8 Public Finance in India

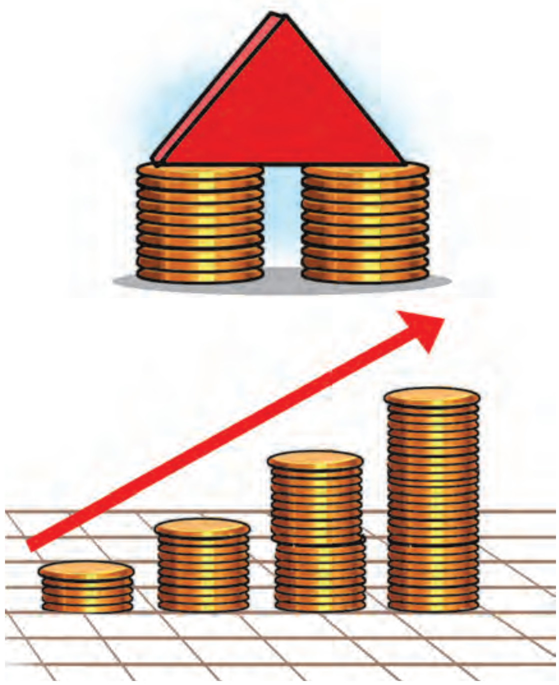


Fig. 8.1

Introduction :

Public finance is one of the old branches of economics which highlights the role and functions of the government in an economy. Government is a formal or informal institution created by the people in a specific region to perform various functions such as protection from external attacks, protection of private property of the people, generation of employment, maintaining internal law and order, provision of social needs like education, health, etc.

These functions of the government can be classified as :

1) **Obligatory functions :** Protection from external attacks, maintaining internal law and order etc. are obligatory functions of the government.

2) **Optional functions :** Provision of education and health services, provision of social security like pensions and other welfare measures etc. are optional functions of the government.

Find out :

More examples of obligatory and optional functions of the government.

Meaning and Nature of Public Finance :

To perform the above mentioned functions, adequately and efficiently, any government needs funds which can be received from various sources. The concept of public finance is a combination of two words 'public' and 'finance, 'Public' is a collective for the individuals living within an administrative territory. In economics, it is used to signify the government which represents the public. 'Finance' simply means income and expenditure. Thus, 'public finance' is nothing but a study of the principles of income and expenditure of the government at central, state and local levels. This study is done under the public finance branch in economics.

Definitions of Public Finance :

Different economists have defined public finance in their own ways. Let us study some of these definitions :

1) **According to Hugh Dalton :** "Public finance is one of those subjects which are on the borderline between economics and politics. It is concerned with the income and expenditure of public authorities and with the adjustment of one with the other." Since we study the activities of the governments in political science too, public finance also constitutes a part of the study of political science.

2) **According to Prof. Findlay Shirras :** "Public finance is the study of the principles underlying the spending and raising of funds by public authorities."

Differences Between Public Finance and Private Finance :

Points of difference	Public finance	Private finance
1) Objectives	To offer maximum social advantage to the society	To fulfil private interests
2) Determination of expenditure	Government first determines the volume and different ways of its expenditure	An individual considers his income and then determines the volume of expenditure
3) Credit status	High degree of credit in the market	Credit of a private individual is limited
4) Right to print currency	The Government can print notes through Reserve Bank of India	Private individual does not enjoy such right
5) Elasticity of finance	Public finance is more elastic	There is not much scope for changes in private finance
6) Effect on economy	Tremendous impact on the economy of country	Marginal effect on the national economy

Structure of Public Finance :

The components or scope of public finance can be shown as below :

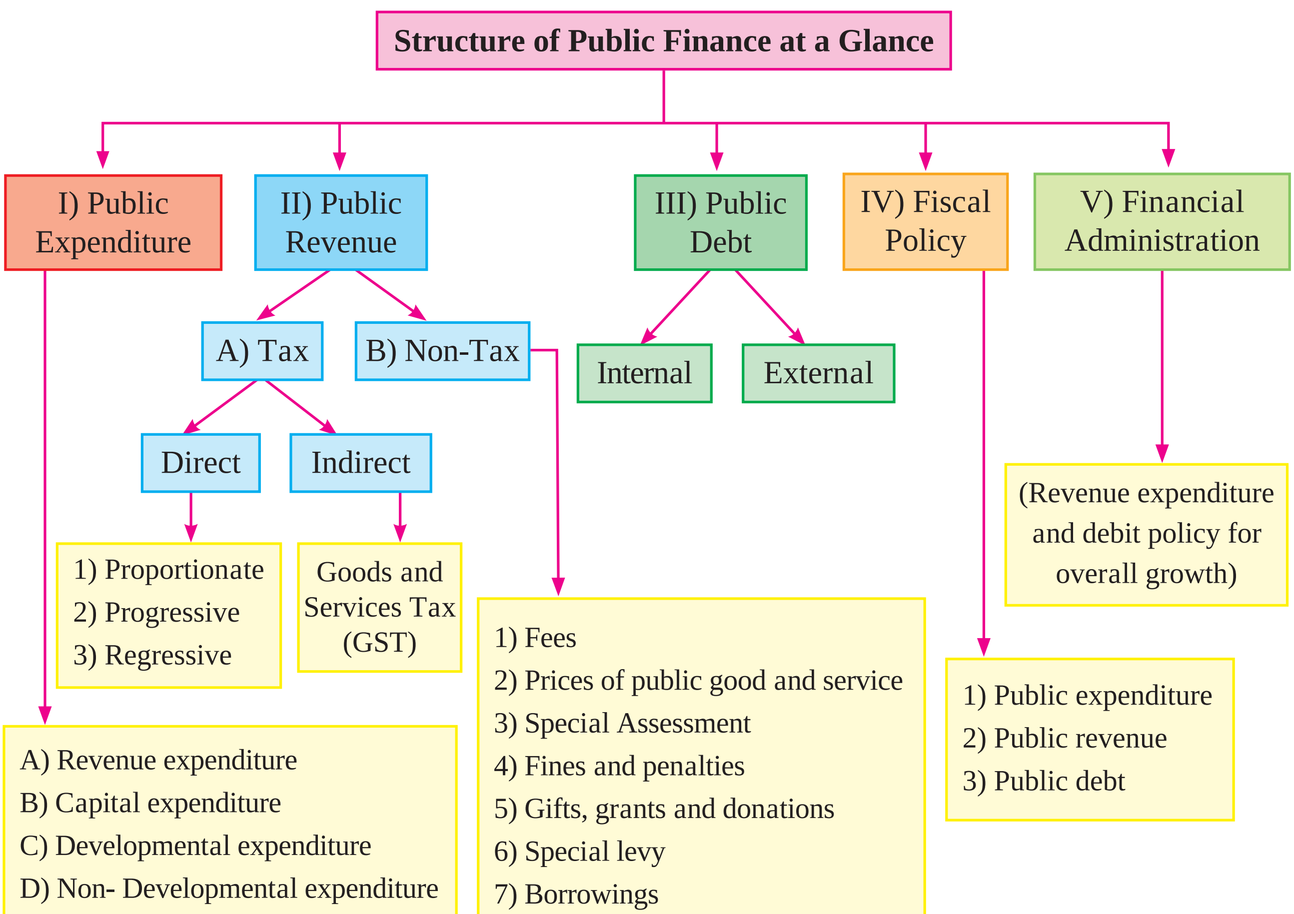


Fig. 8.2

On the basis of figure 8.2, the explanation is as follows :

I) Public Expenditure :

Public expenditure is that expenditure which is incurred by the public authority [Central, State and Local Bodies] for protection of their citizens, for satisfying their collective needs and for promoting their economic and social welfare.

Till 20th century, the majority of the governments had adopted a policy of laissez faire. Under this policy, the functions of government were restricted to the obligatory functions. But, the modern governments not only perform the obligatory functions such as defence and civil administration, but also perform optional functions for promoting social and economic development of their countries. Therefore, study of public expenditure is an important part of study of public finance.

Classification of Public Expenditure :

Different economists have classified public expenditure on different bases. We shall now study some of the important classification of public expenditure.

A) Revenue Expenditure : Revenue expenditure of the government is for incurred carrying out day-to-day functions of the government departments and various services. It is incurred regularly. For example, administration costs of the government, salaries, allowances and pensions of government employees, medical and public health services etc.

B) Capital Expenditure : Capital expenditure of the government is expenditure for progress and development of the country. For example, huge investments in different development projects, loans granted to the state governments and government companies, repayment of government loans etc.

C) Developmental Expenditure : Developmental expenditure is productive in nature. The expenditure which results in generation of employment, increase in production, price stability etc. is known as developmental expenditure. For example, expenditure on health, education, industrial development, social welfare, Research and Development (R & D) etc.

D) Non-Developmental Expenditure : On the other hand, that government expenditure which does not yield any direct productive impact on the country is called non-developmental expenditure. For example, administration costs, war expenditure etc. These are unproductive in nature.

Do you know?

Trends in Public Expenditure in India since Independence

Sr. No.	Year	Total Expenditure (₹ Cr.)
1	1991-92	72,317
2	2001-02	3,62,450
3	2005-06	5,06,123
4	2009-10	10,24,487
5	2015-16	11,95,025
6	2016-17	13,74,203
7	2017-18	14,35,233
8	2018-19	17,29,682

Source - Economic Survey, Government of India- 2018-19

Given table shows trends in public expenditure in India since 1991-92 for select years. It can be clearly observed that there is tremendous growth in the total public expenditure of the country over the period.

Reasons for Growth in Public Expenditure :

It is observed that there is a continous growth in public expenditure in a developing country like India.

Let us study some of the important reasuns :

1) Increase in the Activities of the Government : As mentioned earlier, the modern government performs many functions for the social and economic development of the country. These functions include spread of education, public health, public works, public recreation, social welfare schemes etc. It is observed that new functions are continuously being undertaken and old functions are being performed more efficiently on a large scale by the government. This leads to increase in public expenditure.

2) **Rapid Increase in Population :** Population of developing countries like India is increasing fast. In 2011 Census, it was 121.02 crores. As a result, the government has to incur greater expenditure to fulfil the needs of the increasing population.

3) **Growing Urbanization :** Spread of urbanization is a global phenomenon of the day. This leads to increase in the government expenditure on water supply, roads, energy, schools and colleges, public transport, sanitation etc.

4) **Increasing Defence Expenditure :** In modern times, defence expenditure of the government is increasing even in the peace time due to unstable and hostile international relationships.

5) **Spread of Democracy :** Majority of the countries in the world are democratic in nature. A democratic form of government is expensive due to regular elections and other such activities. This results in the increase in total expenditure of the government.

6) **Inflation :** Just like a private individual, the government has to buy goods and services from the market for the spread of economic and social development. Normally, prices show a rising trend. Due to this, the government has to incur increasing costs.

7) **Industrial Development :** Industrial development leads to an increase in production, employment and overall growth in the economy. Hence, the government makes huge efforts for implementing various schemes and programmes for industrial development. This results in increase in government expenditure.

8) **Disaster Management :** Many natural and man-made calamities like earthquakes, floods, cyclones, social unrest etc. are occurring more frequently. The government has to spend a huge amount for the disaster management which increases total expenditure.

Modern governments are working for 'welfare state'. Hence, there is a continuous increase in the public expenditure.

Find out :

Reasons for growth in public expenditure other than given above.

Find out :

Important social welfare schemes by the Govt.

II) Public Revenue :

Public revenue means the aggregate collection of income with the government through various sources. Public revenue holds the permanent position in the study of public finance which is part of study of economics. Thus, the necessity of public revenue arises due to public expenditure.

The main sources of public revenue are as follows.

Sources of Public Revenue :

A) Taxes B) Non-tax Revenue :

A) Taxes :

1) According to Prof. Taussig : "The essence of a tax as distinguished from other charges by government is the absence of a direct

quid pro quo between the tax payer and the public authority."

2) According to Prof. Seligman, "A tax is a compulsory contribution from the person to the government without reference to special benefits conferred."

A tax possesses following essential characteristics :

1) It is a compulsory contribution to the government and every citizen of the country is legally bound to pay the tax imposed upon him. It is a major source of revenue to the government. If any person does not pay a tax, he can be punished by the government.
2) Tax is paid by a taxpayer to enable government to incur expenses in the common interests of the society.
3) The payment of a tax by a person does not entitle him to receive any direct and proportionate benefits or services from the government in return for the tax.
4) Tax is imposed on income, property or commodities and services.

You should know :

Canons (Principles) of Taxation :

Adam Smith, the founder of Modern economics propounded the following four canons of taxation :

1) **Canon of Equity or Equality :** Smith suggested that every person will pay the taxes to the government in proportion to his 'ability to pay'. It means rich people should pay more tax compared to the poor.
2) **Canon of Certainty :** According to Smith, the taxpayer should know in advance how much tax he has to pay, at what time he has to pay the tax and in what form the tax is to be paid to the government.
3) **Canon of Convenience :** According to this canon, every tax should be levied in such a manner and at such a time that it becomes convenient to the tax payer.
4) **Canon of Economy :** According to this canon, the cost of tax collection should be the minimum. If a major portion of the tax proceeds is spent on the tax collection itself, then such a tax cannot be considered as a good tax.

Types of Taxes :

There are two main types of taxes. They are :

1) Direct Tax and 2) Indirect Tax.

Let us study in details :

1) **Direct Tax :** It is paid by the taxpayer on his income and property. The burden of tax is borne by the person on whom it is levied. As he cannot transfer the burden of the tax to others, impact and incidence of direct tax falls on the same person. For example- personal income tax, wealth tax etc.
2) **Indirect Tax :** It is levied on goods or services. It is paid at the time of production or sale and purchase of a commodity or a service. The burden of an indirect tax can be shifted by the taxpayer (producers) to other person/s. Hence, impact and incidence of tax are on different heads. For example, newly implemented Goods and Services Tax [GST] in India has replaced almost all indirect taxes, custom duty.

Do you know?

Direct taxes are further classified into three categories depending upon the rate of tax. These are :

1) **Proportionate tax :** When a tax is levied at the same and constant rate on all incomes, it is called proportional tax.
2) **Progressive tax :** A tax, the rate of which increases with every increase in income

is called progressive tax. In India we have progressive tax rate system.

3) **Regressive tax :** In regressive taxation, the larger the income of a tax-payer, the smaller is the proportion of the tax levied on him.

B) Non-Tax Revenue Sources :

Public revenue received by the government administration, public enterprises, gifts and grants etc. are called as non-tax revenue. These sources are different than the taxes. A brief information about these sources are as follows :

1) **Fees :** A tax is paid compulsorily without any return service whereas, fee is paid in return for certain specific services rendered by the government. For example- education fee, registration fee, etc.

2) **Prices of public goods and services :** Modern governments sell various types of commodities and services to the citizens. A price is a payment made by the citizens to the government for the goods and services sold to them. For example- railway fares, postal charges etc.

3) **Special Assessment :** The payment made by the citizens of a particular locality in exchange for certain special facilities given to them by the authorities is known as 'special assessment.' For example- local bodies can levy a special tax on the residents of a particular area where extra/special facilities of roads, energy, water supply etc. are provided.

4) **Fines and Penalties :** The government imposes fines and penalties on those who violate the laws of the country. The objective of the imposition of fines and penalties is not to earn income, but to discourage the citizens from violating the laws framed by the Government. For example, fines for violating traffic rules. However, the income from this source is small.

5) **Gifts, Grants and Donations :** The government may also earn some income in the form of gifts by the citizens and others. The government may also receive grants from the foreign governments and institutions for general and specific purposes. Foreign aid has become an important source of development finance for a developing country like India. However, this source of revenue is uncertain in nature.

6) **Special levies :** This is levied on those commodities, the consumption of which is harmful to the health and well-being of the citizens. Like fines and penalties, the objective is not to earn income, but to discourage the consumption of harmful commodities by the citizens. For example- duties levied on wine, opium and other intoxicants.

7) **Borrowings :** The government can borrow from the people in the form of deposits, bonds etc. It also gets loans from foreign governments and organizations such as IMF, World Bank etc. Loans are becoming more and more popular source of revenue for the governments in the modern times.

Do you know?

Goods and Services Tax [GST]

The Goods and Services Tax [GST] came into effect in India on July 1, 2017. It was proposed by the Kelkar Task Force on Implementation of the Fiscal Responsibility and Budget Management [FRBM] Act in July, 2004. The 101st Amendment in the Constitution Act, 2016 provided for the constitution of the Goods and Services Tax Council[GSTC] comprising the Union Finance Minister, the Minister of State[Revenue] and the Finance Ministers of each state, empowering the Council to make recommendations on the GST rates, exemptions, thresholds of the tax etc.

GST is different from an excise or sales tax imposed as a single-stage levy on the manufacture or sale of a product. It is a comprehensive tax base with nationwide coverage of goods and service. GST would replace the following taxes levied and collected by the Centre and States such as Central Excise Duty, Service tax, Additional Duties of Customs, State Value Added Tax, Entry Tax, Entertainment Tax etc.

Central Goods and Services Tax [CGST] - It is a tax levied on interstate supplies of both goods and services by the central government which will be governed by the CGST Act.

State Goods and Services Tax [SGST]- This tax is received by the state in which the goods or services are consumed and not by the state in which these goods are manufactured.

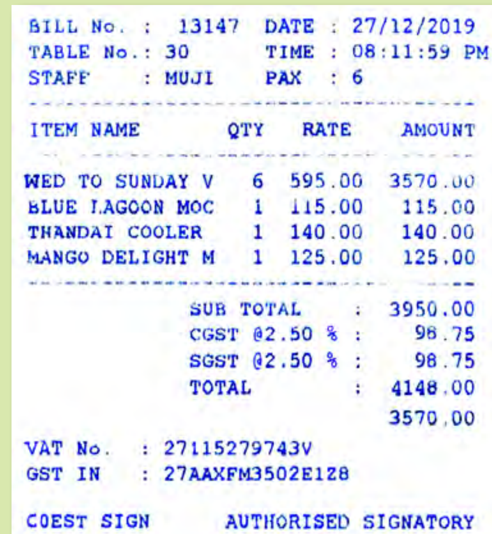
Integrated Goods and Services Tax [IGST]- It is a tax levied on all interstate supplies of goods and services which will be governed by the IGST Act.

Compensation Part - It is for the loss of expected income on the part of the State Governments.

Expected Benefits of GST :

- Creation of a unified common national market for India.
- Boost to foreign investments and 'Make in India', campaign.
- Harmonization of laws, procedures and rates of tax.
- Boost export and manufacturing activity.
- Improvement in the overall investment climate in the country.
- Simplifying the tax system in the country.
- Reducing final price of goods.
- Boost to the industrial sector.
- Poverty Eradication by generating more employment and more financial resources.

Sample showing GST voucher


BILL No. : 13147 DATE : 27/12/2019
TABLE No.: 30 TIME : 08:11:59 PM
STAFF : MUJI PAX : 6

ITEM NAME	QTY	RATE	AMOUNT
WED TO SUNDAY V	6	595.00	3570.00
BLUE LAGOON MOC	1	115.00	115.00
THANDAI COOLER	1	140.00	140.00
MANGO DELIGHT M	1	125.00	125.00

SUB TOTAL : 3950.00
CGST @2.50 % : 98.75
SGST @2.50 % : 98.75
TOTAL : 4148.00
3570.00

VAT No. : 27115279743V
GST IN : 27AAXFM3502E128

COEST SIGN AUTHORISED SIGNATORY

III) Public Debt :

Like a private individual, the government also needs to raise loans. In fact, raising debt is the most common activity of any government, because government expenditure generally exceeds government revenue. Public debt policy of the government plays an important role in public finance.

There are mainly two types of public debt. They are :

1) Internal Debt and 2) External Debt

1) **Internal Debt :** When a government borrows from its citizens, banks, central bank, financial institutions, business houses etc. within the country, it is known as internal debt.

2) **External Debt :** When a government borrows from foreign governments, foreign banks or institutions, international organizations like International Monetary Fund, World Bank etc., it is known as external debt.

Table no. 8.1 shows the difference between Internal debt and External debt.

Table 8.1

Differences between Internal and External Debt

Sr. No.	Internal Debt	External Debt
1	Raised within the economy	Raised outside the economy
2	Voluntary or compulsory in nature	Voluntary in nature
3	Use of domestic currency	Use of foreign currency
4	Less complex for management	More complex for management

Try this :

Classify the following activities into Internal and External Debt :

1) Government selling bonds to its citizens.
2) Government of India borrowing funds from the World Bank for provision of water supply.
3) Government of India takes loans from Nationalized Banks for developing infrastructure facilities in the country.
4) Government of India takes loans from World Bank for Mumbai Metro Train.

IV) Fiscal Policy :

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It deals with the public expenditure, public revenue and public debt. In short, it is the financial policy implemented by the Government.

V) Financial Administration :

A smooth and efficient implementation of revenue, expenditure and debt policy of the Government, is referred to as financial administration. This includes preparation and implementation of the Government budgets along with overall growth of the country.

Government Budget :

Budget is an important instrument of financial administration through which all the financial affairs of the state are regulated. Budget is a financial statement showing the expected receipts and proposed expenditures of the government in the coming financial year. In India, a financial year is from 1st April to 31st March. Article 112 of the Constitution of India has a provision for annual financial statement. In every budget, a set of seven budget documents describe the details of Government finance in India.

The word 'Budget' is derived from the French word 'Bougette',which means a bag or a wallet containing the financial proposals. These financial proposals are in the form of the Government expenditure and revenue.

Do you know?

The term 'Budget' is not used in the Constitution of India. It refers to the 'Annual Financial Statement' of the Government.

Revenue and Capital Budgets :

Central Budget provisions are divided into-

1) Revenue Budget and
2) Capital Budget.

1) **Revenue Budget :** It consists of revenue receipts and revenue expenditure of the government. Revenue receipts are divided into tax and non-tax revenue. Revenue expenditure comprises of interest paid on Government borrowings, subsidies and grants given to the state governments.

2) **Capital Budget :** The capital budget consists of capital receipts and capital payments. Capital receipts are Government loans raised from the public and the Reserve Bank of India, divestment of equity holding in the public sector enterprises, loans received from the foreign Governments and other foreign bodies, State deposit funds, special deposits etc.

Capital payments refer to the capital expenditures on various development projects, investments by the Government, loans given to the state Governments, and Government companies, corporations and other parties. Besides, it includes expenditure on social and community development, defence and general services.

Types of Budget :

The budgetary provisions of public expenditure and revenue need to be at different levels as per the changing needs of the economy. Accordingly, Government budget is of three types :

1) Balanced Budget
2) Surplus Budget
3) Deficit Budget

1) **Balanced Budget :** Government budget is said to be balanced, when estimated revenue and expenditure of the government are equal. That is, Government Receipts = Government Expenditure.

The concept of a balanced budget was advocated by the classical economists like Adam Smith. It was considered as neutral in its effect on the working of the economy and hence, they regarded it as the best.

However, modern economists believe that the policy of balanced budget may not always be suitable for the economy. The modern Governments are welfare entities and hence, they cannot keep their expenditure at the level of their receipts.

2) **Surplus Budget :** Government budget is said to be surplus, when estimated Government receipts are more than the estimated Government expenditure. i.e. anticipated Government Receipts > estimated Government Expenditure.

A surplus budget may prove useful during the period of inflation. In the period of inflation, there is a tendency for prices to rise rapidly. This needs to be checked, particularly in the interest of those who have more or less a fixed income. The rise in prices can be checked by lowering the level of effective demand in the economy. This can be done by increasing taxes which would increase the revenue of the government and reduce the purchasing power of the people. As a result, the aggregate demand will fall leading to downward movement in the price level. Thus, inflationary pressures can be controlled.

However, a surplus budget should not be used in the situations other than inflation as it may lead to unemployment and low levels of output in an economy.

3) **Deficit Budget :** Government budget is said to be deficit, when anticipated Government receipts are less than the estimated Government expenditure. That is anticipated Government Receipts < estimated Government expenditure.

A deficit budget may prove useful during the period of depression. In the period of depression, all economic activities are at low level which results in unemployment. This can be checked by increasing Government expenditure, by borrowing money and through deficit financing. This will increase employment and aggregate effective demand for goods and services which would encourage further investment. In modern times, deficit budget is the most commonly implemented policy of any Government.

Developing countries like India have consistently resorted to deficit budget technique for economic development.

Importance of Budget :

Union Budget is important because it affects people and economy in general in a number of ways. Taxes are the most interesting part of any budget. Taxes determine the fate of businesses and individuals. The level of disposable income of the taxpayers depends on the tax rates presented in the budget. Government expenditure on various heads such as defence, administration, infrastructure, education and health care etc. affects the lives of the citizens and overall economy. Also, budget is important because Governments use it as a medium for implementing economic policies in the country. Budgetary actions of the Government affect production, size and distribution of income and utilization of human and material resources of the country.

Thus, the scope and importance of public finance in a modern economy has undergone an immense change since last 100 years.

EXERCISE

Q. 1. A) Choose the correct option :

1) Optional functions of Government :
   a) Protection from external attack
   b) Provision of education and health services
   c) Provision of social security measures
   d) Collection of tax

Options : 1) b and c 2) a, b and c 3) b, c and d 4) All of the above

2) Obligatory functions of the Government :
   a) Provision of employment
   b) Maintaining internal law and order
   c) Welfare measures
   d) Exporting goods and services

Options : 1) c and d 2) a and b 3) only b 4) a, c and d

3) "Definition - Public finance is one of those subjects which are on the borderline between economics and politics." .... given by
   a) Adam Smith
   b) Alfred Marshall
   c) Prof. Hugh Dalton
   d) Prof. Findlay Shirras

Options : 1) only a 2) only b 3) only c 4) only d

4) Non-tax sources of revenue :
   a) Direct and Indirect Tax
   b) Direct Tax and Fees
   c) Fees
   d) Special Levy

Options : 1) b and c 2) a and c 3) a, b, c and d 4) c and d

5) Trends shown by Public expenditure of any Government shows following trend.
   a) Constant b) Increasing
   c) Decreasing d) Fluctuating

Options : 1) only a 2) only b 3) only c 4) only d

6) Identify the right group of pairs from the given options.

i) Direct tax	a) Non-tax revenue
ii) Indirect tax	b) Inflation
iii) Fees and Fines	c) GST
iv) Surplus budget	d) Personal income tax

Options : a) i-d ii-c iii-b iv-a
b) i-c ii-d iii-a iv-b
c) i-d ii-c iii-a iv-b
d) i-a ii-b iii-c iv-d

Q. 2. Distingwish between following concepts :

1) Public finance and Private finance.
2) Internal debt and External debt.
3) Developmental expenditure and Non-developmental expenditure.
4) Special assessment and Special levy.
5) Direct Tax and Indirect tax.

Q. 3. State with reasons whether you agree or disagree with the following statement :

1) Obligatory function is the only function of the Govenment.
2) Fines and penalties are a major source of revenue for the Government.
3) The goods and services tax (GST) has replaced almost all indirect taxes in India.
4) Democratic Governments do not lead to increase in public expenditure.
5) Public finance is more elastic than private finance.

Q. 4. Read the given passage and answer the questions :

"The conventional notion of social security is that the government would make periodic payments to look after people in their old age, ill-health, disability and poverty. This idea should itself change from writing a cheque for the beneficiary to institutional arrangements to care for beneficiaries, including by enabling them to look after themselves, to a large extent.

The write-a-cheque model of social security is a legacy from the rich world at the optimal phase of its demographic transition, when the working population was numerals enough and earning enough to generate the taxes to pay for the care of those not working. This model is ill-suited for less, well-off India with growing life expectancy, increasing urbanization and resultant migration. Social security under urbanization will be different from social security in a static society.

1) State the conventional notion of social security.
2) What kind of conceptual change is suggested in the given paragraph.
3) What is a legacy of social security from the rich world?
4) Which features of India make the traditional model of social security ill-suited for the economy?

Q. 5. Answer the following :

1) State the types and importance of Government budget.
2) Explain the principles of taxation.
3) Explain non-tax sources of revenue of the Government.

Q. 6. Answer in detail :

1) Explain various reasons for the growth of public expenditure.