each particular good and service provided by the state. Second, in the case of many goods and services, provided by the state, it would be difficult to identify the amount of benefit received by each individual. Just how much benefit (in money terms) do you derive from street lighting, from the police, from the navy, from clean air etc. ?

Another principle of a good tax is that it should be difficult to evade, *i.e.* people should not be able to escape paying it. A distribution here is made between *tax evasion* and *tax avoidance*.

Tax evasion is illegal. This is where, for example, people do not declare income to the tax authorities. Tax avoidance is legal, albeit from the government's point of view undesirable. This is where people try to find ways of managing their affairs so as to reduce their tax liability. They may employ an income tax consultant to help them.

Taxes may discourage people from working longer and harder, from sowing, from investing and from taking initiative. For example, a high rate of income tax may discourage people from doing over time. It is desirable that these disincentives should be kept to a minimum in any tax system.

7. EFFECTS OF PUBLIC EXPENDITURE

Effects of Public Expenditure on Production

Public expenditure can affect a country's production directly and indirectly. Public sector industries make a direct contribution to national income while the expenditure on general administration, roads and railways is indirectly productive. A correct view of the effects of public expenditure on production can be obtained through the study of the following :

1. Effect on ability to work, save and invest.
2. Effect on willingness to work, save and invest.
3. Effect on allocation of economic resources among different uses.

Public expenditure increases the ability of the people to work, save and invest by providing them with facilities of education, medical care, housing sites and means of transport and communication. Public expenditure also increases the working efficiency of the low income groups. Likewise, public expenditure on law and order creates confidence in the people to undertake investment in productive activities. Conversely, wasteful and luxurious public expenditure has an adverse effect on ability to work, save and invest.

Some people think that social security measures like old age pension, provident fund benefits, insurance against sickness and employment insurance reduce a person's willingness to work and save. But such a view ignores the necessity of making it attractive to work. It is only the over provision of social security that is harmful to the willingness to work. Moreover, such public expenditure has also to do with social justice.

Public expenditure diverts resources from private to public use in different ways. Every defence programme subtracts economic resources from other uses in which it might have made a direct contribution to economic welfare. But this does not mean that all defence and police expenditure is undesirable because country's security is of vital importance to its economic prosperity.

The public expenditure on the provision of infrastructure such as roads, railways, irrigation projects etc. is basic to economic growth. This type of public expenditure provides incentive to private investment by enlarging the size of markets. In fact, there is a direct relationship between the growth of economic overheads and economic development. Dalton pointed out that the following forms of public expenditure increase an economy's productive power and are socially desirable :

1. Debt redemption, where most of the money repaid will be reinvested.

2. Productive projects, like irrigating, afforestation, land reclamation, power and transport development etc.

3. Expenditure on education, training research, invention and information ;
4. Public health and
5. Expenditure in aid of social security schemes.

Effect of Public Expenditure on Distribution

Public expenditure is a powerful weapon in the hands of the government for bringing about an equitable distribution of weatlh ; while formulating its expenditure policy, the government has to decide as to which section of the society is to be benefited more than the others. If a major part of the weaker sections of society, inequalities of income can be reduced.

Dalton pointed out that public expenditure can also be regressive, proportional and progressive.

1. If public expenditure is so incurred that it confers benefit on different groups of the community in proportion to their income, such expenditure is said to be proportional.

2. If the benefits of public expenditure accruing to the people increase at a faster rate than their incomes, then the public expenditure is progressive in nature.

3. If public expenditure is so incurred that it confers benefits on different social groups in such a way that the poorer people get proportionately less than the richer people, then this pattern of public expenditures is regressive in nature.

Even components of public expenditure can be progressive or regressive. For example, an equal old-age pension payable to all those who attain a particular age is progressive in nature while interest payments on public debt tend to be regressive.

Different items of progressive public expenditure are as follows :

1. *Cash grants.* A cash grant is a payment made by the government to a person or an institution. Old-age pension, sickness benefit and unemployment dolls are examples of cash grants. Such grants are progressive in nature as these redistribute income in favour of the rich. The progressive nature of these grants can be further improved if these are provided according to the recipients family size and needs.

2. *Free or cheap goods and services.* Public expenditure on free primary education, free ships to the economically backward classes for higher education, provision of milk and mid-day meals to school children of the poor is progressive in nature. It increases the real income as well as the economic welfare of the low income groups. Subsidies on food sold through fair price shops are also progressive grants.

3. *Production Versus Distribution.* Some writers feel that the objective of redistribution incomes through public expenditure may come in conflict with the objective of encouraging production. It has been argued that a steeply graduated tax system may discourage savings and investment by those who are taxed heavily. In case a progressive system of taxation hurts so much as to reduce the output of those who are highly taxed, it is questionable whether it should be used to help those who contribute nothing to national income. In such cases, there is a conflict between efficiency and equity, *i.e.* between production and distribution. But if the progressive taxes only reduce the wasteful consumption of the rich and the money collected from the taxes is used to give better nutrition to those poor people who can now work harder than before, than there is no such conflict between production and distribution. Rather better distribution in such cases encourages production. Therefore, a government would do well to locate the people who can be taxed without hurting their incentive to work and specify the poorer groups of people who must be helped to increase their productive efficiency through grants.

It must be observed here that the effect of public expenditure on production and distribution also depends on how the expenditure is financed. For example, if the increased public expenditure for helping the poor is financed from the printing of additional currency, then it will cause inflation in a less developed economy in which there is no excess capacity in industries or on farms. To take another example, if some additional public expenditure is financed from public borrowing and is used to benefit those who get better training facilities for job performance, then in this case the public expenditure does not produce any conflict between output and distribution.

8. PRINCIPLES OF PUBLIC EXPENDITURE

In modern times public expenditure is regulated by the social needs. In a democracy a government is answerable to the people. Therefore, every government spends in accordance with some basic principles. The famous economist Adam Smith gave four canons of public expenditure. Similarly, Findley Shiraz has also classified the principle into four types. Recently some more principles have been added as government has assumed new economic roles. The main principles of public expenditure are as follows :

1. ***Canon of benefit.*** According to this canon a government should spend to promote the maximum social benefit. Actually, the main objective of a government is to promote the maximum good of the maximum number of people.

2. ***Canon of economy.*** According to this, a government must exercise economy in its spending. There should be no wastage, no extravagance. For necessities of the public there should be no saving of resources. Secondly, a government should spend in such a way as to increase the productive capacity of the economy. The first principle is concerned with the present and the second with the future. A government must appoint commodities to audit its accounts of expenditure so as to find out whether the funds are being spent according to the public purpose.

3. ***Canon of sanction.*** According to this principle whatever expenditure is undertaken, it must be with prior approval of suitable authority. It is useful in keeping a watch on the allocation of public resources on the one hand and checking arbitrary expenditure by any officer on the other. Every officer is authorised to spend a limited fund. After the sanction is obtained it is necessary to see that all expenditure is being done with the utmost honesty and efficiency. This is properly accounted for and presented to audit.

4. ***Canon of surplus.*** The fourth principle governing public expenditure given by Adam Smith is that the public expenditure should never exceed public revenues. This is because once government is given the freedom to spend more than its income, the government becomes indifferent to future. There should be no surplus nor a deficit in the public budget. Both are against public interest.

Modern economists are, however, not agreed with the policy of a balanced budget. In their opinion public budget is an instrument of public policy towards business cycles and economic growth. In other words, modern economists favour functional finance which means budgeting for the public objectives which may be in favour of a deficit or a surplus.

5. ***Canon of elasticity.*** Public expenditure must be so arranged as to be amenable to increase or decrease it depending upon circumstances. In times of crisis expenditure may be easily increased or diminished if there is elasticity.

6. *Canon of productivity.* Public expenditure must be conducted so as to give the maximum encouragement to production. According to Hansen, no nation can raise the standard of its people without raising production. Therefore, the pattern of public expenditure must be such as to maximise production.

7. *Canon of equitable distribution.* Another objective of public expenditure is to promote equitable distribution of wealth and income. A government must so spend its revenues that the backward sections of society benefit more than the relatively richer sections.

8. *Canon of certainty.* Public expenditure for different departments must be specific so that the development activities are properly organised. A government must formulate a budget much before the financial year starts so that it is clear as to how much amount is to be spent in how much time over which items.

9. *Miscellaneous.* While incurring public expenditure the following considerations are also important : (1) Different activities must be given priority according to their relative importance; (2) the method of public expenditure must be properly detailed ; (3) not only the present effects but also the future effects of an expenditure must be considered ; (4) while incurring public expenditure, the population, the area and the physical resources of a country must be kept in view.

9. PUBLIC REVENUE AND TAXATION

The income side of government budget is known as public revenue. There are many sources of government income. These are generally :

(1) taxes, (2) excise duty, (3) fees, (4) income from government property, (5) land revenue, (6) fines (7) grants and gifts from other countries, (8) voluntary loans, (9) compulsory deposits, (10) income from public enterprises, (11) income from paper money issue and (12) special assessment. Out of these, taxation in by far the most important source of income. Therefore, we study this source of income in detail.

Definition of a Tax

Different economists have given different definitions of tax. Prof. Huge, Dalton, an authority on Public Finance, says, "A tax is compulsory contribution imposed by public authority, irrespective of the exact amount of service rendered to the tax- payer in return and not imposed as a penalty for any legal offence."

According to Prof. Seligman, "A tax is compulsory contribution from a person to the Government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."

A tax has the following important characteristics :

1. It is a compulsory payment. It can be levied on any person at any time. It has to be paid.

2. Taxation is justified on the basis of expenditure on different items of public welfare.

3. A tax payer gets not service or facility in lieu of the payment of tax. There is no *quid-pro-quo*. The tax payer cannot demand anything in exchange for his tax payment.

4. There is no direct relation between the income from taxes and public expenditure. Public expenditure may be more or a little less than the taxes depending upon circumstances.

5. A tax may not give anything in return to the tax-payer. But a government must justify the imposition of tax. It is also understood that taxation revenue will be used for social benefit.

Objectives of Taxation

The main objectives behind the imposition of taxes are :

1. *Income.* The most important objective of taxation is to increase government's income. As public expenditure rises, taxation is increased.

2. *Equitable distribution of income.* Another purpose of some taxes like income tax, property tax and wealth tax is to reduce the inequality of income between different sections of the society.

3. *Restraining harmful consumption.* In order to restrain people from the consumption of intoxicants like liquor or hashish or to reduce the consumption of harmful goods like cigarettes, heavy taxes are imposed to make them expensive.

4. *Regulation of Foreign Trade.* Another objective of taxation is to promote exports and reduce imports so that the burden of foreign exchange of the country is kept to a minimum.

5. *Conservation of resources.* Taxes are also imposed on scarce resources so that their export is discouraged by the higher price resulting from taxation. Such non-renewable resources as coal and petroleum must be conserved. Taxes are levied on their exports.

6. *As a fine of punishment.* Sometimes a tax is imposed on a particular area of the country as a punishment for the repeated loss of public property resulting from the irresponsible behaviour of the citizens in the area.

10. CANONS OF TAXATION

Economists have provided many principles or canons of taxation on which good tax system has to be based. Adam Smith gave four main canons of taxation in his book 'Wealth of Nations'. These are as :

1. *Canon of Equality of Ability of Pay.* This canon provides that taxes must be imposed according to a person's capacity to bear a tax. It has been said that the broadest shoulders must bear the heaviest burden. This can be ensured by imposing taxes in such a way that every tax payer makes the same marginal sacrifice, J.S. Mill calls this canon, "Taxation in proportion to means."

2. *Canon of certainty.* Another canon of taxation is that the tax imposed must be clear and certain. Every person supposed to pay the tax must be clearly identified. The time and the method of payment as well as the amount to be paid must be clear to all the tax payers.

3. *Canon of convenience.* According to this canon a tax payer must be able to pay the tax-easily. In the words of Adam Smith, "Each tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it." In other words, the tax payer should not be put to any special difficulty in paying his tax.

4. *Canon of Economy.* According to this canon the cost of collection of a tax should be much lower than the amount collected from the tax. The tax-system should not be very expensive. Modern economists take a broader view of the meaning of economy here. In their view, a tax should not adversely affect the economic situation, trade and industry. In other words a tax is economical if it imposes the least cost on the government as well as the economy.

Modern Canons

Since economic conditions have vastly changed from the time Adam Smith gave his canons, modern economists have added the following canons of taxation to those given by Adam Smith.

5. *Canon of Elasticity.* The system of taxes must be that it should be possible to make changes in government income by changing the tax a little. The expenditure of the government continues to change from time to time. Likewise the income from taxes must also be changeable.

6. *Canon of Productivity.* This canon was given by the classical economists Bastable. Ordinarily it means that a tax should be able to mobilise the maximum resources for the government by affecting the least number of people possible.

7. *Canon of variety.* The taxation system must be based on variety of taxes so that every citizen contributes something to public revenue. There should be a good mixture of direct and indirect taxes so that a balance is maintained between them.

8. *Canon of simplicity.* This provides that a good tax system must be simple so that there is no scope of evasion of taxes by misinterpretation or misunderstanding.

9. *Canon of Desirability.* New taxes must be imposed only for a special objective. There must be adequate justification for buying a new tax or increasing the rate of an old tax.

10. *Canon of sufficiency.* Whatever tax is imposed, it must be able to mobilise resources for the objective for which it is imposed. According to this canon it is better to have a few big taxes than to have numerous small taxes.

In short, the tax system must be so designed as to give the government the needed resources without endangering the position of a democratic government.

11. KINDS OF TAXES

From the point of view of their effects on the richer and the poorer sections of the society, taxes have been classified into the following types :

1. *A Proportional tax.* A proportional tax is that which is imposed directly in proportion to the income of citizen. A man with the five hundred rupees of incomes pays five times the tax paid by a man with hundred rupees as income. Example of proportional tax in India are sales tax, excise duty and passenger tax.

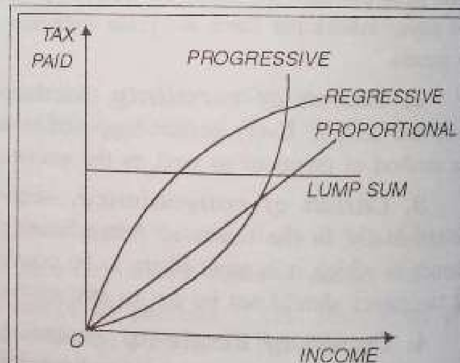


Fig. 28.2 Kinds of Taxes

A proportional tax does not distinguish between the rich and the poor. It is simple and easily understood. It is certain and productive because it has a simple arithmetic. But it is not favoured on the grounds of social justice.

2. *Progressive tax.* The progressive tax is one whose tax increases with the increase in income and diminishes with reduction in income. The rate of this tax is lower on the lower income slabs and rises with higher income slabs. An example of such a tax is the income tax in India. Generally a progressive tax is not imposed on a minimum level of income. Then the next income slab has the minimum rate of tax. The rate of tax continues to increase with successive income slabs. This ensures that the rich are taxed according to their level of income while the poorest go tax free. The richer a man is the greater is the contribution made by him through a progressive tax. It is very helpful in reducing the income inequalities. Further a progressive tax is generally productive and economical.

Some people object to high progressivity in taxation on the ground that this affects the saving capacity adversely and encourages evasion. Therefore, the intensity of the progressivity of a tax should be judged properly.

3. *A Regressive tax.* Some taxes impose a relatively higher burden on poorer people than on the rich people. If the rate of tax does not increase with increase in income and the burden of tax lightens with increased income, it is called a regressive tax. It is the opposite of a progressive tax because the rate of taxation in this case increases less than proportionately with income. An example of such a tax is the sale tax on wheat. Poor people consume far more wheat than the rich people. As a result the amount of sale tax paid by poorer people on wheat is much higher than that paid by the rich. This tax imposes a higher burden on the poor people rather than lower burden. Therefore, regressive taxes are always against the public interest. They are the negations of social justice.

4. *Degressive tax.* It is a mixture of the proportional and the progressive taxes because it is proportional upto a limit and then the rate of taxation increases beyond this limit. The proportional rates are meant to raise revenue certainly. The progressivity is meant to promote social justice. As a result, the rich people are not affected that much as in a highly progressive tax.

We can explain the difference among the kinds of taxes with the help of figure 28.2 which shows the response of tax paid by a person to changes in income. The figure shows the total amount of tax a person pays out of his income. With a progressive tax the curve gets progressively steeper, showing that the average rate of tax (T/Y) rises with the rise in total income. The more steeply upward sloping is the tax curve, the more progressive is the tax.

In the case of regressive tax, the tax response curve is getting flatter as it rises, *i.e.* the slope of the curve is falling with rising income. So regressivity of a tax means that it hurts the poor more than the rich.

The response curve of a proportional tax is a straight line. Its slope remains constant as income rises. Such a tax affects the rich and the poor equally.

The response curve of the lump sum tax is a horizontal line showing that the tax paid is the same whether a person is rich or poor. For example, the rate of road tax for a small car (Maruti 800) is the same as for a bigger, more expensive car (Maruti Esteem). It is the case of a lump-sum tax.

The above classification of taxes is relevant when we use taxes as a means of achieving greater equality. The desirable principle is that the rich must be taxed proportionately more than the poor. Therefore, in India, the income tax rates rise with the rise in an assessy's total income. The income-tax in India is a progressive tax. But the excise duty and sale tax on petrol are proportional tax. The rate of the tax on petrol is the same for the poor moped owner and the rich luxury car owner.

12. DIRECT VERSUS INDIRECT TAXES

To distinguish between direct and indirect axes, we must know the idea of tax shifting *Shifting of a tax* Shifting of a tax is the process through which the impact of a tax is on one person while the incidence is on the other. Tax shifting is not always possible : for example, income tax, wealth tax, property tax etc. have to be paid by the person taxed. There is no shifting possible here. Incidence and impact of income tax is on the same man. On the other hand, an excise duty on say cloth is passed on to the consumers by the manufacturers in the form of the sale prices being charged.

The idea of tax shifting is helpful in distinguishing between direct and indirect taxes.

Direct taxes

In a direct tax there is no difference between the person having the impact and the person bearing the incidence of tax. According to Dalton, "A direct tax if really paid by the person on whom it is legally imposed." Similarly Adam Smith defined a direct tax which is not shiftable to others by the tax-payer. In India, examples of direct taxes are income tax, estate duty and wealth tax.

Merits of Direct Taxes

Direct taxes are preferred due to the following merits :

1. ***Progressive Nature.*** Direct taxes can always be made progressive by levying them on the richer sections and increasing the rate of a tax with income rise.

2. ***Economy.*** Direct taxes are easy to collect because those taxed are richer people having the ability to pay. Those taxed are expected to deposit the direct taxes themselves.

3. ***Certainty.*** Direct taxes can be always clearly specified. Therefore, government can always be sure to receive the revenues from such taxes.

4. ***Elasticity.*** Direct taxes obey the canon of elasticity because as the richer sections get higher incomes, the revenue from direct taxes also increases proportionately.

5. ***Productive.*** These taxes bring in a good deal of revenue to the government in all countries.

6. ***Simplicity.*** Since direct taxes are imposed according to the prevalent laws of the land, they are easier to understand, collect and deposit.

7. ***Convenience.*** Direct taxes are collected from people at the time they get income from different sources. Therefore, these are convenient.

8. ***Public Spirit.*** Direct taxes induce in the citizens paying taxes an interest in the running of the government. Direct tax payers are always more aware of the way revenue is being used. As a new direct tax is levied or the rate of old tax is increased, the tax the payers feel the pinch and try to find out the justification for increased tax.

9. ***Distributive Justice.*** Direct taxes are helpful in promoting social justice because their burden mainly falls on the rich people.

Demerits

Direct taxes are opposed due to the following demerits :

1. ***Unpopular.*** Direct taxes are not popular because the tax payer is made to feel the pinch of the tax directly. The tax payers are conscious of the payment. Direct taxes cannot be avoided without risk.

2. ***Evasion of taxes.*** Since the tax payers are in direct touch with the government, they try to evade the taxes as much as possible either by manipulating the accounts or by greasing the palm of tax officials.

3. ***difficulty in assessment and payment.*** A direct tax payer has to get the tax amount assessed and deposit it later on. For this he has to go to the tax office many times. This is quite inconvenient.

4. ***Some direct taxes are not economical.*** Some direct taxes like the expenditure tax involve so much expenditure of the government on collection that it is not thought to be worth-while imposing them.

5. ***Arbitrary Element.*** The assessment of a direct tax involves a good deal discretion for the taxation officer. They can arbitrarily fix the amount which increases the possibility of corruption.

6. ***Disincentive for capital formation.*** Direct taxes reduce the saving capacity of those who are taxed as a result of which capital formation is discouraged.

7. ***Discourages the inflow of foreign capital.*** Foreign investors always calculate the burden of direct taxes before investing in a particular country.

8. ***Non-discrimination regarding the sources of income.*** Direct taxes do no discriminate between earned and unearned income. Social justice demand that earned incomes be lightly taxed. But it is not always possible to clearly distinguish between the two.

9. ***Narrow Base.*** Direct taxes are generally imposed on a minority of the population. Particularly in less developed countries the majority of the population goes tax free. Thus direct taxes come to have narrow base.

In short, it can be said that the demerits of direct taxes arise mainly out of the difficulties of administration. These difficulties can be removed gradually with experience. Direct taxes induce a sense of responsibility in the tax payers to watch the government in a democracy. Therefore, Gladstone was led to remark, "If you had only direct taxes, you would have economic government."

Indirect Taxes

An indirect tax is that in which there is possibility of tax shifting. In other words, impact of an indirect tax falls on a person who shifts it to others so that the persons bearing the incidence are different from the one having the impact.

According to Dalton, "Indirect taxes are those which are imposed on one person but he is able to shift them partially and or wholly to another person." J.S. Mill also defined an indirect tax as that which is "one demanded from one person in the expectation and intention that he shall indemnify himself at the expenses of an other." Examples of indirect taxes in India are sales tax, excise duty and customs duty.

Merits of Indirect Taxes

Indirect taxes are preferred because of the following merits :

1. ***Convenient to pay.*** Indirect taxes are convenient in that they are paid immediately when the commodities are purchased. Indirect taxes are part of the price. Therefore, the consumer does not feel the pinch. They are convenient for the government also because these are easy to collect from the producers or importers.

2. ***Difficult to Evade.*** Indirect taxes cannot be easily evaded because the sellers are held responsible for charging them. There is the risk of having punishment for evasion.

3. ***Variety.*** Indirect taxes can be imposed in a variety of ways. There are excise duties, sales tax, customs etc. The rate and the number of commodities under indirect taxation can be varied according to the purpose of indirect taxation. This adds variety of the tax system.

4. ***Elasticity.*** Indirect taxes are elastic. The income from these taxes automatically goes on increasing with the increases in income.

5. ***Popular.*** Indirect taxes do not bring any bad name to the government because the tax payer is not directly conscious of the tax payments.

6. ***Checking Harmful consumption.*** Indirect taxes are a good instrument of restraining people from the consumption of harmful goods like liquor, opium, tobacco. This increases the social benefit.

7. ***Broader Base.*** A tax system must have a broad base. It must reach every person and tax him according the his capacity. Indirect taxes have a wide base. Both rich and poor people pay indirect taxes according to the purchases made by them.

8. ***Equity Element.*** Indirect taxes can be mainly imposed on the luxury goods of the rich such as air conditioning equipment, high class jewellery and costly clothing.

9. ***An instrument of Protection.*** Import duties are helpful in raising the price of import so that domestic producers can compete the foreign producers successfully. Thus indirect taxes are useful in giving protection to industry.

Demerits of Indirect Taxes

Indirect taxes are not favoured due to some demerits. These are as under :

1. ***Regressive.*** Indirect taxes are generally regressive. Their burden falls much on the poorer section than the richer people. Therefore, indirect taxes are not socially justified when the tax rate is the same for the rich and the poor. Sometimes the regressive element is reduced by raising the rate of taxes in cases of luxuries like cars and television.

2. ***Uncertain.*** Indirect taxes are not certain because the revenue obtainable from them depends upon a large number of factors not easily predicted.

3. ***Uneconomical.*** Indirect taxes require a costly administrative machinery. This makes them uneconomical.

4. ***Lack of Public Spirit.*** Indirect taxes do not arouse any consciousness among the tax payers to watch the use of the tax revenue. There are paid by a large number of consumers unmindful of the payment of tax. As a result a government tends to go inefficient and even wasteful.

5. Discourage production. Indirect taxes have an adverse effect on the production of the commodities taxed. With the rise in excise duty of refrigerators in the early 1970's demand for them suddenly slumped with the result that the industry was in difficulty.

6. Breed corruption. All indirect taxes involve three parties, the producers or sellers, the consumers and the tax officials. Since the market is very large and decentralised, indirect taxes are evaded on a large scale in order to benefit the seller, the consumer or even tax-officials.

Conclusion

In short, direct and indirect taxes have their own merits and demerits. However, they can complement one another to overcome the shortcomings of each. In income redistribution they are complementary. A balanced tax system must contain both types of taxes in the right proportion. The famous English Prime Minister, Gladstone had remarked, "direct and indirect taxes are like two beautiful sisters which every Finance Minister has to respect equally." In underdeveloped countries indirect taxes are more important than direct taxes as far as productivity is concerned. But direct taxes can be used to take care of income redistribution and control of income inequalities.

13. AD VALOREM AND SPECIFIC DUTIES

We must distinguish between ad valorem and specific duties. *An ad valorem duty is one which is levied as a percentage of the value of a commodity.*

A specific duty is one which is levied on a commodity for a definite measure, weight, volume or stage of manufacture.

An example of an ad valorem duty is 20 per cent import duty on electronics goods. An example of a specific duty is an export duty of say 5 paise per metre of cloth or Rs. 4 per quintal of jute goods.

Specific Duties Versus Ad Valorem Duties

Both businessmen and administrators favour specific duties and oppose ad valorem duties. The main arguments in the discussion are :

1. Specific duties result in higher revenues only when there is an increase in physical output. These duties continue to earn the same revenue even when there is a distinct increase in the quality and value of output, if volume of output remains the same. Therefore in case of specific duty goods, the revenue earned as a proportion of the price of the commodity taxed falls as price rises. In other words, the elasticity of revenue from specific duties is less than one.

2. Specific duties tend to be regressive, because such duties form a higher percentage of the value of poor men's varieties than those varieties which are used by the rich. For example, a has a greater ad valorem incidence on the ordinary fans and a lower incidence on the fancy brands. And as a result, producers of fans have a higher profitability on fancy varieties as compared to the ordinary varieties. They are more eager to produce the former than the latter.

3. Some writers are of the view that ad valorem duties increase inflationary pressure by pushing up costs. However, this is not always the case. As the L. K. Jha Committee pointed out, inflation in India is more often the result of shortage of goods than of rise in costs. When commodity prices rise suddenly, windfall profits are made by the stockists. Some of which flow to the exchequer through ad valorem duties. In such a case, the ad valorem duties restrain

inflationary pressures. If prices of commodities rise as a result of the rise in costs, the ad valorem duties can be suitably adjusted downawards so as to contain the cost-push inflation.

4. It has been pointed out that ad valorem duties are difficults to administer as disputes over valuation of goods are widespread. The Indirect Taxation Enquiry Committee appointed in India in 1976 admitted that this difficulty is there. But it can be got over appropriately through suitable legal and procedural reform.

In conclusion it may be pointed that the choice between the specific duty and ad valorem duty is not a choice between black and white as it seems. Now, in India we have a system of *Traiff valuation* as a combination of specific and ad valorem duties. Under this system, certain articles of common use such as salt, kerosene oil, spirits and matches are subjected to specific duties. Other commodities are assessed under the tariff valuation system. From time to time, the government determines the values of the articles for assessment purposes. These values are then taken as the standard values for the articles subjected to ad valorem duty for the whole year.

The Indirect Taxation Enquiry Committee recommended the switching over to Ad Valorem duties in lieu of specific duties on goods in order to impart adequate elasticity to revenue income from such duties. It was pointed out that under the ad valorem duties it would no more be necessary to undertake an annual revision of the rates applicable to individual products for specifying the duties. May be, some change in the individual rates become necessary after sometime in order to correct short-term imbalances in demand and supply or to signal new investment priorities.

Secondly, it was observed that as and when a rise in the contribution of duties to the exchequer becomes necessary, the increase in the rates on individuals products would be small as the net of ad valorem duties would be spread wider.

Thirdly, the committee said that the switch over from specific to ad valorem duties would impart more stability to India's tax system.

In conclusion, we can say that *Ad valorem* customs duties are considered more useful as compared to specific duties. United States, Canada and Australia mainly have ad valorem customs duties, although varying degrees.

13A. VAT (VALUE-ADDED TAX)

Value-Added Tax (VAT) is an indirect tax which has been introduced to replace a number of indirect taxes on commodities such as sales taxes, entry tax and octroi. As the name indicates, it is a tax on the value added to a commodity at each stage of its handling where value is added to it. The stages are manufacturing, transportation, wholesaling and retailing. The manufacturer buys raw-materials and pays some tax on the same. When he turns it into a product for use, he adds value to it. Suppose that the taxes on purchase of raw-materials already paid by him are Rs. 1000 per unit and the product is sold to the wholesaler such that he gets a profit per unit of Rs. 5000, then the value added is Rs. 5000 minus Rs. 1000, i.e. Rs. 4000. He gets the rebate of Rs. 1000 from the tax proceeds due to him for his value addition. Suppose the tax rate is 4 percent. Then the tax per unit is Rs. 5000 × 4%, which is Rs. 200. The wholesaler pays the value-added tax on his purchase from this manufacturer which he can claim as rebate from his total value-added tax. In this way, governments collect tax at each stage of the manufacturing, processing, transportation and final sale of commodities. There is much less scope for tax evasion under VAT as the process of taxation is transparent. The producers, traders and retailers have to keep sleek accounts of their transactions and therefore there is no scope for generation of black money.

It has been claimed that the introduction of VAT would increase the country's tax base without actually raising the tax rates. A large section of the traders dodges taxes by entering into off-the-record transactions, thus encouraging the generation of black money. With the VAT regime in place, they will have to maintain records and issue receipts to seek refunds for taxes already paid. Everyone involved in the production, distribution and retail chain will have to pay taxes on the value added at his or her stage.

A reasonable profit margin is allowed at every level. No honest tax-payer can oppose such a foolproof tax regime, which is in use in several developing countries.

In India, 20 states agreed to introduce VAT from April 1, 2005, notwithstanding the threats of prolonged strikes from traders. They passed bills giving effect to this new tax regime. But the BJP-ruled states did not implement the VAT apprehending its political fall-out. One of the objections of traders to the VAT is that the states are not themselves clear about the implementation of the new tax system. The central sales tax has not been abolished. The turn-over tax too remains as it is. Octroi and entry taxes have to be paid in each state. Then where is the simplicity in this tax reform ? Secondly, it should have been implemented by the central government so as to impart uniformity of tax rates throughout the country. Thirdly, by having two tax slabs of 4 percent and 12.5 percent, VAT is open to influence from lobbying for inclusion or exclusion of certain products in a particular slab. This may lead to politicking with the new tax regime. The states also have the discretion to encourage or discourage the sale of particular products. The centre should have minimised discretion at the state level to develop a single market in the country. This would have paved the way for the introduction of a nation-wide goods and services tax (GST). Thus, only a beginning has been made to the process of reforming the tax system at the state level. The state governments will have to sort out the emerging irritants with the traders associations before it can yield the promised benefits.

14. TAXABLE CAPACITY

Meaning

Taxable capacity means the ability of a society to pay taxes. It tells us the limit to which the people of a country can be taxed. If we deduct the expenditure needed on maintaining the capital wealth of the country and the productive talents of the people from the country's national income, then the surplus available is an indicator of the taxable capacity of the nation.

For an individual citizen, taxable capacity may be defined as the maximum amount which the citizens of a country can contribute towards the expenses of the public authorities without having to undergo an unbearable strain. Different citizens have different capacities to pay taxes. Richer people can pay higher taxes but their standard of living is also higher. Nobody can pay so much taxes as to reduce his standard or living. Therefore, *Taxable capacity is the total surplus of production over the minimum consumption required to produce that volume of production, the standard of living remaining intact.*

Obviously, taxable capacity tells us the limit to which the people can be taxed. The capacity to pay taxes is higher during the period of national calamities than in normal time. But a tax- system should not dislocate the economic organisation or make people very unhappy. Therefore, Sir Josiah Stamp remarked, "Taxable capacity is the margin of total consumption. It is the maximum amount which citizens of a country can contribute towards the expenses of the public authorities, without having a really unhappy and downtrodden existence and without dislocating the economic organisation too much."

Taxable capacity tells us the *limit* to which a nation can be taxed. According to Ellinger, the limit would be reached when so much is taken out of the tax payers' pockets that the incentive to produce is reduced, and when insufficient remains to provide the necessary capital to make up for wastage and to set to work new workers in increasing population.

Absolute and Relative Taxable Capacity

Taxable capacity is understood in two different forms : (1) absolute taxable capacity ; and (2) relative taxable capacity. Absolute taxable capacity of a country is the measure of the limit to which a nation can be taxed at a particular time. It is a measure of the toleration level of taxation of the people in the country. For example, if people in a country can part with 20 per cent of their income as tax, then the total amount of tax revenue which can be raised is the indicator of absolute taxable capacity.

Relative taxable capacity involves comparisons between nations. These comparisons are made in percentage terms. For example, if the English people can pay 30 per cent of their incomes as tax while Indians can pay only 15 per cent of their incomes as tax because Indians are relatively poorer, then we can say that the relative taxable capacity of an average English man is double that of an average Indian.

It is very difficult to estimate the absolute taxable capacity of a nation because the taxable capacity depends upon a variety of factors all of which are not measurable. It is not independent of the way public money is spent. Therefore, Dalton has called absolute capacity a myth. In his view, it is the relative taxable capacity which has some practical relevence. It can be used to compare the taxation rates of two countries or at two different items for the same country.

Factors influencing taxable capacity

Taxable capacity of a country depends upon the economic conditions in a country. It changes from time to time. It is a dynamic limit of the extent to which people can be taxed. It depends on (*i*) the number of inhabitants in the state, (*ii*) the distribution of wealth, (*iii*) the methods by which the taxes can be raised, (*iv*) the purpose of taxation and (*v*) the psychology of tax payers. We can discuss the various factors affecting taxable capacity.

1. *Level of National Income.* Nations with high levels of national income and per capita income have higher taxable capacity than the poor nations. Taxable capacity is higher during periods of prosperity than during depressions.

2. *Size and Growth of Population.* When a country has a big and growing population to support and its income is not rising fast, the taxable capacity gets reduced. For example, in India, the numbers of the poor people are going up fast with rising population and unemployed persons. As a result, taxable capacity has goes down. It has become more and more difficult to raise revenues from taxation.

3. *Pattern of Public expenditure.* Taxable capacity also depends upon the way public spending takes place. If the government spends a major part of its revenue on defence, then it does not raise the productive capacity of the country. The taxable capacity, therefore, remains where it was. On the other hand, if a major share of the budget expenditure is on the creation of capital (productive) assets, the taxable capacity goes up.

4. Distribution of Wealth. Taxable capacity also depends upon the nature of income distribution in the country. If the few rich people receive a major share of a country's national income, they can be taxed easily and heavily for obtaining tax revenues. On the other hand, if the vast majority of the people share the national income equally, then the taxable capacity is much less because of the difficulties of taxing the not-so-rich people and of collection of revenue from a large number of people.

5. *Stability of income.* Greater the stability of income in a country higher is the taxable capacity. If people have highly variable income like the farmers, the tax-base is not dependable. Variability of incomes leads to variability of revenues. Industrial incomes are relatively more stable and therefore the taxable capacity of industrialised nations is much higher. In India, majority of the people are in agriculture. Their incomes are uncertain. Therefore, the capable capacity is low.

6. *Nature of the tax system.* Taxable capacity also depends on the organisation of the tax system. If the tax structure is scientifically planned, the taxable capacity goes higher. Relatively simpler and fewer taxes of direct and indirect nature may yield more revenue than a complex and unwieldy taxation system. A scientific tax system has a well thought-out mixture of taxes which get something from everybody without generating resentment and harming production. It has a simple and inexpensive tax collection procedure. The way the taxes are collected affects the taxable capacity very much.

7. *Objectives of taxation.* Taxable capacity also depends much on the objectives of taxation. If the motives for taxation are considered desirable by the tax-payers, taxable capacity is higher. If a tax is being imposed (or collecting money) to reduce the suffering of the people in general or to provide facilities of a socially beneficial nature, then the people voluntarily come forward to pay additional taxes. A tax imposed for a noble cause increases the taxable capacity of the people. It is commonly found that it is easier to enhance the taxes for fighting particular epidemics or expansion of education. But people oppose the taxes imposed for fighting a war far away from the country, for increasing the salaries of government servants or for giving foreign aid.

8. *Co-operation from the public.* As Findley Shirras has said, the psychology of the people taxed has much to do with the extent of taxable capacity. People are often willing to bear heavier taxation on patriotic or sentimental grounds. The altitude of the people towards a government has much to do with taxable capacity. It is well known that the American people refused lo pay taxes when they were not represented in the British parliament. The slogan raised by them was : "No taxation without representation." A popular government can more easily levy additional taxes. Also people become prepared to pay higher taxes when the freedom of the country is threatened. People become more co-operative in such conditions.

9. *Economic conditions.* Taxable capacity is the highest during periods of prosperity and full employment. It is the lowest in a period of deep economic depression such as that of 1930-34. Taxable capacity also goes down in a period of inflation because the purchasing power of the people gets reduced at a fast rate when prices rise fast. The taxation limit has to be raised thereby keeping more and more people out of the tax net.

10. *Rate of Economic Growth.* Taxable capacity also depends upon the rate of economic growth in as much as people are more readily prepared to part with increments to their income through taxation than to surrender a portion of their existing incomes. Therefore taxable capacity is higher in a growing economy as compared to that in a stagnant economy.

11. *Character of the people.* Taxable capacity also depends upon the character of the people in general. If the people are by nature habitual of avoiding taxes and the officials are corrupt, then the taxable capacity is definitely lower. On the other side, if the people of a country are highly conscious of their duty to their country and honestly pay taxes, then the taxable capacity is more.

To conclude, we can say that taxable capacity is a very general concept. It cannot be quantified easily. In so far as it depends upon political and psychological conditions, taxable capacity changes from time to time.

15. TAX INCIDENCE AND TAX SHIFTING

When a government imposes a tax on a particular person, he tries to pass it on to others. Sometimes he succeeds in this, sometimes not. Therefore, it is of interest to the government to know as to who is paying the tax and on whom the actual burden of the tax is falling. Thus the problem of incidence is the analysis to determine who pays the tax, *i.e.*, on whom the money burden of rise tax falls or rests.

By the incidence of taxes is meant the final resting place of their payment.

Incidence of a tax depends upon the nature of a tax. The incidence of a direct tax such as the income tax is on the person on whom it is levied. He cannot shift it to others. But the incidence of an indirect tax such as sales tax is on the customer who pays it when he purchases something. A direct tax cannot the shifted. Its incidence is on the very person who is supposed to deposit it in the government treasury. An indirect tax can be shifted. The factory owners or shop-keepers deposit it with the government treasury but the purchasers of the goods pay it and bear its money burden. We can say that *the analysis of tax incidence is the analysis of tax shifting.*

Impact and Incidence of a Tax

In order to understand tax shifting, we must distinguish between impact and incidence of a tax. The impact of a tax is on the person from whom the tax is collected by the government while incidence is on the person who is ultimately made to bear the burden of the tax. For example, the impact of, an excise duty on radio sets is on the producers of the sets while the incidence of the excise duty is on the purchasers of the radio sets because they pay the excise duty in the prices they are changed. 'Impact' and 'incidence' differ in the case of indirect taxes such as sales tax. But in the case of direct taxes, such as income tax, the incidence and impact are on the same person. This is because direct taxes like income. tax cannot be shifted by the person paying the tax onto another person.[1]

It must be understood that impact of a tax is immediate. It has to be paid by the due date. But incidence of a tax can be traced out only after some time when the shifting process has been

1. We must distinguish also between the 'incidence' of a tax and its 'effect'. It must be made clear that 'incidence' of a tax refers to the immediate and direct money burden of a tax'. 'Effect' of a tax includes all the direct and indirect results of the tax in terms of production and distribution of goods and services

completed. Incidence is the ultimate result of shifting of a tax. Tax shifting is a process which takes time. In fact, those on whom the impact of a tax falls try to find out ways of passing the tax on to others. If they succeed in their effort, tax shifting becomes a reality.

Importance of the concept of 'incidence'

The concept is of great importance in public finance. This is because a tax is always levied with some objective or objectives. No finance minister can afford to forget about the final resting place of the burden of a tax. In raising a revenue from the tax, the finance ministers usually try to satisfy some other objectives too. For example, by taxing the income of a person, they also try to reduce the income disparities between the rich and the poor. Similarly, a Lax on liquor is supposed to raise its price and discourage its consumption.

In order to socially justify a tax, the finance minister has to know not only its incidence but also its impact. In the absence of such a knowledge, the real purpose of a tax is likely to get defeated. For example, the finance minister may impose the property tax with a view to tax the propertied class and obtain a part of their income. But if the property-owners are successful in shifting the tax to their tenants who are the poor, labouring class then the incidence of the tax falls on the people on which it was not intended. Thus, the property tax becomes a poor-man's tax and it does not achieve the real objective of taxing the rich.

In studying the incidence of all the taxes a finance minister has levied, he gets to know the distribution of the tax burden on different classes of people. Thereby he can change the pattern of taxation to distribute the burden of taxation according to the capacity of a person.

Factors governing incidence of taxation

Study of the incidence of a tax becomes important in so far as it is wholly or partially shifted to other persons by the persons on whom its impact falls. How far and in which direction a tax is shifted depends upon a number of factors.

1. Nature of the tax. Nature of a tax refers to the basis of the tax, size of the tax and the object of taxation.

(*a*) A tax can be based on the price of commodity of its quantity as measured by weight, length and volume, etc. For example, the excise duty on a television set is based on its price but octroi charges are the same whatever the price. Generally the taxes are based on prices of the products so that the cheaper products bear less burden as compared to the dearer products. But if a tax is based on the nature of the item purchased rather than its value, as in the case of octroi duty, then the cheaper items bear a disproportionate burden of the tax. This puts the producers of cheaper items at a disadvantage. They find it more difficult to shirt the tax on to the consumers.

(*b*) Size of the tax in proportion to the price of the product also influences its shifting. If the tax is very small as compared to the price of a product, then the producers can easily absorb the tax in their costs. Tax shifting may not take place. On the opposite if the tax is large in relation to the price of an item, the producers will try their best to shift it to the purchasers because the producers cannot afford to reduce their profit margin to the extent of the tax.

(*c*) If the objective of a tax is to reduce the profit-margins of the producers of a product, then other measures are necessary to ensure that the tax is not shifted. If a taxed product can be transferred easily, tax shifting is possible. So the government can control the price of the product and declare it as non-transferable. If a service which is non-transferable is taxed, then tax shifting cannot take place. For example, stay in a hotel or lunch at a restaurant. In such cases the objective of the tax itself is to get some revenue from the richer visitors.

2. Nature of the commodity. The incidence of a tax also depends upon the nature of the commodity taxed.

(*a*) If the commodity is a necessary of life such as wheat, atta or rice, then the tax can be easily shifted to the consumers. If the commodity is a luxury, then tax shifting may not be possible in full.

(*b*) If the commodity taxed has no substitutes, tax shifting is easily possible for the sellers. On the opposite, if a taxed commodity has many substitutes, the consumers will start purchasing the substitutes rather than the commodity taxed.

(*c*) If a commodity has a sticky price because it has become the customary price or because there is fierce competition for its sale, then the tax cannot be easily shifted.

3. Elasticity of Demand and supply of the taxed commodity. The incidence of taxation also depends upon the relation of the elasticity of demand with the elasticity of supply of the commodity taxed. Professor Dalton observed :

The direct money burden of a tax on any object is divided among buyers and sellers in the proportion of the elasticity of supply of the object taxed to the elasticity of demand for it.

Figure 28.3 shows the supply curves of a taxed commodity before and after the tax imposition. The three panels of the diagram combine the supply curves with different demand curves. Figure (*a*) shows a perfectly inelastic demand curve with two different supply curves. Figure (*b*) shows a perfectly elastic demand curve *D*. The supply curves marked *SS* show the supply position of the commodity before the tax while the supply curve labelled S′S′ shows the position of supply after the excise tax is levied on the commodity. The effect of the excise tax on the price of the commodity in the three situations can be easily read in the three diagrams.

(*i*) In the case of the perfectly inelastic demand curve, the equilibrium price paid by the consumer increases by the full amount of the tax. This is clear from Figure 28.3 (*a*) where PP′ = *t*. We therefore infer that

(*a*) Perfectly inelastic demand for a commodity leads to a rise in price by the full amount of the tax for the consumers.

(*b*) Perfectly elastic demand for a commodity does not raise the prices for the consumers; the whole tax burden falls on the producers.

(*c*) The more inelastic is the demand the greater is the rise in price for the consumers due to the tax and the lesser is the fall in price received by the producers.

(*ii*) In the case of the perfectly-elastic supply curve, the equilibrium price for the consumer is unchanged, the price remaining where it was : The producer pays the whole tax. See Figure 28.3(*b*).

(*iii*) Figure 28.3 (*c*) shows that when the demand curve has the slope shown by D_1D_1 the price rise for the consumers is PP_1. If the demand curve changes its slope to take the position shown by D_2D_2, the price rise for the consumers becomes PP_2. We find that even though the tax rate remains the same at *t*, the consumer has to bear a bigger share of the tax burden, the more inelastic the demand for the taxed commodity.

The conclusions of the above three paragraphs can be generalised. We can say that :

The more inelastic the demand for a commodity, the greater the rise in the price paid by the consumer and the lesser the fall in the price received by the producer as a result of the imposition of any given tax.

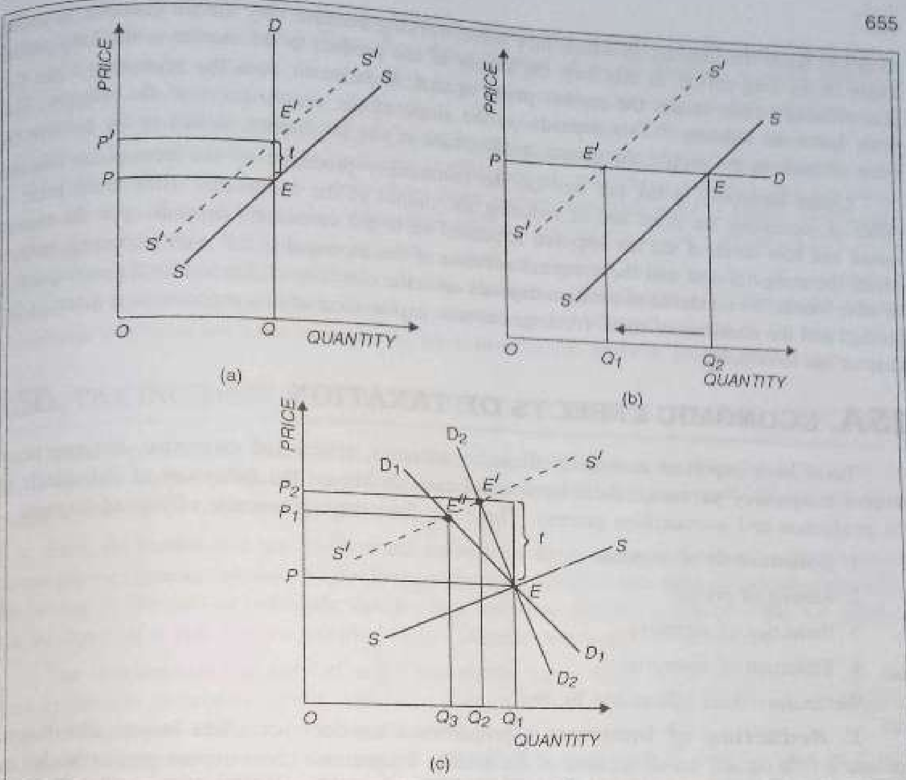


Fig. 28.3 Incidence of taxation (excise tax) for different supply and demand elasticities.

Similarly, by drawing the diagrams for the supply curves having different slopes, with demand curves being of the given slope, we can show that the greater the slope of the supply curve (*i.e.* the steeper the supply curve), the greater is the share of the tax burden falling on the consumer and the lesser the share of the tax burden borne by the producers.

4. Nature of the tax law. Possibility of tax shifting is more for a commodity whose price is written on it and the buyers take it to be a standard commodity such as is Colgate dental cream. In this case, the additional tax can be easily charged from the consumer as "local taxes extra." The consumer does not mind paying an additional tax with the written price.

5. Nature of the market structure in which the taxed commodity is sold. How much of a tax can be shifted to the consumers and how much of it is absorbed by the producers depends also on the nature of the market structure in which the commodity is sold.

Under perfect competition, the producers are unable to shift the burden of a tax to the consumers in the short period because none of them has any influence on the price. The tax becomes a cost for the producers to be borne in the short period. The more efficient firms may pay the tax and yet earn a profit. The less efficient firms may suffer a loss in production and are forced to leave the industry in which they were working because they cannot continue to suffer losses in the long period. In this way, the supply of the product to the market in the long period gets reduced which causes the market price to rise. How much does the price rise when the firms leave the industry ? This depends on the slope of the supply curve of the industry. The more inelastic is the supply, the greater is the share of the tax burden shifted to the consumers.

Under monopoly, a tax per unit on the commodity produced by the monopolist has the effect of increasing the price and of reducing the output of the commodity. How much price is raised and how much of the tax imposed is passed on to the consumers depends upon the rate at which the marginal cost and the marginal revenue of the monopolist fall with increasing output. In other words, the incidence of taxation depends upon the elasticity of demand for the monopolist's product and the elasticity of costs. (A diagrammatic explanation of this proposition is given in the chapter on monopoly).

15A. ECONOMIC EFFECTS OF TAXATION

Taxes have important economic effects on incomes, prices and enterprise. Because taxes involve compulsory payments, these have significant effects on the behaviour of individuals in the production and consumption process. There are four major economic effects of taxation.

1. Redistribution of incomes
2. Raising of prices
3. Reduction of incentive
4. Reduction of enterprise

We analyse these effects one by one.

1. *Reduction of incomes.* A proportional tax does not affect income distribution because it falls equally on all sections of the society. Progressive taxes impose greater burden on the richer sections, than on the poor. Therefore, these taxes redistribute income in favour of the poorer sections. Taxes which are regressive impose a relatively greater burden on the poorer sections of society as compared to the richer classes. Therefore, these worsen the income inequalities.

2. *Raising of prices.* Indirect taxes are added to the prices of the commodities by the sellers and are fully charged from the consumers. Whenever excise duties on commodities are raised, their prices go up. It fans the fires of inflation, but when the prices of coal, petrol or railway freight rates are raised, it worsens the inflationary situation in two ways–via increased prices of all manufactures and via increased wage demand from workers owing to the higher cost of living.

3. *Reduction of incentive to work.* Heavy taxation of income and wealth seriously reduce the incentive to work hard. If a rich man's income is taxed at the rate of 60% on the margin, he may as well decide to curtail his involvement in his profession. Or if income taxation in professions where income cannot be concealed is high, the professionals–doctors, lawyers and consultants–may divert their activities to lines where they can earn unaccounted money. Therefore, a case for light taxation earned of incomes is often made.

Similarly, heavy taxation on different forms of wealth adversely affects the incentive to work. People want to save and have property. They want to work harder to obtain it. But if the property holders are harassed by the tax officials, they might as well keep their wealth in forms which cannot be easily detected. Thus, the whole purpose of wealth taxation may get defeated.

4. *Adverse effect on risk-taking.* Heavy rates of profit taxation of companies discourage the entrepreneurs from undertaking risky investments. Greater the amount of risk involved in an investment project, higher must be the promise of profit therefrom if it is to be undertaken. If entrepreneurs earn handsome profits through risk-taking and then they are asked to pay high profit taxes, it discourages them from undertaking such risks in future. This would reduce the rate of growth and also discourage efficient use of the nation's resources.

Economic effects of taxation must be taken into account in the process of selection of taxes if the revised tax structure is to serve the attainment of economic goals before the nation. Further, the burden of taxes should be so distributed among different sections of the society that individuals and firms have the incentive to work to fulfil the goals of growth with equity.

15B. TAX INCIDENCE : THE EFFECT OF TAXES ON DISTRIBUTION

When a government levies a tax, it writes a law assigning responsibility for payment of the tax to specific people or specific organisations. To understand a tax, we must look beyond those named in the law as the initial tax payers.

First, the burden of a tax is ultimately borne by individuals or households ; institutions have no tax-paying capacity. Second, the burden of a tax is not always borne by those initially responsible for paying it. Directly or indirectly, tax burdens are **often shifted** to others. When we speak of the incidence of a tax, we are referring to the ultimate distribution of its burden.

The simultaneous reactions of many households and/or firms to the presence of a tax may lead to changes in relative prices, and price changes affect households' well-being. Households may feel the impact of a tax on the sources side or on the uses side of the income equation. (We use the term **income equation** because the amount of income from all **sources** must be exactly equal to the amount of income allocated to all uses–including saving– in a given period). On the **sources side** a household is hurt if the net wages or profits that it receives fall ; on the **uses side**, a household is hurt if the prices of things that it buys rise. We can say that :

The imposition of a tax or a change in tax can change behaviour of the firms and households. Changes in behaviour can affect supply and demand in the markets and cause prices to change in the input and output markets. Due to these changes, some households are made better off and some are made worse off. These final changes determine the ultimate burden of the tax.

Tax shifting takes place when the households can alter their behaviour and do something to avoid paying a tax. This is easily accomplished when only certain items are singled out for taxation. Suppose a heavy tax were levied on tobacco products such as cigarettes. Initially, the tax would make the price of such products much higher, but there are many potential substitutes for cigarettes such as *bidis* and pipes. Consumers can avoid the tax by not buying cigarettes, and that is what many will do. However, as demand drops, the market price of cigarettes falls and tobacco growers lose money. The tax shifts from consumers to the growers, at least in the short run.

A tax such as the retail sales tax, which is levied at the same rate on *all* consumer goods is harder to avoid. The only thing consumers can do to avoid such a tax is to consume less of everything. If consumers do, saving will increase, but otherwise these are few opportunities for tax avoidance and therefore for tax shifting. It can be said that ***broad-based taxes are less likely to be shifted and more likely to "stick" where they are levied than "partial" taxes are.***

16. PUBLIC DEBT – NATURE AND MEANING

Public debt means the debt which a government owes to its subjects or to the nationals of other countries. These days, government revenues from taxation and fees are not enough to meet the rising costs of government. Since, governments are also taking active part in the economy's development, they borrow on a long-term basis from banks, business organisations and individuals. The public borrowing is known as public debt.

Public debt is the obligation on the part of the government to pay the money back to the individuals from whom it has been obtained.

There are differences between private and public debt.

1. Government can use compulsion to obtain the needed loans at its own rate of interest. No lender can force a government to repay his loans. All this is not possible for a private individual.

2. Governments often obtain long-term loans and offer to repay the loans in instalments of its own choice. A government has the authority and stability to borrow for a long term. People have confidence in it. But private debt is often incurred for a short period of time and repayment is on the lender's terms.

3. Government has far more sources of debt than an individual or a private company. A government can borrow from within the country or form the lending institutions in the international market. The sources of private finance are limited.

4. Public debt is used for productive purposes or for promoting the welfare of the weaker sections of society. Private debt can as well be used for consumption purposes.

5. A government can pass on the burden of public debt to those very people from whom the government had borrowed. Rich people, companies and financial institutions subscribe to the government loans. The government can levy additional taxes on these individuals and institutions for repaying the debt itself.

6. Repayment of public debt has a pervasive effect on the economy. Excessive debt repayment can produce economic disorder which affects national income adversely. Individual debt repayment has no such effects on the economy as a whole.

7. A government needs borrowing more often than an individual because public expenditure is often inelastic while revenues tend to be quite elastic. The deficit has to be financed through public borrowing. An individual has always the option to reduce its expenditure to suit his income.

8. Public debt is not always aimed at financing public expenditure. For example, during inflation, a government may borrow in order to reduce purchasing power in the hands of the public. The objective of public borrowing generally is economic stability.

9. Private borrowing is possible only on the basis of some security or collateral such as gold or property. The value of the security should exceed the amount of the loan taken. A government has no such compulsion. It can issue government securities in lieu of the loan to the

people who lend to the government. A government security consists of a treasury bill, a gilt-edged security or a consol. The total amount of securities issued is called the national debt.

17. SOURCES OF PUBLIC BORROWING

Public borrowing is possible from two different sources :

1. Internal sources.
2. External sources.

1. Internal Sources

Internal sources of public borrowing are :

1. *Borrowing from citizens.* In order to borrow from its citizens, a government has to sell saving certificates, securities and bonds to the citizens who purchase these out of their savings. This does not affect their consumption. Government obtains the needed resources for economic development and social welfare.

2. *Borrowing from financial institutions.* Some financial institutions such as insurance companies specially invest their resources in the purchases of government securities. This puts vast resource in the hands of the government for a long period which the government can invest in heavy, basic and key industries since these require large-scale investment. Financial institutions perfer to purchase government securities, bonds and debentures because this keeps their deposits safe. Such investments are highly liquid in the sense that these can be got cashed at any time.

3. *Loans from the Central Bank.* The union government can obtain loans from the Central Bank as and when there is a pressing need for resources. The Central Bank purchases the government securities, bonds and debentures from the government. The government draws cheques on the Central Bank for payment to its creditors who deposit these with their banks. This increase the deposits of commercial banks who have to deposit a part of their additional deposits with the Central Bank. This considerably restricts the addition to the money supply with the public.

4. *Loans from Commercial Banks.* Government can also obtain loans from Commercial Banks who invest a part of their deposits in government bonds and securities to fulfil the liquidity requirements of their portfolios. This reduces the credit- creation power of the commercial banks.

There are *limits to raising of resources* through internal borrowing in a less developed country.

Firstly, the national income being low, people have low saving to income ratio. Only a few rich people can participate in contribution to government loans and purchase of government securities.

Secondly, the capacity of a government to raise loans also depends upon the political conditions in the country. When there is political stability in the country, this capacity is higher.

Thirdly, development of commerce and banking also helps a government in selling its securities and thereby mobilising resources through borrowing.

Fourthly, the nature and size of public debt which a government has already accumulated also determines its borrowing capacity.

Fifthly, the nature of economic policy which a government is following also influences its borrowing capacity. If a government has announced a programme of industrialisation and agricultural development, the people are likely to enthusiastically participate in public saving and investment programmes. On the other hand, if a government resorts to public borrowing for waging war in distant lands, the citizens may not respond to the schemes of public borrowing.

Sixthly, how efficiently are the public loans repaid along with the rate of interest also influences the willingness of the people to purchase more government securities and contribute to government loans.

2. External Sources

When a government is unable to finance its development programmes through internal borrowing only, then it can go to some external sources, *i.e.*, the sources available at the international level. These sources are :

(*a*) ***International money market.*** There are foreign exchange banks situated in Paris, London and New York which have big deposits of foreign exchange to lend to any government which makes a request for a loan. These loans are available at the current international rate of interest in the market. These rates are generally high.

(*b*) ***Loans from foreign governments.*** Some friendly foreign governments can also lend money in the form of their currency by agreeing to supply the needed goods through a contract. The governments of U.S.A., U.K., France, West Germany and Japan give loans of this type.

(*c*) ***Loans from international financial institutions.*** Some international financial institutions have been set up under the auspices of the U.N. with the view to help the needy governments to tide over their financial problems at the international level. The International Monetary Fund (I.M.F.) gives loans to its members on a short-term basis. The World Bank gives long-term loans for economic development on reasonable rates of interest. The International Development Association (I.D.A.) also gives soft loans for special programmes of removal of poverty.

Is there any economic limit to the size of the debt ?

There has been a tendency among less developed countries to increase the absolute size of public debt. Some of them have even stepped up the relative size of public debt *i.e.*, the ratio of public debt to national income. Is it really undesirable to go beyond a limit considered safe ?

The answer to this question depends upon the use to which the public debt is being put. (1) In so far as the money raised by borrowing is spent on items which add to national income, the public debt creates the extra income out of which extra taxes can be raised to pay the interest. (2) The extent to which the borrowing is spent on items which do not add to our national income, it will be necessary to increase existing taxes so as to provide funds to meet the interest payments. Upto a point, it will not cause any serious problems because the process of paying interest on the debt involves only a transfer from some citizens (tax payers) to other citizens (holders of government bonds). However, there is a limit beyond which it is not safe to do so. This is because if the tax payers of the additional funds happen to be the nation's poor and the bond holders are always the rich, then it involves rewarding the rich and impoverishing the poor further. Obviously, the size of interest payments on the public debt should not go beyond a particular percentage of national income, especially when the public expenditure of the funds raised through borrowing is of an unproductive nature. The situation must be a source of national worry if the non-income creating debt is increasing very much faster than the national income. Such a situation exists in some countries during war times only.

A dependable indicator of whether the public debt is reaching dangerous levels is the willingness of the general public to take government bonds at various rates of interest. As long as they have the confidence in the government's ability to pay back its debt, the price of government bonds will rule steady. The moment investors in government bonds lose confidence in them, their price would fall and interest rates would rise because borrowers would demand a premium for risk. Such a situation has rarely been seen. The fact is the government can always find funds for borrowing if the riskless bonds are available. This shows that the financial institutions are not concerned about the size of the public debt.

18. EFFECT OF PUBLIC DEBT

The processes of public borrowing and repayment of public debt definitely influence production and distribution. Although it is not possible to specifically determine the effects of a public loan, even then it is possible to trace out the general economic effects of public debt in general. The economic effects of public debt depend upon many factors, the main being as under: (*i*) the amount of public debt, (*ii*) the objectives of public borrowing, (*iii*) the rate of interest, and (*iv*) the conditions of repayment. On the relative strength of these factors depends the net effect of public debt on production, consumption, prices and income distribution. We study these effects one by one.

1. *Effect on national output.* In the first place, the effect of public debt on production depends upon the amount of the public debt. If the amount of public borrowing is small, then it has little effect on national output because people can contribute to it from their additional savings. But if the amount is large, then people purchase government bonds by diverting their funds from their private investments. This may adversely affect production. In order to repay big public loans, the government has to impose additional taxes which might act as disincentive to work for increased output.

Secondly, the effect of public debt on national output also depends upon the objectives of public debt. If the public loans are meant for increasing productive activity through direct public investment or through incentives for private investment, then the public debt will serve to increase national output. In the same way, if the public expenditure is done on provision of education, training and health care to workers, even then it is likely to prove productive. On the opposite side, if the loans raised by the government are spent on the expansion of staff and office building for administrative work only, then the public debt may be injurious to growth of output because that will not increase any output while the interest charges to be paid on the loan will have to be financed out of additional taxation.

Thirdly, the effect of public debt on national output will also depend upon the methods of repayment of the public loan. If the loan is paid in a lump sum, it might fan the fire of inflation. If the loan is repaid during recession or depression, it may improve the conditions for investment. If the public loan is repaid through instalments over a long period, that will not have an unsettling effect on the economy.

2. *Effect on consumption.* Public debt tends to encourage consumption. Those contributing to public loans purchase government bonds on which they earn a capital gain if they hold it. The bond holders may also earn a capital gain if they choose to sell them as their market prices rise. This especially happens when the market interest rates tend to fall. When the market price of government bonds rises, the bondholders have a tendency to step up their consumption.

Public debt can reduce the consumption of those people who have to pay additional taxes for the payment of the interest on the public loans. Therefore, the burdern of taxation to finance debt charges must be made to fall on the people who hold public bonds, as far as possible.

3. *Effect on the general price level.* Public borrowing and its repayment have a significant effect on the price level in so far as these affect the money supply. When the government borrows from the public, government bonds are sold to the public as a result of which the money supply with the public goes down. The reduced money supply has a restraining effect on the rising price level in a period of inflation. On the contrary, during a period of depression, when the government pays back the debt to the people by purchasing the government bond holdings of the people, the money supply with the public goes up. This helps the banks also in creation of more credit. Easier money supply position helps economic recovery and raises the general price level.

4. *Effect on income distribution.* The net effect of public debt on income distribution in a society depends upon (a) who are the lenders to the government and (b) who are the tax-payers for repayment of the public loan. Generally, the government bondholders are the financial institutions while the tax-payers are the general public. In as much as the interest-receivers are the rich people while the interest-payers of the public debt are poorer people, public borrowing tends to widen the inequalities in income distribution. This is particularly so when the government spends the funds raised through public borrowing on purchases which are supplied by the rich contractors. Therefore, government has to plan their borrowing and spending.

19. BURDEN OF PUBLIC DEBT

The burden of external debt must be distinguished from the burden of the internal debt because the former involves, the repayment of debt in terms of foreign currency which must be earned through exports while the latter does not involve any such obligation. External debt is the obligation of the government to foreigners while internal debt is the obligation to the citizens of one's own country.

Then, we must also distinguish between the direct burden and indirect burden of public debt because of the differences in the money costs and real costs involved in the public debt.

The direct burden of public debt equals that amount of money which is repaid as the principal plus the interest to the holders of government bonds.

The indirect burden of public debt is calculated in terms of real costs. It is equal to the loss of public welfare resulting from the reduction in public expenditure due to the repayment of public debt. It is measurement of the loss in welfare in terms of the additional goods and services which could have been made available to the citizens of the country through public expenditure of the money paid back to government bondholders.

It should be obvious that the indirect burden of a public debt which is spent on productive programmes is much less than that of the public debt which is incurred for unproductive pursuits.

Productive public debt raises the national output which can help repayment of the debt while unproductive public debt gives no such sources of repayment. Therefore the economic consequences of economic debt policies will depend on the nation's productive output rather than on the size of its public debt per. Hence objections that a large public debt may endanger the nation's credit rating are based on psychological fear, not economic facts.

The burden of external debt

The direct money burden of public debt held by foreigners is equal to the total amount of money which has to be paid to them in the form of interest on the external loans. Higher is the rate of interest on foreign loans, greater is the direct burden of the debt.

The direct real burden of external debt is measured by the loss of economic welfare which these payments involve to members of the debtor community. The loss in welfare involved is lower if the repayment of external debt is financed from exports which would form the rich man's consumption in the absence of such exports. The loss of welfare involved in external debt will be more if the needed foreign exchange is earned out of the exports of goods normally consumed by the low-income groups.

The indirect burden of external public debt is much more as compared to the direct burden. This is because payment of external debt involves (*i*) taxation of the people within the country, and (*ii*) reduction of public expenditure welfare. Owing to these two factors the indirect burden is much more than the direct money burden of the external debt.

The indirect money burden of foreign debt is measured by the value of the foreign currency obtained through the loan and the value of the goods and services exported to finance its repayment. If a foreign loan is well spent, it ought to improve exporting capacity of the country for financing the loan as well as for producing a surplus in order to strengthen its foreign exchange reserves.

The indirect real burden of an external debt arises from any check on production due to (*i*) the taxation required to meet the debt charges and (*ii*) any reduction of public expenditure which would have promoted production in the country. It should be obvious that the indirect real burden of external debt depends upon (*a*) how far the foreign loans improve the production capacity of the country, and (*b*) which method is used to finance the repayment of external debt.

Burden of internal debt

The nature of internal debt is different from that of external debt. In internal debt, the government owes money to its own citizens. For repayment of such debt, the government has to tax one group of people, raise revenue and pay to the government bondholders.

The direct burden of internal public debt is not so harmful to the welfare of the general public. The direct money burden equals the principal plus the rate of interest. According to Findley Shirraz, there can never be any direct money burden, or direct money benefit of an internal debt. This is because all transactions connected with an internal debt resolve themselves into a series of transfers of wealth within the community. The government taxes one group of people and pays the additional revenue to repay the public debt. There is no effect on output and employment within the country. Internal debt simply involves the transfer of money from the general public to the government and then back to the public.

The direct real burden of internal public debt depends upon the economic conditions of the people taxed to repay the debt and the economic status of the individuals who get the repayments.

If the people taxed are the poor and those who get the repayment are the rich, then the internal debt is a real burden. On the contrary, if the people taxed are the rich non-labouring class while those getting the income transfers from government spending of the public debt are the hard-working poorer class, then it involves a real benefit. The debt will involve a direct real burden or a real benefit to the community according as the series of transfers from tax-payers to public creditors increases or decreases the inequality of income.

The indirect burden of public debt is put on the people through its adverse effect on production and income distribution as well as through increase in the price level induced by the public debt. The indirect money burden of public debt depends upon the extent of the increase in demand for goods and services generated by the expenditure of the money raised.

The indirect real burden of public debt is in the form of reduction of output caused by the additional taxation necessitated by it. If the additional taxes discourage the will to save and invest and further if the amount raised through public debt is spent on unproductive activities, then the real burden of public debt is definitely heavy. In addition to the fall in output, if the public debt worsens also the distribution of income, the real burden is increased all the more.

In short, the burden of internal debt depends upon the extent to which :

(*a*) the expenditure of resources raised is used to raise national output,

(*b*) the will to save and invest is strengthened or weakened,

(*c*) the aggregate demand for goods and services is raised, and

(*d*) the income distribution is worsened.

Does public debt shift the burden to the next generation ?

Some persons have been propagating the view that public debt is a means of shifting the burden of financing a war or a programme of economic development to the next generation because in the absence of public debt, the present generation would have borne additional taxes. The present generation escapes taxation while the next generation has to repay the debt. Such a view is, however, erroneous because of the monetary view of the debt it takes. Financing a war or a programme of economic development is essentially in terms of the real goods and services forgone by the present generation in these activities. Fighting a war means less goods and services made available to the present civilian population so that the next generation is able to live in peace. Similarly, a programme of industrialisation through massive investment now means increased productive capacity made available to the next generation. The present generation saves and invests more at the cost of current consumption.

We can say, therefore, that as far as internal public debt is concerned, the burden of the debt falls on the present generation itself. It is not a means of shifting the burden of taxation onto the next generation.

The external debt burden

Does a large external debt impose a burden on future generations? The answer is that it can. This is because future generations must pay interest and the principal without receiving corresponding benefits in return. The foreign investors may well spend the dividends received from India in their own country rather than in India. Not only this. Foreign investors can try to withdraw their investments at the time of the country's currency crisis. This can force the country to devalue their currency. Flight of capital from Indonesia in the nineties aggravated its foreign debt burden.

However, an exception can occur if the original borrowings from foreigners were spent here to buy capital goods and to create jobs. In that case, the resulting current output may be large enough to cover most if not all of the interest and principal payments on the debt. A clear sign of a country's public debt position is its rating by international lending institutions. A rapidly worsening position of the country's credit rating is a signal to halt further borrowing for unproductive purposes and seek moratorium on debt repayment. At the same time, countries under serious balance of payments difficulties are advised to carry out structural reforms.

20. METHODS OF DEBT REDEMPTION (DEBT MANAGEMENT)

Whatever borrowing a government does, it has to be repaid at some date of maturity of the loan. The government has to arrange for the means of repayment or redemption of debt. The different methods of debt redemption commonly used are as follows :

1. *Utilisation of Budget Surplus.* The government can reduce its expenditure below the income expected from the various sources of revenue in order to generate a surplus which can be utilised to pay back old debt. A budget surplus can be utilised lo pay back old debt. Since a budget surplus is a rare thing these days, and since such surpluses are used for other, more pressing needs of the government, other methods of debt redemption have been used more often.

2. *Sinking Fund.* This is a special fund which is built up entirely for debt redemption. Such a fund can be established in two ways : One is to deposit a part of the tax revenue into a fund regularly. The second method is to use the income obtained from the projects built through the use of public debt. However, not all the projects built from the use of public debt are income-earning. Therefore, the practice these days is to retire a pre-determined portion of the public debt from a part of the tax revenues obtained each year.

3. *Payment by capital levy.* A capital levy is a special tax on the increase in values of the capital assets owned by different institutions. A capital levy is a one-time payment to the government. Since the money obtained from the capital levy is sizeable, it can be used to repay a major part of the public debt. Such a levy was suggested after the First World War in England.

4. *Terminal Annuity.* When the public debt is so large that the government cannot hope to pay it back all at once, then the government can decide to pay it back in instalments along with the rate of interest due to the instalment. The total public debt is divided into annual instalments which when paid help to terminate a part of the new debt. These instalments are called terminal annuities.

5. *Loan Conversion.* To reduce the burden of public debt arising from the high rates of interest on public loans, a government can resort to loan conversion. The government can convert old loans into new ones which bear a lower rate of interest, *i.e.*, the rates of interest prevailing in the market. The government bondholders are given new bonds convening the old ones into the new bonds.

6. *Refunding.* When the conditions for fresh public borrowing are favourable new loans are raised and the funds obtained therefrom are used to pay back the old public debt. This is a very useful instrument of public debt management. It differs from conversion of loans in that under refunding the government bondholders may change while under loan conversion, they remain the same.

21. DEFICIT FINANCING

Meaning

When a government spends more than the revenue obtained from taxes, fees and surpluses of public enterprises, the practice is called deficit financing. The gap between expenditure and revenues may be filled up by (1) borrowing from the commercial banks or (2) drawing down the cash reserves of the central bank or (3) through printing and issue of additional currency. All these methods of financing the resources gap are different ways of deficit financing.

According to the Indian Planning Commission, "The term 'deficit financing' is used to denote the direct additions to gross national expenditure through budget deficits, whether the deficits are on revenue or on capital account. The essence of such a policy lies in government spending in excess of the revenue it receives in the shape of taxes, earning of state enterprises, loans from the public, deposits and funds and other miscellaneous sources." Thus in India all types of borrowing from the public is excluded from the definition of deficit financing.

In general we can define deficit financing as a deliberately created gap between public revenue and public expenditure *i.e.* budgetary deficit, the method of financing being such as results in a net addition to national outlay. In other words, deficit financing puts extra purchasing power in the hands of the public without providing any matching extra supply of goods and services in their hands. Deficit financing includes the following :

(*a*) withdrawal of past accumulated cash balances by the government;

(*b*) borrowing from the Central bank;

(*c*) issuing of new currency by the government.

Case for deficit financing

Deficit financing has become one of the important instruments of planning for economic development. The case for deficit financing is made out on the following grounds :

1. *Increasing the rate of net investment.* In less developed countries, the rate of private investment is so low that the rate of economic growth is altogether inadequate in relation to the growth of population. Public investment in agriculture and industry is very necessary for raising the rate of growth to the desired level. Investment on the required scale is not possible without deficit financing.

2. *Building of social overhead capital.* Less developed countries need massive investment in social overhead capital such as railways, roads, ports, airfields, power projects and educational institutions. Investment in these socially productive capital assets raises the productive capacity of the economy by breaking structural rigidities. Deficit financing is the only means of financing such heavy investments.

3. *Investment of forced'saving.* Deficit financing raises community savings. It is an instrument of forced saving. When the government spends money through deficit financing, it purchases the goods and services needed, thereby raising the general price level. The people, in general, willingly pay the slightly raised prices of goods and services when they would not have been otherwise willing to pay more through taxation. In a way, deficit financing forces people to save more. The' common man contributes to national saving through this method.

4. *Deficit financing is necessary in a developing economy.* Where real output and incomes are rising, the public needs more money for transactionary and precautionary purposes. In the absence of a raised supply of money, the general price level has a tendency to fall, which is not a desirable tendency for encouraging future investment.

5. *Monetisation of the economy.* In such economies as have a barter sector, deficit financing is necessary for monetising the backward areas where barter sector is found at present. As the barter sector contracts, the use of currency increases which offsets any increases in money supply.

6. *Matching an import surplus with increased money supply.* As a result of increasing foreign aid, an import surplus may develop which may push up the demand for money. This increase in demand for money can be met properly through deficit financing.

It is argued that deficit financing is not harmful as long as the supply of goods and services is increasing in a developing economy. There may be a temporary disequilibrium between the supply of money and the supply of output. If further investments are directed at breaking the bottlenecks to increased production, then the general price level cannot rise much. Therefore, deficit financing is not always inflationary. It is inflationary only when the spending is of the unproductive type or when the expected increase in output does not occur.

Case against deficit financing

Some writers consider deficit financing as a dangerous tool in less developed countries for financing their economic development.

In the first place, deficit financing sows the seeds of inflation which tends to be dangerous in less developed countries. Inflation in these countries is not only economically harmful but socially undesirable also. The initial small rise in the price level may change into hyper-inflation because these economies have specific features which render them specially sensitive to inflation.

According to Dr. V. K. R. V. Rao, there are four reasons for deficit financing giving rise to inflation :

1. Expansion of currency brings with it the possibility of a greater expansion of money supply through the expansion of credit ;

2. Absence of direct return on deficit finance in the form of goods and services which reduces the possibility of mopping up a part of the increased purchasing power through taxation;

3. Absence of saleable securities against which the government outlay is undertaken reduces the chances of additional incomes mopped up ;

4. Greater possibility of waste and failure to promote greater productivity associated with government investment in the absence of an exceptionally competent and honest standard of public administration, as a result of which output fails to rise and match the additional purchasing power.

Secondly, deficit financing does not encourage saving and investment in the free-market underdeveloped economies. These countries have market imperfections. There is immobility of resources which leads to inelasticities of supplies of goods and services which are in high demand. Thus, while deficit financing increases the aggregate demand, the aggregate supply remains inelastic. This creates serious inflationary pressure.

Thirdly, deficit financing often makes the food problem more serious. When incomes increase as a result of deficit financing, the demand for food products goes up quickly. In countries like India, the income-elasticity of demand for food products is as high as 0.8. Agricultural sector being backward and unresponsive, the supplies of food products lag behind the fast- increasing demand which leads to a sharp rise in food prices. Soon this price rise spreads to the other parts of the economy.

Fourthly, the use of deficit financing for building up of infrastructure is bound to be inflationary because this investment is slow to give yields. These projects have a long gestation or fruition period. Such heavy investments generate demand for consumer goods immediately, particularly for consumers goods produced in industries which do not have excess capacity. This creates serious shortages and inflation.

Fifthly, the inflation generated by deficit financing is not easily controlled. This is because inflation becomes inimical to the process of economic development itself. Inflation has very harmful effects on not only the economy but also the society.

1. Inflation discourages voluntary saving. The fixed-income group who save on their own are hard hit by inflation. They do not save, for they try to maintain their standard of living. Those who can still save in the face of inflation are attracted towards quick profit-making investments of the speculative type such as real estate, inventories, jewellery and foreign assets. Such savings are not conducive to economic development.

2. Inflation also discourages real investment. Continuous inflation creates an atmosphere of uncertainty of the rate of return in real investment, especially when it takes the form of cost inflation. The entrepreneurial class is caught up in a situation of spiral inflation. At such a time, if the inflation is halted by government policy, the entrepreneurs may suffer losses due to the recessionary effects of this policy.

3. Inflation gives rise to serious social costs. In this connection, Higgins has observed that "the destruction of the middle classes, impoverishment of workers and enrichment of speculators and blackmarketeers intensity social conflict and permit radical parties of the right or left to take power. Underdeveloped countries prone to political instability cannot afford the added burdens of hyper-inflation.

4. When the general price level is increasing, the costs of development projects go up even within the time of construction which necessitates revision in project costs. It takes a long time to obtain the sanction for the revised estimates. Due to delays in the construction of dams, power houses and canals, the speed of inflation is increased all the more.

5. Inflation also creates balance of payments difficulties by discouraging both exports as well as the flow of foreign capital into the exports sectors. Foreign investors are scared by the price spiral which the economy gets caught. On the opposite, imports are encouraged when these are cheaper than home-made goods. This may create a foreign exchange crisis.

From the case against deficit financing made up above, we can easily conclude that less developed countries are like extremely weak and sensitive patients. These economies can tolerate only a mild dose of deficit financing. Beyond a limit, deficit financing threatens to do more harm than good to these economies. In other words, there are some safe limits to deficit financing.

Conclusion – The safe limit to deficit financing

The safe limits to deficit financing are set by the nature of organisation and structure of the economy which is developing. Every economy has a particular sensitivity to inflationary finance. To judge this sensitivity, we must examine the following factors working in the economy.

1. *Growth rate of the economy.* The money supply in the economy can safely increase at the rate at which the national output is growing.

2. *Expansion of the monetised sector.* The rate of increase in money supply can be more than the rate of growth of national output to the extent the barter sector of the economy is getting monetised.

3. *A surplus on the balance of payments.* Deficit financing is also additionally possible to the extent there is a surplus on the balance of payments accounts made possible either by the greater inflow of foreign capital or promotion of exports.

4. *Increase in public borrowing and taxation.* Public borrowing and tax revenues reduce the purchasing power in the hands of the public. More of deficit financing is possible if the government proposes to levy additional taxes or borrow more.

5. *Increase in equity capital and undistributed profit of public limited companies.* In the private sector investment increases to the extent to which the equity capital and undistributed profits increases in the public limited companies. To this extent the absorption capacity of the economy for additional money is augmented.

6. *Nature of investment in the economy.* If the investment is in quick-yielding projects, the deficit financing is less inflationary. Investment in long gestation projects the safe limit of deficit financing.

We can conclude by saying the deficit financing is useful only as long as it is controlled. It may be likened to fire which, if under control, gives warmth and light. If the fire is unregulated it can bring havoc. Deficit financing is a very delicate and yet dangerous instrument of financing economic development if used without caution.

QUESTIONS

1. Explain the difference between
   (*i*) public finance and private finance, and (*ii*) public goods and private goods.
2. What is the principle of Maximum Social Advantage ? Explain it with the help of examples and a diagram.
3. What are the basic principles of public expenditure ? What are the effects of public expenditure ?
4. Explain the main features of a good taxation system ? Do we have a good taxation structure in India ?
5. What is taxable capacity ? On what factors does it depend ?
6. What are the factors governing incidence of taxation ? When can an indirect tax be shifted?
7. What is public debt ? Is there any economic limit to the size of public debt ?
8. How do internal and external public debts impose a burden on the society ?
9. What is deficit financing ? Discuss the case for and against deficit financing in less developed countries ?
10. What are the factors influencing the safe limit to deficit financing ?

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29 Unemployment

UNEMPLOYMENT

It is difficult to define the concept of "full employment". One can initially interpret it to mean that everyone who is in the labour market–100 percent of the labour force–is employed. But such is not the case. Frictional and structural unemployment are regarded as normal cyclical unemployment, although abnormal, seems to be unavoidable at times. Moreover, developing economies like India also suffer from substantial amounts of chronic unemployment and under employment.

Frictional unemployment

Given freedom of occupation and job choice at any point in time some workers will be "between jobs". That is, some workers will be in the process of voluntarily switching jobs. Others will have job connection but will be temporarily laid off because of seasonality, as in agriculture. And there will be some workers, particularly young people, looking for their first jobs.

Economists use the term frictional unemployment for the group of workers who are unemployed for these kinds of reasons. Frictional unemployment is regarded as inevitable and, at least in part, desirable. Why desirable ? Because workers typically move from low-paying, low-productivity jobs to higher-paying, higher-productivity jobs. This means more wages for the workers and a better allocation of labour resources and a larger real output for the economy as a whole.

Structural Unemployment

Another type of unemployment is structural unemployment. Important changes occur over time in the structure of consumer demand and technology. These change the structure or the composition of the total demand for labour. Unemployment exists because the composition of the labour force does not respond quickly or completely to the new structure of demand. As a result, some workers find that they have no readily marketable talents ; their skills and experience have been rendered obsolete and unwanted by changes in technology and consumer demand. Examples: Years ago, hundreds of thousands of highly skilled handloom and handicrafts workers were thrown out of work due to the development of modern manufacturing industries. At present, in the green revolution areas, millions of unskilled and inadequately-educated agricultural workers are being dislodged from agriculture due to the growing mechanization of farms. Many of these workers migrate to the cities and suffer long periods of unemployment and underemployment.

The distinction between frictional and structural unemployment is hazy. The difference essentially is that frictionally unemployed workers have jobs or are in the process of obtaining jobs, whereas structurally unemployed workers are not readily reemployable without retraining, additional education, and possibly geographic movement.

Cyclical Unemployment

By *cyclical unemployment* we mean unemployment caused by the business cycle, that is, by a deficiency of aggregate or total demand. As the overall level of business activity falls, cyclical unemployment increases ; as business activity increases, cyclical unemployment decreases. Cyclical unemployment at the peak of the Great Depression in the 1930s reached a very high proportion of the total labour force.

Chronic Unemployment and Underemployment

Chronic unemployment and underemployment are caused by the shortages of property resources–land, machinery, equipment, and so forth–which must be combined with labour resources to produce output. In India, chronic unemployment and underemployment have grown steadily in recent decades because the supply of labour has grown faster than the supply of property resources. We can readily identify four types of chronically unemployed and underemployed workers currently found in India :

1. *Open unemployment.* Open unemployment is said to exist when a certain proportion of the labour force remains unemployed throughout the year because workers cannot find even part-time, seasonal, or occasional employment. In India, open unemployment is found in varying degrees throughout the economy. In the urban areas, open unemployment is found widely among the highly educated, skilled, and rural migrant workers. In the rural areas, it is found predominantly among the agricultural labourers.

2. *"Hidden" unemployment.* Workers afflicted with *"hidden" unemployment* are those who are compelled to engage in non-income occupations such as household chores either because jobs simply do not exist for persons with their educational levels or because the society's cultural values inhibit them from accepting available jobs. These persons are the hidden unemployed because they are not actively seeking employment in the market. Many Indian housewives fall into this category. They are unable to work for wages because they lack marketable education and training and because their families would not allow them to accept available jobs as sales persons, clerks, peons, drivers, vendors, and so forth.

3. *Disguised unemployment.* *Disguised unemployment* is found among workers who appear to be partially or fully employed under the work and income-sharing arrangements in joint-family and other business firms, but whose marginal revenue productivity is zero or close to zero in current employment. The implication is that these workers do not really contribute anything to the output of the firm which employs them and therefore the firm can dismiss them without the loss of output. Although disguised unemployment is found throughout the Indian economy, it is greatly concentrated in the rural areas.

4. Underemployment. *Underemployed workers* are those who, upon failing to obtain full time permanent positions, are forced (*a*) to take part-time, seasonal, or occasional employment, (*b*) to accept jobs requiring lower skills than their training and education justifies ; and (*c*) to engage in "unproductive" self-employment, that is, in petty businesses with very meagre amounts of property resources. All these workers are underemployed because their incomes in current employment are far lower than what they can earn with full-time jobs. In India, a significant portion of the educated, skilled, and unskilled workers, as well as many of the self-employed in agriculture, handicrafts, village industries, petty trade, and so on, are underemployed.

Output, Employment, and Prices with Chronic Unemployment

It is clear from the foregoing discussion that frictional and structural unemployment are unavoidable and, to some extent, even desirable. Cyclical unemployment, although unavoidable at times because it results from recession or a deficiency in aggregate demand, can be alleviated by increasing total spending, as our discussion of Figure 29.1 clearly indicates. But what about chronic unemployment ? Can an increase in total spending remedy chronic unemployment also ? The answer may surprise you ; Figure 29.1 reveals the outcome.

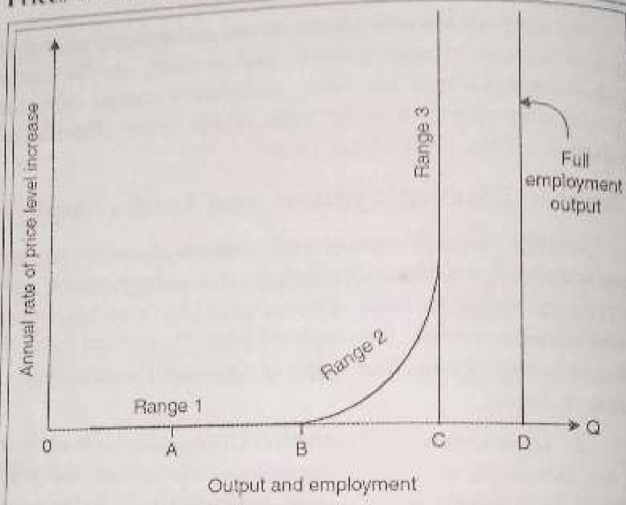

Fig. 29.1 The Price, Employment, and Output Levels with Chronic Unemployment. The price level begins to rise at B, that is, before full-employment output D. Economic expansion follows the path A to B to C. Premature inflation occurs in range 2 and pure inflation in range 3. Chronically unemployed workers CD remain unemployed.

As shown in Figure 29.1, assume first that the economy's total supply of human or labour resources is *OD*. This implies that the economy will achieve full-employment production, that is, full employment of all human and property resources at *OD* level of employment and output. For convenience in discussion, assume also that the economy is suffering from chronic and cyclical unemployment. Suppose that to *CD* workers are chronically unemployed, that is, idle property resources simply do not exist in the economy to provide full-time productive employment *CD* workers. Moreover, recession has caused the actual employment of human and property resources to decline to '*A*' in range 1 ; that is, the economy's current employment and output is *OA* in Figure 29.1. It is obvious therefore that the total unemployment (*AD*) is equal to cyclical unemployment (*AC*) *plus* chronic unemployment (*CD*).

Now suppose that government increases total spending with a view to achieve full employment of *all* human and property resources. The initial increases in total spending will increase employment and output without causing inflation in range 1, that is, between *A* and *B* in Figure 29.1. Why ? Because, as mentioned earlier, there are unemployed human and property resources who will be willing to be employed at the current resource prices. Therefore, employment and output will grow in range 1 without increases in the price level. If total spending continues to rise, some increases will occur in employment and output, but premature inflation will set in, that is, the price level will also rise. Why ? Because the economy's employment, output, and prices will be pushed into range 2 or between *B* and *C* in Figure 29.1. The price level will rise because the property resources will become relatively scarce compared to human resources. In fact, at *OC* employment and output, all property resources will become fully employed. Consequently, in range 2 the prices of property resources will rise and so will the prices of final goods and services. All further increases in total spending will cause pure inflation, that is, in range 3 sharp increases will occur in the price level but employment and output will not rise. Why ? Because the producers of goods and services will not be able to acquire additional property resources to combine with idle labour resources to increase output. Employment and output will remain fixed at *C*. In short, the shortage of property resources will halt the expansion of employment and output and an inflationary trend will set in at less-than-full-employment of labour resources. The *CD* unemployed workers will remain unemployed. The massage is clear : *Any attempt to remedy chronic unemployment will fail in the absence of adequate property resources. To provide full-time productive employment to chronically unemployed workers, the economy must increase the supply of property resources.* And this is the function of economic progress. Economic progress alone can increase the supply of property resources–machinery and equipment in particular–to create full-time productive jobs for the chronically unemployed workers.

Defining "Full Employment"

Economists regard some frictional and structural unemployment as unavoidable ; hence "full employment" is defined as something less than employment of 100 per cent of the labour force. In some industrially advanced countries–the United States, for example–it has become customary to estimate this unavoidable minimum unemployment to be 4 per cent of the labour force. Therefore, in general, full employment is said to exist when 96 per cent of the labour force is employed. Using this definition, in 2006, full employment would exist in India if approximately 9.5 million of the 237 million persons in the civilian labour force were out of work.

Great caution should be used, however, in applying the 4 per cent unavoidable unemployment rate to all world economies, including India. Why? Because the statistical evidence on actual levels of unemployment is both conflicting and incomplete. One set of statistical evidence suggests that the unavoidable unemployment rate should be lower than 4 per cent and another set indicates that it should be higher. To illustrate, historical record shows that the unemployment rate in certain industrially advanced nations has fallen below 4 per cent during periods of high economic prosperity. In fact, the unemployment rate in some Western European economies– Switzerland, for instance–has rarely risen above 3 per cent. This suggests that 4 per cent unavoidable unemployment rate is probably too high. On the other hand, the growing participation of women and young workers in the labour force has caused unemployment levels to rise in virtually all world economies, including India. Moreover, the recently expanded unemployment compensation programmes–the number of workers covered and size of benefits–allow unemployed workers in many countries to seek reemployment at a more leisurely pace. Also, official unemployment statistics are often grossly inaccurate and hence misleading. In some countries, official unemployment estimates exclude part-time and "discouraged" workers.[1] All this points to the possibility that 4 per cent unavoidable unemployment rate is probably too low.

In the case of India, however, there are also other, and far more serious, statistical problems. For example, according to the National Sample Survey data for 1977-78 the unemployment rate, estimated on the basis of "daily status employment situation" in current activity was 7.7 per cent for rural and 10.3 per cent for urban areas. This means that approximately 8 per cent of India's labour force was unemployed in that year. Whether these figures include all the tens of millions of hidden and disguised unemployed and underemployed is unclear. Moreover, no historical data are available to tell us anything about the manner in which the unemployment and underemployment levels have fluctuated over time, especially during the business cycles. Even today, excepting a small number unemployed and underemployed workers who are registered with the employment exchanges, no reliable estimates of total unemployed and underemployed workers are available. In the absence of such data, it is impossible to agree upon an unavoidable unemployment rate for India.

Common sense tells us, however, that 4 per cent avoidable unemployment rate is clearly too low for India due to *three* reasons. First, the level of frictional unemployment is obviously high in India. Why ? Because the competition is very intense among the unemployed and underemployed workers for the few full-time jobs which the economy creates each year. That is, excepting the few lucky ones who are able to obtain jobs quickly, an average unemployed and underemployed person takes a long time to land a full-time job. Second, the level of structural unemployment is also high in India. Why so ? Because, being a developing economy, modernization in production and changes in consumer demand patterns are occurring very rapidly. As a consequence, great numbers of workers are thrown out of employment each year. On the other hand, facilities are quite limited to provide them with retraining and education for new jobs. Consequently, such workers have to wait for long periods to acquire additional training and education. Furthermore, after obtaining retraining and education, they must re-enter the labour market as "new" workers and compete with other unemployed and underemployed workers who have similar training and education. This tends to lengthen their unemployment period between the jobs. Yet another reason for high unavoidable unemployment rate in India is its inadequate employment information system. As is well known, the main function of this system is to bring unemployed workers and potential employers together with maximum efficiency, that is, with a minimum loss of time between the creation of new job openings and actual hiring of workers by employers. In India, however, unemployed workers are often unaware of new job openings for their particular skills, and potential employers are unaware of unemployed workers with skills they need. The result is that many job openings either go unfilled for long periods of time or are filled with less qualified workers.

Economic Costs of Unemployment

Above-normal or "true" unemployment entails great economic and social costs. The cost of unemployment is obviously forgone output–the goods and services which society could have produced but didn't. And the higher the true unemployment, the greater the cost. To illustrate,

1. "Discouraged" workers are those who unsuccessfully sought employment and, discouraged by their efforts, dropped out of the labour force.

suppose there is full employment. Suppose also that these workers produce Rs. 50,000 crores worth of output. Now, if less than full-employment exists–if, for example, 10 per cent of the labour force is unemployed–then this unemployment will result in lost or forgone output of about Rs. 5,000 crores, or about the same percentage of the GNP as the percentage of unemployed labour force. It is clear, therefore, that the Indian economy has lost in the past, and is losing currently, hundreds of crores worth of output due to the existence of high levels of unemployment and under-employment.

GNP gap. One way to measure the cost of unemployment is the *GNP gap*. The gap is simply the amount by which the *actual GNP falls short of potential GNP*. Potential *GNP* is determined by assuming that full employment (defined as a given per cent level of unavoidable unemployment) prevails in the economy. Therefore, *GNP* gap is the difference between the potential *GNP*–that is, the money value of output that the economy could have produced at full employment–and the actual *GNP*.

Table 29.1. Actual and Potential GNP and The Unemployment Rate

(1) Year	(2) Aactual GNP in crores of rupees (1970-71 = 100)	(3) Assumed rate of excess unemployment percent	(4) Potential or full-employment GNP in crores in crores of rupees	(5) GNP gap or GNP lost due to excess unemployment in crores of rupess (4)–(2)
1970-71	Rs. 34,235	5	Rs. 35,947	Rs. 1,712
1971-72	34,715	5	35,451	1,736
1972-73	34,191	9	37,268	3,077
1973-74	35,967	6	38,125	2,158
1974-75	36,411	7	38,960	2,549
1975-76	40,011	5	42,012	2,001
1976-77	40,534	6	42,966	2,432
1977-78	43,857	8	47,366	3,509
1978-79	45,637	7	48,832	3,195

[1]**Source :** *Economic Survey* 1979-80, p. 75.

Since actual unemployment figures are not available for India, we shall illustrate the concept of *GNP* gap as shown in Table 32.1. Column 2 contains the actual GNP figures for India for the period 1970-71 to 1978-79. Column 3 shows the hypothetical or assumed rate of true unemployment for each year, that is, the rate of unemployment over and above the unavoidable unemployment rate. Figures in column 4 are estimated values of potential GNP which the Indian economy could have realized with full employment. And column 5 shows the GNP gap or GNP lost each year due to true unemployment. It is clear from Table 10.1 that (*a*) true unemployment invariably results in the under-utilization of an economy's resources and hence in the loss of potential output, and (*b*) the size of GNP gap varies with the rate of true unemployment. The higher the unemployment rate, the greater the GNP gap ; and the lower the unemployment rate, the smaller the GNP gap. With full employment, the GNP gap disappears.

Unequal burdens. Aggregate figures conceal the fact that the cost of unemployment is unequally distributed. An increase in the unemployment rate from, say, 4 to 8 per cent would be more tolerable if every worker's hours of work and wage income were reduced proportionately. But, in fact, unemployment is borne heavily by young persons, by women, by lower caste groups, and by unskilled and untrained workers. Furthermore, a rise in unemployment increases underemployment. A decrease in aggregate demand forces workers from full-time to part-time jobs and, in many cases, to jobs which require lower levels of training and education than they possess.

Noneconomic Costs

Unemployment is much more than an economic problem, it is a social catastrophe as well. Unemployment means idleness. And idleness means loss of skills, loss of self-respect, a plummeting of morale, family disintegration, and sociopolitical unrest.

Unemployed workers cannot apply the skills they possess. As a result, they may lose those skills and require expensive retraining and education. The greatest deprivation any one can suffer is to have no chance of looking after himself and his family by making a livelihood. An unemployed worker tends to lose his self-respect and respect of his family and friends. His children may feel that their father is a failure, because he does not provide even the basic necessities of life. In a joint-family, an unemployed worker and his family depend upon the relatives for sustenance. These relatives may discriminate against his children, deny them necessary education for economic advancement in the future, and mistreat and humiliate his wife. Frequent quarrels between an unemployed husband and his wife may induce their grown up children to leave home and become members of juvenile gangs in large cities. Angry and frustrated by his failure to earn a living, an unemployed worker may become alienated from his family and resort to crime, alcholoholism, and gambling. In extreme cases, disenchanted with existing values and institutions which deny gainful employment, unemployed workers may join radical groups and engage in disruptive social and political activities.

History makes it all too clear that severe unemployment is conducive to rapid and sometimes violent social and political change. There can be no question that the heavy concentration of unemployment among young workers in India is an important cause of unrest, crime, and violence. The violence in Sri Lanka in the early 1990s was clear evidence of troubles which can ensue when large numbers of educated workers in cities are confronted with a shortage of job opportunities. These experiences, and spreading student unrest, have disturbed other governments throughout Asia where unemployment problems have reached magnitudes of major consequence. Even the industrially advanced countries have not gone unscathed by the serious consequences of unemployment. Witness the movement to the left of American political philosophy during the Depression of the 1930s. The Depression-inspired New Deal was a veritable revolution in American economic and political thinking. Witness also Hitler's ascent to power against a background of high unemployment in Germany.

QUESTIONS

1. Write a detailed note on the various types of unemployment.
2. How can we define "Full Employment ?"
3. Explain the economic and non-economic costs of unemployment.

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30 Fiscal Policy

Fiscal policy relates to a variety of measures broadly classified as (*a*) taxes, (*b*), public borrowing and (*c*) public spending. It is related to public finance and public finance involves the use of taxation, public borrowing public expenditure by government for securing economic stabilisation and economic growth. Fiscal policy involves giving positive and negative incentives to producers and consumers through the expenditure and revenue policies. According to Arthur Smithes, fiscal policy means "policy under which the government uses its expenditure and revenue programmes to produce desirable effects and to avoid undesirable effects on the national income, production and employment." G.K. Shaw has defined fiscal policy much more broadly and intensively : "We define fiscal policy to encompass any decision to change the level; composition or timing of government expenditure or to vary the burden, structure or frequency of the tax payment."[1] The instruments of fiscal policy include a nation's budget, taxes, spending and borrowing. They also include relief expenditures, subsidies, social security benefits and transfer payments. A skilful management of a nation's budget over the long run can go a long way in maintaining economic stability as well as in ensuring higher rates of economic growth.

Objectives of Fiscal policy

Broadly speaking, fiscal policy as an instrument of policy has the following main objectives:

(*i*) Securing efficient allocation of economic resources.

(*ii*) Accelerating the rate economic growth.

(*iii*) Controlling equitable distribution of income and wealth.

(v) Attaining and maintaining full employment.

1. G.K. Shaw, *An Introduction to the Theory of Economic Policy*, (1971), Ch 5, p. 87

Choice of the set of Objectives

The various objectives of fiscal policy, as described above are generally consistent but sometimes there might be some conflict between them. (1) The objectives of attaining an accelerated rate of economic development may come in conflict with the objective of counter-acting inflation particularly in the initial stages of economic development. (2) Similarly as economic development proceeds, wealth gets concentrated in the hands of a few; if this concentration of economic wealth is not checked over a period of time, then these compound into glaring inequalities in the distribution of income and wealth. In view of this, it is not easily possible to determine the order of priorities of the various objectives. Priorities will differ from country to country and from time to time, depending upon the economic, political and social conditions prevailing in the country.

Role of Fiscal Policy

The attitude of economists and governments to the role of fiscal policy radically changed as a result of the Keynesian impact. The old conception of 'neutrality' of public finance was given up and the government adopted a new budgetary philosophy called 'functional finance'. With the adoption of development planning, public finance has been assigned a positive and dynamic role for the promotion of economic development.

The role of fiscal policy in less developed countries differs from that in developed countries. The problem of developed countries is to strabilise the rate of economic growth by maintaining effective demand at a high level. For this purpose, fiscal policy aims at reducing the savings of the people and increasing their propensity to consume. The problem of under- developed countries is however different. They need more savings so as to increase the rate of capital formation which is the key to a higher rate of economic development. But in these countries the general level of incomes of the people is low and their propensity to consume is high and hence the rate of savings is small. The fiscal measures in these countries, therefore, should aim at raising the rate of capital formation by controlling saving consumption and encouraging investment.

Since the per capita incomes and savings are extremely low, capita formation in under-developed economies cannot be left to voluntary savings. According to an U.N. Study[1], the annual per capita incomes in the Middle East, in Asia and in Latin America are less than 200 U.S. dollars or less than one-seventh of the U.S. level and one-fourth of the Canadian level. During the First year plan in India, savings contributed only $2\frac{1}{2}\%$ of the national income for development purposes. As the crucial determinant of economic growth, the rate of saving could not be expected to grow automatically. On the contrary, fiscal measures had to be adopted to increase the savings of the people and to mobilise them for productive purposes.

The backward countries are caught in the vicious circle of low income, low consumption, low savings, low rate of capital formation and, therefore, low incomes. "To break out of this circle, apart from foreign aid", observes an U.N. Study, "calls for vigorous taxation and government development programmes." Thus in poor countries, the importance of fiscal policy lies in raising the rate and volume of savings and in diverting these into the desired channels.

Coming down to details, we can say that fiscal policy can affect the rate of economic development in different ways such as by increasing the rate of saving and investment, improving

1. U.N. *National and per capita Incomes in Twenty Countries, a 1949 and National Income and its Distribution in Under-developed Countries,1951.*

the allocation of resources, controlling inflation, promoting economic stability, securing equitable distribution of income and wealth and creating additional employment opportunities. We now discuss these in detail.

1. Increasing the Rate of Saving and Investment

There are certain forces operating in these countries which increase consumption and reduce savings. The first among them is the rapidly increasing population pressure. Second, the high income groups spend much of their incomes on conspicuous consumption and their propensity to consume is further reinforced by the 'demonstration effect.' Still worse, a large part of the meagre saving is dissipated in unproductive channels-real estate, hoarding, gold, jewellery, speculation etc., Fiscal policy can be employed effectively to divert saving of the people into productive channels. It should aim at raising the incremental saving ratio through taxation and public borrowing and making funds available for investment purposes. For this, high taxes on personal and corporate incomes and commodity taxes of articles of wide use and conspicuous consumption can be imposed to check the potential consumption of the people. The purpose of taxation should not be merely to transfer funds from private to public use but to enlarge the total volume of savings available for investment. This requires that the general emphasis of all fiscal measures should be on curtailing and restraining consumption for increasing the volume of savings in the community. Different countries employed sure and adequate methods of tapping the economic surplus. In Japan, for example, agricultural productivity was doubled between 1885 and 1915 and the instrument of taxation was used effectively. Much of the increase in production was taken away from the farmers by imposing on them higher rents and taxes. The resources thus collected were chanelled into productive investment. Forced loans were also imposed on the business community to mop up surplus funds for economic development. In the U.S.S.R. collective farms were heavily taxed and agricultural surplus was siphoned off by raising the prices of manufactures in relation to the prices of farm products. Prof. K.K. Kurihara has listed the fiscal roles of government as an additional saver, an investor, an innovator and an income-redistributor.

As an additional saver, the government should, "maintain a persistent budgetary surplus through (*a*) a decrease in the government average propensity to spend, (*b*) an increase in the average propensity to tax or (*c*) a decrease in the government average porpensity to make transfer payments." Prof. Kurihara further observes, "As far as underdeveloped economy is concerned, budgetary surplus is the relevant position to be achieved and maintained. For it is in supplementing deficient private saving that the fiscal role of government as a saver is to be contemplated."

As an additional investor, the government can increase the productive capacity of the economy and secure an accelerated rate of economic growth by changing the pattern of investment and laying emphasis on capacity-creating rather than on income-generating projects ; by decreasing government consumption and thereby increasing government investment and by raising the tax-rate which "has the effect of decreasing private consumption expenditure and hence of increasing that part of real income which is available for government investment."

As an innovator, the government should spend on research and experimentation and stimulate innovations and new techniques of production. This will reduce the cost of production, increase the profit margin and encourage investment. The government can encourage innovations by giving subsidies and tax-relief to those firms and industries which may introduce them on their own.

The government has an important role to play as an income redistributor and for that fiscal measures can be adopted specifically for reducing economic inequalities. A broad-based and moderately progressive tax structure can serve as an effective weapon in the hands of the state to secure equitable distribution of income and wealth.

However, there is a limit to which taxation can be carried for resource mobilisation. If the taxes are excessive, they will adversely affect people's desire to work, save and invest. To avoid such a situation, the gap in resources required for economic development and available through taxation may be covered by mobilising savings through public borrowing. Borrowing is not harmful if the loans are used for productive projects. Further, borrowing from the public does not adversely affect people's desire to work, save and invest if the lending is voluntary and if the lenders also earn attractive rate of interest on it.

However public borrowing also has certain limitations in under- developed countries. The general masses are poor and their propensity to consume being high they have no lending capacity. The rich generally do not like to lend to the government. Instead they divert their investible resources into speculative channels as they can get immediate and sizeable gains from such investments and can escape taxation also.

There are some institutional obstacles in the way of borrowing on a large scale. There is the absence of organised money and capital markets, inadequate banking facilities and lack of confidence in the financial and political stability of the governments of most of the underdeveloped countries.

But inspite of all these fiscal, financial and developmental efforts, if adequate resources are not forthcoming, the government may resort to compulsory borrowing for financing economic development. In this connection, Nurkse says, "Since individuals are interested not only in their consumption but also in the size of their asset holdings, there is a case for forced loans as an alternative to taxation. They may be little more than tax receipts and yet make a difference to the incentive to work and to produce as was found during the war period when the unspendable cash reserves accumulated as a result of rationing made consumers feel much better off. Forced loans in place of taxation would be a method of forced saving in form as well as substance."

Those people who spend the major portion of their income on conspicuous consumption and divert their resources into unproductive channels or those who stand to benefit from particular development projects may be forced to invest in government bonds. But it may be noted that no democratic government can rely on forced loans except for a short period and that too for certain specified projects. Ultimately, it is the voluntary lending by the people that matters.

Public expenditure is also an instrument of promoting economic development in the hands of the state. In under developed countries, there is lack of basic facilities such as transport, power, irrigation, education etc. and also of basic and key industries. But these cannot be provided by the private sector for want of resources and entrepeneurial ability. Thus, public expenditure should aim at creating basic facilities and establishing basic and key industries in the public sector besides encouraging the development of agriculture and industry by giving adequate loans, grants and subsidies.

A carefully planned public expenditure creates the necessary environment for the growth of the economy. But public expenditure can achieve its wider objective of development only if it conforms to certain well defined principles of public expenditure. Firstly, the expenditure on the armed forces must not be overdone and other wasteful and excessive expenditure on administration must be avoided. Secondly, public enterprises must conform to the principle of economic efficiency so that costs decrease and profits increase. Thirdly, care should be taken that public expenditure does not adversely affect people's desire to work, save and invest. The majority of the poor should not be provided with direct money loans but with goods and services in the form of capital assets, free education, free medical facilities etc. This will increase the efficiency and productive capacity of the people.

We can conclude the above discussion by referring to the various methods of increasing the volume of savings available for investment. These methods are :

(*i*) Direct physical controls.

(*ii*) Increase in the rates of existing taxes.

(*iii*) Imposition of new taxes.

(*iv*) Surplus from public enterprises.

(*v*) Public borrowing of a non-inflationary nature.

(*vi*) Deficit financing.

Direct physical controls can be used most effectively to curtail consumption and check socially undesirable investment. Though direct physical controls are not compatible with democratic freedom and may be difficult to administer in democratic society, yet these are a necessary adjunct to a developmental fiscal policy.

Other methods of resource raising have also got their own limitations.

1. In some countries profits made in public enterprises have been used for financing development. State enterprises bring the government closer to economic realities and enable it to measure the efficiency and tax paying capacity of their counter-part in the private sector. It is desirable that the government herself starts profitable enterprises and utilises the surplus for economic development. But the scope for any large surplus from public enterprises in under-developed countries is limited due to high cost of production in the initial stages of economic development and also because of the limited number of such enterprises.

2. A mild dose of deficit financing is very useful for the employment of unemployed economic resources but its scope is limited in under-developed countries because of its inflationary impact resulting from the lags in the supply of consumer goods.

3. Similarly, public borrowing cannot be expected to bring in adequate resources in the absence of properly developed capital markets in most of the under-developed countries. Rather, a vigorous programme of public borrowing may push up interest rates and affect investment adversely. Among all the methods, therefore, main reliance has to be placed on taxation mobilisation of resources in economic development. Fiscal policy has also got a role to play in encouraging investment in the private sector. It has been found that "fiscal policy in the shape of fiscal concessions such as investment and depreciation allowances, provision of finance and foreign exchange, tax- holiday, development rebates, subsidies etc. can contribute materially to the growth of investment in the private sector of the economy."[1]

1. R.N. Tripathy, *Public Finance in Underdeveloped Countries*, p. 221.

2. Promotion of the Optimum Pattern of Investment

A less developed country can ill-afford the diversion of her limited resources into socially undesirable channels. Fiscal measures can be used to secure the pattern of investment which is in conformity with the criterion of social marginal productivity. High taxes on land value increments, on capital gains and other windfalls should be imposed to prevent the flow of funds into unproductive channels such as land, buildings, inventories and other investments of speculative nature. The tax system can be used to provide positive inducement to productive and socially desirable investments in the private sector. This can be done by differential rates of taxation and of tax exemption in selected cases.

Investment in economic and social over-heads *viz.* transport, power, soil conservation, education, public health and technical training facilities is of top priority for attaining optimum pattern of investment because provision of these basic facilities is essential for speeding up development. Such investment widens the extent of the market, reduces costs of production and raises productivity by creating external economies. Private enterprise cannot be expected to provide such basic facilities as the investment involved in, them is huge and as they are low-yielding and slow-yielding projects. Therefore, government. should take the responsibility for construction of these basic facilities. Such projects should be financed through taxation and not with borrowed funds because these do not yield direct returns necessary for the repayment of these debts. The tradition of raising of resources through taxation for such development programmes is now widely recognised.

3. Counteracting inflation

The process of economic development inevitably leads to inflationary pressure as a result of the imbalance between the demand for and supply of goods and services. The pressure of wages on prices, structural rigidities of their economic system, market imperfections and bottle-necks impede the supply of goods and services and prices start rising. Inflation feeds on itself and if it goes out of control, it paralyses the entire economy. That is why economic growth and stability are regarded as joint objectives for under-developed countries. The choice is not between economic growth and stability but only over the interrelationships between them and over the policies necessary to achieve them.

Fiscal measures should be used to counteract the inflationary pressures by keeping under check the overall effective demand. For this, the tax structure should be so devised that it mops up a major proportion of the rise in money income. This would be possible if the tax structure is dominated by progressive direct taxes and commodity taxes, the yield of which changes more than proportionately to changes in tax base. Special anti- inflationary taxes on excess profits, capital gains and other windfalls including taxes on articles of conspicuous consumption may be imposed.

In addition to the reform of the tax system, the government should attempt at removal of structural rigidities and market imperfections. In the short period, the government can impose physical controls but in the long run they have to provide subsidies and protection to essential consumer goods industries. However, if inflationary pressures go on mounting, capital levy on cash balances and liquid assets might also be imposed.

To fight inflation, the government has to either increase the burden of taxes to create a budget surplus or slash its expenditure. Developing upon the political situation in the country, the government can also adopt a combination of the two policies also. We can think of four such policy combinations.

(i) ***Reduction in Government Spending with No Change in Tax Rates.*** Such a fiscal policy will give rise to a budget surplus and drain out the purchasing power of the people. This will reverse the process of government expenditure multiplier and bring about a reduction in inflationary pressure.

(ii) ***Reduction in Government Spending with Increase in Tax Rates.*** This set of fiscal measures is likely to be more effective than the previous one since an increase in tax rates coupled with a reduction of government spending will create a larger budget surplus and, consequently, a quicker relief from inflation will-be felt.

(iii) ***Rigid Government Spending with Increase in Tax Rates.*** Sometimes government spending cannot be reduced as, for instance, during the period of war. The reduction in aggregate spending can be effected, in this case, only through an increase in tax rates. This results in a reduction in private disposable incomes as a result of which private consumption and investment expenditures all and inflation is checked. It was through such a policy that the United States could siphon off purchasing power by a measure sufficient to finance more than 43 per cent of the cost of the Second World War out of tax proceeds.

(iv) ***Reduction in Government Spending and an Equivalent Reduction in Taxes.*** A decrease in government spending and equivalent decrease in tax revenues bring about a reduction in national expenditure on account of the reverse operation of the balanced-budget multiplier. If these fiscal changes result in a redistribution of income between the beneficiaries of government expenditure and tax payers in such a way that the net propensity to consume decreases, the reduction in national income will be greater than the reduction in government expenditure. A balanced budget multiplier of value greater than unity will in this situation have an anti- inflationary impact.

This discussion clearly brings out the fact that variations in the rate and basis of taxes is the most crucial instrument of anti-inflationary impact of income tax and consumption tax of an equal yield. The latter is sometimes conceived as more effective since it results entirely in the reduction of consumption. The income tax, on the contrary, falls partly upon consumption and partly upon saving. To the extent income tax reduces savings, it will not help in curtailing inflationary pressure.

4. Promoting Economic Stability

The under-developed countries are susceptible to economic instability resulting from deficiency of effective demand in the shortrun and fluctuations in demand for their products in the world markets in the long run. Under-developed countries mainly export agricultural and mineral products the demand for which is generally less elastic. On the other hand, these countries import capital good, and finished manufactured articles, the demand for which is elastic. When the prices of export goods fall in the international market, the terms of trade become unfavourable, foreign exchange earnings decline and national income falls which produces recessionary effects on the economy. The under-developed countries cannot push their exports to take advantage of the fall in prices because their capacity to produce more is limited. Similarly, when the prices of the exports rise due to the boom conditions in the world-markets, the increase in export earnings does not induce increased output from the exporters. The export earnings tend to be dissipated in conspicuous consumption, and speculative investment which further generates inflationary pressure in the economy.

Fiscal measures can be used to offset the effects of international cyclical fluctuations in the prices of exports. For example, in booms, heavy export/import duties may be imposed. Export duties neutralise the windfall gains arising from the rise in world market prices while import duties tend to discourage conspicuous consumption. The earning from such export and import duties can be used for capital formation. In periods of depression, on the other hand, subsidies may be given to encourage exports through cost reduction and quality improvement. Contra-cyclical fiscal policy has to be followed to mitigate the effects of international cyclical movements. At the same time, efforts should be made to diversify the export base so as to reduce an excessive dependence on the primary exports alone.

5. Securing Equitable Distribution of Income and Wealth

An equitable distribution of income and opportunity is a *sine qua non* of economic development. It provides the necessary environment conducive to the whole-hearted, intelligent and continuous cooperation of the people in development programmes. The redistributive side of fiscal policy consists in reducing the high bracket incomes and raising those of the people below the poverty line. Imposition of progressive direct taxes and taxation of articles consumed by the upper strata of society can help in the equitable distribution of income. To raise the incomes of the poor, direct government investment in economic and social over-heads is essential. In a country of continental dimensions like India, balanced regional development of the different sectors of the economy is necessary. The redistributive role of fiscal policy, therefore, does not merely consist of reducing non-functional inequality in the distribution of income and wealth, it also extends to the provision of positive incentives for development of backward areas.

It must be clearly pointed out that only those inequalities should be removed through taxation which arise from the institution of the ownership of the means of production and inheritance. Functional inequalities, which arise from hard work, education, intelligence, skill etc., have a vital role to play in the development process as they serve as a necessary incentive to hard work.

Taxation can play an effective role in securing equitable distribution of income only if it has an over-all progressivity. This is so if there is buoyancy in the tax system *i.e.* if it is income-elastic. Secondly, the tax- structure should have built-in-flexibility which implies that the tax system should be progressive : goods with high income-elasticity of demand should be heavily taxed. As a result of these characteristics the marginal rate of taxation will be higher than the average rate and so the share of the government will increase more than proportionately as income increases.

6. Increased Employment with Economic Growth

The ultimate objective of development is to create conditions of full employment and to provide people with rising standard of living.

Functional Finance implies integration of the government budgets with the nation's economic budgets. The nation's budget refers in the income and expenditure of the community for a given period of time. It can be divided into sub-budgets (*i*) the government budget and (*ii*) The non-government budget. In a capitalist economy, the non-governmental portion of the national budget is determined by the general propensity to consume, the propensity to save, and the propensity to invest of the people and of the entrepreneurial class. Since the way in which a given economy functions depends on the aggregate saving, consumption expenditure, investment expenditure, the nature of consumption, the productivity of investment, there is definite need to integrate the government budget with the nation's budget. In a planned economy the government budget is a part and parcel of the nation's budget because the income and expenditure of the government form part of the planned income and expenditure of the nation. The policy of managed budget is followed under planning which consists of a deliberate attempt to adjust revenues, expenditures and public debts in a way so as to provide maximum employment without inflation.

Conclusion

We must conclude by saying that fiscal policy in a developing economy has to be planned on a long-term basis. A simple and stable tax system must be evolved. Public borrowing must be kept with in safe limits. Deficit financing should be the last resort of a finance minister if he is committed to a policy of economic stability.

QUESTIONS

1. What is fiscal policy ? What are its objectives and instruments ?
2. What are the methods of resource raising in less developed countries ? Explain the contents of an anti-inflationary fiscal policy.
3. What are the different fiscal instruments of raising the rate of saving in less developed countries ?

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