2018

INTEGRATED LEARNING PROGRAMME, ILP

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[ECONOMY VALUE ADD]

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Contents

EXTERNAL SECTOR IN INDIA

Forex Reserves

- **Foreign Currency Assets/Reserves** - The total foreign currencies (of different countries) an economy possesses at a point of time is its 'foreign currency assets/reserves'
- The **Forex Reserves or FOREX** of an economy is its 'foreign currency assets' added with its gold reserves, SDRs (Special Drawing Rights) and Reserve Tranche in the IMF.
- **Reserve tranche** - It consists of India's quota (member subscription fee) to IMF and lending to General Resource Account of IMF)

External Debt

- External debt (or foreign debt) is the total debt a country owes to foreign creditors, complemented by internal debt owed to domestic lenders. The debtors can be the government, corporations or citizens of that country.
- After the BoP crisis of 1991, India's prudent external debt policies and management with a focus on sustainability, solvency, and liquidity have helped to limit the size of external debt to a moderate level
- The rise in total external debt in recent years is due to long-term commercial borrowings and NRI deposits.
- **Important features** of India's external debt:
    - Major portion long-term debt than short-term debt.
    - Most part of debt is hold by non-governmental debt.
    - Non-concessional debt (commercial loans borrowed by the non-governmental body) accounts 91.3% while concessional is just 8.7%

Fixed Currency Regime

- A fixed exchange rate is a country's exchange rate regime under which the government or central bank ties the official exchange rate to another country's currency or to the price of gold.
- The purpose of a fixed exchange rate system is to maintain a country's currency value within a very narrow band.

Floating Currency Regime

- In the floating exchange rate system, a domestic currency is left free to float against a number of foreign currencies in its foreign exchange market and determines its own value.
- They are also called as **market driven exchange rates**.

- This system is regulated by factors such as the **demand and supply of the domestic and the foreign currencies** in the concerned economy.

Managed Exchange rates

- This system is a hybrid of the fixed and flexible exchange rate systems in which the government of the economy attempts to affect the exchange rate directly by buying or selling foreign currencies or indirectly, through monetary policy (i.e., by lowering or raising interest rates on foreign currency bank accounts, affecting foreign investment, etc.).
- Most economies have shifted to this system, including **India**
- Almost all countries tend to intervene when the markets become disorderly or the fundamentals of economics are challenged by the exchange rate of the time.

Pegging of Currencies

- Small economies peg their currencies to a major currency or to a basket of currency in a fixed exchange rate-known as the **pegging of currencies**.
- **Gliding or crawling peg system** - At times, the peg is allowed to glide smoothly upward or downward—a system which is known as gliding or crawling peg.

Exchange Rate in India: Background

- Before 1948, Indian rupee was linked with British Pound Sterling.
- After coming up of IMF, India shifted to the fixed currency system.
- India wanted to keep rupee's external value (i.e., exchange rate) in terms of gold or the US ($ Dollar).
- In 1975 – rupee was **delinked** from the British Pound and the **RBI started determining rupee's** exchange rate with respect to the exchange rate movements of the basket of world currencies.
- In 1992-93 – India moved to floating currency regime. (with its own method of 'dual exchange rate')
  - **'Dual Exchange Rate'** - RBI may intervene in the forex market via the demand and supply of rupee or the foreign currencies.
- **Note:** No country had followed an ideal free-floating exchange rate till date. They need some mechanism to intervene in the FOREX market because this is a highly speculative market.

Trade Policy

- A country's **trade policy** includes taxes imposed on import and export, inspection regulations, and tariffs and quotas.
- Also known as **foreign trade policy or the Exim Policy.**
- These policies are specific to each country and are formulated by its public officials. Their aim is to boost the nation's international trade.

Depreciation

- Increase in the exchange rate i.e. fall in the external value of domestic currency because of more demand for foreign currency (less supply of foreign currency) or more supply of (less Demand of) Domestic currency is called **depreciation**.

Appreciation

- Fall in the exchange rate i.e. increase in the external value of domestic currency, due to more demand for home currency (or less supply of home currency) or less demand for (or more supply of) foreign currency is called **Appreciation**.

Balance of Payment (BoP)

- The BoP of a country is a systematic record of all its economic transactions with the outside world in a given year.
- The balance of payments in the India is composed of 3 subaccounts: the current account, the capital account and the forex reserves.

Balance of Trade

- The **balance of trade (BOT)** is the difference between a country's imports and its exports for a given time period.
- The balance of trade is the largest component of the country's balance of payments (BOP).

Current Account

- Account maintained by every government in which every kind of current transaction is shown. This account is maintained by central bank of the country.
- Current transactions of an economy in foreign currency all over the world are—**export, import, interest payments, private remittances and transfers.**
- All transactions in current account are shown as either **inflow or outflow** (credit or debit). At the end of the year, the current account might be positive or negative.
- India had surplus current accounts for three consecutive years (2000—03) - the only such period in Indian economic history.

Capital Account

- The capital account includes foreign direct investment (FDI), portfolio and other investments, plus changes in the reserve account.
- A nation's capital account summarizes the country's overall economic status. The markets closely monitor the capital account because it shows the overall direction of the country's economy and provides buy and sell signals for various industries or portfolio strategies.

Convertibility

- Facility of exchanging domestic currency for foreign currency at market determined exchange rate without restriction on either rate or quantum of money exchanged is called **convertibility**.
- **Full current account convertibility** - If domestic currency is allowed to convert into foreign currency for all current account purposes, it is a case of full current account convertibility.
- **Full capital account convertibility** - In cases of capital outflow, if the domestic currency is allowed to convert into foreign currency, it is a case of full capital account convertibility.

Convertibility in India

- The convertibility in India is a gradual one. Introduced in – 1990s.
- Convertibility in current account was introduced first and then it was introduced in the capital account.

Current Account Convertibility

- Current account convertibility refers to the freedom of converting home currency into foreign currency with respect to transactions in current account.
- Budget 1992 — 93 introduced Liberalized Exchange Rate Management System (LERMS).
    - In this system, 60% of foreign exchange earnings are convertible at open market rate, and remaining 40% at RBI fixed rate.
- In 1993-94, government introduced full convertibility in Trade account.
- In 1994 - 95 budget, full convertibility in current account was introduced.

Capital Account Convertibility

- Capital Account Convertibility (CAC) is not just the currency convertibility freedom, but more than that, it involves the freedom to invest in financial assets of other countries.
- The Committee on Capital Account Convertibility (1997, Chairman SS Tarapore) in its report has given a working definition for the CAC which is as following:
- ***"CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world."***
- Capital account convertibility is thus the freedom of foreign investors to purchase Indian financial assets (shares, bonds etc.) and that of the domestic citizens to purchase foreign financial assets.
- It provides rights for firms and residents to freely buy into overseas assets such as equity, bonds, property and acquire ownership of overseas firms besides free repatriation of proceeds by foreign investors.
- India currently provides for **partial** capital account convertibility

NEER and REER

- NEER stands for Nominal Effective Exchange Rate and REER stands for Real Effective Exchange Rate.
- Usually the exchange rate is determined for a domestic currency against a single foreign currency. In the effective exchange rate (EER) system, a currency is fixed against a basket of currencies. For NEER and REER the basket is SDR (Special Drawing Rights at IMF) currencies.
- The way real GDP arrived from nominal GDP after correcting it for price change the REER is arrived from NEER.

Hard Currency

- It is the international currency in which the highest faith is shown and is needed by every economy.
- The **strongest currency of the world** is one which has a high level of liquidity.
- Basically, the economy with the highest as well as highly diversified exports that are compulsive imports for other countries (as of high-level technology, defence products, lifesaving medicines and petroleum products) will also create high demand for its currency in the world and become the hard currency. It is always scarce.
- By the time you have read this para you have realized that today hard currency is US $.
- Till 2nd world war, the best hard currency was the Pound Sterling (£) of the UK, but soon it was replaced by the US Dollar.

- **Best hard currencies of the world** - US **Dollar**, the Euro **(€),** Japanese Yen **(¥),** UK Sterling Pound **(£)** and Chinese **Yuan**.

Soft Currency

- Currency that is easily available in any economy is called as soft currency.

Heated Currency

- Domestic currency which is under enough pressure (heat) of depreciation due to a hard currency's high tendency of exiting the economy (since it has become hot).

Cheap Currency

- If a government starts repurchasing its bonds before their maturities (at full-maturity prices) the money which flows into the economy is known as the cheap currency
- If a government follows above path it means country is witnessing a period of comparatively lower/softer interest rates regime.

Special Economic Zone (SEZ)

- SEZ is essentially an industrial cluster meant largely for exports.
- An SEZ is governed by a special set of rules aimed at attracting direct investment for export-oriented production.
- They are also known as 'Export Processing Zones' or 'Free Trade Zones'.
- Salient features of SEZs are:
  - Both manufacturing of goods or service are allowed
  - No routine examination by customs authorities of export/import cargo
  - No requirement for import license
  - Units in SEZs have to become net foreign exchange earners within 3 years
  - Domestic sales from them are subject to full customs duty and the import policy in force.
  - Developing self-sustaining industrial townships so that the increased economic activity does not create pressure on the existing infrastructure.
  - SEZ developer would be responsible for all civic amenities and infrastructure including roads, sewerage, open spaces, green spaces, education facilities, power, water supply and housing etc.
- SEZ is an improvement to the concept of Export Processing Zones.
- India was one of the 1st in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports
- Asia's first EPZ set up in Kandla in 1965.

Aim of SEZ

- Need to aggressively promote exports of goods and services in highly competitive global market place to provide sustained growth and creation of formal employment
- Create a strong manufacturing base in the country
- Improve the balance of trade

GAAR: General Anti-Avoidance Rules

- GAAR was originally proposed in the Direct Taxes Code 2010.
- It is an anti-tax avoidance regulation. As the name suggests, it is set of laws aimed at curtailing tax avoidance in general.
- GAAR is set of rules under the Income Tax Act which empowers the revenue authorities to deny tax benefits transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit.

What is Tax Avoidance?

- Tax avoidance is deliberate measures to avoid or reduce tax burden by an individual or a company. It is not illegal or forbidden by the law as such. (Tax evasion is illegal)

Concerns Related to GAAR

Troubling provisions that will make doing business in India more challenging –

- It is presumed that obtaining tax benefit is the main purpose of the arrangement unless otherwise proved by the taxpayer.
- GAAR is a very broad-based provision and can easily be applied to most tax—saving arrangements.
- There are concerns such as the interplay between GAAR and DTAAs, the thin line of difference between tax planning and tax avoidance, the co-existence of GAAR and Specific Anti-Avoidance Rules (SAAR), the scope of conflicting interpretation over IAAs, the functioning of the approving panel, etc.
- The discretionary powers to invoke GAAR and undo a transaction that complies with the provisions of the existing tax regime may extensively hinder the business environment.

New Steps to Promote Foreign Trade

- **E-filing and e-payments** – application for various trades can be filed online and application fees paid through electronic transfer. No. of documents required are cut down to 3.
- **Single window for customs** – aimed at providing importers/exporters a single point interface for customs clearance, thereby reducing personal interface with governmental agencies, dwell time and cost of doing business.

- **24*7 customs clearances** – aimed at faster clearance of import and export, reducing dwell time and lowering the transaction cost.
- **Paperless environment** – aims to move towards a paperless 24*7 working trade environment. A new facility has been created to upload documents in exporter/importer profile so that exporters are not required to submit documents repeatedly.
- **Simplification** – attention has also been paid to simplifying various 'aayat niryat' forms, bringing in clarity in different provisions, removing ambiguities and enhancing electronic governance.
- **Training/outreach** –
  - '**Niryat Bandhu Scheme'**, a training/outreach program is aimed at skill india – organized at MSME clusters with the help of export promotion councils (EPCs) and other willing partners and knowledge partners.
  - **Niryat Bandhu at your desktop** – an online certificate programme in export import business.

New Foreign Trade Policy

- **For period** – 2015-2020
- It provides a framework for increasing exports of goods and services as well as generation of employment and increasing value addition in the country, in keeping with the Make in India.
- **Focus** - support both the manufacturing and services sectors, with a special emphasis on improving the '**ease of doing business**'
- Special features of the FTP:
  - 2 new schemes introduced –
  - **MEIS (Merchandise Exports from India scheme)** - for export of specified goods to specified markets.
  - **Services Exports from India Scheme (SEIS)** - for increasing exports of notified services.
  - Procurement of capital goods from indigenous manufacturers under the EPCG (Export Promotion Capital Goods) scheme by reducing specific export obligation to 75% of the normal export obligation. This will promote the domestic capital goods manufacturing industry.
  - Measures to boost exports of defense and hi-tech items have been taken. E-commerce exports of handloom products, books/periodicals, leather footwear, toys and customized fashion garments through courier or foreign post office would also be able to get benefit of MEIS. This will capitalize India's strength in these area, increase exports and provide employment.

- Extension of benefits of both the reward schemes (MEIS and SEIS) to units located in SEZs will give a **boost to exports from SEZs** and also to development and growth of SEZs in country.
- **Trade facilitation** and enhancing the ease of doing business are the other major focus areas—24*7 customs clearance, paperless environment, single window for customs, aayat-niryat etc. (already covered above)
- Number of steps (like fast track clearance facility, sharing of infrastructure facilities, etc.) had been taken for encouraging manufacturing and exports under 100 % schemes.
- **MSME Clusters-**108 clusters have been identified for focused interventions to boost exports.

PUBLIC FINANCE IN INDIA

Note- We will provide a summary of Budget and Economic Survey- 2018, separately.

Important Terms

Budget

- It is the 'annual financial statement' – a **statement of accounts** of the Government
- **Article 112** (Central Government) and **Article 202** (State Government) of the Indian Constitution requires the annual financial statement to be laid before the respective legislatures.

Fiscal Policy

- Fiscal policy refers to the use of government spending and tax policies to influence macroeconomic conditions, including aggregate demand, employment, inflation and economic growth.

Plan and Non-Plan Expenditure (in news)

- **Plan Expenditure** - any expenditure that is incurred on programmes which are detailed under the current (Five Year) Plan of the centre or centre's advances to state for their plans is called plan expenditure. Provision of such expenditure in the budget is called Plan Expenditure. Plan expenditure is further sub-classified into Revenue Expenditure and Capital Expenditure
    - Such plans ware developed by the erstwhile Planning Commission after consulting individual ministries.
    - Each Plan specifies programs that ministries will fund and develop over the next five years (like Mid-Day Meal scheme and the Sarva Shiksha Abhiyan)
    - Plan expenditure can have both revenue and capital components.
    - For instance, under the Sarva Shiksha Abhiyan, salaries of teachers could be classified as **revenue expenditure**, while expenditure on the building a school might be classified as **capital expenditure**.
- **Non-Plan Expenditure** - this refers to the estimated expenditure provided in the budget for spending during the year on routine functioning of the government. Non- Plan expenditure is all expenditure other than plan expenditure of the govt.
    - It includes interest payments on government debt, expenditure on organs of the state such as the judiciary and the police and even expenditure on the maintenance of existing government establishments such as schools and hospitals.

- Non-plan expenditure too, has revenue and capital components.

C. Rangarajan Committee Report

- Recommended removal of the distinction between plan and non-plan expenditure due to vagueness of the terms and the rigid categorization of expenditure
- As 5-years plans and its formulating body (Planning Commission) were taken down, the government during Budget 2017 did away the distinction between plan and non-plan expenditure.

Receipts

- Every receiving or accrual of money to a government by revenue and non-revenue source is a receipt. Their sum is called total receipts.

Revenue Receipts

- Receipts which **do not have a direct impact on the assets or liabilities** of the government. Mostly revenues from taxes, dividends from companies owned by the government, user charges on some public services and license fees received from licensees such as telecom companies.
- Revenue receipts of a government are of 2 kinds—**Tax Revenue Receipts and Non—tax Revenue Receipts**—consisting of the following income receipts in India:

Tax Revenue Receipts

- It includes all money earned by the government via the different taxes the government collects, i.e., all direct and indirect tax collections.

Non-Tax Revenue Receipts

- It includes all money earned by the government from sources other than taxes.
- Sources:
  - Profits and dividends from public sector undertakings (PSUs).
  - Internal lending or external lending's interest received by the government. This income might be in both domestic and foreign currencies.
  - Fiscal services (like currency printing, stamp printing, coinage and medals minting, etc.)
  - General Services (power distribution, banking, community services, etc.)
  - Fees, Penalties and Fines received by the government.
  - Grants which the governments receives-it is always external in the case of the Central Government and internal in the case of state governments.

Revenue Expenditure

- It is the expenditure **not used to create assets** e.g. expenses on salaries or other administrative costs.
- A broad category of things that fall under such expenditures in India are -
  - Interest payment by the government on the internal and external loans
  - Salaries, Pension and Provident Fund paid to government employees
  - Subsidies
  - Defense expenditures
  - Postal Deficits of the government
  - Law and order expenditures (i.e., police & paramilitary)
  - Expenditures on social services (includes all social sector expenditures as education, health care, security, poverty alleviation, etc.) and general services (tax collection, etc.)
  - Grants by GoI to Indian states and foreign countries.

Revenue Budget

- Revenue Budget consists of the revenue receipts of the government (tax revenues and other revenues) and the expenditure met from these revenues.

OR

- The part of the Budget which deals with the income and expenditure of revenue by the government
- It presents the annual financial statement of the total revenue receipts and the total revenue expenditure.
- If the balance emerges to be positive it is a **revenue surplus budget**, and if it comes out to be negative, it is a **revenue deficit budget**.

Revenue Deficit

- Revenue deficit is the difference between revenue expenditure and revenue receipts.
- Revenue Deficit = (Revenue Expenditure — Revenue Receipts)
- It implies government's Revenue Budget is running in losses and the government is earning less revenue and spending more.

Revenue Surplus

- It is the opposite of revenue deficit.
- A government might have its revenue expenditures less than its revenue receipts, i.e., having (revenue surplus) budget.
- **It is very rare**. But if it is there then we must see how the government has managed this surplus and whether the policies which made this happen are judicious enough or not.

- For example - In the 2nd Plan, India emerged as a revenue-surplus state, but experts did not appreciate it as it had many bad impacts on the economy-higher tax rates culminated in tax evasion, corruption, creation of black money, etc.

Effective Revenue Deficit

- It is a new term introduced in the Union budget 2011-12.
- It is defined as the **Revenue Deficit 'excluding'** those revenue expenditures of the GoI which were done in the form of GoCA (**grants for creation of capital assets**).
- Earlier such grants to states by GoI was included in revenue expenditure.
- But actually such revenue expenditures contribute to the growth in the economy and therefore, should not be treated as unproductive in nature like other items in the revenue expenditures.
- GoCA includes - the GoI grants forwarded to the states & UTs for the implementation of the centrally sponsored programs such as Pradhan Mantri Gram Sadak Yojana, Accelerated Irrigation Benefit Programme, Jawaharlal Nehru National Urban Renewal Mission, etc.,

Capital Budget

- Capital Budget consists of **capital receipts** and **capital payments**.

Capital Receipts

- The capital receipts are loans raised by the Government. The loans received from foreign Governments and bodies, **disinvestment receipts and recoveries of loans** from State and Union Territory Governments and other parties are also part of capital receipts.
- In short, they are -
  - Receipts due to disposal of permanent assets
  - Recovery of Loans given to others
  - Fresh loans raised by the government

Capital Expenditure

- Expenditure that create **permanent assets** and yield periodical income, and loans given to state government and local bodies are called capital expenditure.
- In short, they are:
  - Loan disbursals by the government
  - Loan repayments by the government of the borrowings made in the past
  - Plan expenditure of the government

- Capital expenditure on defense by the government - defense is a non-plan expenditure which has capital as well as revenue expenditures element in its maintenance.
- General services - railways, postal department, water supply, education, rural extension, etc.

Fiscal Deficit

- It is the difference between total expenditure and total receipts except borrowing and other liabilities.
- FD = Total expenditures – total receipts except borrowing and other liabilities.
- FD means government is spending more than its income (all receipts of the government are not income. Receipts are all forms of money accruing to the government, be it income or borrowings).

Primary Deficit

- Primary Deficit is measured by subtracting the interest payments from fiscal deficit.
- It is a measure of current year's fiscal operation after excluding the liability of interest payment created due to borrowings under taken in the past.
- **Primary Deficit = Fiscal Deficit — Interest payment**
- It is a very handy tool in the process of bringing in more transparency in the government's expenditure pattern.

Monetized Deficit

- The part of the fiscal deficit which was provided by the RBI to the government in a particular year is Monetized Deficit.
- It is an innovation in the fiscal management which brings in more transparency in the government's expenditure behavior and its dependence on market borrowings by the RBI.

Deficit and Surplus budget

Deficit Budget

- Click here for video
- A budget deficit occurs when expenditures exceed revenue.
- The term "budget deficit" is most commonly used to refer to government spending rather than business or individual spending.

Surplus budget

- A budget surplus occurs when revenue is greater than government spending. Therefore, the government can use the surplus revenue to pay off the national debt.
- Budget surpluses are **quite rare** in modern economies because of the temptation for politicians to spend more money and cut taxes.
- Another reason for not presenting a surplus budge is it symbolizes government's lower concerns towards development.

Need of Deficit Financing

- When government needs to spend more money than it was expected to earn or generate in a particular period, to go for a desired level of growth and development.
- Once the growth had taken place the extra money spent above the income would have been reimbursed or repaid.
- It was first tried by US and followed by whole Euro-American governments. Through this route the developed world was able to come out of the menace of the Great Depression (1929).
- India tried it in 1969 and since the 1970s it became a routine phenomenon, till it became wild and illogical, demanding immediate redressal. Finally, India headed for a slow but confident process of fiscal reforms that is also known as the **process of fiscal consolidation.**

Means of Deficit Financing

1. **External Aids**
    - Best money as a means to fulfil a government's deficit requirements.
    - They are free i.e. neither interest nor any repayments.
2. **External Borrowings**
    - External loans are considered an erosion in the nations sovereign decision making process but are considered better than the internal borrowings due to 2 reasons -
        - Bring in foreign currency/hard currency which gives extra edge to the government spending as by this the government may fulfil inside and outside requirement.
        - Preferred over the internal borrowings due to 'crowding out effect'. If the government itself goes on borrowing from the banks of the country, the private sector gets crowded out.
3. **Internal Borrowings**
    - Even though they lead to crowding out of private sector, they are relatively stable not affected by exchange rate.
4. **Printing Currency**

- Increases inflation proportionally because supply is same but demand for goods is increased as people have more money.
- Creates regular pressure on the government for upward revision in wages and salaries of government employees which increases the government expenditures necessitating further printing of currency and further inflation—a vicious cycle into which economies entangle themselves.

Deficit Financing in India

Background

- After independence India went for planned economy and so development responsibilities of the government were very high.
- This created a need for huge funds in rupee as well as in foreign currency forms.
- But India faced continuous crisis in managing the required fund to support its Five Year Plans because neither foreign funds came nor internal resources could be mobilized in sufficient amount due to lower tax collections, weaker banking system and negligible saving rate, etc.
- And so India headed towards deficit financing from late 1960s.
- Deficit financing in India was in following 3 phases –

First phase (1947-1970)

- No concept of deficit financing
- Tried internal and external borrowing but unable to meet the target.
- In the 1950s, tried to increase tax collections and check revenue expenditures to emerge as a surplus revenue budget economy but didn't get success.
- Heavy borrowings from the RBI and nationalization of banks increased the interest burden of the governments and ruptured the whole financial system

Second Phase (1970-1991)

- It was period where India adopted deficit financing
- Nationalization policy (control of government like nationalization of banks)
- Emphasis on expansion of the PSUs. But PSUs were in huge loss because of low revenues, high salary burden, PFs, and pensions.
- No check on rising population and no mass employment generations.
- Subsidies increased exponentially due to populist measures
- Majority of plan expenditure became non-economic i.e. non-plan expenditure

Third Phase (1991 onwards)

- Initiation of the economic reforms process under the conditionalities put forth by the IMF.
- As the economy moved from government control to market dominance, things needed a restructuring and public finance also needed a touch of rationality.

Indian Fiscal Situation – a Summary

- In 1985 – GoI presented a discussion paper in parliament titled '**Long Term Fiscal Policy**'
- It was a long term perspective on the fiscal issue of government.
- It recognizes the deterioration in India's fiscal position and accepted it among the most important challenges of the 1980s.
- It set specific targets and policies to set the things right.
- In 1987 – government come with 2 bold steps – one, virtual freeze on government expenditure and another ceiling on the budgetary deficit.
- But they created temporary positive impact and since mid-1988 the situation again started deteriorating and 1990 saw BoP crisis because of high fiscal deficit and due to a high level of external borrowings.
- IMF supported India in crisis but with conditions.
- With the process of economic reforms which started in 1991-92, the government also announced its commitment to reduce fiscal deficit to 3-4% (of GDP) by the mid-1990s.
- India's fiscal situation up to the 1990-91:
    - **Fiscal deficit keeps on increasing**. It was 4% of GDP in 1970s and went to 7% in second half of 1980s
    - The revenue (i.e., current) expenditure of the government (Centre and states combined) increased from 11.8% of GDP to 23% between 1960 and 1990. The revenue receipts of the government also went up. But the gap between revenue receipts and expenditures remained negative (i.e. Revenue deficit)-financed largely by domestic borrowings.
    - The fiscal situation of the states was not good either. The states' expenditure on the social sector went down while their interest payments had increased during the 1980s.
    - The debt situation in the states would have been even worse, but for the fact that the states, unlike the Centre, did not have independent powers to borrow either from the RBI or the market because of the statutory overdraft regulatory scheme. (Now this scheme has changed. After the implementation of suggestions of 12th FC states are now allowed to go for market borrowings to take care of their plan expenditures once they have passed and enacted their Fiscal Responsibility Acts (FRAs) in consonance with the FRBM Act, 2003.)

Q.) Why the government has not been able to check the menace of fiscal deficits even though there has been a consensus to do so?

- **Political factor** - The political lobbies and popular politics as well as the subsidies are supposed to be one big factor for rising government expenditure.
- **Institutional factor** - The administrative size combined with the processes of reporting, accounting, supervising and monitoring getting greater importance than the production and delivery of goods and services.
- **Populist factor** - There are many heads of such expenditures such as subsidies (food, power, fertilizer, irrigation, etc.) poverty alleviation programmes, employment generation programmes, education, health and social services. The logic for such expenditure comes from the idea that the government should function as protector of the poor and provider of jobs for them implying that such government expenditures benefit the poor.

In 2000 that the double menace of revenue and fiscal deficits got attention from the government and as a result, the **Fiscal Responsibility and Budget Management Bill**, 2000 was proposed in the Parliament.

FRBM Act, 2003

- **The Fiscal Responsibility and Budget Management** Act, 2003 (FRBMA) is an Act to institutionalize financial discipline, reduce India's fiscal deficit, improve macroeconomic management and the overall management of the public funds by moving towards a balanced budget.

Objectives

- The main objectives of the act were:
    - To introduce transparent fiscal management systems in the country
    - To introduce a more equitable and manageable distribution of the country's debts over the years
    - To aim for fiscal stability for India in the long run
- Additionally, the act was expected to give necessary flexibility to Reserve Bank of India (RBI) for managing inflation in India.

Why FRBM Became Necessary?

- The FRBM Act was enacted in 2003 as **rising government borrowing** and the resultant **government debts** seriously eroded the financial health of the government.
- High revenue deficit due to higher expenditure on subsidies, salaries, defense etc. compelled the government to make big borrowing from early 1990s onwards. With

inadequate revenues, government resorted to high level of borrowing which produced high interest payments.

- In this way, **interest payments** became the **largest expenditure** item of the government. To arrest this financial weakness in its budget, the government has taken some serious deficit cut targets by introducing a law in the form of the FRBM.

Main Provisions of FRBM Act

- It set a target reduction of fiscal deficit to 3% of the GDP by 2008-09. This will be realized with an annual reduction target of 0.3% of GDP per year by the Central government.
- Similarly, revenue deficit has to be reduced by 0.5% of the GDP per year with complete elimination by 2008-09.
- Later, the target dates were reset and budget 2016-17 aims to realize the 3% fiscal deficit target by March 2018.
- The Finance Minister has to explain the reasons and suggest corrective actions to be taken, in case of breach of sticking to target.
- **Following are the provisions of the Act in detail.**
  1. The government has to take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by 2008-09 and thereafter, sizable revenue surplus has to be created.
  2. Setting annual targets for reduction of fiscal deficit and revenue deficit, contingent liabilities and total liabilities.
  3. The government shall end its borrowing from the RBI except for temporary advances.
  4. The RBI not to subscribe to the primary issues of the central government securities after 2006.
  5. The revenue deficit and fiscal deficit may exceed the targets specified in the rules only on grounds of national security, calamity etc.
- Though the Act aims to achieve deficit reductions prima facie, an important objective is **to achieve inter-generational equity** in fiscal management. This is because when there are high borrowings today, it should be repaid by the future generation. But the benefit from high expenditure and debt today goes to the present generation. Achieving FRBM targets thus ensures inter-generation equity by reducing the debt burden of the future generation.
- Other objectives include - long run macroeconomic stability, better coordination between fiscal and monetary policy, and transparency in fiscal operation of the Government.

Recent Debate on Fiscal Targets

- Binding the government expenditures to a **fixed number may be counterproductive** to the economy at a large.
- Due to a hard-and-fast discipline regarding fiscal targets, some highly desirable expenditures by the government may get blocked, for example – expenditures on infrastructure, welfare etc.
- GoI announced 2 important changes in Budget 2016-17 –
    - It may be better to have a fiscal deficit target range as target. This would give necessary policy space to the government to deal with dynamic situation.
    - A need is felt to align fiscal expansion or contraction or expansion respectively in the economy.

Fiscal Consolidation in India

- A number of steps were taken by the government at the Centre in direction of fiscal consolidation and there had been incessant attempts to do the same in the states' public finances too. Major highlights in this direction are following –

1. **Policy initiatives towards cutting revenue deficits**
    a. **Cutting down expenditure:**
        i. Cutting down the burden of salaries, pensions and the PFs.
        ii. Cutting down the subsidies
        iii. Internal, external and other borrowings interest burden to be cut down
        iv. Budgetary supports to the loss-making PSUs to be an exception than a rule
        v. Expenditure reform started by the governments in different areas and departments;
        vi. General Services to be motivated towards profit with subsidized services to the needy only.
        vii. Postal deficits to be checked
    b. **Increasing revenue receipts:**
        i. Tax reforms initiated – GST etc.
        ii. The PSUs to be disinvested and even privatized
        iii. Surplus forex reserves to be used in external lending and purchasing foreign high quality sovereign bonds, etc.
        iv. State governments allowed to go for market borrowing for their plan expenditure, etc.
2. **The borrowing programme of the government:**
    a. The Ways and Means Advances (WMA) scheme commenced in 1997 under which the government commits to the RBI about the amount of money it will

give as part of its market-borrowing programme, to bring **transparency** in public expenditure and to **put political responsibility** on the government.

b. The **RBI** will **not be the primary subscriber** to government securities in the future— committed way back in 1997.

3. **The fiscal responsibility on the governments:**
    a. **The Fiscal Responsibility and Budget Management (FRBM) Act** was passed. The government was not to borrow from the RBI except by the WMA.
    b. Government to bring in greater transparency in fiscal operations.

Conclusion – India's fiscal consolidation process by now has had a mixed performance.

Zero Based Budgeting (ZBB)

- Zero-based budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period.
- Zero-based budgeting starts from a "zero base," and every function within an organization (such as a ministry) is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the previous one
- 3 essential questions which must be answered objectively before going for any expenditure as per the techniques of ZBB:
    - Should we spend?
    - How much should we spend?
    - Where should we spend?
- Everything including expenditure and receipts begin from a scratch under ZBB. Budget estimates for each Ministries or heads are provided on the basis of what is needed for the upcoming period, regardless of the budget activity of the previous years.
- Under ZBB, allocations or funding are based on program efficiency and necessity rather than budget history. However, ZBB is a time-consuming process that takes much longer time than traditional, cost-based budgeting.
- Prioritizing the competing needs is another special feature of ZBB. As the resources/funds are always scarce, in the process of prioritized allocation, the item/ items at the bottom might not get any funds.

Limitations of ZBB

- There are certain expenditures upon which the government/parliament does not have the power of scrutiny (as the 'Charged Expenditure' in India).
- There are certain public services which defy the cost-benefit analysis—defense, law and order, foreign relations, etc.

- Scrutiny is a subjective matter and so this might become prey to bias. Again, if the scrutinizers have a complete utilitarian view many long-term budgeting and public policy might get marginalized.
- It has scope for emergence of the Ministry of Finance as the all-powerful institution dictating other ministries and departments.
- Bureaucracy does not praise it as it evaluates their decisions and performances in a highly objective way.

Q.) So, we should go for ZBB or not?

- Despite the strong limitations, the ZBB has a sound logic and should be considered a long-term budgetary reform process.
- The basic idea of this form of budgeting is to **optimize the benefits of expenditure** in every area of activity and in this sense it is exceptional.
- It is already successful in corporate world.
- Many of the profit-fetching PSUs have been able to use it successfully and optimize their profits.

Charged Expenditure

- According to article 112 of Indian constitution the public expenditure which is beyond the voting power of the Parliament and is directly withdrawn from the Consolidated Fund of India.
- For example - The emoluments of the President, Speaker and Deputy Speaker of the Lok Sabha, Chairman and Deputy Chairman of the Rajya Sabha, Judges of the Supreme Court and the High Courts, etc., in India.

Gender Budgeting

- It refers to the process of planning, approving, executing, monitoring, analyzing and auditing budgets in a **gender-sensitive way**.
- Involves analysis of actual expenditure and revenue (usually of governments) on women and girls as compared to expenditures on men and boys.
- It is done in an economy where socio-economic disparities are chronic and clearly visible on a sex basis (as in India).
- It started in India with the **Union Budget 2006-07**

Outcome and Performance Budgets

- **Outcome Budgets** – presented by different departments and divisions of a ministry or the government.
    - It is a **micro level process.**
- **Performance Budget –** Performance budget is a budget that reflects the input of resources and the output of services for each unit of an organization. This type of

budget is commonly used by the government to show the link between the funds provided to the public and the outcome of these services.

- It is presented by the Ministry of Finance on behalf of the government.
- It is a **macro level process.**
- There are many outcome budgets in any one performance budget.

- Both go for '**quantitative' as well as 'qualitative' progress reports** of the performance.
- **Basic objective of such budgeting** - to bring in **transparency** and thereby making the government more and more responsible to the House and the public.
- Naturally, they bring in **prudence** and **optimization** elements in public spending.

TAX STRUCTURE IN INDIA

IMPORTANT TERMS:

Tax Base

- The aggregate value of the income or assets on which tax can be imposed.
- For example, in the case of income tax, the tax base is determined by what the tax authorities' state as the minimum amount of annual income that can be taxed (taxable income). If this minimum amount (tax threshold) is lowered, this will automatically increase (widen) the tax base; if it is raised, the tax base will be narrowed.

Incidence of Tax

- Incidence of a tax is on its final resting place, i.e. those economic units which finally bear the money burden of tax, and which are not able to pass it to others.
- In case of income tax, it is the income recipient who has to bear the money burden of paying tax.

Impact of Tax

- Impact of a tax is on its first point of contact with the tax payers. It is upon those who bear the first responsibility of paying it to the authorities.
- For e.g. in case of Income Tax, it is income recipient. In case of VAT, it is Seller.

Taxes are classified under two categories namely direct and indirect taxes. The largest difference between these taxes is their implementation. Direct taxes are paid by the assessee while indirect taxes are levied on goods and services.

Direct Tax

- If the impact and incidence lies on same point it is called as direct tax.
- Direct taxes are **progressive** in nature

Income Tax

- It is the tax that is levied on your earning in a financial year. There are many facets to income tax, such as the tax slabs, taxable income, tax deducted at source (TDS), reduction of taxable income, etc. The tax is applicable to both individuals and companies.
- For individuals, the tax that they have to pay depends on which tax bracket they fall in.
- Amounts invested in certain investments like Employee Provident Fund, Public Provident Fund, Tax saving Fixed Deposits, are also eligible for deduction under section 80C upto Rs.1,50,000 per year.
- One of the bodies that overlook these direct taxes is the **Central Board of Direct Taxes (CBDT)** which is a part of the Department of Revenue. It has, to help it with its duties, the support of various acts that govern various aspects of direct taxes.

Capital Gains Tax

- It is a **direct tax**.
- It applies on the sales of all 'assets' if a profit (gain) has been made by the owner of the asset—a tax on the 'gains' one gets by selling assets.
- The tax has been classified into two:

1. **Short Term Capital Gain**
   - It applies 'if the asset has been sold within 36 months of owning it'.
   - 'Rate' of this tax is similar to the normal income tax slab.
   - Period is '12 months' in cases of shares, mutual funds, units of the UTI and 'zero coupon bond'—in this case the 'rate' of this tax is 15 per cent.
2. **Long Term Capital Gain**
   - It applies 'if the asset has been sold after 36 months of owning it'.
   - 'Rate' of this tax is 20 per cent.
   - In cases of shares, mutual funds, units of the UTI and 'zero coupon bond' there is 'exemption' (zero tax) from this tax.

Securities Transaction Tax

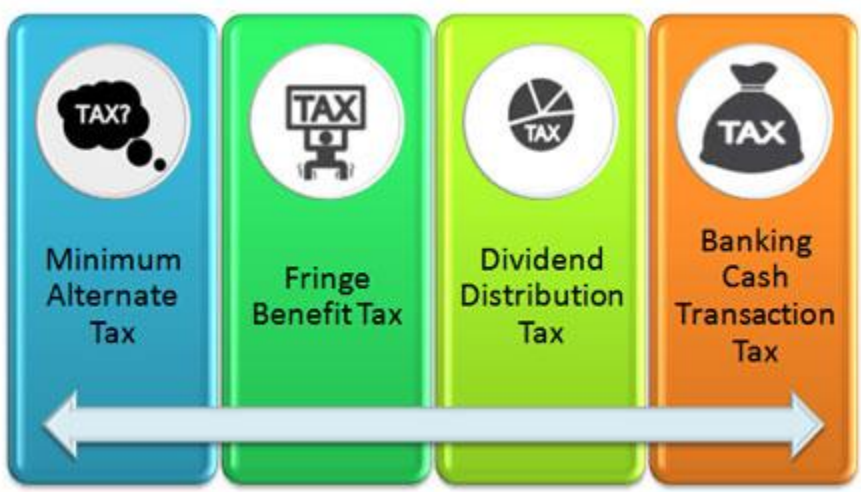
- It's no secret that if you know how to trade properly on the stock market, and trade in securities, you stand to make a substantial amount of money. This too is a source of income but it has its own tax which is known as the Securities Transaction Tax . How this tax is levied is by adding the tax to the price of the share. This means that every time you buy or sell shares, you pay this tax. All securities traded on the Indian stock exchange have this tax attached to them.

Perquisite Tax

- Perquisites are all the perks or privileges that employers may extend to employees. These privileges may include a house provided by the company or a car for your use, given to you by the company. These perks are not just limited to big compensation like cars and houses; they can even include things like compensation for fuel or phone bills. How this tax is levied is by figuring out how that perk has been acquired by the company or used by the employee.
- In the case of cars, it may be so that a car provided by the company and used for both personal and official purposes is eligible for tax whereas a car used only for official purposes is not.

Corporate Tax

- Corporate tax is the income tax that is paid by companies from the revenue they earn. This tax also comes with a slab of its own that decides how much tax the company has to pay. For example a domestic company, which has revenue of less than Rs. 1 crore per annum, won't have to pay this tax but one that has a revenue of more than Rs. 1 crore per annum will have to pay this tax.
- It is also referred to as a surcharge and is different for different revenue brackets. It is also different for international companies where the corporate tax may be 41.2% if the company has revenue of less than Rs. 10 million and so on.



Minimum Alternate Tax

- It is a tax imposed on companies, which escaped corporate tax net or pay very low tax by using the provisions of exemptions, deductions, and incentives etc., which are called **Zero Tax Companies**.

- It was introduced in 1996 - 97.
- In case, total income of the company after availing all eligible deductions is less than 30% of the book profits, the company shall be charged to a minimum tax as a percentage of total income. This is to ensure that companies pay at least a minimum amount of tax.
- It is applicable on all companies except those engaged in infrastructure and power sectors, free trade zones, charitable activities, and venture and angel funds.
- Foreign companies with income sources in India also come under it.
- The Union Budget 2016-17 has rationalized the MAT provisions for the FIIs (Foreign Financial Institutions)-now they do not need to pay MAT on their profits from capital gains on transactions in securities (which are liable lower tax rate)

Dividend Distribution Tax

- Dividend Distribution Tax was introduced after the end of 2007's Union Budget. It is basically a tax levied on companies based on the dividend they pay to their investors. This tax is applicable on the gross or net income an investor receives from their investment. Currently, the DDT rate stands at 15%.

Note- Fringe Benefit and Banking Cash Transaction- Scrapped

Indirect Tax

Goods and Services Tax (GST)

GST stands for Goods and Service Tax. It is a kind of tax imposed on sale, manufacturing and usage of goods and services. Goods and Service Tax is applied on services and goods at a national level with a purpose of achieving overall economic growth.

- Goods & Services Tax Law in India is a comprehensive, multi-stage, destination-based tax that is levied on every value addition.
- In simple words, Goods and Service Tax is an indirect tax levied on the supply of goods and services. **GST Law has replaced many indirect tax laws that previously existed in India.**
- GST is one indirect tax for the entire country.

Watch this video – **click here**

- It is a uniform value-added tax on goods and services throughout the country.
- There are GSTs namely **State GST and Central GST and Integrated GST** for inter-state trade

The following is the list of indirect taxes in the pre-GST regime:

- Central Excise Duty
- Duties of Excise

- Additional Duties of Excise
- Additional Duties of Customs
- Special Additional Duty of Customs
- Cess
- State VAT
- Central Sales Tax
- Purchase Tax
- Luxury Tax
- Entertainment Tax
- Entry Tax
- Taxes on advertisements
- Taxes on lotteries, betting, and gambling

All these taxes have been replaced with Central GST, State GST, and Integrated GST.

Advantages of GST

- It **simplifies** the indirect-tax structure in India. It will decrease cost of tax administration
- Different GST slabs ranging from 0% to 28% make indirect taxes **progressive**
- Creating a **single market** will help the business and industry by bringing down the cost of business
- GST has **potential to increase GDP** up to 2%.
- **Cascading effect** of tax-on-tax is removed
- There will be **no competition between states** to reduce tax and attract investment.
- In the long-term, prices of commodities will come down, thus benefitting the end customer

GST Council

- The GST council consists of the following members:
  - Union finance minister (Chairman)
  - Union minister of state in-charge of revenue or finance
  - Minister of finance or any other minister nominated by each state government to GST council

Functions of GST Council

- The GST Council makes recommendations on the following:
  - Taxes, cesses, and surcharges to be included under the GST
  - Goods and services which will be subject to, or exempt from GST

- **Rates of GST** (5%, 12%, 18%, 28%)
- GST laws, principles of levy, apportionment of IGST and principles associated with place of supply
- Special provisions with respect to the eight north eastern states, Himachal Pradesh, Jammu and Kashmir, and Uttarakhand; and other associated matters.
- Other matters pertaining to the implementation and regulation of GST in India.

Tax Expenditure

- There is significant divergence in India between the official rates of taxes and the actual or effective rate of taxation because of tax exemptions.
- Tax expenditure is also known as **revenue foregone**.
- But such forgone taxes do not necessarily mean that they have been waived off by the government. It should be interpreted as incentives given by the govt. to promote certain sectors, in absence of which they may not have come up.
- High tax expenditure simply means complex tax system. The tax expenditure can be brought down by simplification in tax system and improvements in the tax administration.
- The level of tax expenditure is slated to fall steeply once the GST is 'fully' operationalized in the country.

Methods of Taxation

3 methods of taxation:

1. Progressive Taxation

- If tax rate increase with the increase in size of tax base, it is called **progressive tax**.
- Progressive taxation helps to **ensure economic equality** in the society.
- Indian income tax is a typical example of it. The idea here is less tax on the people who earn less and higher tax on the people who earn more—classifying income earners into different slabs.
- This tax is **pro-poor**.

2. Regressive Taxation

- If tax rate decreases with the increase in the tax base it is called regressive tax.
- As for example, to promote the growth and development of small scale industries, India at one time had regressive excise duty on their productions—with increasing slabs of volume they produced, the burden of tax used to go on decreasing.
- It rewards higher producer or income-earners and punishes poor and low-producers.
- **Used rarely** and only for specific intended outcomes.

3. Proportional Taxation

- Tax levied as a % of tax base irrespective of size of tax base, at a uniform rate is called as proportional tax.
- Here the **% of tax rate remains the same** but the absolute amount of tax increases with increase in size of tax base.
- Such taxes have fixed rates for every level of income or production, they are neutral from the poor or rich point view or from the point of view of the levels of production
- Indirect taxes usually follow proportional taxation.

Features of a Good Tax System

- There has always been a debate about characteristics of a good tax system.
- But there is a broad consensus on 5 principles of a good tax system. They are:

1. Fairness

- It is the first criteria of a good tax system
- A taxation system must include these 2 elements - horizontal equity and vertical equity to make it fair.
- **Horizontal equity** - Individuals in identical or similar situations paying identical or similar taxes is known as horizontal equity.
- **Vertical equity** - When 'better off people pay more taxes it is known as vertical equity.

2. Efficiency

- Its potential to affect or interfere the efficiency of the economy
- A good tax system raises revenue with the least cost on the taxpayers and least interference on the allocation of resources in the economy
- Taxes can improve efficiency of the economy—taxes on pollution or on smoking give revenue to the government and serves broader social purposes, too. This is known as the **double dividend of a tax**.

3. Administrative Simplicity

- It includes factors like computation, filing, collection, etc. They should be as simple as possible.
- Simplicity **checks tax evasion** and lowers cost of tax collection

4. Flexibility

- Scope of desirable modifications in it if there is any such need.

5. **Transparency**
    - How much tax taxpayers are actually paying and what are they getting against it in the form of the public services should be ascertainable.

Other Taxes in News:

Commodities Transaction Tax

- Introduced in Union Budget 2013-14.
- It is only for non-agricultural commodity futures at the rate of 0.01%
- Aim:
    - Discouraging excessive speculation, which is detrimental to the market.
    - To bring parity between securities market and commodities market such that there is no tax/regulatory arbitrage.

Securities Transaction Tax

- The Securities Transaction Tax (STT) is a type of **'financial transaction tax'** levied in India on transactions done on the domestic stock exchanges.
- Rates of STT are prescribed by the central government.
- It is a direct tax.
- In India, STT is collected for the GoI by the stock exchanges.
- Till date, STT is not applicable in case of preference shares, government securities, bonds, debentures, currency derivatives, units of mutual fund other than equity oriented mutual fund, and gold exchange traded funds and in such cases, tax treatment of short-term and long-gains shall be as per normal provisions of law.
- Transactions of the shares of listed companies on the floor of the stock exchange, takeover, buyback, delisting offers, etc., also does not come under STT framework.

14th Finance Commission

- Chairman – Dr. Y.V. Reddy
- Recommendations of the Commission will apply for the period 2015—20.

Finance Commission: Constitutional Background

- Article 280 of the Constitution of India provides for a finance commission as a quasi-judicial body. It is constituted by the President of India every fifth year. It consists of a chairman and four other members to be appointed by the president.
- It makes recommendations about the following to the President of India:
  - The distribution of the net proceeds of taxes between the centre and the states and the allocation between the states of the respective shares of such proceeds
  - The principles that should govern the grants in aid to the states by the centre
  - The measures needed to augment the consolidated fund of states to supplement the resources of the local governments in the states on the basis of the recommendations made by the State Finance Commissions.
  - Any other matter referred to it by the President in the interests of the sound finance.

Note: The recommendations made by finance commission are only advisory in nature and hence, are **not binding** on the government.

14th Finance Commission: Recommendations

- **Devolution to states -** States' share in net proceeds from tax collections to be 42% - a huge jump from 32% recommend by the 13th FC, and the largest change ever in the percentage of devolution (biggest increase in vertical tax devolution)
  - 30.5 (2005-10) → 32 (2010-15) → 42 (2015-20)
- **Resource transfer -** Tax devolution be the primary route resource transfer to states
- **Grants -** Should be distributed to states for local bodies on the basis of the 2011 population data; the grants be divided into two broad categories on the basis of rural and urban population — constituting gram panchayats, and constituting municipal bodies
- **Types of grants -** A basic grant and a performance grant — the ratio of basic to performance grant be 90:10, with respect to panchayats; and 80:20 in the case of municipalities
- **Total grants** - Rs 2,87,436 crore for a five-year period from April 1, 2015, to March 31, 2020; of this, Rs 2,00,292.20 crore to be given to panchayats and Rs 87,143.80 crore to municipalities

- **Disaster relief -** The percentage share of states to continue as before and follow the current mechanism — to the tune of Rs 55,097 crore. After implementation of GST, disaster relief will be given according to the recommendations of the Finance Commission
- **Post-devolution revenue deficit grants -** A total of Rs 1,94,821 crore on account of expenditure requirements of states, tax devolution and revenue mobilization capacity of the states. These will be given to 11 states
- **Delinking of schemes -** 8 centrally sponsored schemes (CSSs) will be delinked from support from the Centre; various CSSs will now see a change in sharing pattern, with states sharing a higher fiscal responsibility
- **Cooperative federalism -** There are recommendations on cooperative federalism, GST, fiscal consolidation road map, pricing of public utilities and PSUs, too

Concepts Related to Finance Commission:

Tax Devolution

- Tax devolution (from the Divisible Pool) is the primary instrument to attend the issue of 'horizontal imbalances' of revenue accruing to the state.
- Advising a formula to distribute the Union tax proceeds between Union and the States is the most important task of the FC, as the share of states in the net proceeds of Union taxes is the predominant channel of resource transfer from the Centre to states.

Grants-in-Aid

- It is a complimentary/secondary instrument to attend the issue of 'horizontal imbalances' of revenue accruing to the state.
- The primary tool is tax devolution.
- As per the Article 275, the **FC recommends the principle** - as well as the quantum of grants to those states which are in need of assistance - different sums may be fixed for different states (one of the pre-requisites for such grants is the assessment of the needs of the states).
- The 1st FC had laid down 5 broad principles for determining the eligibility of a state for grants:
  - The Budget of a state as the starting point for examination of a need.
  - The efforts made by states to realize the potential.
  - The grants should help in equalizing the standards of basic services across states.
  - Any special burden or obligations of national concern, though within the state's sphere, should also be taken into account.

- Grants might be given to further any beneficent service of national interest to less advanced states.

All the Best. Keep revising, Keep improving!!