Budgetary System

(WITH SPECIAL REFERENCE TO INDIA)

(MA ECONOMICS ELECTIVE CODE: 1310304109)

Suman Kalyan Chakraborty

Edited by

Dr. Sanjib Kumar Hota

Directorate of Distance and Continuing Education

Utkal University, Bhubaneswar - 751 007.

Printed and Published by:

Mrs. Meena Pandey

Himalaya Publishing House Pvt. Ltd.

"Ramdoot", Dr. Bhalerao Marg, Girgaon, Mumbai-400 004.

Phones: 23860170 & 23863863; Fax: 022-23877178

Email: himpub@vsnl.com ● Website: www.himpub.com

For:

Directorate of Distance and Continuing Education

Utkal University, Vani Vihar, Bhubaneswar - 751 007.

Website: www.ddceutkal.org

DIRECTORATE OF DISTANCE AND CONTINUING EDUCATION
UTKAL UNIVERSITY : VANI VIHAR
BHUBANESWAR – 751 007

From the Director's Desk

The Directorate of Distance & Continuing Education, originally established as the University Evening College way back in 1962, has travelled a long way in the last 52 years. **'EDUCATION FOR ALL'** is our motto. Increasingly, the Open and Distance Learning Institutions are aspiring to provide education for anyone, anytime and anywhere. DDCE, Utkal University has been constantly striving to rise up to the challenges of Open Distance Learning system. Nearly one lakh students have passed through the portals of this great temple of learning. We may not have numerous great tales of outstanding academic achievements, but we have great tales of success in life, of recovering lost opportunities, tremendous satisfaction in life, turning points in career and those who feel that without us they would not be where they are today. There are also flashes when our students figure in best ten in their Honours subjects. Our students must be free from despair and negative attitude. They must be enthusiastic, full of energy and confident of their future. To meet the needs of quality enhancement and to address the quality concerns of our stakeholders over the years, we are switching over to self-instructional material printed courseware. We are sure that students would go beyond the courseware provided by us. We are aware that most of you are working and have also family responsibility. Please remember that only a busy person has time for everything and a lazy person has none. We are sure, that you will be able to chalk out a well planned programme to study the courseware. By choosing to pursue a course in distance mode, you have made a commitment for self-improvement and acquiring higher educational qualification. You should rise up to your commitment. Every student must go beyond the standard books and self-instructional course material. You should read number of books and use ICT learning resources like the internet, television and radio programmes, etc. As only limited number of classes will be held, a student should come to the personal contact programme well prepared. The PCP should be used for clarification of doubt and counseling. This can only happen if you read the course material before PCP. You can always mail your feedback on the courseware to us. It is very important that one should discuss the contents of the course materials with other fellow learners.

We wish you happy reading.

DIRECTOR

SYLLABUS

Budgetary System

Unit I

1. Budgetary System: Making of Budgets, Social Accounting and Income Calculation, Budgetary Policy and National Income Determination.

Unit II

2. Normative Principles of Public Expenditure and Taxation, Decision Making Process and Institutional Choices.

3. The Effects of Budgetary Measures on Resources Allocation, Distribution of Income and Wealth, Aggregate Expenditure and Economic Growth.

Unit III

4. The Relation between Government Budget and National Plans, Role of Fiscal Policy in Resource Mobilization for Development.

5. Budgetary under Federal Set-up, Budgeting at National Level and Regional Levels and their Co-ordination Performance, Budgeting, Budget Classification, Analysis and Interpretation of Budgeting and Plans.

Unit IV

6. Broad Trends of Indian Budget and Orissa Budgets during the Plan Period, Budgetary Trends, Important Testure, Major Components of Revenue and Expenditure, Budget as an Instrument of Social and Economic Policy.

Unit V

7. Budget Cycles (with Reference to India and Orissa), Budget Formation, Legislative Encashment Implementation of Public Accounts Committee, Estimates, Committee Efficiency and Accountability of the Present System of Budgeting Suggestions for Improvement.

CONTENTS

UNIT III

Union Budget and Fiscal Policy

UNIT IV

Overview of Indian Budget and Orissa Budget

UNIT V

Budget and Its Accountability

Unit I: Budgetary System and National Income Determination

1 Chapter

INTRODUCTION

Objectives

This chapter is focused on the following objectives:

- Introduction
- Budgetary System: Making of Budgets
- Social Accounting and Income Calculation
- Budgetary Policy
- National Income Determination

Structure:

1.1 INTRODUCTION

A budget is a quantitative expression of a plan for a defined period of time. The term budget (derived from old French word 'bougette' means a small leather bag or a wallet, i.e., money bag or purse) is a quantified financial plan for a forthcoming accounting period. A budget is an important concept in microeconomics, which uses a budget line to illustrate the trade-offs between two or more goods. In other words, a budget is an organizational plan stated in monetary terms. The Chancellor of Exchequer used to carry financial proposals in a leather bag to the House of Commons each year. According to the Indian Constitution, Budget implies annual financial statement containing estimates of all expected revenue and expenditure of government for coming financial year. Government of India budget is a constitutional obligation under Article 112 of the Constitution. It is a statement of receipts and expenditure of Central Government prepared for every financial year and placed before the Parliament. It provides actual financial accounts for previous year along with budget estimates of current year.

NOTES

In brief, the purpose of budgeting is tools:

1. Tools provide a forecast of revenues and expenditures, i.e., a model of how a business might perform financially if certain strategies, events and plans are carried out.
2. Tools enable the actual financial operation of the business to be measured against the forecast.
3. Lastly, tools establish the cost constraint for a project, programme, or operation.

Government Budget

The budget of a government is a summary or plan of the intended revenues and expenditures of that government. There are three types of government budget, i.e., the operating or current budget, the capital or investment budget and the cash or cash flow budget.

Need of Government Budget

Following are need of government budget on account of the following reasons:

(i) Increase in government activities.
(ii) Solving various problems in the economy.
(iii) Stimulating production level.
(iv) To acquire knowledge about government activities.
(v) Reduction of inequalities of wealth and income.

Objectives of Government Budget

Following are main objectives of government budget:

(i) Reallocation of resources.
(ii) Achieving economic stability.
(iii) Redistribution of income and wealth.
(iv) Management of public enterprises.

Union Budget of India: The budget is prepared by the Budget Division of Department of Economic Affairs of the Ministry of Finance annually. This includes supplementary excess grants and when a proclamation by the President as to failure of constitutional machinery is in operation in relation to a State or a Union Territory, in preparation of the Budget of such State. The railway budget is presented separately by the Ministry of Railways.

1.2 BUDGETARY SYSTEM

The aggregate of budgets of the state administrative-territorial units and the budgets (estimates) and accounts of institutions and funds that are autonomous in a budgetary sense. These budgets are based upon economic relationships and legal norms. Nature of the budget system is determined by socio-economic and political system of the country, whereas its organizational structure depends on the form of the administrative as well as state arrangement.

The Capitalist Countries: In the unitary states such as Great Britain, France and others, the budget system is composed of the state budget and the budgets of bodies of local self-administration, whereas in case of federal states, it is composed of the central federal budget, the budgets of members of the federation (states in the United States, cantons in Switzerland, Lander in West Germany) and local budgets. Individual budget are

NOTES

opposed to each other, expresses class contradictions and contradictions between different bourgeois groupings. With this process of increasing concentration of production, centralization of capital and intensification of monopoly power, bureaucratic centralization budget system takes place. An increasingly large part of the income sources is concentrated in the hands of the state. Local budgets become more dependent on the Centre financially. This was the special feature of the 1950s and 1960s, while local budgets increased significantly faster than that of central budget. A typical feature of this budget systems of the capitalist countries is the existence of numerous autonomous budgets of individual organizations and existence of non-budgetary estimates and funds that are not subject to ratification by members of parliament. This makes it possible for monopoly capital to use capital from the state treasury in their own interests without external checking. In the United States, in addition to the general treasury and state budget, there are the following non-budgetary funds, i.e., the Agency for International Development, the Civil Aeronautics Administration, the Veterans Administration, and other so-called credit funds. Also included among non-budgetary funds are earnings from the sale of state property and securities. These earnings are used to pay back part of the state debt.

The Developing Countries: In developing nations, they have adopted a policy of struggling to strengthen their political and economic independence. Organization of the budgetary system is subordinated to the problems of eliminating the remnants of feudalism and consequences of colonialism. In view of the weakness of the national bourgeoisie and inadequacy of their capital, most important measures in the areas of economics and culture of countries like Burma, the Arab Republic of Egypt, India etc. are financed through the state budget. Further, to involve broad layers of the population in the accomplishment of national economic and political tasks, governments of these nations adopt a policy of developing the initiative and budget capital of local bodies.

The Socialist Countries: In USSR, the budget system includes the Union budget and the state budgets of the Union republics which, taken together, constitute the state budget of the USSR. This budget provides for financing of measures envisioned by the plan for development of the national economy of the USSR, participation by Union republics in carrying out plans of all Union significance, comprehensive development of the economies and cultures of the Union republics and mutual assistance among the republics. The state budget of the USSR also includes the state social insurance budget, which is drawn up by the All Union Central Council of Trade Unions and executed by the trade unions. The state budgets of the Union republics amalgamate the republic budgets, the state budgets of autonomous republics, and local budgets. Applications and amount of expenditures of different budgets are determined by the tasks and functions of Union, republic and local bodies of power as assigned by the constitutions of the USSR and the Union republics and other legislative documents. Economic and cultural sectors subordinate to Union Bodies and having all-Union significance are financed from the USSR Union budget, as are expenditures for the country's defense and for all-Union bodies of state power and administration. Sectors subordinate to republic bodies are financed from the state budgets of the Union republics, whereas local budgets primarily finance sectors of local industry and expenditures for socio-cultural institutions that serve the population of particular locales. In the other socialist countries, the budget system is constructed on the same principles as are used in the budget system in the USSR.

Numerous non-budgetary estimates and funds that existed before the revolution in these countries were joined with the state budget, a very significant step in consolidating the entire system of national, economic and financial planning. In a majority of the socialist

NOTES

countries, the budget system consists of two primary elements – the central budget and the local budgets, i.e., in Bulgaria, they are the Okrug (city) budgets and the budgets of the communes; whereas in the Korean People's Democratic Republic, they are the budgets of the provinces and districts (cities); in the Mongolian, the individual republics (members of the federation) and the budgets of local agencies. In the interests of strengthening the organizational uniformity of the budget systems, in a majority of the socialist states, the local budgets are successively amalgamated into each other and into the central budget to form a single state budget. Leading role in the state budget belongs to the central budgets, which on the average have about three-fourths of all the expenditures of the state budget.

As a rule, the task of the central budgets is to finance national, economic and socio-cultural measures and the country's defense. Local budgets ensure development of the local economy and socio-cultural and domestic service to population. In recent years, rights of local bodies in the fields of economic and cultural building have been expanded, that leads to a rapid growth in their budgets and also an increase in their share in the single state budget.

Making of Budgets: Annual Financial Statement or the Statement of the Estimated Receipts and Expenditure of the Government of India in respect of every financial year is known as the Budget. In fact, the Budget process is a massive exercise and thereby has different stages and each such stage kicks off at a different stage of budget making process.

Moreover, the Finance Ministry possess overall responsibility to frame the budget. Every department of the ministry has specific responsibilities that includes – Department of Expenditure, Department of Economic Affairs and Department of Revenue. Obtaining inputs from the Planning Commission, the Comptroller and Auditor General, Administrative Ministries, extensive consultations are held with other stakeholders, i.e., industry, political parties, economists and also civil society groups. Once the pre-budget meetings are over, a final call on the tax proposals is taken by the Finance Minister, in consultation with the PM.

Passing the Budget: The Finance Minister presents the Budget in Lok Sabha on the last working day of February. The Budget speech has two parts. Part A deals with general economic survey and policy statements while Part B contains taxation proposals. Annual Financial Statement is laid on the table of the Rajya Sabha after the FM's speech along with the 'Annual Financial Statement' Government presents the following documents – an Explanatory Memorandum which briefly explains the nature of receipts and expenditure during the current year as well as the next year and also clarifying the reasons for variations in the estimates for the two years, the Books of Demands mentioning the provisions Ministry-wise and a separate demand for every such department and service of the Ministry. The Finance Bill which provides the taxation measures as proposed by the Government is introduced immediately after the presentation of budget accompanied by a memorandum that explains the provisions of the Bill and their effect on the finances of our country. Ultimately, discussion on the Budget begins a few days after its presentation, in a democratic set-up.

Discussion: The budget is discussed in two stages in Lok Sabha. First, there is the general discussion on the budget as a whole, which lasts for about 4 to 5 days. Only the broad outlines of the budget and the principles as well as policies underlying thereby are discussed at this stage. Consideration of the demands by Standing Committees of Parliament is also obtained.

After the first stage of General Discussion on both Railway as well as General Budget is over, the House is adjourned for a fixed period. During this period, the demands for grants

NOTES

of several Ministries or Departments including Railways are considered by concerned Standing Committees (Rule 331G).

On the last day of the allotted days, the Speaker puts all the outstanding demands to the Vote of the House and this device is popularly known as 'guillotine'. Lok Sabha enjoys the power to assent to or refuse to give assent to any demand or even to reduce the amount of grant sought by Government. Again, in Rajya Sabha, there is only a general discussion on the budget. It does not vote on the demands for grants motions to reduce various demands for grants are made in the form of Cut Motions for reducing the sums sought by Government on grounds of economy or for difference of opinion on matters of policy or just in order to voice a grievance. Finally, the Appropriation Bill is intended to give authority to Government for incurring expenditure from and out of the Consolidated Fund of India.

Again, the Finance Bill seeking to give effect to the Government's taxation proposals which is introduced in Lok Sabha immediately after the presentation of the General Budget, is taken up for consideration and passing after the Appropriation Bill is passed.

Budget of a State under President's rule is presented to Lok Sabha. The procedure followed in regard to the Budget of the Union Government is followed in the case of State Budget also with certain variations or modifications, as the Speaker may make.

1.3 SOCIAL ACCOUNTING AND INCOME CALCULATION

Social Accounting: A New Method for Calculating National Income

Recently, with the development of social accounting, national income is also being measured by the social accounting method. In the social accounts, transactions among various sectors such as firms, households, governments, etc. are recorded and their interrelationships are traced. From the total value of these transactions recorded in matrix form, the national income value is known. The social accounting framework is useful for economists as well as for policy makers, because it represents the major economic flows and statistical relationships among the various sectors of the economic system.

It is of particular interest and significance to the policy makers because by studying the national income series over a period of time, it becomes possible to forecast the trends of economy more accurately. In many countries, annual economic planning is in the form of national budgets which are, in fact, nothing but forecasts of social accounts for the following years.

Sectors for Social Accounts

In social accounting, the economy as a whole is divided into certain parts called sectors, which is a group of individuals or institutions having common interrelated economic transactions. Therefore, sectors are usually delineated in such a manner that economic entities whose functions are similar are contained in one group. Thus, sectors are distinguished on a functional basis and not on any institutional criterion.

Conventionally, under the scheme of social accounting, the economy is divided into the following sectors, viz., (i) Firms, (ii) Households, (iii) Government, (iv) Rest of the world and (v) Capital sector.

Firms are producing entities of the economy. They undertake productive activities. They are all organizations which employ the factors of production to produce goods and services.

NOTES

Households are consuming entities and represent the factors of production, who receive payments for services rendered to firms. Households consume the goods and services that are produced by the firms.

Thus, firms make payments to households for their services. Households spend money income so received, again on the goods or services produced by the firms. There is, thus, a circular flow of money between these two groups.

The Government Sector refers to the economic transactions of public bodies at all levels, centre, state and local. In their work concerning social accounting, Edey and Peacock have defined government as a collective person that purchases goods and services from firms. These purchases may be financed through taxation, public borrowings or any other fiscal means. The main function of the government is to provide social goods like defence, public health, education, etc. meant to satisfy the collective wants of society. However, public enterprises like post offices and railways are separated from the government sector and included as firms.

The Rest of the World Sector refers to saving and investment activities. It includes the transactions of banks, insurance corporations, financial houses, and other agencies of the money market. These are not included as firms. These agencies merely provide financial assistance to the firm's activities.

The System of Social Accounts:

Social accounting is based on double-entry bookkeeping principles. Like debit and credit sides, each sector account contains a balancing item (credit) of one sector is the allocation item (debit) of the other related sector.

(i) However, a firm's account usually contains the following items:

Debit side:

1. Payments to factors of production — households in the form of wages, interest, rent, dividend, profits.
2. Imputed cost retained by the firm such as depreciation allowances and undistributed profits.
3. Payment of corporate taxes, excise duties and licence fees, etc. to the government sector.
4. Payment to the government for buying its factor services.
5. Payment to firms for buying raw materials, machines etc.

Credit side:

1. Households' spending on goods and services produced by firms.
2. A firm's items sold to other firms.
3. Government spending in buying goods from the firms.
4. Net export earnings.
5. Net income earned from abroad.

(ii) On the other hand, a Household account usually contains:

Debit side:

1. Payment to firms for buying their goods and services.
2. Tax payments to government.

NOTES

3. Transfer payments.
4. Individual saving.

Credit side:

1. Income received by selling factor services to the firms.
2. Transfer payment made by the government to individuals.
3. Transfer payment made from a foreign country.

(iii) A Government sector account usually contains the following items:

Debit side:

1. Public spending on goods and services of firms.
2. Government payment to administrative staff.
3. Amount of subsidies given to producers.
4. Debt servicing charges.
5. Transfer payments to individuals.
6. Transfer payments made abroad.

Credit side:

1. Taxes received from firms and households.
2. Collection of fees, penalties, etc.
3. Interest, rent, dividend, etc. receipts of the government.
4. Foreign aid.

(iv) A Capital sector account will have the following items:

Debit side:

1. Firms' savings.
2. Households' savings.
3. Savings of the government.
4. Net external public borrowings.

Credit side:

1. Aggregate expenditure on capital assets (investment in capital goods industries).
2. Net change in business inventories.

Assuming a close economy with only two sectors, firms and households, we may illustrate the sectorial accounting as shown in Table 1.1.

Table 1.1: Sectoral Accounts

(₹ Crores)

(Dr.) **Firm's Accounts** **(Cr.)**

Payments	**₹**	**Receipts**	**₹**
Purchase of factor services from households	1,000	Sale of consumption goods and services to households	1,000

Another method is to present these data in the form of a matrix, a rectangular arrangement of entries into a set of rows and columns. Receipts or credit items of a sector are placed in the rows of the matrix, while payments or debit items are presented in the columns. A single matrix may be used for all sectoral items.

The above given data can be represented in a matrix form as shown in Table 1.1.

NOTES

Table 1.2

(₹ Crores Matrix)

Receipts	Payments by		Total
	Firms	Household	
(1)	(2)	(3)	(4)
(a) Firms	–	1,000	1,000
(b) Households	1,000	–	1,000
(c) Total	1,000	1,000	2,000

Matrix is very important for tracing the interrelationship between different economic entities or sectoral transactions. While measuring the national income of any country, it must be remembered that: (i) Income is a flow concept. Therefore, we do not measure the stock of economic goods or wealth at a given moment of time, but we measure the flow of economic goods produced by the nation in a year. Actually, there is a continuous flow of production. But we, for the sake of convenience, take a time interval of one year into account and measure national income every year. (ii) The national income is measured as a realized flow. So, final goods which have already been produced during the year are to be accounted for. The values of incomplete goods are, therefore, to be excluded. We should not predict the values of the goods yet to come. We measure only what has already been produced. Remember, national income is a realized flow of goods and services. Thus, we can estimate national income for the year 2014 only in 2015, because then only can we have data of production between January, 2014 and December, 2014.

1.4 BUDGETARY POLICY

Policy Concept of Deficit Budget

Budget Deficit

A budget deficit implies when a country's government spends more than it takes in from taxes or other forms of revenue. Although individuals, companies and other organizations can run deficits, the term usually applies to governments. That's because there are immediate penalties for most organizations that run persistent deficits. If an individual or family does so, their creditors come calling. As the bills go unpaid, they lose a good credit score, which makes new credit more expensive. Eventually, they may have to declare bankruptcy. The same applies to companies who have ongoing budget deficits. Their bond rating is lowered, and they have to pay higher interest to get any loans at all. However, most governments can run moderate deficits for years. That's because they are usually highly likely to repay their creditors. Government leaders retain popular support by providing services. If they want to continue being elected, they want to spend as much as possible while keeping their lenders happy. Many countries, including the US, have the added benefit of being able to print their own currency. As bills come due, they simply create more credit and pay it off. This does lower the value of the currency as more supply is available. But, if the deficit is moderate, it doesn't hurt the economy. In fact, it can boost economic growth because government spending is a component of a nation's total output, known as Gross Domestic Product (GDP).

Policy Basics: Deficits, Debt, and Interest

Three important budget concepts — deficits (or surpluses), debt, and interest are often misunderstood.

Deficits (or Surpluses)

NOTES

For any given year, the federal budget deficit is the amount of money the federal government spends (also known as outlays) minus the amount of money it takes in (also known as revenues). If the government takes in more money than it spends in a given year, the result is a surplus rather than a deficit. When the economy is weak, people's incomes decline, so the government collects less in tax revenues and spends more for safety net programmes such as unemployment insurance. This is one reason why the deficit typically grows (or a surplus shrinks) during recessions. Conversely, when the economy is strong, the deficit tends to shrink (or a surplus grows). Recessions aren't the only causes of deficits. A government may also face a structural deficit or one that would exist even if the economy were operating at full capacity, with high employment. Economists generally believe that increases in the deficit resulting from an economic downturn perform a beneficial automatic stabilizing role, helping moderate the downturn's severity by cushioning the decline in overall demand. In contrast, when the government runs structural deficits and borrows large amounts of money even in good economic times, that borrowing is much more likely to have harmful effects on private credit markets and hurt economic growth over the long term.

Debt

Unlike the deficit, which drives the amount of money, the government has to borrow in any single year, the national debt is the cumulative amount of money the government has had to borrow throughout our nation's history. When the government runs a deficit, it increases the national debt; when the government runs a surplus, it shrinks the debt.

There are two common measures of the national debt: Debt held by the public (sometimes called net debt) measures the government's borrowing from the private sector (including banks and investors) and foreign governments.

Gross debt is debt held by the public plus the securities the Treasury issues to US government trust funds — that is, money that one part of the government lends to another. For example, each year, Social Security takes in more money in payroll taxes and other income than it distributes in benefits; the amounts not needed to pay current benefits are invested in Treasury bonds and the Treasury uses the proceeds to help pay for government operations. As a result, the Treasury owes money to the Social Security Trust Fund and will repay it when Social Security needs the money to pay future benefits.

Debt held by the public is a far better measure of debt's effect on the economy because it reflects the demands that the government is placing on private credit markets. When the Treasury issues bonds to Social Security and other trust funds, by contrast, that internal transaction does not affect the credit markets.

The budget does not have to be balanced to reduce the economic burden of the debt. Under current budgetary policies, the debt-to-GDP ratio is expected to be virtually flat in coming years. The ratio is currently high by historical standards, leading some policy makers and analysts to call for more deficit reduction in order to lower the debt ratio. While economists generally believe that the debt-to-GDP ratio should be stable or declining when the economy is strong, too much deficit reduction too fast is harmful to an economy struggling to return to full strength after a recession.

Interest

Interest, the fee, a lender charges a borrower for the use of the lender's money, is the cost of government borrowing. Interest costs are determined by both the amount of money borrowed (also known as the principal) and the interest rate. When interest rates rise or fall,

NOTES

interest costs generally follow, making the national debt a bigger or smaller drain on the budget.

Policy Concept of Public Debt

Macroeconomic Developments

The GDP growth rate in the first quarter (April-June) of financial year 2014-15 (FY15) rebounded to 5.7 percent per annum as compared with growth of 4.6 percent per annum in the previous quarter (Q4 of FY14). The economic activities which registered significant growth in Q1 of 2014-15 over Q1 of 2013-14 were electricity, gas and water supply at 10.2 percent, financing, insurance, real estate and business services at 10.4 percent and community, social and personal services at 9.1 percent. The estimated growth rates in other economic activities were 4.8 percent in construction, 3.5 percent in manufacturing, 2.8 percent in trade, hotels, transport and communication, 3.8 percent in agriculture, forestry and fishing, and 2.1 percent in mining and quarrying during this period.

Inflation rates moderated and touched new lows in the second quarter of FY15, on account of significant correction in commodity prices since June 2014. India's wholesale price inflation eased for a fourth straight month in September 2014 to 2.38 percent, its lowest level in nearly five years. CPI inflation rate which remained elevated in July 2014 eased for a second consecutive month in September 2014 touching a three-year low reading of 6.5 percent. Average WPI inflation in Q2 of FY 15 was lower at 3.85 percent as compared with 5.80 percent in the previous quarter and 6.63 in Q2 of FY 14. Average CPI inflation rate during Q2 of FY 15 also moderated to 7.38 percent as compared with the 8.11 percent in previous quarter and 9.67 percent in previous year's Q2. Food inflation declined to 3.52 percent during September 2014 (y-o-y) as compared with 18.68 percent in September 2013 due to decline in prices of cereals, onion, vegetables and protein products. Inflation rate of fuel and power group moderated to 9.34 percent due to decline in prices of petrol and high speed diesel and manufactured products too showed a slightly lower inflation rate of 3.69 percent in September 2014 (3.88 percent during September 2013). Within manufactured products, prices of sugar, textiles, chemicals and chemical products, cement and lime, basic metals, alloy and metal product registered a decline in inflation rate in September 2014, while prices of leather and leather products, rubber and plastic products, paper and paper products rose y-o-y during September 2014. Build-up inflation rate in the financial year so far was 2.61 percent as compared to a build-up rate of 6.23 percent in the corresponding period of the previous year.

Growth in **Index of Industrial Production (IIP)** was placed higher at 2.5 percent in September 2014 as compared to growth of 0.5 percent and 0.4 percent respectively in August 2014 and July 2014. The mining, manufacturing and electricity components recorded growth (y-o-y) rates of 0.7 percent, 2.5 percent and 3.9 percent, respectively in September 2014 as compared with growth rates of 3.6 percent, 1.4 percent and 12.9 percent, respectively in September 2013. The cumulative growth in IIP during the financial year 2014-15 (April-September) was, higher at 2.8 percent as compared to 0.5 percent during the same period of the previous year.

India's exports during Q2 of 2014-15 (July-September 2014) registered a growth of 3.9 percent (y-o-y) as compared with a growth of 4.6 percent (y-o-y) during Q1 of 2014-15. Imports rose significantly by 10.4 percent (y-o-y) during Q2 of 2014-15 as compared with a decline of 6.9 percent (y-o-y) in Q1 of 2014-15. Trade deficit in Q2 of 2014-15 (July-September 2014) increased to USD 37.5 billion from USD 36.9 billion in Q1 of 2014-15. On a y-o-y basis, trade deficit increased by 28.1 percent during Q2 FY15 (July-September)

NOTES

as compared with a decline of 24.1 percent in Q1 of 2014-15. On a monthly basis, while exports posted a positive growth of 2.7 percent in September 2014 for the fifth consecutive month, growth rate has been low and declining since June 2014. Imports registered a significantly higher growth of 26.0 percent in September 2014 after registering low positive growth of 4.5 percent and 2.1 percent in July 2014 and August 2014 respectively. The average monthly trade deficit during July-September 2014 increased marginally to USD 12.5 billion as against USD 12.3 billion in Q1 of 2014-15.

Net inflows on account of foreign investment declined marginally during July-September 2014 on account of lesser inflows of portfolio investment by foreign institutional investors notwithstanding higher FDI inflows. During the quarter, the pressure on rupee accentuated and rupee crossed ₹ 61.6 a USD mark on September 30, 2014 after remaining at average ₹ 60.1 a USD in July 2014 and average ₹ 60.9 a USD in August 2014, respectively. Besides, widening of trade deficit during second quarter of FY 15, the other major factors that put pressure on Indian rupee during the quarter included general strength of US dollar since July 2014 (USD index DXY rose from sub-80 levels to 83 by September 2014 and currently trading around 88) due to recovery in the US, market expectation for early rate hike by US Fed, worries on account of falling growth in other developed economies like Europe and Japan, etc., notwithstanding intermittent rise of rupee.

Debt Management – Primary Market Operations

Government Finances

The gross fiscal deficit of the Central Government in budget estimates (BE) 2014-15 (FY15) was placed at ₹ 5,31,177 crore (4.1 percent of GDP) as against ₹ 5,24,539 crore (4.6 percent of GDP) in the revised estimates (RE) for 2013-14. The gross and net market borrowing of the Government in FY15 BE at ₹ 6,00,000 crore and ₹ 4,61,205 crore shows an increase of 6.4 percent and 1.6 percent, respectively over the levels of ₹ 5,63,911 crore (gross) and ₹ 4,53,902 crore (net) in FY14 RE.

The CGA released the fiscal outcome for first half (H1) of the FY 15 (April-September 2014) on October 31, 2014. Gross tax collections during the H1 of FY15 were ₹ 4,90,618 crore, which was 36.0 percent of BE, showing a growth of 7.1 percent over H1 of previous year. Collections from income tax, customs duty, excise duty and services tax stood at ₹ 109,412 crore, ₹ 87,408 crore, ₹ 60,547 crore and ₹ 65,201 crore respectively, which was 38.5 percent, 43.3 percent, 29.2 percent and 30.2 percent, respectively of the 2014-15 budget estimates. Total expenditure during April-September 2014 stood at ₹ 8,62,053 crore showing a growth of 6.6 percent over H1 of 2013-14 and was 48.0 percent of budget estimates. Revenue deficit and fiscal deficit during April-September 2014 at 91.2 percent and 82.6 percent of BE were placed at ₹ 3,45,053 crore and ₹ 4,38,826 crore respectively.

Issuance Details

Gross and net market borrowing requirements of the Government for FY15 were budgeted at ₹ 6,00,000 crore and ₹ 4,61,205 crore, respectively, than ₹ 5,63,911 crore and ₹ 4,53,902 crore in the revised estimates for FY14. During Q2 of FY15, the Government issued dated securities worth ₹ 1,54,000 crore taking the gross borrowings for HY1 of FY15 to ₹ 3,52,000 crore (58.7 percent of BE), as compared to ₹ 3,44,000 crore (59.4 percent of BE) in H1 of FY14. Net market borrowing (including repurchases) during the first half at ₹ 2,76,887 crore or 56.0 percent of BE was higher than ₹ 2,69,265 or 55.6 percent of BE in the previous year. The government repurchase securities worth ₹ 12,671.4 crore (notified aggregate amount of ₹ 20,000 crore) and ₹ 6,043.5 crore (notified aggregate amount of

NOTES

₹ 8,000 crore) on September 16, 2014 and September 25, 2014 respectively to prematurely redeem the Government Stocks by utilizing surplus cash balances.

The auctions were reduced by ₹ 16,000 during August 14, 2014 to September 30, 2014, from the proposed auction calendar for H1 FY15 in March 2014, after review of Central Government's cash position. Auctions during Q2 of FY15 were, thus, held broadly in accordance with the pre-announced calendar. During the quarter, emphasis on reissues was continued with a view to build up adequate volumes under existing securities imparting greater liquidity in the secondary market. One new benchmark security of 10 year maturity (8.40 percent GS 2024) was issued during the quarter on July 28, 2014. The amount issued under new securities constituted ₹ 32,000 or 20.8 percent of total issuances during Q2 of FY15, remaining being reissues.

The gross amount raised through treasury bills (91, 182 and 364 day treasury bills) during Q2 of FY15 amounted to ₹ 2,45,121 crore while total repayments amounted to ₹ 2,40,854 crore, resulting in net issuance of ₹ 4,267 crore compared with net issuance of ₹ 47,861 crore in previous quarter and ₹ 10,872 crore in Q2 of FY14. The lower net issuance of treasury bills during Q2 of FY15 was in line with scheduled calendar for issuance of treasury bills in view of comfortable cash flow outlook during Q2 of FY15.

Taking cognizance of market demand and yield curve movements, the weighted average maturity of primary issuance was increased during the second quarter of FY15. The weighted average maturity (WAM) of dated securities issued during Q2 of FY15 at 14.70 years was higher than 14.13 years for dated securities issued in Q1 of FY15. The weighted average yield (cut-off) of issuance during Q2 of FY15 also declined to 8.67 percent from 8.92 percent in Q1 of FY15, reflecting a moderation in yields during the quarter. The weighted average maturity of outstanding government securities at end-September 2014 declined marginally to 10.18 years from 10.19 years at the end of previous quarter.

Cash Management

Government's cash account is maintained with the Reserve Bank. The cash flow mismatches of the Government are largely managed through issuance of Cash Management Bills, Treasury Bills and access to the Ways and Means Advances (WMA) facility from the Reserve Bank when in deficit and through buybacks or investment in Government securities held by the Reserve Bank when in surplus. The limits for Ways and Means Advances (WMA) for the first half of the financial year 2014-15 (April 2014 - September 2014) had been fixed at ₹ 35,000 crore. Liquidity conditions in the economy remained comfortable during the quarter, barring period of advance tax outflows, with the liquidity deficit, as reflected by net borrowings from RBI under Liquidity Adjustment Facility (LAF), remaining near the Reserve Bank's stated comfort zone of about one percent of net demand and time liabilities (NDTL) of banking system. The net amount provided under LAF operations during the quarter moderated with average amount provided at ₹ 89,258 crore in July 2014, ₹ 80,749 crore in August 2014 and ₹ 53,339 crore in September 2014. The quarter began with LAF borrowings at ₹ 87,579 crore on July 01, 2014 which peaked to ₹ 1,15,688 crore on 24 July, 2014. After easing liquidity conditions for most of the quarter, borrowings under LAF again peaked at ₹ 1,29,215 crore on 29 August, 2014. However, the average net borrowings under LAF during Q2 of FY 2014-15 at ₹ 74,503 crore was lower than ₹ 81,797 crore in the previous quarter (Q1 of FY 2014-15). On policy front, RBI in its third bi-monthly monetary policy review on August 5, 2014 reduced the statutory liquidity ratio (SLR) of scheduled commercial banks by 50 basis points from 22.5 percent to 22.0 percent of their NDTL with effect from the fortnight beginning August 09, 2014 while keeping policy rate under LAF unchanged at 8.0 percent. There was status quo on providing

NOTES

liquidity through overnight repos at 0.25 percent of bank-wise NDTL and providing liquidity under 7-day and 14-day term repos up to 0.75 percent of NDTL of the banking system.

The cash position of the Government during Q2 of FY15 was comfortable barring a few occasions, when it took recourse to WMA. Net amount of Treasury Bills issued through competitive route decreased, leading to net repayment of ₹ 1,362 crore. A net amount of ₹ 13,041 crore was received through non-competitive route during the quarter. Overall, the net amount mobilized through treasury bills (under competitive and non-competitive routes) during Q2 of FY15 amounted to ₹ 4,267 crore.

Government of India in consultation with the Reserve Bank of India, after reviewing the cash position of the Government of India, has notified the amounts for the issuance of Treasury Bills for the quarter ending December 2014. It will continue to have the flexibility to modify the notified amount and timing for auction of Treasury Bills depending upon the requirements of the Government, evolving market conditions and other relevant factors.

Trends in Outstanding Public Debt

The Public Debt of the Central Government (excluding liabilities under the Public Account) provisionally increased to ₹ 4,960,472.3 crore as at end-September 2014 from ₹ 4,827,485.6 crore at end-June 2014. This represented a quarter-on-quarter (QoQ) increase of 2.8 percent compared with an increase of 3.7 percent in the previous quarter (Q1 of FY15). Internal debt constituted 91.7 percent of public debt, compared with 91.5 percent at the end of the previous quarter. Marketable securities (consisting of rupee denominated dated securities and treasury bills) accounted for 83.9 percent of total public debt as compared with 83.5 percent as at end-June 2014. The outstanding internal debt of the Government at ₹ 4,549,351.3 crore increased marginally to 40.1 percent of GDP at end-September 2014 from 38.9 percent as at end-June 2014.

Maturity Pattern for Outstanding Government Debt Stock

The weighted average maturity of outstanding stock of dated securities as at end-September 2014 decreased marginally to 10.18 years from 10.19 years at end-June 2014. Over the same period, the weighted average coupon of outstanding stock increased marginally to 8.06 percent from 8.03 percent. The proportion of debt (dated securities) maturing in less than one year increased to 5.8 percent at end-September 2014 from 4.4 percent a quarter ago and debt maturing within 1-5 years decreased to 22.6 percent from 24.2 percent at end-June 2014. Thus, the proportion of debt maturing in less than 5 years at end-June 2014 decreased marginally to 28.4 percent of total debt from 28.6 percent a quarter ago. The proportion of outstanding debt maturing in less than 10 years was also lower at 59.1 percent than 60.1 percent a quarter ago, while proportion of debt maturing in more than 10 years increased to 40.9 percent at end-September 2014 from 39.9 percent a quarter ago. The change in composition of debt in terms of various maturity buckets reflects the maturity structure of securities issued during Q2 of FY15 as well as the maturity dynamics of outstanding securities. Overall, 28.4 percent of outstanding stock has a residual maturity of up to 5 years, which implies that over the next five years, on an average, around 5.68 percent of outstanding stock needs to be rolled over every year, which is lower than about 6 percent level seen in the recent past. Thus, the rollover risk in the debt portfolio continues to be low. With the implementation of budgeted buyback, switches in coming quarters is expected to reduce roll over risk further.

NOTES

Holding Pattern

The holding pattern of Government securities is available with a lag of a quarter; the latest data are available for end-June 2014. Banks (including banks that are primary dealers and co-operative banks) continue to dominate as the major investor category with a decline in their share in holding of Government securities to 46.2 percent at end-June 2014 from 47.2 percent as at end-March 2014. Among the long-term investors, the share of holding by insurance companies increased during the quarter to 20.2 percent from 19.5 percent at end-March 2014, while the share of provident funds increased marginally to 7.21 percent from 7.18 percent at end-March 2014. Proportion of securities held by the Reserve Bank at end-June 2014 decreased to 15.03 percent from 16.05 percent a quarter ago. While the holding of securities by FIIs, financial institutions, corporates and mutual funds were higher at end of Q1 of FY15 as compared with their position a quarter ago, holdings by others category showed a decline over the quarter.

Secondary Market

Government Security Yields

The movement in Government bond yields (10-year yield as benchmark) during this quarter and the 10-year benchmark yield traded in the range of 8.40 percent to 8.80 percent during Q2 of FY15. It opened at 8.73 percent on July 1, 2014 and closed at 8.52 percent on September 30, 2014. The G-Sec market opened Q2 FY15 steady but remained cautious ahead of Annual Budget 2014-15. Market worries relating to higher fiscal deficit in the first two months of the financial year drove the yields marginally higher to quarter high in mid-July 2014. Subsequently, the reassurance by Finance Minister regarding fiscal prudence and RBI notification on July 23, 2014 enhancing the debt limit in G-Sec available to FII/QFI/FPI by USD 5 billion with an equivalent reduction in the limit available for long-term investor (from USD 10 billion to USD 5 billion) within the overall limit of USD 30 billion led to fall in yields. The sharp correction in the chart near July 2014 end is also on account of alignment of the curve to new benchmark paper. RBI in its third bi-monthly monetary policy review on August 5, 2014, while keeping policy rate under LAF unchanged at 8 percent, reduced the statutory liquidity ratio (SLR) of scheduled commercial banks by 50 basis points from 22.5 percent to 22.0 percent of their NDTL. However, policy said that the balance of risks around the medium-term inflation path, and especially the target of 6 percent by January 2016, is still to the upside. Market, which was already having negative sentiments on account of some changes proposed by RBI for the auctions held on August 1, 2014 (as it saw some devolvement), reacted negatively to these policy announcements. However, the notification by RBI reducing half-yearly borrowing plan for G-Sec (HY1 2015) and Quarterly borrowing plan for T-bills (Q2 2015) on account of comfortable cash position of the Government reversed this sentiment in mid-August 2014, which was sustained till quarter end on account of positive news flow on different accounts. Positive Q1 FY15 GDP numbers were released on August 29, 2014, weaker than expected US non-farm payroll data were released and crude prices touched a 14 month low in first week of September 2014, moderation in CPI inflation and reining in of core CPI inflation reported in mid-September 2014, buyback worth ₹ 20,000 crore announced in third week of September 2014, crude continuing to decline, etc. These developments led to softening of the yield and the 10-year benchmark yield closed at 8.51 percent as on September 30, 2014. This gradual decline in yield was halted occasionally on news flows, such as geopolitical news coming out of Iraq and Ukraine, a report by the Federal Reserve Bank of San Francisco which said that surveys suggested market participants seem to be expecting a more accommodative monetary policy than the members of US FOMC themselves, data and Fed announcements from US etc.

NOTES

Compared to previous quarter, bonds yields moderated across the curve. Further the yield curve flattened at the longer end of the curve. The 1 year to 10 year spread decreased to (–) 6 bps at end-September 2014 from 45 bps at end-June 2014, while 10 year to 30 year spread increased to 19 bps from 9 bps over the same period. Overall, the 1 year to 30 year spread at end of Q2 of FY15 decreased to 13 bps from 54 bps at the end of the previous quarter.

The soft inflation numbers as well as comfortable liquidity condition during month of September, 2014, resulted in softening of yield at the quarter end across the Treasury bill yield curve. Further, the Treasury bill yield curve saw marginal steepening during the quarter. The 1 m to 12 m spread was up at 18 bps at end-September 2014 as compared with 16 bps at end-June 2014. The 1 m to 3 m spread was up at 10 bps from 5 bps, while 3 m to 6 m spread was down at 6 bps from 10 bps at end of June 2014.

Trading Pattern for Domestic Securities

The total volume of Government securities transacted on an outright basis during Q2 of FY14-15 stood at ₹ 20.33 lakh crores, a decrease of 23.17 percent over volume of ₹ 26.46 lakh crores during the preceding quarter. Central Government dated securities, showing a decrease of 24 percent, contributed to most of the decrease in trading activity during the quarter. While the transactions volumes in treasury bills decreased by 12 percent during the quarter, trading volumes in state government securities were lower by 50 percent over the previous quarter. The annualized outright turnover ratio for Central Government dated securities (G-Secs) for Q1 of FY14-15 decreased to 3.90 from 5.30 during the previous quarter. Including repo transactions, the annualized total turnover ratio for Q2 of FY14-15 decreased to 8.27 from 9.55 during the previous quarter.

Central Government dated securities continued to account for a dominant portion of total trading volumes. During Q2 of FY14-15, their share, however, decreased marginally to 88.9 percent of total outright volumes from 89.5 percent in the previous quarter. Central government securities accounted for 51.6 percent of the total repo volumes during Q2 of FY14-15 as compared to 48.2 percent in the previous quarter.

The top 10 traded securities accounted for 85.03 percent of the total outright transaction volume during the quarter as compared with 86.4 percent during Q1 of FY14-15. The share of top three traded securities marginally increased to 68.32 percent from 68.2 percent during Q1 of FY14-15.

However, reflecting the increased trading activity in 10-year benchmark securities, 7-10 year's maturity range accounted for the highest share of trading volumes during Q2 of FY14-15 (57.0 percent, lower than 66.1 percent in Q1 of FY14-15) followed by 10 years and above maturity range (29 percent, higher than 18.4 percent in Q1 of FY14-15). The transaction volume of securities in the maturity range of 3 to 7 years during the quarter was lower at 13.1 percent compared with 13.9 percent in Q1 of FY14-15. The share of trading volume in the below 3 years maturity bracket decreased to 0.9 percent from 1.7 percent a quarter ago.

Foreign banks continued to be the dominant trading category with their share in total outright trading activity increasing to 33.4 percent (of total trading volumes) during Q2 of FY14-15 from 29.6 percent during Q1 of FY14-15. The share of public and private sector banks decreased or increased to 12.4 percent and 19.0 percent, respectively, from 19.3 percent and 14.1 percent during the previous quarter. The share of primary dealers decreased to 18.2 percent from 21.6 percent in Q1 of FY14-15. The primary dealers were the only net sellers category of government securities (₹ 83,825 crore) during the quarter.

NOTES

Public sector banks were the largest net buyer (₹ 33,431 crore) in the secondary market followed by Foreign banks (₹ 14,184 crore).

Policy Concept of Fiscal Deficit

Fiscal Deficit occurs when government's total expenditures exceed the revenue that it generates excluding money from borrowings. Deficit differs from debt, which is an accumulation of yearly deficits. Outlining the roadmap for fiscal consolidation, government will retain the fiscal deficit target for 2014-15 at 4.1 percent of GDP and reduce it further to 3 percent by 2016-17. The fiscal deficit which had touched a high of 5.7 percent in 2011-12, was brought down to 4.8 percent in 2012-13 and further to 4.5 percent in 2013-14. Prevailing economic situation presents a great challenge and there was a need to introduce fiscal prudence that will lead to fiscal consolidation and discipline. Outlining the roadmap for fiscal consolidation, fiscal deficit would be brought down to 3.6 percent in 2015-16 and 3 percent by 2016-17. Reduction in fiscal deficit was mainly achieved by a reduction in expenditure rather than by way of realisation of higher revenues. Apart from that, there are challenges to lowering the fiscal deficit as the country had two years of low GDP growth, almost static industrial growth, a moderate increase in indirect taxes, a large subsidy burden and not so encouraging tax buoyancy. Though the task is very challenging to revive growth, particularly in manufacturing sector and infrastructure and yet choice has to be made whether or not to be victims of mere populism and wasteful expenditure.

The fiscal policy of 2014-15 has been calibrated with two fold objectives – first, to aid economy in growth revival; and second, to continue on the path of fiscal consolidation by containing fiscal deficit so as to leave space for private sector credit as the investment cycle picks up. Having contained the spending within sustainable limits in the previous financial year, budget 2014-15 provides 3.5 percent increase in the plan expenditure over the budgeted estimates of FY 2013-14. Against the actual expenditure in 2013-14, this allocation marks an increase of 26.9 percent and is expected to adequately meet the developmental requirements. A growth of 9.9 percent has been provided for non-plan expenditure in BE 2014-15 over 2013-14 keeping in view the requirements for defence, subsidies, interest payments, finance commission grants and increase in salaries and pensionary payments etc. This would result in overall expenditure increase of 14.8 percent in BE 2014-15 over provisional actuals of 2013-14. As a result of these measures, fiscal deficit is estimated to come down to 4.1 percent of GDP, improving over the target set in the roadmap for fiscal consolidation announced by the government. As percentage of GDP, total expenditure is estimated to be 13.9 percent in BE 2014-15 as against 13.8 percent in 2013-14. Apart from containing growth in expenditure, the reduction in fiscal deficit is planned to be achieved in conjunction with targeted revenue augmentation both through tax and non-tax revenues. Tax to GDP ratio estimated at 10.9 percent of GDP in BE 2013-14, stood at as 10 percent of GDP as per provisional accounts in 2013-14, due to slowdown in economic growth. However, with the recovery in GDP growth expected in FY 2014-15, tax to GDP ratio of 10.6 percent is targeted in BE 2014-15. This implies a growth of 19.8 percent over actuals in 2013-14; however, it is only 10.4 percent growth over the budget estimate of FY 2013-14. Moderation of GDP growth in last few years had led to lower than budgeted performance; it is expected that with revival of growth in the economy to above 6 percent levels, with existing tax provision, this target can be achieved. It is noteworthy that additional measures introduced last year on the service tax, corporation and surcharges will continue in 2014-15 as well. Growth of 6.7 percent has been provided for non-tax revenue in BE 2014-15 as compared to actuals in 2013-14. However, as compared to BE 2013-14, there is substantial growth of 23.4 percent. This has been made possible due to unlocking of resources lying in various funds, higher dividend paid by RBI and increase in estimates of spectrum charges.

Composition of Budget

NOTES

Concepts and Broad Components of the Budget Speech

The entire budget speech of the Finance Minister is broadly classified under two parts, viz., Part A and Part B. Part A of the speech covers the broad allocation of funds for various sectors and sub-sectors, initiation of new schemes, and focus areas of the government. This part is more concerned about the development issues at macro level. On the other hand, Part B covers the specific tax proposals in the economy. It has direct bearing over household and manufacturing or service providing unit. Therefore, it deals with the micro aspects of the economy.

Budget

The budget is the outline of a government's planned receipts and expenditures for some future period, normally one year.

Revenue Expenditure

The revenue expenditure is a kin to consumption expenditure. In addition to expenditure on salaries and administration of government departments, it includes subsidies, interest payments on past debts and pension.

Capital Expenditure

Unlike revenue expenditure, capital expenditure is on the creation of assets. It includes government expenditure on roads, structures and equipments, government investment including shares and loans to public sector undertakings (PSUs).

Plan Expenditure

The plan expenditure deals with the new initiatives of government. It includes the central plan expenditure; and the central assistance to state and union territory plans. Plan expenditure has the budget heads of revenue plan expenditure and capital plan expenditure.

Non-plan Expenditure

Unlike plan expenditure, non-plan expenditure deals with the past commitments of the government. Non-plan expenditure has the budget heads of revenue non-plan expenditure and capital non-plan expenditure. Compared to revenue non-plan expenditure, the share of non-plan capital expenditure is much lower. Within the capital component of non-plan expenditure, the largest allocation goes to defence.

Revenue Receipt

Government's revenue receipt is consisting of tax revenue (net to centre) and non-tax revenue. Tax revenue includes both direct and indirect taxes. Direct tax includes corporation tax, personal income tax and wealth tax. Direct taxes, by nature, cannot be passed on to other. It is based on the ability to pay principle. Indirect tax includes custom duty, excise duty and service tax.

Non-tax Revenue

Public income received through the administration, commercial enterprises, gifts and grants are the source of non-tax revenues of the government.

Thus, non-tax revenue includes:

(i) Administrative revenue
(ii) Profit from state enterprises
(iii) Gifts and grants

Administrative Revenues

Under public administration, public authorities can raise some funds in the form of fees, fines and penalties, and special assessments.

NOTES

Fees: Fees are charged by the government or public authorities for rendering a service to the beneficiaries. According to Seligman, a fee is a payment to defray the cost of each recurring service undertaken by the government, primarily in the public interest, but conferring a measurable advantage to the payer. Court fees, passport fees, etc. fall under this category. Similarly, licence fees are charged to confer a permission for something by the controlling authority, e.g., driving licence fee, import licence fee, liquor permit fee, etc. Fees are to be paid by those who receive some special advantages. Generally, the amount of the fee depends upon the cost of services rendered. Fees are a by-product of the administrative activities of the government and not a payment for a business. Thus, fees are distinct from prices. Prices are always voluntary payments, but fees are compulsory contributions, though both are made for special services. Sometimes, a fee contains an element of tax when it is charged high in order to bring revenue to the exchequer, e.g., a licence fee.

Fines and Penalties: Fines and penalties are levied and collected from offenders of laws as punishment. Here, the main object of these levies is not so much to earn an income as to prevent the commission of offences and infringement of laws of the country. Fines and penalties are arbitrarily determined and have no relation to the cost of administration or activities of the government. Hence, collections from such levies are insignificant as a source of public revenue.

Special Assessments: A special assessment, as Seligman points out that, it is a compulsory contribution levied in proportion to the social benefits derived to defray the cost of a specific improvement to property undertaken in the public interest. That is to say, sometimes when the government undertakes certain types of public improvements such as construction of roads, provision of drainage, street lighting, etc., it may confer a special benefit to those possessing properties nearby. As a result, values of rents of these properties may rise. The government, therefore, may impose some special levy to recover a part of the expenses so incurred. Such special assessment is levied generally in proportion to the increase in the value of the properties involved. In this respect, it differs from a tax. In India, these special assessments are referred to as betterment levy. Betterment levy is imposed on land when its value is enhanced by the construction of social overhead capital such as roads, drainage, street lighting, etc. by the public authority in an area.

Profits of State Enterprise

Profits of state undertakings also are an important source of revenue these days, owing to the expansion of the public sector. For instance, the Central Government runs railways. Surplus from railway earnings can be normally contributed to the revenue budget of the central budget.

Likewise, profits from the state transport corporation and other public undertakings can be important sources of revenue for the budgets of State Governments. Similarly, other commercial undertakings in the public sector such as Hindustan Machine Tools, Bokaro Steel Plant, State Trading Corporation, etc. can make profits to support the central budget.

Earnings from state enterprises depend upon the prices charged by them for their goods and services and the surplus derived therefrom. Thus, the pricing policy of state undertakings should be self-supporting and reasonably profit-oriented. Again, prices are charged with an element of *quid pro quo*, i.e., directly in proportion to the benefits conferred by the services rendered.

A price is a form of revenue derived by the government by selling goods and services of public enterprises. Thus, price is the revenue obtained from business activity undertaken by the public authorities. Many public enterprises like postal services run on cost-to-cost basis. The prices are charged just to cover the cost of rendering such services.

However, in certain cases, when the state has an absolute monopoly, prices having a high profit element are charged. Such monopoly profits of a state enterprise are in the nature of a tax. The difference between price and fee is this: the former usually can never be less than the cost of production or service, while the latter may not necessarily cover the cost of service.

Gifts and Grants

These constitutes a very small part of public revenue. Quite often, patriotic people or institutions may make gifts to the state. These are purely voluntary contributions. Gifts have some significance, especially during war time or an emergency.

In modern times, however, grants from one government to another have a greater importance. Local governments receive grants from state governments and state governments from the centre. The central government gives grants-in-aid to state governments in order to enable them to carry out their functions. When grants are made by one country's government to another country's government, it is called foreign aid. Usually, poor countries receive such aid from developed countries, which may be in the form of military aid, economic aid, food aid, technological aid, and so on.

Tax Revenue (Net to Centre)

A fund raised through the various taxes is referred to as tax revenue. Taxes are compulsory contributions imposed by the government on its citizens to meet its general expenses incurred for the common good, without any corresponding benefits to the tax payer. According to 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. Seligman defines a tax as "a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to specific benefits conferred."

Sources of Public Revenue

↓

Taxes

↓

Fees

↓

Fines and Penalties

↓

Special Assessments

↓

Price

↓

Gifts and Donations

↓

Grants-in-aid

Characteristics

The main characteristic features of a tax are as follows:

1. A tax is a compulsory payment to be paid by the citizens who are liable to pay it. Hence, refusal to pay a tax is a punishable offence.

NOTES

2. There is no direct *quid pro quo* between the tax payers and the public authority. Alternatively, the tax payer cannot claim reciprocal benefits against the taxes paid. However, as Seligman opines that the state has to do something for the community as a whole for what the tax payers have contributed in the form of taxes. But this reciprocal obligation on the part of the government is not towards the individual as such, but towards the individual as part of a greater whole.
3. A tax is levied to meet public spending incurred by the government in the general interest of the nation. It is a payment for an indirect service to be made by the government to the community as a whole.
4. A tax is payable regularly and periodically as determined by the taxing authority. Taxes constitute a significant part of public revenue in modern public finance. Taxes have macroeconomic effects. Taxation can affect the size and mode of consumption, pattern of production and distribution of income and wealth.
5. Progressive taxes can help in reducing inequalities of income and wealth by lowering the high income group's disposable income. By disposable income is meant the income left in the hands of the tax payer for disbursement after tax payment. Taxes imply a forced saving in a developing economy. Thus, taxes constitute an important source of development finance.

Direct Tax

A tax that is paid directly by an individual or organization to the imposing entity. A tax payer pays a direct tax to a government for different purposes, including real property tax, personal property tax, income tax or taxes on assets. Direct taxes are different from indirect taxes, where the tax is levied on one entity, such as a seller, and paid by another, such a sales tax paid by the buyer in a retail setting. A direct tax cannot be shifted to another individual or entity. The individual or organization upon which the tax is levied is responsible for the fulfillment of the tax payment. Indirect taxes, on the other hand, can be shifted from one tax payer to another.

Income Tax

A tax that governments impose on financial income generated by all entities within their jurisdiction. By law, businesses and individuals must file an income tax return every year to determine whether they owe any taxes or are eligible for a tax refund. Income tax is a key source of funds that the government uses to fund its activities and serve the public. Most countries employ a progressive income tax system in which higher income earners pay a higher tax rate compared to their lower earning counterparts.

Indirect Tax

Government has to perform many functions in the discharge of its duties like infrastructure development, health, education, defence of the country, removal of poverty, maintenance of law and order, etc. To meet these requirements, huge amount of capital is required. The government collects money from public through a wide variety of sources, i.e., fees, fines, surcharges and taxes. Indirect Tax is a tax that increases the price of a good so that consumers are actually paying the tax by paying more for the products. The Ministry of Finance (Department of Revenue) through the Central Board of Excise and Customs (CBEC), an apex indirect tax authority, implements and administers excise (central excise), customs and service tax laws. Circulars, notifications and clarifications issued by the CBEC supplement these indirect tax laws.

NOTES

1. Service Tax

Service tax is a part of Central Excise in India. It is a tax levied on services provided in India, except the State of Jammu and Kashmir. The responsibility of collecting the tax lies with the Central Board of Excise and Customs (CBEC). Service Tax is a form of indirect tax imposed on specified services called taxable services. Over the past few years, service tax been expanded to cover new services and recently list of negative services has been introduced. The objective behind levying service tax is to reduce the degree of intensity of taxation on manufacturing and trade without forcing the government to compromise on the revenue needs. For the purpose of levying service tax, the value of any taxable service should be the gross amount charged by the service provider for the service rendered by him.

2. Excise

Central Excise duty is an indirect tax which is levied and collected on the goods or commodities manufactured in India. The Central Excise Act, 1944 and other connected rules which provide for levy, collection and connected procedures. It is mandatory to pay Central Excise duty payable on the goods manufactured, unless exempted, e.g., duty is not payable on the goods exported out of India.

3. VAT

Value Added Tax (VAT) is a tax on value addition and a multi-point tax, which is levied at every stage of sale. It is collected at the stage of manufacture or resale and contemplates rebating of tax paid on inputs and purchases.

Custom Duties

These are referred to duties charged on goods imported to or exported from the country. Accordingly, the importer or the exporter pays custom duties. It is being regulated by the Customs Act, 1962.

Peak Rate

Peak rate is the highest rate of custom duty applicable on an item.

Excise Duties

These are referred to duties imposed on goods produced or manufactured within the country.

Capital Receipt

The capital receipt is consisting of non-debt and debt receipt. The former consists of loan recovery, net grants, proceeds from PSUs disinvestments. The latter includes public borrowing from both internal and external sources, and other liabilities.

Revenue Deficit

The revenue deficit is defined as the difference between the government revenue expenditure and government revenue receipts. In fact, revenue receipt is not enough to meet revenue expenditure. However, as per the Fiscal Responsibility and Budget Management (FRBM) Act 2003, revenue deficit should not have been since 2008-09.

Budgetary Deficit

The budgetary deficit refers to the difference between government total expenditure (revenue expenditure and capital expenditure) and total receipts (revenue receipts and capital receipts).

Fiscal Deficit

The fiscal deficit is defined as the difference between the government total expenditure and the government total non-debt receipt. It is also defined as the combination of budgetary

NOTES

deficit and government debt receipt, i.e., borrowing from both internal and external sources, and other liabilities.

Primary Deficit

The primary deficit is measured by the difference between the fiscal deficit and interest payments (a component of non-plan revenue expenditure).

FRBM Act 2003

The Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) is an Act of the Parliament of India 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. The main purpose was to eliminate revenue deficit of the country (building revenue surplus thereafter) and bring down the fiscal deficit to a manageable 3 percent of the GDP by March 2008. However, due to the 2007 international financial crisis, the deadlines for the implementation of the targets in the Act was initially postponed and subsequently suspended in 2009. In 2011, given the process of ongoing recovery, Economic Advisory Council publicly advised the Government of India to reconsider reinstating the provisions of the FRBMA.

Current Account Deficit

The current account deficit refers to the difference between the country's export and import.

Gross Domestic Product (GDP)

The gross domestic product (GDP) is defined as the money value of final goods and services produced within the country's territory, irrespective of the ownership of the resources that produced it.

Gross National Product (GNP)

The gross national product (GNP) is defined as the money value of final goods and services produced by the country's owned resources, irrespective of the place of production [GNPF = GNPM – Indirect Taxes + Subsidies].

Net Domestic Product (NDP)

The net domestic product (NDP) is measured as the difference between GDP and the capital consumption, i.e., depreciation.

Net National Product (NNP)

The net national product (NNP) is measured as the difference between GNP and the capital consumption, i.e., depreciation. The net national product at factor cost (NNPF) is internationally referred to as national income.

Public Expenditure

Please refer page 44 to 47, Point 2.2 of Chapter 2 for detail explanation.

Revenue Budget (Revenue Receipt and Revenue Expenditure)

What is a Revenue Budget?

The revenue budget consists of revenue receipts of the government (revenues from tax and other sources) and its expenditure.

Revenue receipts comprise interest and dividends on investment made by the government. Revenue receipts and capital receipts together implies the government's total cash inflow. Thus, Revenue receipts are divided into tax and non-tax revenue.

Tax revenues are made up of taxes such as income tax, corporate tax, excise, customs and other duties that the government levies.

NOTES

In **non-tax revenue,** the government's sources are interest on loans and dividend on investments like PSUs, fees, and other receipts for services that it renders.

Revenue expenditure is the payment incurred for the normal day-to-day running of government departments and various services that it offers to its citizens.The government also has other expenditure like servicing interest on its borrowings, subsidies, etc. Usually, expenditure that does not result in the creation of assets, and grants given to state governments and other parties are revenue expenditures. The difference between revenue receipts and revenue expenditure is usually negative. This means that the government spends more than it earns. This difference is called the revenue deficit.

Impact of Public Expenditure and Revenue Passing Proceeding Effect on Economy

Impact of Public Expenditure

Public expenditure diverts economic resources into channels determined by the government in accordance with national objectives and public policy. As a consequence, the scale and direction of public expenditure may affect the following:

(i) Pattern and levels of consumption of the community
(ii) Volume of production
(iii) Allocation of resources
(iv) Distribution of incomes
(v) Economic stabilization levels of prices and employment.

These effects are discussed below:

(i) Pattern and Levels of Consumption of the Community: Public expenditure enhances the quality of life of people by providing recreational, cultural, educational and public health facilities, such as public parks, playgrounds, libraries, educational institutions, hospitals and dispensaries and scientific, cultural and commercial exhibitions. Consumption, after all, is the end objective of economic activity of individuals. By promoting the level of economic activity and a more equitable distribution of income, the state can bring about a greater sense of social and economic security in the lives of individuals. The government enables them to live a fuller and richer life.

(ii) Volume of Production: The roles of private and the public sectors are complementary. The public sector provides the infrastructure, transport and communications, power, education and public health programmes. In the absence of goods and services provided by the government sector, private sector can hardly make any meaningful contribution towards production and development: According to Dalton, other things being equal, taxation should not adversely affect production and public expenditure should increase it as much as possible. Public expenditure can affect: (i) the ability to work, save and invest, (ii) the desire to work, save and invest, and (iii) allocation of resources as between different uses. Public expenditure can influence these factors either favourably or unfavourably.

The economies of developing countries cannot make significant progress unless they concentrate on development of investment goods sector. This may not result in production in the immediate future, as in education and health programmes, infrastructural projects and projects with long gestation periods. This would, however, certainly build up growth potential in the economy, and help take the economy to a self-generating level.

(iii) Allocation of Resources: Public expenditure allocates resources in accordance with national priorities. The priorities may be defence, agricultural production and self-

NOTES

sufficiency in food, industrial development, generation of employment opportunities, an equitable distribution of income, balanced regional development, population control, a better ecological balance etc. Public expenditure in these areas is bound to raise the community's productive power. According to Dalton, increased public expenditure in many of these directions is desirable in order to bring about that distribution of the community's resources between different uses, which will give the best results, balancing without bias the present and future.

Changes in national priorities, from time to time, will be reflected in the pattern of public expenditure. Again, resource allocation has to take into account the balance between present needs and future requirements. Apart from imparting a sense of fairness as between generations, projects with long gestation periods can be undertaken only by the state. Hence, allocation has to keep in view the fact that market economy cannot always take care of social needs. These can be taken care of only by the state.

(iv) Distribution of Income: According to Dalton's view, other things being equal, that system of public expenditure is best, which has the strongest tendency to reduce the inequality of incomes. A system of grants and subsidies is equitable in the measure in which it is progressive. This leads to maximum social benefit. An approximation to this principle would be provided by a system of grants which would bring all incomes below a certain level to that level, i.e., above the poverty line without adding anything to incomes above that level. A public distribution system which makes available essential commodities at subsidized prices to the poor, will also achieve the same result. Free provision of services to all members of the society, e.g., free health service or free education, narrows the area of inequality. Social security measures and social insurance schemes, which are helped partly or wholly from public funds, e.g. old age pensions, sickness and maternity benefits, unemployment relief, industrial injury compensation, widows pension etc., improve distribution by reducing inequality of incomes.

(v) Economic Stabilization Levels of Prices and Employment: Business activity in an economy is usually characterized by fluctuations of a cyclical nature. A boom in the economy may burst and lead to a depression. While during boom, prices rise beyond the reach of common person, spelling misery. During depression, employment and production levels fall drastically causing colossal damage. During depression, when employment, production and national income start declining, government can undertake compensatory spending. This may imply heavy public works programmes so that employment and incomes may pick up leading to economic recovery. During boom, public expenditure should be strictly curtailed, leading to surplus budgets. During depression, public expenditure policy would lead to heavy outlays on public works; expenditure would thus be in excess of revenues, leading to deficit budgets. Thus, public expenditure, if properly planned and conscientiously undertaken, will have the favourable effect of raising employment, production and national income, after pulling the economy out of depression and thus bringing about greater economic stability.

Revenue Passing Proceeding Effect on Economy

What are the Benefits of a Revenue Budget?

The main benefit of a revenue budget is that it requires looking into the future. The revenue budget should contain the assumptions made about the future and the details about the number of units to be sold, the expected selling prices, and so on. The budgeted amount of revenue is then compared to the budgeted amount of expenses in order to determine if the revenues are adequate. Learning of a potential problem before the year begins is a huge

NOTES

benefit because it allows for alternative actions to be developed prior to the start of the new year.

When an annual revenue budget is detailed by month, each month's actual revenues can be compared to the budgeted amount. Similarly, the actual year-to-date revenues can be compared to the budgeted revenues for the same period. In other words, monthly revenue budgets allow you to monitor revenues as the year progresses instead of being surprised at the end of the year. Preparing a detailed, realistic budget requires you to plan ahead. This in turn gives the insights prior to the start of the accounting year. Monthly revenue budgets allow to monitor the receipts right from the beginning of the year.

1.5 NATIONAL INCOME DETERMINATION

National Income

Concept of national income and national product has occupied most significant place in the macroeconomic analysis. Both this two macro concepts are frequently used to estimate economic performance of an economy. While national product refers to flow of goods and services over any stipulated period of time, national income represents flow of total factor earnings in an economy during any specified time period.

Concept of national income is important in the context of production and distribution in the economic theory. It is an essential statistics for a nation in the similar manner as personal income in the case for an individual. It provides information about nation's productive capacity and economic stability. Study of national income also tells information regarding unemployment status.

But concept of national income is a broad issues and thus possess diverse interpretations. According to Marshall, labour and capital of any country working on its natural resources produce annually curtain net aggregates of goods.

Importance of National Income

Measuring national income is crucial for various purposes. The study of National Income is important because of the following reasons:

1. The measurement of the size of the economy and level of country's economic performance;
2. To see the economic development of the country;
3. To trace the trend or the speed of the economic growth in relation to previous year(s) also in other countries;
4. To assess the development objective;
5. To know contribution of the various sectors to the National Income;
6. To know the composition and structure of the national income in terms of various sectors and the periodical variations in them;
7. To make projections about the future development trend of the economy;
8. To help government formulate suitable development plans and policies to increase growth rates;
9. To fix various development targets for different sectors of the economy on the basis of the earlier performance;
10. To help businesses to forecast future demand for their products.
11. To make international comparison of people's living standards.

NOTES

Significance of the Study of National Income

Every sector of economy uses human, natural as well as material resources to contribute in aggregate flow of commodities as well as services in a specified time interval normally is a year's time. According to Simon Kuznets, national income is net output of goods and services flowing in a year from nation's production to the actual consumers or net addition to nation's capital goods. While comparison is made with growth rate of net national income with the growth rate of relevant population — which states whether the status of economy is stagnant, developing or declining.

Different Concepts of National Income

Study of concepts of national income follows from that of definition. Generally, countries have been compiling national income estimates for several years and they incorporated into them and following concepts which are as follows:

1. Gross National Product (GNP): GNP is basic measure of nation's output stated in terms of money and represents total value of a nation's annual output. It is evaluated in market prices and includes all economic productions in an economy.

Gross national product may be defined as money value of national production for any specific period of time. But it is to be remembered that money value of final goods and services produced in the economy should be taken into consideration. Intermediate. products are excluded from GNP.

Secondly, while calculating for GNP, money value of exclusively currently produced goods and services are taken into account to estimate economy's productivity during a particular year.

Thirdly, word "gross" has sufficient significance is the term GNP. Depreciation or replacement of the fixed assets are not to be deducted. Depreciation is treated as loss to the economy and thus it will not to be deducted from GNP manufactured in the economy.

The term GNP often used in national income concept calculation of GNP for several years and comparing them will indicate whether there has been a long-run growth or decline in the economy.

Symbolically,

$$\text{GNP} = C + IG + G(X - M) + NFIA$$

where,

C = Private Final Consumption Expenditure

IG = Gross Investment

G = Government Expenditure

(X – M) = Net Exports, i.e., Export minus Imports

NFIA = Net Factor Income from Abroad

2. Gross Domestic Product (GDP): Gross domestic product in money value of all goods and services produced in the domestic territory of a country is in year's time. Various sectors of a country engaged in the production activities produce normally a certain amount of goods and services like fertilizers, cement, steel, rice, services of doctors teachers and advocates etc. Money value of all these goods and services taken together provides in the value of GDP.

Symbolically,

$$\text{GDP} = P(Q) + P(S)$$

where,

GDP = Gross Domestic Product

P = Per unit

NOTES

Q = Gross Output

S = Services

3. Net National Product (NNP): Net national product at factor cost (NNP) is volume of goods and services turned out during an accounting year, counted without duplication. It can also be defined as net value added at factor cost in an economy during an accounting year. In terms of income earned by factors of production, net national product at factor cost or national income is defined as sum of domestic incomes and net factor income from abroad.

Symbolically,

NNP (National Income) = DFI + NFIA

where, DFI = Domestic factor income

NFIA = Net factor income from abroad

Alternatively,

NNP may also calculated as gross national product minus depreciation during that year.

Symbolically,

$$NNP_{MP} = GNP - \text{Depreciation}$$

NNP is also called national income at market prices.

Net national product is a better and highly useful concept in the study of growth of economics because, it takes into account of net increase in total production of that country. But this concept has complex problem of fixing appropriate rates of depreciation for plants buildings, equipment, etc. in an economy.

4. National Income at Factor Cost: National income at factor cost is marginally separate concept from GNP and NNP. It is total of entire incomes earned by owner of factors of production for their contributions. So, in measuring national income at factor cost, those payments which are not made for any productive service is not to be included. Therefore, an individual may take value of gifts he receives, transfer payments from firms and governments to estimate his income, but he has not done any service to get that income. Thus, they are not to be entered in computation of national income at factor cost.

Thus, we can say that national income is aggregates of factor earnings. It does not consider government allowance, capital consumption, individual as well as business transfer payments and also indirect taxes. Likewise, if government pays any subsidy to any sector, that will be included.

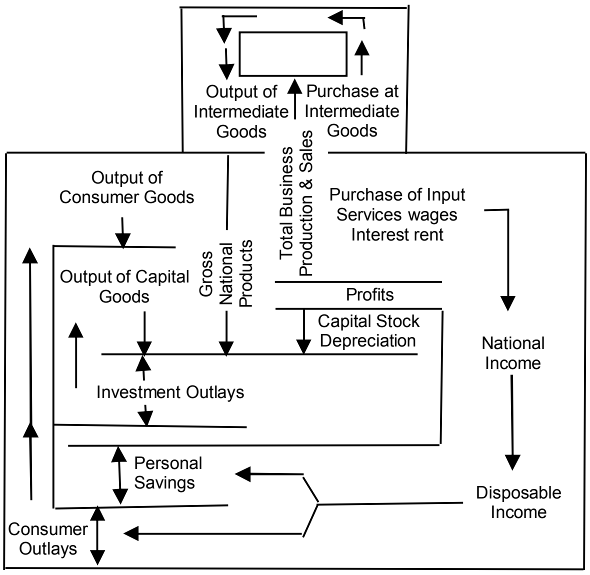
Symbolically,

National Income (at Factory Cost) = $NNP_{MP} - \text{Net} - \text{Indirect Taxes} + \text{Subsidies}$

In Flow Chart 1.1, relationship between NI and GNP can be studied with the help of a hypothetical economy. Let us assume that in our hypothetical economy is a market economy without any government. So, there will be no government outlays, no taxes, subsidies and social insurance contribution also. Apart from above, we also consider that simple economy is a closed economy.

As per above situation, production process occurs in business sector, output of intermediates goods is positioned at top in the form of a small box. Total product originates in business sector.

NOTES



Flow Chart 1.1: Relationship between GNP and National Income at Factor Cost

After making capital depreciation, it goes into national income flow by way of interest, rent profits and wages from business sector to factory owners which is presented on RHS. Out of the national income, individual segregates it into consumption and savings which is presented at bottom side on RHS — which is return flow to business sector by way of demand for consumption and capital goods and in this way, circular flow becomes complete.

But in actual world economy, situation differs from this simple economy. In simple closed economy — absence of government, NI, NNP and disposable income — are same. But in reality international relations and government sector are important and therefore, social accountings are more complex in comparison to single national income accounts.

5. Private Income: Private income refers to income which accrues to individuals from any source; within domestic territory of a country and from abroad in an accounting year. It is obtained after adding to income from domestic product accruing to private sector, the sum of net factor income from abroad, current transfer from rest of the world and interest on national debt.

Private Income = Income from Domestic Product Accruing to Private Sector + Net Factor Income from Abroad + Current Transfer from the Government + Net Current Transfer from Rest of the World + Interest on National Debt.

6. Personal Income (PI): Personal income refers to aggregate money payment actually received by the individuals or household within domestic territory of a country from all source in an accounting year. It means aggregate money payments received by people by way of wage interest profits as well as rents. It is spendable income at current prices available to individuals. This aggregate amount will be different from national income at factor cost. National Income at factor cost is what is earned and personal income is what is received. This undistributed corporate profits is not available for individuals. Corporate income taxes and payment towards social security measures will also not be available for individuals. Therefore, all sorts of these amounts is to be deducted from what is actually earned. On the other hand, there are certain sources of income which are not currently earned but paid to individuals. For instance, payments like old age pensions or widow pensions unemployment allowance, payment of scholarship or other welfare measures accrued to individuals — which is known as transfer payments by Government. All these types of income are to be added up to get the amount of Personal Income. Thus,

Personal Income = National Income – Corporate Taxes – Undistributed Corporate Savings or Profits — Social Security Contributions + Transfer Payments.

7. Personal Disposable Income: Personal disposable income refers to that part of the personal income which is actually available to individual for consumption and saving purposes. Entire personal income received by individual cannot be spent by them at their desire. They have to pay personal direct taxes, viz., income tax, education tax, etc. Thus,

Personal Disposable Income = Personal Income — (Direct Taxes + Fines, Fees etc. – Social Security Contributions).

8. Net National Disposable Income (NNDI): Concept of net national disposable income is different from personal disposable income. Net national disposable income is computed by adding to national income net indirect taxes and other current transfer from rest of the world, i.e., net capital transfers. Thus,

Net National Disposable Income = National Income + Net Indirect Taxes + Net Capital Transfers from Rest of the World (ROW)

Methods of Estimation of National Income

Estimates of National Income provide economists as a powerful tool in the analysis of the performance of an economy. Thus, it is required to measure reliable as well as accurate estimates. National income of a country can be computed in three different ways like: (i) as a flow of goods and services, (ii) as a flow of income and (iii) as a flow of expenditure. Accordingly, there are three techniques to estimate national income, i.e., (i) Product Method, (ii) Income Method and (iii) Expenditure Method.

(i) Product Method: Product method is also called output method, inventory or census method. It is used for finding out market value of all goods and services manufactured during a year.

In this case, economy is divided into various sectors like, industry, agriculture, direct services and also for big transactions. In every sector, we prepare stocks of commodities produced and find out finished product to make an addition to value of commodities. Value added method is adopted to avoid double accounting. Value added by a firm is less if its output is less than whatever it purchases from other firms like raw materials and also other relevant inputs.

In direct service sector, value of services of professionals, e.g., dramatists, soldiers, politicians, doctors, engineers, etc. are taken into account and added up.

In case of international transactions, sector, value of commodities exported and imported, payments received a made from abroad are clubbed to get national income at market prices.

This method is beneficial as it helps to make a comparative idea of importance of various activities in the economy like manufacture, trade, agriculture, etc. But in developed countries like USA, their methods are useful for easy availability of data from government records. But in the underdeveloped countries, this method may create problems like imputation of money values to non-monetized sectors.

In this case, money value of final goods and services is computed at market price, i.e., GDP at market price. When we deduct indirect taxes and add up subsidies, we get GDP at factor cost. Thereafter, when depreciation cost is deducted from it, we get NDP at factor cost

NOTES

and later when NFIA (net factor income from abroad) is added up, we get NNP at factor cost and we credit national income.

(ii) Income Method: Income method refers to gross national income obtained by addition of wages and salaries, profits, interests and rents of individuals and institutions and including government income earned either from property or through work. To get, aggregate income of a nation, following procedure will be followed:

1. Wage salaries and entire earnings of person employed excluding pensions
2. Earnings in the form of interests
3. Income of joint stock companies
4. Income from overseas investment
5. Net rents includes rental value of owner occupied houses.

Aggregates of above income gives gross national income at factor cost and after deducting depreciation from it, we get value of national income.

(iii) Expenditure Method: American economist Samuelson calls it 'Flow of Product Approach'. But in India, it is termed as 'outlay method'. Expenditure (final expenditure) method is also called 'consumption and investment method' of computing national income. In order to use this method, we will consider expenditure or consumption and investment on finished products by the community, i.e.,

1. Expenditure by manufactures on investment of goods.
2. Expenditure by consumers on commodities and services.
3. Expenditure by government on consumption and capital goods.

Disposition of national income can take two forms. It can be consumed by government or individual or also may be utilized by enterprises to creates assets, investments or capital formation. Thus,

$$Y = C + I$$

where,

Y = National income

C = Final consumption expenditure

I = Investment expenditure or capital formation

Alternatively, in this case, we will add money received from abroad by trade as well as other payments. Resultant will be treated at GNP. Advantage of this technique is it believes in identity between national expenditure income and total product.

Whatsoever technique will be followed, result will be more or less same. Alternatively, by adding depreciation cost, we get GNP. On contrary, we should consider only incomes to get NI at factor cost. On the other hand, if value of expenditure on all items are added, we obtain gross national expenditure at market prices. If subsidies are added up and indirect taxes are deducted from gross national expenditure, we obtain gross national expenditure at factor cost.

Above three methods of estimation provide three different measures of national income, i.e., gross national product, gross national income and gross national expenditure which are equivalent in value in an economy, i.e.,

$$GNP = GNI = GNE.$$

All the three techniques can be utilized to cross-check authenticity of our computation. But application of a particular technique depends upon division of economic activities, structures and statistical data. But no country has perfected national income accounting to much extent.

Methodology of National Income Estimation

NOTES

It is not possible to estimate National Income in India by any uniform method. Several measures are adopted in this regard. Let us discuss these techniques separately:

While production approach is adopted, contribution of domestic product like livestock, forestry, fishing, agriculture etc. are estimated. It requires estimation of gross value of products or ancillary services and thereafter value of inputs of raw materials and services deducted.

But, on the other hand, there are certain categories of services which cannot be conveniently used by the production approach. For instance, for measuring income in irrigation, total factor incomes for irrigation services are computed and so, approximately 33 percent of national income may be estimated by output method.

While estimating output from construction sector, in case of pucca construction estimation, commodity flow approach is used and in kutcha construction, expenditure method is used.

On contrary, in case of unregistered manufacturing like small-scale manufacture, self-employed individual in non-agricultural sector, results of the National Sample Survey are used.

Apart from above data obtained from various publications, annual report of financial institutions, budget documents etc. are used in this estimation of national income.

Methodology of estimation of national income may be tabulated as follows:

Methodology of Estimation of National Income

Sector	Nature of Data	Description of Method for Estimation
Category A: Product Approach		
Forestry, fishing, agriculture, etc.	Commodity-wise output figures prices and value of input-output proportion.	Product-wise price output multiplication gives gross output and from it, deduction of total input is to be made to attain value added estimates.
Category B: Income Approach		
Railways, organized road and water transport, air transport, defence, real estate, public administration etc.	Actual figures of factor earnings noted in annual accounts of various undertakings published on regular basis.	Actual figures of compensation of employees, rent, profit or operating surplus are summed up to get value added estimates.
Category C: Income Approach		
Unorganized manufacturing, road and water transport, hotel, restaurants, ownership of dwellings etc.	Working force estimates are derived from decennial population census data and average productivity of labour from periodic sample survey.	Decennial estimates of working force and periodic estimates of average productivity are considered. Year-wise workers estimates and average productivity are multiplied to get value added estimates.
Category D: Expenditure Approach		
Rural construction	Basic of value of output estimation is NSSO estimates.	Here, NSSO estimation are used to value added estimates.

NOTES

Problems in Estimation of National Income

Various problems in measurement of national income can be segregated into three heads: (i) Conceptual problems, (ii) Statistical problems and (iii) Practical problems.

(i) Conceptual Problems: National Income Committee has mentioned the following conceptual difficulties.

1. Considerable portion of our produced goods are not offered for sale in the market — which is either retained for self-consumption or for barter system. It is especially applicable for agricultural produce.

2. In maximum cases, manufacturers do not maintain appropriate records of their total production depreciation details, as such more guessing of gross value of output is taken into account.

3. Lack of occupational specification prevails. An individual is engaged in diverse economic activities simultaneously. Thus, it becomes difficult to collect accurate statistics of origin-wise distribution.

4. There is differences in opinion relates to the term "nation" in the concept of national income. It is required to clarify what does it signify? Whether it is geographical entity of the country or nationals those residing abroad. Since, national income comprises a quantitative measure of economic activity instead of verbal description, problem of including services has become a controversial one.

5. As everything has to be equated to money value services rendered in the economy for love of humanity, affection and philanthropy cannot be taken into account in computing national income.

6. In rural sector of underdeveloped economies artisans, cottage industry workers, cultivators do not have exact idea of expenses of their occupation. Thus, net value of their products cannot be computed accurately.

7. Where there is a big sector of non-monetized sector and barter systems are prevalent there, problem of inputting value of cottage dealt outside monetized sector creates a problem — resulting to guesswork and approximation.

(ii) Statistical Problems

1. Several times statistics are not at all available. Thus, "gap" occur in calculations. Moreover, whatever statistics are available are not always complete, reliable and correct. For instance, it is especially difficult to obtain accurate data relates to consumption total expenditure and saving potentialities of rural population.

2. Heterogeneous economic conditions prevails in various portions of a country. Thus, it becomes impossible to apply information collected for one area to other areas.

3. Former estimates refer to undivided India and cannot be used for making comparisons.

(iii) Practical Problems

1. Ignorance, illiteracy and lack of accounting habits of the people in rural sector of underdeveloped economies data may not be available or unreliable — which makes the task of estimating national income very difficult.

2. Lack of availability of trained personal makes calculation of national income estimate difficult.

3. Banking sector is another difficulties in unorganized sector. Village moneylenders and indigenous bankers maintain absolutes secret of their transactions and does not provide true information.

4. Self-consumption and error of double counting is another setback in estimation of national income.

5. In India, units of productions are generally very small and scattered. It also makes the task cumbersome.

6. Incomes earned by foreign companies set up in India and by our nationals abroad also makes complications.

Precautions Related to Measuring National Income: Following are few major precautions to be taken while measuring national income:

1. Main precautions in the value added approach are: (i) avoid double counting, (ii) output produced for self-consumption and (iii) sale of second hand goods not to included.
2. Main precautions in the income distribution method are: (i) include all cash and kind benefits to employees in compensation of employees and (ii) include only that interest payment which is made against loan taken for production and do not include transfer income in the form of gifts, donations and taxes etc.
3. Major precautions in the final expenditure method are: (i) do not include intermediate expenditure, (ii) do not include transfer expenditure on gifts, donations, taxes and (iii) do not include expenditure on second hand goods.

Uses of National Income Statistics

1. National Income statistics are important tools of economic analysis and helpful to policy makers. It is useful in planning as well as formulation of realistic plans.

2. National income estimates helps to study inter sectoral growth. It is helpful in international comparisons and to study rate of growth of the economy. Growth of National Income is an index of the growth of the productive capacity of an economy.

3. National income estimates helps to study class distribution. Per capita income and consumption are indicators of economic welfare. But they fail to express distribution of income in society. Thus, national income on distribution of income are prepared.

4. National income estimates enables to study standard of living of the people.

5. National income shows capacity of each country to bear some common burden of international institutions, e.g., U.N.O.

To be precise, national income figures help governments in planning, policy making, preparation of budgets and forecasting the level of economic activity.

Factors Determining National Income

1. Quality and Quantity of Factors of Production: Quality and quantity of land, climate, rainfall, etc. determine quantity and quality of agricultural production. It determines size of national income. Quantity of labour has double impact, as labour is both a factor of production and consumer of what is manufactured. Quality of labour depends on training and intelligence which decides volume of industrial productivity. It will have decisive influence on output. Similarly, quality and quantity of entrepreneurial capability is also a main element in determination or estimation of national income of the city.

2. Political Stability: Key to increase national income rests with important factors, e.g., national resources, capital formation, political stability, technical know-how and moreover national character of the people.

3. State of Technical Know-how: Extent of technical know-how and technology in production determine capital formation of that country. Any country rich with abundant

NOTES

resources will be dormant without any determination if resources are not scientifically exploited. Natural resources combined with advanced technology will go a long way in increasing size of national income.

Methods of Measuring National Income: Production and sale of goods and services and generation of income which accompanies these activities are processes that go on continuously in any economy. Production gives rise to income, income gives rise to demand for goods and services and demand gives rise to expenditure, again expenditure leads to further production. This circular flow of production, income as well as expenditure represents three related phases, viz., production, distribution and disposition. These three phases enables us to look at national income or as a flow of expenditure on goods and services. To measure it at each phase, we need different data and techniques. If we want to measure it at the phase of production, we have to find out the sum of net value added by all the producing enterprises of the country. Again, if we want to measure it at the phase of income distributed, we have to find out the total income generated in the production of goods and services. Ultimately, if we want to measure it at the phase of disposition, we have to know the sum of the expenditures of the three spending units in the economy, viz., government, consumer households and producing enterprises as well.

Corresponding to the three phases, there are three techniques of measuring national income. These are:

1. Value Added Method (Product Method).
2. Income Method.
3. Expenditure Method.

1. Value Added Method: Value added method measures contribution of every producing enterprise in the domestic territory of a country and thereby involves the following steps:

(a) Identifying the producing enterprise and classifying them into industrial sectors according to their activities.

(b) Estimating net value added by every producing enterprise as well as every industrial sector and adding up the net value added by all the sectors.

However, all producing enterprises are broadly segregated into three main sectors, viz., (i) Primary sector, i.e., agriculture and allied activities, (ii) Secondary sector, i.e., manufacturing units and (iii) Tertiary sector, i.e., services such as banking, insurance, transport. These sectors are further divided into commodity group or service group.

For computing net product of the industrial sector, we need to know about gross output of this sector, the raw materials and intermediate goods as well as services used by the sector and the amount of depreciation. For an individual unit, we substract from the value of its gross output, value of raw material and intermediate goods and services used by it and from this, we substract the amount of depreciation to get net product or value added by each unit. Adding value added by all the units in one sub-sector, we get value added or net product of that sector. Thus, for the economy as a whole, we get net products contributed by every sector to get Net Domestic Product. If the information regarding the final output and intermediate goods is available in terms of market price, we can convert it in terms of factor costs by subtracting or adding as the case may be, net indirect taxes to it. If we add or subtract net income from abroad, we obtain Net National Product at factor cost that is nothing but National Income.

2. Income Method: Different factors of production pool their services for carrying out production activities. These factors of production, in return are paid for rendering their

NOTES

services in the form of factor incomes. Thus, labour gets wages, land gets rents, capital gets interest and entrepreneur gets profit. Alternatively, whatever is produced by a producing unit is distributed among the factors of production for their services and aggregates of factor incomes of all the factors of production of all the producing units constitute or form the subject matter of calculation of national income by income method.

Only incomes earned by owners of primary factors of production are included in national income. Thus, while wages of labourers will be included, pensions of retired workers will be excluded from national income. Labour income includes – apart from wages and salaries, bonus, commission, employers' contribution to provident fund and compensations in kind. On contrary, non-labour income includes dividends, undistributed profits of corporations before taxes, interest, rent, royalties and profits of incorporated enterprises and of government enterprises.

However, it is difficult to separate labour income from capital income as in many instances people provide both labour and capital services. Such is the case with self-employed people such as lawyers, engineers, traders, proprietors, etc. In economies where subsistence production and small commodity production is dominant, most of the income of people would be of mixed type. In sectors like agriculture, trade, transport etc., in underdeveloped nations including India, it is difficult to differentiate between labour element and capital element of income of the people. Thus, in order to overcome this difficulty, a new category of incomes, called mixed income is introduced that includes all those incomes which are difficult to separate.

Net income from abroad need not be added separately since the incomes received by people include net foreign incomes as well. But, if national income is calculated not from incomes received by the people but from data regarding incomes paid out by producers, then net income from abroad would have to be added separately as incomes paid by producers would total to domestic income. So, to arrive at national income, net income from abroad should be added to domestic income.

3. Expenditure Method: Different sectors, i.e., household sector, business sector and government sector either spend their incomes on consumer goods and services or save a part of their incomes or they spend a part of their income on non-consumption goods or capital goods. Total expenditure in an economy consists of expenditure on financial assets or goods produced in preceding periods, as raw materials and intermediate goods and services and on final goods and services produced in the current period.

Expenditure on financial assets which are produced and owned with the country is excluded but expenditure are financial assets of foreign countries is included in national expenditure. However, only the net expenditure, i.e., the difference between expenditure on foreign financial assets by residents and expenditure on the country's financial assets by non-residents or foreigners is incorporated. This difference is also called as net foreign investment. Goods produced in preceding years are excluded from national incomes of the periods while they are produced. Likewise, expenditure on raw materials and intermediate goods and services are excluded as there would be double counting as some of the items included in the national income. Government expenditure like pensions, scholarships, unemployment allowance etc. should be excluded as these are transfer payments. Thus, only expenditure on final goods and services produced in the period for which national income is to be measured and net foreign investment are included in the expenditure method of calculating national income.

NOTES

Expenditure on final goods and services is broadly classified into expenditure on consumer goods and services, i.e., consumption expenditure and expenditure on capital goods, i.e., investment expenditure. Consumption expenditure is classified into private consumption expenditure of the household sector and government consumption expenditure and investment expenditure is classified into private investment expenditure by business sector and investment expenditure by government. To the total domestic investment, we add net foreign investment to arrive at national investment. Therefore, aggregates resulting from the expenditure method measured at market prices are as follows:

Gross National Expenditure = Consumption Expenditure + Net Domestic Investment + Net Foreign Investment + Replacement Expenditure (i.e., Expenditure on Replacement Investment).

Net National Expenditure = Consumption Expenditure + Net Domestic Investment + Net Foreign Investment.

Net Domestic Expenditure = Consumption Expenditure + Net Domestic Investment

As a matter of fact, developing countries like India are unable to estimate this national income wholly by one method. Contributions of different sectors to the national income are estimated by different methods. So, in agricultural sector, net value added is estimated by the production method, in small-scale sector. Net value added is estimated by the income method and in construction sector, net value added is estimated by the expenditure method.

Income method may be most suitable for the developed economies where people properly file their income tax returns. Gradually, with the growing facility in the use of the commodity flow method of estimating expenditure, an increasing portion of the national income is being estimated by the expenditure method. Estimation of the national income of a country is not an easy task. Appropriate and completely reliable data to accomplish this work is not available even in developed nations. However, following problems occurs in this regard:

1. Presence of a large non-monetized sector.
2. Lack of appropriate and reliable data.
3. Problem of double connecting.
4. Problem of transfer payments.
5. Difficulties in classification of working population.
6. Unreported illegal income.

1.6 SUMMARY

1. A budget is a quantitative expression of a plan for a defined period of time.
2. The budget of a government is a summary or plan of the intended revenues and expenditures of that government.
3. Nature of the budgetary system is determined by socio-economic and political system of the country, whereas its organizational structure depends on the form of the administrative as well as state arrangement.

NOTES

1.7 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1. The term budget (derived from old _________ word _________, means a small leather bag or a wallet, i.e., money bag or purse) is a quantified financial plan for a forthcoming accounting period.
2. Social Accounting can also be used in conjunction with _________.

II. True and False

1. According to the Indian Constitution, budget implies annual financial statement containing estimates of all expected revenue and expenditure of government for coming financial year.
2. In USSR, the budget system includes the Union budget and the state budgets of the Union republics which, taken together, constitute the state budget of the USSR.
3. Social accounting cannot be used in the context of business or corporate social responsibility (CSR), although any organization, including NGOs, charities as well as government agencies may engage in social accounting.

III. Multiple Choice Questions

1. Main objectives of government budget__________.
   (a) Reallocation of resources
   (b) Achieving economic stability
   (c) Redistribution of income and wealth and management of public enterprises
   (d) All of the above
2. Social accounting emphasises the __________.
   (a) Strategy of corporate accountability
   (b) Strategy of costing accountability
   (c) Strategy of financial accountability
   (d) None of the above

Short Answer Questions

1. What is the need of the government budget?
2. Define the term 'Social Accounting' and 'Social accounting matrix'.

Long Answer Questions

1. Explain the budgetary system in India.
2. Explain the method of measuring national income.

NOTES

1.8 KEY TERMS

- Budgetary System
- Capitalist
- Computable general equilibrium (CGE)
- Monopoly
- Socialist
- Social accounting
- Social accounting matrix (SAM)
- Standardized national accounting (SNA)

1.9 KEY TO CHECK YOUR ANSWER

I. 1. French, bougette, 2. Community Based Monitoring (CBM).
II. 1. True, 2. True, 3. False.
III. 1. (d), 2. (a).

Unit II: Public Expenditure and Economic Growth

2

PUBLIC EXPENDITURE AND TAXATION

Chapter

Objectives

This chapter is focused on the following objectives:

- Introduction
- Importance, Objectives, Significance, Composition, Determinants, Impact on Other Variables, Long-term Trends and Business Cycle Behaviour of Public Expenditure
- Public Expenditure — Hypothesis, Effects and Evaluation
- Effects of Public Expenditure on Production and Distribution
- Principles of Public Expenditure
- Public Expenditures (Normative View)
- Taxation Decision Making Process and Institutional Choices

Structure:

2.1 INTRODUCTION

Public expenditure is that expenditure incurred by the public authorities, i.e., central, state and local government to satisfy those common wants, i.e., for protecting the citizens or for promoting their economic and social welfare, which the people in their individual capacity are unable to satisfy efficiently. Public expenditure, thus, tends to satisfy collective social wants. In the old police state which maintained only the law and order, the volume of public expenditure was insignificant. The modern welfare state is interested in promoting the

NOTES

welfare of the society including policing duties. As a result, the volume of public expenditure has increased enormously.

In modern times, public expenditure in all the countries increased to a great extent. In fact, change in the role of the state and public policy is the root cause of the growth of public expenditure in recent times.

During the classical era, the state was assumed to have a very limited function under the laissez-faire policy. Functions of the state were restricted to Justice, Police and Arms. Classicists believed that every particle of expenditure incurred beyond what necessity absolutely requires for preservation of social order and also for protection against foreign attack is waste and unjust and oppressive imposition on the public. According to J.B. Say, the very best of all plans of finance is to spend little.

Today, however, role of the state has changed under the welfare criterion and there is a persistent trend towards an extensive and intensive increase in the scale of Governmental performance. Apart from performing old functions efficiently, the modern state constantly undertook new functions and also added responsibilities day by day. This increase in the governmental functions has been responsible for increasing trend of the public expenditure.

2.2 IMPORTANCE, OBJECTIVES, SIGNIFICANCE, COMPOSITION, DETERMINANTS, IMPACT ON OTHER VARIABLES, LONG-TERM TRENDS AND BUSINESS CYCLE BEHAVIOUR OF PUBLIC EXPENDITURE

Importance: Following are the main important factors which are responsible for increasing the government expenditure:

1. **Welfare of the People:** Every government is spending a huge amount of money to provide various facilities to the public. Every government is spending money on medical aid, education, transport and housing facilities to the people. So, it has extended the expenditure of the government.
2. **Population Pressure:** In the developing countries, birth rate is very high. To provide the basic necessities of life to the population, government has to spend the huge amount of money.
3. **Development of Backward Areas:** Every government is developing its neglected areas, so public expenditure has increased. Every government allocates particular amount every year in the budget to develop these areas.
4. **To Increase the Output:** Every government is spending money to cultivate the barren lands and to increase the output of the country. Because without increasing the growth rate, we cannot improve the economics condition of the people.
5. **Inflation:** In the developing countries, rate of inflation is very high. So, their expenditure on goods and services is also increasing day by day.
6. **Increase in Administrative Expenditure:** To maintain peace, security and democracy, every government is spending money. Now, Terrorism has also increased the growth of public expenditure.
7. **Tax Collection:** As the tax capacity of the people is increasing, government is also spending a huge amount of money on the revenue department. It has also increased the expenditure of the government.

NOTES

8. **Defence Expenditure:** The defence is main factor which has increased the public expenditure that is defence. Now, armament race among the nations is increasing day by day. This expenditure has contributed to increase in the expenditure.

Thus, public expenditure has to create and maintain conditions conducive to economic development. It has to improve the climate for investment. It should provide incentives to save, invest and innovate.

Objectives: The major objectives of public expenditure are:

1. Administration of law, order and justice.
2. Maintenance of police force.
3. Maintenance of army and provision for defence goods.
4. Maintenance of diplomats in foreign countries.
5. Public administration.
6. Servicing of public debt.
7. Development of industries.
8. Development of transport and communication.
9. Provision for public health.
10. Creation of social goods.

Significance: Public expenditure is the value of goods and services bought by the State and its articulations. Public expenditure plays main roles:

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

With its prioritized structure and its peculiar decision making processes, it substantiates the prevailing kind of State. In democracy, public expenditure is an expression of people's will, managed through political parties and institutions. At the same time, public expenditure is characterized by a high degree of inertia and law dependency, which tempers the will of the current majority. Public expenditure can be financed through taxes, public debt, money emission and international aid.

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

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

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

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

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

NOTES

Here, we should note that public expenditure usually does not consolidate state-owned firms. Their capital goods expenditure is added to investment. In modern states, the expenditure of the different bodies is interlinked, with national programmes co-financing both international and decentralized projects. The co-financing with the private sector is sometimes actively looked for.

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

1. Justice and public order;
2. Infrastructure (roads, railways, etc.);
3. Military system;
4. Education system;
5. Environmental protection;
6. Healthcare;
7. Support for the poor, the old, the disadvantaged;
8. Support for firm's export and production in general;
9. Regional policies for rural and urban areas;
10. Special policy expenditure (foreign aid, integrated fight against drugs etc.).

These priorities can be financed independently one from each other or be integrated and built in complex packages, as it happens with urban regeneration and policies for the policies for the transition to a green low-carbon economy.

In different places and over time, those macro-functions have largely changed their level of priority and even the social acceptance of the idea that it is the State that must take care of them. In particular, as a very sketched framework, one may distinguish at least three general models of state to which public expenditure corresponds:

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

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

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

Needless to say, the State does not exert its influence on economy and society through public expenditure only, but also for example through laws. By integrating laws, public expenditure and the tax system (as well as other components) one put together comprehensive policies.

In certain countries, public expenditure contains a wide arrays of waste and resource dissipation, duplicative employment of low-productive bureaucrats, boosted quotations in tenders, leading to super-normal profits of the few selected firms, which, if there is any lax legislation, practice and enforcement, generate the incentive for corruption. Transparency and public monitoring of prices of the goods purchased by public authorities can substantially increase the efficiency and the consensus around public expenditure.

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

Sometimes considered as a completely exogenous variable, the public expenditure would thus be fully in the hand of political decision makers without dependency from the economic context.

Yet, policy makers may turn out to follow an anti-cyclical broad control of public expenditure. Automatic stabilizers may be at work, as with the case of support for unemployment in this case, higher unemployment and disappointing GDP growth would lead to higher public expenditure through unemployment benefits and financial support to firms.

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

Law makers facing elections are sensitive to the public opinion. Usually, low-income social groups are in favour of expanding public expenditure in social issues, as stimulus for jobs, and provision of free or subsidized services. The rich tend to use less public services and to be more worried by the amount of tax necessary to fund public expenditure. The middle class is ambivalent and will react depending on the specific frame that will be proposed by politicians.

Specific expenditure categories and items have their favourable and opponent constituencies. Certain large-scale projects can be the subject of a national debate and the decision can depend on its outcome.

The process of public budgeting is crucial to influence the outcome, e.g., with the sequence of decisions being capable of “leaving no money” for the “last” choices. The current level of public deficit or surplus is ambivalently used to influence changes in the level of public expenditure. For those who desire a more or less balanced budget, the surplus is an invitation to spend, a deficit to cut. However, the same surplus can instead be directed to tax cut and the deficit gap can be filled in by new taxes or more incisive fight to tax evasion.

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

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

Moreover, if consumers interpret the increase in public expenditure as a fall in their disposable income (i.e., after-tax income), consumption may fall accordingly.

NOTES

Public expenditure is also told to crowd-out investment, possibly through an interest rate increase, further leading, in a floating exchange rate regime, to a currency appreciation. Exports would then be displaced as well.

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

Conversely, the part of public expenditure which is burned in rent-seeking behaviours, corruption, and purposeless purchases can alter the rules of the game in markets, firms, and income distribution.

Long-term trends: In developed countries, it has always grown, whatever the political orientation of the government. Just the tempo can change. With a few exceptions, only under extremely strong constraints has public expenditure been cut in absolute terms, so that this attempt can be judged as difficult.

Wars are episodes of extremely high public expenditure, followed usually by a return to normality, unless the pressure of the ex-soldiers for social advancement is met with an extension of the welfare state.

Business cycle behaviour: Public expenditure may turn out to be pro-cyclical or anti-cyclical depending on the political and institutional attitude toward public deficit.

During recessions, tax revenue tends to fall, public budget usually degradates. Some governments react by reducing public expenditure and freezing employment and wages in the public sector. Other decide to spend more to stimulate the economy.

The former risks to worsening GDP dynamics and engendering a vicious cycle, which can be broken by international trade dynamics, financial inflows or other variables.

The second would provoke a deep public deficit, waiting for GDP rebound and, possibly, new taxes.

Still, real world data show often little reaction of public expenditure to the cycle. Most cycles show public expenditure as a stabilizing tool just keeping the same dynamics when the rest "goes wrong".

2.3 PUBLIC EXPENDITURE — HYPOTHESIS, EFFECTS, EVALUATION

1. Wagner's Law: Tendency towards persistent rise in public expenditure was observed in the 19th century. Adolf Wagner, German fiscal theorist of the 19th century, presented his law of 'increasing expansion of public and particularly state activities' which is referred to as the law of 'increasing expansion of fiscal requirement' — this is known as Wagner's Law and that may be stated as follows:

Comprehensive comparisons of different nations in different periods indicate that among progressive peoples with which alone we are connected — an increase regularly takes place in the activity of both the Central and local governments, which may be both extensive as well as intensive. Central as well as local governments constantly undertake new functions when they undertake both old and new functions more efficiently and completely. In this manner, the economic needs of the people to an increasing extent and also in a more satisfactory way are satisfied by the Central and local governments.

Again, extension in government activity has led to an increase in public spending. All democratic nations those are free from colonialism, desires to develop their economic welfare. In this perspective, they usually indulge in planning activities that raise public expenditure both by the Centre and State Governments as well. Shift from laissez-faire to welfare economy has increased public expenditure. In the last century, it was considered that, public expenditure beyond what would be absolutely required to safeguard the nation from external aggression and internal disorder was fruitless wastage. This concept is linked to the laissez-faire doctrine that government is the best which governs the least. But, on the other hand, any welfare state must provide from, what is called — cradle to grave or womb to tomb — and thereby implies any expansion of state activities indicates consequent rise in public expenditure.

2. The Peacock-Wiseman Hypothesis (Peacock and Wiseman's Displacement Effect: A Reappraisal and a New Test): Peacock and Wiseman conducted a new study based on Wagner's Law. They studied the public expenditure from 1891 to 1955 in UK. They found out that Wagner's Law is still valid.

Peacock and Wiseman further stated that:

1. The rise in public expenditure greatly depends on revenue collection. Over the years, economic development results in substantial revenue to the governments, this enabled to increase public expenditure.
2. There exists a big gap between the expectations of the people about public expenditure and the tolerance level of taxation. Therefore, governments cannot ignore the demands made by people regarding various services, especially, when the revenue collection is increasing at constant rate of taxation.
3. They further stated that during the times of war, the government further increases the tax rates, and enlarges the tax structure to generate more funds to meet the increase in defence expenditure. After the war, the new tax rates and tax structures may remain the same, as people get used to them. Therefore, the increase in revenue results in rise in government expenditure.

Peacock and Wiseman (1961), hereafter referred to as P-W, adopt a clearly inductive approach to explaining the growth of government expenditure. When P-W observed that expenditures over time appeared to outline a series of plateaus separated by peaks and that these peaks coincided with periods of war and preparation for war they were led to expound the displacement effect hypothesis. The three basic propositions underlying the P-W analysis are that: (i) governments can always find profitable ways to expend available funds, (ii) citizens, in general, are unwilling to accept higher taxes, and (iii) governments must be responsive to the wishes of their citizens. From these basic tenets, P-W derive the key concept of a tolerable burden of taxation. It is assumed that notions about taxation remain fairly stable in peacetime. As a consequence, the limited revenue capacity of the government in peacetime prevents major increases in expenditures. Therefore, in settled times, the desired government expenditures and the limits of taxation are likely to diverge. During periods of social upheaval such as war, this divergence is likely to be narrowed, permanently displacing the burden of taxation upward. The end result is the attainment of a new expenditure plateau at a higher level than before the onset of the upheaval. In times of crisis, formerly unacceptable revenue-raising methods will be tolerated and it is claimed the higher tax tolerance will persist even after the crisis subsidies, thus enabling the government to implement expenditure programmes that it previously desired but could not finance. Furthermore, P-W argue that a war brings into focus problems that were not identified before. This is called the inspection effect. Although the displacement hypothesis was induced from a study of British data between 1890 and 1955, P-W claim that it gives us an approach for the subject that might be equally fruitful in studying other countries or periods. Despite their assertion of the validity of the displacement effect across countries and time

NOTES

periods, the authors hold that they are not seeking to find universal laws, but rather a way of looking at year-to-year changes in government spending. But, as Rosenfeld (1973) points out, this is not what they do, since there is no attempt to study cyclical variations around underlying expenditure trends in their study. Thus, the displacement effect is undoubtedly an attempt to explain why the horizontal trend line shifts upward in discrete steps over time. Therefore, the displacement effect is a theory about the secular behaviour of government spending, comparable, for instance, to Wagner's famous Law of Expanding State Activity. Even if P-W make the reservation that the displacement effect should not be assumed to govern the growth of public expenditures in all countries at all times, one can safely conclude that the effect is assumed to apply to the two world wars. P-W do not deny that other more permanent factors may also influence the growth of government spending. The effects of three such factors are examined by P-W, namely changes in population, prices and unemployment (the business cycle). It is found to make little difference whether government expenditures are measured per capita or not. When the effects of price changes are removed, the time pattern of spending growth remains virtually unchanged. When P-W discuss price changes, their primary interest is not relative prices, but rather the possible effect of general inflation (or deflation) on public revenues through fiscal drag. Hence, the more recent emphasis in the literature on the productivity lag in public production as one of the main causes of the growth of exhaustive expenditures is of no concern to P-W. This is quite consistent, since they presume that government expenditures are determined from the financing side, rather than via the demand for public services by the citizenry. Relative prices may be of importance in determining the composition of aggregate public spending, especially the division between exhaustive expenditures and transfer payments. However, P-W assume that these have little or no bearing on the level of total expenditures, which they believe is determined from the revenue side. Finally, although P-W find support for a short-run positive relationship between government expenditures and the rate of unemployment, they claim that there was no permanent change in the level of expenditures following upon periods of unemployment. Consequently, we may conclude that P-W find that the pattern of expenditure development is mainly dictated by the displacement effect. As noted, it is quite clear that P-W posit that the tolerable burden of taxation is the engine that runs the displacement effect. Unfortunately, it is not quite clear how this concept should be defined. In the introduction to their book, P-W state that tolerable burden of taxation should be understood as tolerable tax rates, and that these tax rates translate into a certain share of government expenditure relative to GDP, which remains broadly constant in normal times. On the other hand, there is also evidence that at times they have in mind the absolute level of expenditure per capita. As pointed out by Bird, it is quite surprising that in none of P-W's charts, which are their principal tools of analysis, do they relate government expenditures to GDP or to some other appropriate measure of national income. This ambiguity is intensified by the following statement by P-W: A rising real GNP per head brings increasing tax yields with constant tax rates, so that if people's ideas of tolerable burdens are concerned with tax rates rather than total payments, this provides a reason why the peacetime plateau described by public expenditures may have an upward slope. As we can readily see from this quotation, P-W do not specify whether the tolerable burden should be interpreted in absolute or relative terms. From the above review of the original P-W hypothesis, we may derive the following two testable versions of the displacement effect hypothesis: **I. The strong version:** real absolute government expenditure per capita evolves in a step-like pattern, where the movement from one step to another coincides with major social disturbances, such as wars. **II. The semi-strong version:** government expenditure as a share of national income evolves in this same fashion. In several subsequent treatments of P-W's writings, e.g., Bird (1972), Musgrave (1969), Herber (1975), and André and Delorme (1978), the displacement effect has been significantly reinterpreted. Instead of assuming a constant government share relative to GDP (the semi-strong version), this share is seen as rising secularly over time as a result of growing income per capita, i.e., mostly as a result of Wagner's Law. If there is a displacement effect, it gives an upward shift of the trend line, which may already be upward sloping. This takes us to the third version of the displacement effect: **III. The weak version:** the ratio of government expenditures to GDP follows an upward sloping trend in normal times. This trend is shifted permanently upward following a social upheaval. A possible variation may be that government expenditure per capita in normal times follows an upward sloping trend that is permanently shifted upward as a result of an upheaval. At this juncture, it should be noted that this notion cannot be found in P-W (1961). Although they concede that increasing income can lead to a proportional increase in government spending (if the burden of taxation is perceived in relative terms), there is no claim that spending could start growing more than in proportion to national income in peacetime. And as noted above, the change in total income is not among the permanent factors considered by P-W as potential determinants of government spending. Gupta (1967), a student of Peacock, was the first to set out to make a statistical test of the P-W hypothesis. Here, we encounter the first attempt at a reformulation of the original thesis. Gupta reinterprets the displacement effect so that it also covers the possibility for a changed rate of growth of government expenditure after a social upheaval, despite the fact that there was no such notion present in the P-W book. The lack of this notion is evidenced by the fact that the displacement hypothesis (in its weak version) implicates that government spending would not grow faster than GDP. In the introduction to the second edition of their book, P-W (1967) shifted the focus of the original displacement hypothesis to one dealing with a change in the character of public expenditures. However, they did this without specifying how and in what direction this change is expected to take place, and thus they made the theory even more difficult to test (Bird, 1972)). A close associate to P-W, Diamond (1977) reformulated the displacement hypothesis thoroughly and interprets it as a theory of structural break, the main claim being that the usual *ceteris paribus* assumption of unchanged tastes, preferences and institutions after the upheaval is denied. This reinterpretation is endorsed by P-W (1979) in a review article of different approaches to the analysis of government expenditure growth. Hence, P-W and their followers have thoroughly revised their original view of the tolerable burden of taxation and its upward displacement after major disturbances as the chief determinant of the time pattern of public expenditure growth. This leads us to the fourth and final version of the displacement hypothesis: **IV. The amorphous version:** the values of the parameters of the relevant model explaining the development of government expenditures will change following a social upheaval. It is unclear whether it is the public spending share of GDP or spending per capita that is supposed to change, but all tests have used spending per capita in some form as the dependent variable. More importantly, as we will see below, this version has been tested empirically but with income as the only regressor. Thus, in these tests, versions III and IV are equal save the fact that the income coefficient may change between time periods. The different versions of the hypothesis will be thoroughly commented upon in the following sections when we consider different ways of testing for the presence of a displacement effect.

A Review of Previous Empirical Tests: Gupta (1967) was the first attempt to subject the displacement hypothesis to empirical testing. He fitted the following equation for different subperiods separated by social upheavals:

NOTES

$$\ln G_{ct} = a + b\ln Y_{ct} + \varepsilon_t$$

where G_c is real per capita public expenditure (other than war-related but including defense), Y_c is real ε_t is assumed to be a well-behaved error term. The test was carried out for five (per capita and GNP) countries and in most cases, a significant change in slope as well as intercept was found between contiguous sub-periods. To test for displacement, the fitted value of G_c was calculated using both estimated equations for the first year following the upheaval. If the value calculated by the equation for the later period significantly exceeded the value calculated with the equation for the earlier period, Gupta concluded that there had been an upward displacement. Gupta found significant displacement after the world wars in all cases except for Sweden after World War II. However, this finding seems to be due to an estimation error. He also found significant displacement caused by the Great Depression in the case of the US and Canada. Unfortunately, the study is awash with methodological shortcomings making the empirical findings highly doubtful. Several sub-periods only contain as few as five observations; in many cases, observations are arbitrarily dropped due to their alleged abnormality; the sub-periods compared are in some cases separated by as much as 18-21 years; neither standard errors nor Durbin-Watson statistics are reported despite the fact that the author admits a likely autocorrelation of residuals; the Great Depression is arbitrarily tested as an upheaval in the US and Canada, but not in any of the other countries, and so forth. It is evident that Gupta was testing for an upward shift in the underlying trend and in this sense was testing version III of the hypothesis. On the other hand, he was also testing for a change in that trend after the upheaval and therefore the test includes elements of version IV as well. The test of Bonin, Finch and Waters (1969) is similar in many ways to Gupta's. They test for displacement in the UK after the two world wars estimating the following equations:

$$G_{nt} = a + bY_{nt} + cD + dDY_{nt} + \varepsilon_t$$

$$G_{xt} = a + bY_{nt} + cD + dDY_{nt} + \varepsilon_t$$

where, G_n = per capita public expenditures net of debt, war-related and defense spending

$G_x = G_n$ less replacement of non-military goods sacrificed during war time

Y_n = GNP per capita less total public expenditure per capita

$D = 0$ in pre-war periods and 1 in post-war periods

In contrast to Gupta, Bonin *et al*. concentrate on civilian public spending. In the second variant, they try to account for possible shifts in government spending caused by the need to catch up with the backlog of foregone peacetime spending. Because all replacement (calculated as the cumulated difference between the extrapolated pre-war trend of G_n and actual G_n during the war) is assumed to take place in the immediate post-war years, there is a considerable difference between the two series in the early portion of the sub-periods, something which shows up in large differences in the slope shift dummies for G_n and G_x, respectively. In general, the slope changes are positive but insignificant. However, the intercept shift, which is what the authors interpret as displacement, is always significant. There is upward displacement after World War I for both series and for G_n after World War II. However, for the G_x series, there is a significant downward displacement after World War II. In testing for Great Depression displacement, similarly conflicting results are obtained: strong upward displacement for G_x, whereas there is a weak downward displacement for G_n. Hence, the results seem clearly sensitive to the definition of the dependent variable, which is no surprise given that the number of observations used in each sub-period in no case exceeds ten and in the pre-World War I period is as low as six. It is

NOTES

also likely that the error terms are auto correlated. Thus, the arbitrary fashion used to account for replacement, the insufficient number of observations, and the contradictory findings make this test of (a variant of) version III of the displacement effect highly questionable. As previously mentioned, Diamond explicitly restates the displacement hypothesis as a theory of structural break. He tests this empirically with a Chow test comparing two time periods separated by a social upheaval. If this shows significant structural change in the estimated parameters, he concludes that there has been displacement. Three measures of government spending per capita are regressed on GNP per capita. Of nine Chow tests, only five were significant at the 5 per cent level or better. More importantly, as emphasized by Taussig and Henning (1979), the Chow test does not distinguish between upward and downward displacement. In no case did slope as well as intercept terms increase. In eight cases, they changed in opposite directions and in one case they both declined. From the test, we cannot infer whether the slope or the intercept change is dominant. To do that would have required a procedure that accounted for the change over time in the variables to which the coefficients apply. Diamond's test may be seen as a test of version IV of the hypothesis, since it includes a test of changes in the slope term. In light of the original P-W formulation, we are inclined to agree with Taussig and Henning's conclusion that Diamond's Chow tests are virtually worthless as tests of the Peacock-Wiseman displacement hypothesis. A further critique of Diamond's analysis is that of Watt (1979). He shows that the assumption of equal error variance across sub-periods is incorrect in most cases, making the Chow test inappropriate to test for structural break. Ironically enough, Diamond himself questioned the validity of the results obtained by Bonin *et al.* on exactly those grounds. Other tests of the displacement effect, basically using the Gupta methodology are André and Delorme for France and Nagarayan for India. In both cases, support is lent to the hypothesis. The above reviewed studies have one important thing in common — they all in some way relate government spending to income. This may be somewhat surprising since in the original P-W hypothesis government spending was taken to be a theory of the development of government spending over time. The only test using time as an explanatory variable is that of Pryor, who estimates the following two simple time relationships on UK data:

$$\text{In } G_t = a + b_t + CWW1 + DWW2 + \varepsilon_t$$

$$\text{In } G_{nt} = a + b_t + CWW1 + dWW2 + \varepsilon_t$$

where, G = total government expenditure per capita

G_n = per capita public expenditures net of debt, war-related and defense spending

t = Time

$WW1 = 0$, 1890-1913; $= 1$, 1923-37, 1950-61

$WW2 = 0$, 1890-1913, 1923-37; $= 1$, 1950-51

Pryor finds statistically significant upward displacement for G ($c, d > 0$) but not for G_n. The final significant methodology that has been applied for the testing of displacement is that of Taussig and Henning. In their study, a comprehensive set of explanatory variables is applied simultaneously as potential determinants of public non-defense spending growth. The presence of a displacement effect was tested for by including intercept dummies, one for each post-war period in a way similar to that of Pryor. These tests failed to indicate upward displacement. The dummies were either insignificant or negatively significant.

3. Modern Wars: Most prominent single factor in pushing public spending upwards during the 20th century is wars. Wars and its rumours have compelled nations to be armed all the time for war. Cost of defence has been enhanced over the years — which includes not

NOTES

only outlays on officers and men of various defence services but also pensions to war veterans and interest on war debts etc. as well.

4. Price Elasticity of Demand and Differential Productivity: W.J. Baumol is the architect of this development and in his thesis, it is assumed that productivity growth in public sector is slower than that of private sector and price elasticity of demand for public services is low. So, these two assumptions combinedly increase total outlay on public services. Further, advancement of technology is low in the public sector, which should definitely increase. It will consequently lead to a rise in public spending.

5. Economic Development: Since independence, our country is wedded to the idea that government should play an active role in our economic development. In this perspective, government should not only boost private sector, but should itself also become an entrepreneur. Industries that necessitates huge investment or which will not be undertaken by the private enterprise, though which are considered important by the government are also being set up by the government. Planning process has become one important feature of many developing and underdeveloped nations. India has adopted planning process to attain economic development. During the first four plans, the total public sector expenditure was ₹ 30,270 crore. But gradually, it has been raised and during the eighth plan (1992-97), it was put at ₹ 4,34,100 crore at 1991-92 prices and according to the central plan outlay in 2014-2015 budget estimates department of ₹ 2598 crore.

This strategy raises one debatable issue of conflict between defence as well as development. Defence expenditure has been mounting everywhere, which may not pose a problem for an advance country. But, for developing country like India, it is really a complicated problem to satisfy defence requirements. Evidently, defence is an important as development for any nation like India — which is surrounded by hostile neighbours.

6. Socialistic Pattern and Setting Up of Mixed Economy: Acceptance of mixed economy vested the State with the new functions and new responsibilities. Government has to control and regulate private sector enterprises through the system of permits, controls, licensing etc. Apart from that, it has to set up public sector enterprises to boost industrial development in our country and also to prevent concentration of income in a few hands. It has also been committed to the use of fiscal policy and taxation to reduce inequalities, public expenditure to increase low incomes. As a consequence, therefore, these additional responsibilities have further increased public expenditure.

7. Income Elasticity and Increase in Per Capita Income: It is true that, there is a steady rise in public spending and also the per capita income. Hence, these development together, there is a close link between these two in GNP terms. Alternatively, one factor that explains the relative increase in public expenditure is increase in per capita income.

Effects of Public Expenditure: In underdeveloped nations, the State has assumed according to the spirit of the age, responsibility for rapid economic development. In any underdeveloped country, there are many investment opportunities but enterprise is shy and there is lack of capital. Private enterprise desires to invest in tried as well as safe channels, where gestation period is short and returns are considerably faster. People are unfamiliar with investment habit and thus private industrialists cannot undertake projects that need huge investment of capital, several years to complete and another few years to be profitable. Construction of railways, irrigation projects, multipurpose river valley projects, modern steel plants are beyond the resources available to private sectors in underdeveloped nations. Henceforth, Government arranges the resources needed to finance these projects as the outlay is large and also profits accrue after several years. Apart from that, most of the foreign aid is also received in these countries on Government account. Now, as Government has also to incur large expenditure on both economic and social overheads, therefore, public expenditure helps to boost growth rate, improves standard of living and provides an expanding field for employment. Growth of public sector also helpful to reduce concentration of wealth and income. In addition to that, public sector also tends to reduce regional imbalances in an economy by exploiting unemployed resources and thereafter moved to other areas. Thus, public expenditure gradually brings prosperity to such backward regions and in turn strengthen the country's economic situation. Thus, there has been a persistent and continuous increase in public expenditure in countries all over the world. This tendency was observed in the 19th century, but it has become clear and definite in the 20th century. Changes in the role of the state and public policy is the root cause of the growth of public expenditure in recent times.

1. Concept of Welfare State: Modern state is a welfare state whose main objective is to promote economic, political and social well-being of citizens. It, thus, makes every effort to improve living standard of the common people. Important fields of economic activity may be as follows:

(i) Governments undertake compensatory spending to maintain full employment.

(ii) Government spend a large amounts of money on education especially free education and also on social sector.

(iii) In underdeveloped nations, such as India, large amount of money are spent on development programmes for the purpose of economic development and also on progress of the country.

In fact, there has been a change in the basic concept of the state. As a result of which, new functions or tasks are being performed by the state involving enhancement in public expenditure.

2. The Economic Development: Major objective of the policy in any underdeveloped country is the attainment of a high rate of growth. It is the duty of public expenditure to fulfill this objective. In fact, the theory of public expenditure in an underdeveloped country should be a theory of public investment in view of the fact that without increasing investment for productive purposes the economy of an underdeveloped economy cannot take a different turn.

3. War and Preparation for War: Most important single factor in pushing public expenditure upward in the 20th century is war. Expenditure on national defence normally accounts for half of the total expenditure, larger the country greater the percentage of revenue allotted to national defence. Wars and rumours of war between countries have forced countries to be armed all the time and be ready for war. Cost of defence has also been increased to much extent. Further, the progress of military arts and sciences has been so rapid that the machines of war have become extremely expensive to purchase and the rate of obsolescence extremely high. Apart from that, defence expenditure includes not only outlays on men, materials and maintenance during and between wars but also includes pensions to war veterans and interest on war debt and so on.

4. Role of Democracy and Socialism: Recent growth of democracy and socialism every where in the world has caused public expenditure to increase very much. Democratic structure of Government inevitably more expensive than that of totalitarian Government.

5. Effect of Urbanization: Spread of urbanization is an important factor that leads to the relative growth of public expenditure in modern times. With the growth of urban areas, there has been an increasing tendency of expenditure on civil administration, expenses on

NOTES

water supply, maintenance of roads, schools and colleges, traffic controls, parks and libraries etc. have increased enormously in these days. Similarly, expenditure on courts, prisons etc. is increasing especially in urban areas.

6. Increasing State Activity: According to Wagner's Law of Increasing State Activity, in the course of the economic development process, public expenditure increases more than proportionately with the increase in per capita output. Government's functions have increased both extensively and intensively. Old functions are being performed and many new ones are being undertaken. Objectives of welfare state and high rate of economic development have led to tremendous increase in the scope of the Government activities. Nowadays, Government expenditure on anti-poverty and anti-unemployment programmes has also increased substantially, which adds to the Government expenditure.

7. Effect of Population: Secular growth of population calls for increase in public expenses as all the state functions are to be performed more extensively. Increasing population also possess several problems in poor nations. State will have an added responsibility of solving unemployment, housing and sanitation. Further, an overpopulated country such as India will have to check such growth problems like food and population. State has to spend more and more on family planning campaigns every year.

8. Effect of Planning: In a developing economy, Government adopts economic planning for the development of the country. In a planned economy, while the public sector is expanding its role, public expenditure evidently shows an increasing trend. Therefore, the Government has to spent a huge public expenditure in plans.

9. Concept of Functional Finance: Today, the nation of public expenditure has been changed form sound finance to functional finance. Efficacy of fiscal policy has been recognized as a controlling measure during cyclical fluctuation. Thus, Government has to incur a large public expenditure during a period of recession or depression.

10. Increase in Non-plan Expenditure: Large increase in public expenditure is very disturbing. The non-plan expenditure includes expenditures incurred on collection of taxes and duties, administrative services, debt services, pensions, etc.

11. Effect of Rural Development: In an underdeveloped country, Government has also to spend more and more for rural development. It has to undertake schemes like integrated rural development projects and other social measures.

12. Massive Increase in Central Subsidies: In recent years, there has been a manifold increase in central subsidies that has further swelled the Central Government's expenditure. Subsidies, nowadays, are one of the major items of the Central Government's expenditure.

2.4 EFFECTS OF PUBLIC EXPENDITURE ON PRODUCTION AND DISTRIBUTION

Dalton is of the opinion that the level of production and distribution in any country depends upon the following factors:

1. Ability of the People to Work, Save and Invest: If public expenditure can increase the efficiency of a person to work, it will promote production and national income, public expenditure on education, cheap housing facilities, recreational facilities and medical services. At the same time, public expenditure promote saving on the part of lower income groups by providing additional income to them, because with larger income normally it is expected that people will save more. Public expenditure especially with repayment of public

NOTES

debt will place additional fuds at the disposal of those who can invest. Thus, public expenditure evidently promote ability to work, save and invest and therefore promote production and distribution.

2. Willingness to Work, Save and Invest: Effects of public expenditure on the willingness as different from ability to work, save and invest are not clear. Pensions, interest on loans, provident fund and other government payments provide security and safety to a person and reduce the willingness of persons to work and save. Public expenditure has far-reaching effects on the utilization of resources as between alternative uses.

Dalton talks about the government expenditure on armaments and armed forces. To meet such expenditure usually known as economic waste, government diverts economic resources from the general public to the government. These economic resources could have contributed the economic welfare provided they had been allowed to remain with the people themselves.

Public expenditure can bring about a better allocation of economic resources as between the present and the future. In a free capitalist society, very little provision is is made for future. Therefore, we may mention public expenditure on transport, irrigation and other projects which do not yield immediate returns but will yield social and economic benefits for generations to come. Secondly, government spends money in the conservation of economic resources which are very inevitable for the future. Thirdly, government spends money to encourage research and invention, promote education and training, supervize public health and sanitation, in addition to the responsibility of social security measure. So, it is required to emphasize that the diversion of economic resources will greatly increase production.

To create a condition of stability and also to bring about equality of saving and investment of private sector, government expenditure in the form of public works will be inevitable. Government expenditure on the public works programme has favourable effects on production and employment also.

2.5 PRINCIPLES OF PUBLIC EXPENDITURE

Range of state economics activities has been increased in the modern age. Following are the main important principles of public expenditure:

Principles of Maximum Social Advantage: According to Dalton, public expenditure in every direction must be carried just so far that advantage to the community of a further small increase in any direction is just balanced by the disadvantage of a corresponding small increase in taxation and in receipts from any other source of public income. It gives the ideal of public expenditure and of public income. Pigou also states the same principle in more or less the same terms, i.e., expenditure should be pushed in every directions upto the point, at which satisfaction obtained from the last shilling expended is equivalent to the satisfaction lost in respect of the last shilling called up on government service.

Maximum Social Advantage and Equi-marginal Utility: The principle of maximum social benefit is similar to the principle of maximum satisfaction or utility which every individual tries to realize in his everyday expenditure. For example, to maximize one’s satisfaction from the limited income which he possesses, every individual distributes his income, so that the marginal utility of money in all items is more or less equal. If marginal utility in one case is more as compared to other, individual will do better to spend more on commodity in which marginal utility of money is high and less on other and thereby he can attain highest level of satisfaction.

NOTES

Benefits for the Whole Community: Principles of maximum social benefit implies that government expenditure should lead to benefit for the entire community and not to any section or group only. It is, thus, necessary that, the state takes required care so that funds coming from the community are not utilized for the benefit of some particular group only.

Difficulties to the Principle: As a general principle, maximum social benefit has no substitute or alternative. But there are many difficulties and shortcomings in its applications. For example, it is difficult to make a proper estimate or measurement of the benefits that may arise from some or many of the items of public spending. Benefit derived from, for example, expenditure on the armed forces is difficult to determine or estimate, whereas government spending on railways or irrigation or industrial development is far more concrete and henceforth measurable.

Other Principles of Public Expenditure:

1. **Canon of Growth:** The public expenditure should stimulate the production and reduce the poverty. It should not have an adverse effect on the economy.
2. **Canon of Social Welfare:** It is very important principle of public expenditure. Government should spend the money in such a way that it should give maximum benefit to whole society. Expenditure cannot be justified, if one particular class enjoys all the benefits at the expenses of the whole society.
3. **Canon of Prior Permission (Sanction):** All the public expenditure should be incurred by getting prior sanction from the competent authority. It will stop the wastage of money and help the auditors to audit the expenditure properly. Sanction procedure in public expenditure is required for the enforcement of economy as well as for the prevention of the misuse of public funds.
4. **Canon of Economy:** Government money should be spent in such a manner that there should be no wastage of expenditure. The money collected through taxes from the people should not be spent lavishly. It implies that, public expenditure should be incurred carefully and economically. Economy, here, means avoidance of extravagance and wastages in public spending. Therefore, public expenditure must be productive and efficient.
5. **Canon of Elasticity:** Public expenditure should be fairly elastic. It can be increased or decreased according to the requirement of the situation. In case of inflation, it may be decreased and in case of deflation, it may be increased without disturbance.
6. **Canon of Proper Distribution:** Public spending should not concentrate in any particular class. It should reduce the inequalities of wealth in the country.
7. **Canon of Balanced Budget:** Surplus and deficit both budgets are not appreciative. Surplus budget indicates that heavy taxes are imposed on the people, while deficit budget shows that revenue is less than the expenditure. So, all the governments should prepare the balanced budget.
8. **Canon of Surplus:** This canon suggests that saving is a virtue for the Government. So, an ideal budget is one which contains an element of surplus by keeping public expenditure below public revenue. Alternatively, it implies that the government should avoid budgeting in the interest of its own creditworthiness.
9. **Canon of Productivity:** Canon of productivity implies that public spending should tend to encourage production in the economy. It implies that a large part of public expenditure must be allocated for developmental purposes. In a less developed economy, vast expansion of public expenditure is required to enhance

NOTES

output of social and public services and also amenities for community consumption.

All the canons do not have the similar importance. Actually, the principle of maximum social benefit is the only canon worth noting. Others are merely administrative rules that should guide the authorities in the matter of spending public funds entrusted to their care.

2.6 PUBLIC EXPENDITURES (NORMATIVE VIEW)

While dealing with the theory of public expenditures, two approaches may be taken. Let us take a normative view and explore the role that public expenditures should play in an efficiently functioning an economy or we may also examine the sociology or politics of fiscal behaviour, i.e., to explain the forces that determine actual expenditure policy in the prevailing historical and institutional context. It is directed largely towards the normative question, i.e., attention being given in turn to three major aspects of expenditure policy — the allocation, distribution and stabilization functions.

Allocation Function: The central issue in the theory of public expenditures and in the theory of public finance, is how to determine the proper level and pattern of public services. Putting it differently, the question is how available resources should be divided between the satisfaction of 'private' and of 'social' wants. Looked at as an economic problem, which immediately poses a second issue. If resources are to be used for public services or else to satisfy social wants, which private services or satisfactions are to be forgone? As public services must be justified in terms of their opportunity cost, the theory of expenditure making cannot be separated from that of the theory of expenditure financing. Actually, the theory of public expenditures and the theory of taxation are different sides of the same coin.

Attempts at dealing with this problem have a long and frustrating history. Adam Smith, in his book The Wealth of Nations, squarely addressed himself to both its aspects. Certain services must be provided by the state, including the upkeep of the sovereign, defence, some phases of education and certain public works that require too much capital or are too distant in their payoff to be undertaken privately. The finance in turn should be provided through taxes levied so that all will contribute as nearly as possible in proportion to their respective abilities, i.e., in proportion to the revenue which they respectively enjoy under the protection of the state. Ingeniously embedded in a single formula, this rule contains the roots of both the ability to pay and the benefit theory, the two approaches that were to provide the major strands of future discussion.

The ability-to-pay doctrine became the dominant view among British writers. It was reformulated by J.S. Mill in 1848 in terms of equality of sacrifice, translated by Edgeworth in 1897 into a requirement of least total sacrifice and refined by Pigou in 1928 into a choice between equality of absolute, proportional or marginal sacrifice. As a doctrine, it was attractive both to social reformers, who looked upon it as an instrument of income equalization and to conservatives, who shied away from more positive view of public expenditures embedded in the benefit approach.

Distributional Function: Till now, we have dealt with budgetary provision for goods and services designed to satisfy social wants. This allocation aspect of the public household, although perhaps the most basic function of the revenue expenditure process of government, is by no means the only one. Distributional adjustments must also be considered.

If tenets of modern welfare economics are accepted, economics has nothing to say on the basic issue of income distribution. While the economic analyst may explore the consequences (with regard to the level of output, growth, and other factors) of various

NOTES

changes in distribution, he cannot compare the merits of alternative distributions of a given output. This could be done only if interpersonal utility comparison is admitted and an operational procedure of comparison could be devised.

However, it may be distribution does present a policy issue. This is obvious in the socialist setting, where the return to capital accrues to the state and wages paid need not equal the return to labour as a planning cost. But even in the most capitalistic of countries, distribution is not left entirely to the ownership of factors (labour as well as capital and natural resources) and the market system of factor pricing. Some degree of intervention is held necessary, if only to provide for the indigent. Beyond this, society may consider the unadjusted state of distribution to be less or more equal than is held desirable and choose to make the necessary adjustments. Necessity for some distributional adjustments is thus generally accepted, even though the desired degree of adjustment is highly controversial.

Most direct and efficient tool for carrying out such adjustments as desired is provided through the tax transfer process. Use of the tax transfer instrument is superior to interference with factor pricing, that gives rise to inefficient resource use in the private sector of the economy. It is superior as well to interference with product prices (subsidies) or redistribution in kind (i.e., distribution of free goods rather than cash), since transfers do not interfere with the option of consumer choice. Such at least is the case unless redistributional objectives coincide explicitly with situations where interference with consumer choice is held desirable in order to satisfy merit wants.

Stabilization and Growth: Having considered the allocation and distribution function, it remains to note the stabilization function of budget policy. In a decentralized market system, there is no assurance that the level of aggregate demand may not at times be excessive (inducing inflation) or deficient (inducing unemployment). To provide the necessary corrective, monetary and fiscal measures may be needed. Expansionary fiscal action may be taken in several ways, including expenditure increase, tax reduction, and balanced budget expansion.

Fiscal politics: The preceding discussion was addressed to the question of how to secure efficient conduct of the public sector in a democratic society. An alternative approach to the theory of public expenditures is to provide an explanation of the actual conduct of expenditure policy.

This approach, which will be noted here briefly, may be referred to as fiscal sociology or fiscal politics. Karl Marx, in the Communist Manifesto, considered that capitalism might be undermined by progressive taxation, just as it would be weakened and this should be added to place his judgment in proper perspective by popular education. Adolph Wagner predicted an increasing ratio of public expenditures to Gross National Product as a law of social and political development. Wicksell foresaw the possibility that a fiscal mechanism followed by majority voting could lead to the exploitation of the rich by the poor and thus reversing the earlier concern of social reformers. Rudolf Goldscheid presented a sweeping theory of budget behaviour to cast in the context of a Marxist view of history. The wealthy state of feudal society gave way to the impoverished modern state. To be more precise – as the ruling class relinquished control over the state to the people. Joseph Schumpeter (1918), taking off from Goldscheid, re-examined the change of fiscal forms in the transition from feudalism to capitalism and so forth.

2.7 TAXATION DECISION-MAKING PROCESS AND INSTITUTIONAL CHOICES

Taxation: Taxation is an important instrument not only for allocation of resources and distribution of incomes, but also promoting capital formation and curbing inflation. The experience of developing countries like Hong Kong, Singapore, the Philippines etc. has shown that low tax rates encourage economic growth. In India, however, the tax structure is itself a major hindrance to achievement of a high rate of growth.

Objectives

1. Consistency: The tax system should be consistent with overall economic policy that may include such objectives as favouring saving versus overconsumption, raising private investment and producing a favourable impact on the balance of payments.

2. Resource Mobilization: Tax policy is to be directed towards effective mobilization of all available resources and to harness them in the execution of development programmes. Taxation can be a most effective means of increasing the total volume of savings and investment in any economy when the propensity to consume is normally high. A tax system must have an adequacy of both depth and range, it is to promote an accelerated pace of development. In the field of direct taxation, higher rates in respect of personal income tax should be accompanied by some relief for income which is saved and invested.

3. Development of the Private Sector: In a mixed economy, private sector forms an important constituent of the economy. While taxation should aim at maximum mobilization of resources for financing expansion of the public sector, private sector should not be starved. The private sector has to make a significant contribution to the development of the economy and should be given encouragement. The expansion of the private sector is also necessary in the interest of the viability of the economy.

4. Equitable Distribution: Attainment of a wider measure of equality in income, wealth and opportunities must constitute an integral part of economic development and social advance. Instrument of taxation, thus, must be used as a means of bringing about a redistribution of income in favour of the poorer communities of the society.

5. Economic Stability: Another important objective of fiscal policy is to promote economic stability and use taxation as an instrument for dealing with inflationary or deflationary situations. Automatic capacity of the tax system to cope with economic fluctuations can be increased by placing greater reliance on progressive direct taxes.

6. Co-ordination and Flexibility: Tax system should provide revenue sources to each level of Government allowing it flexibility and initiative in carrying out programmes.

It seems reasonable to conclude from the above analysis that taxation should have the following important objectives:

1. To make available for economic development the maximum flow of human and material resources consistent with minimum current consumption.
2. To reduce extreme inequalities in wealth, income and consumption standards which undermine productive efficiency, offend justice and political stability.
3. To maintain reasonable economic stability in the face of long-run inflationary pressures and short-term international price movements.

Therefore, the principal aim of the taxation in underdeveloped nations is to provide incentives to promote saving and investment and thereby high rate of economic growth. The

NOTES

task for the tax policy is to mobilize the economic surplus and direct it into productive channels.

Principles of Tax Policy

1. Taxation policy should enable the public sector to obtain adequate resources to finance programme of economic development and increase the country's national income.
2. Tax increases should not destroy incentives for private undertakings of a development nature.
3. Taxation should mobilize a part of the initial increase in income in order to prevent initial improvement in productivity from being dissipated in accelerated consumption or in increased leisure. The system should be flexible enough to progressively more responsible to increased incomes.

Guidelines for a Suitable Tax Policy

1. The tax policy should be determined primarily by the need to raise revenue and to encourage investment and secondarily to secure social justice and redistribute income.
2. Taxation should be diversified with a view to raising revenue and restraining consumption.
3. Tax structure should be simplified.
4. Tax policy should activize equity market and attract foreign investment.
5. Tax administration should be made efficient to check evasion.
6. Too steep graduation at the top income levels should be avoided. Corporate taxation should be brought down.
7. There should be greater emphasis on consumption taxes to increase revenues and restrain consumption.
8. Effective steps should be taken to unearth black money.
9. Taxes should be carefully selected so that they do not adversely affect incentives to save and invest.
10. To secure social justice and reducing inequalities, there should be a mild adjustment in tax rates, major reliance being put on public expenditure.
11. Depreciation policy should be liberalized and initial allowances increased.

Principle of Ability to Pay

The ability approach is based on the broad assumption that those who possess income or wealth should contribute to the support of public functions according to their relative abilities. The ability principle of taxation has always received general popular acclaim and has had a tremendous appeal to the lower income groups.

Ability Principle in the Past: The idea of a just and equitable taxation – the distribution to tax burdens should be associated from the earliest times with the concept of ability to pay. In the 16th century, Gincciardini and Jean Bodin argued for taxation on the basis of ability. William Petty and Adam Smith spoke of the ability concept, as has been pointed out earlier, they had combined the ability principle with that of benefit. Contrary to popular belief, Adam Smith's opinion should be taken as favouring benefit rather than ability.

According to Mill, equality in taxation means equality of sacrifice. Taxation becomes just and equitable while distribution of tax burden is such that all those who contribute to the common good incur equal sacrifice.

Justification for Ability Approach: Supporters of the ability approach have sought to justify it on three grounds.

1. The sacrifice interpretation of ability as Dalton has stated, sacrifice interpretation of ability look at the psychological effects of tax payments upon individual taxpayers or every group of taxpayers.
2. The second justification of ability is known as the faculty interpretation. Faculty is the capacity of an individual to produce and consume and this is represented by the income and the accumulated wealth of an individual.
3. The third justification of ability is in terms of diminishing marginal utility of income. According to this principle, increase in income will imply lower utility from the additional income. Incomes, it may be noted are meant to satisfy human wants.

The Ability-to-pay Approach

In modern taxation, the ideal of justness or equity is endorsed by the principle of ability to pay. This principle suggests that every person should be taxed in accordance with his ability to pay. It means that the broadest shoulders should bear the heaviest burden that persons having greater ability to pay should be taxed heavily. While those with less ability should be taxed lightly and those lacking any ability should be exempted. By ability to pay is meant the economic conditions and liabilities of a person. The ability-to-pay approach is, thus, based on assumption that those who possess income or wealth, therefore placed in better economic circumstances, should contribute to finance the public activities according to their relative abilities. On account of its tremendous appeal to the lower income groups, the ability to pay principle of taxation has been widely claimed.

Ability-to-pay and Equality of Sacrifice

Since the time of Mill, the ability-to-pay principle has been interpreted in terms of equality of sacrifice for the tax payers. In order to translate equal sacrifice principle into specific patterns of distribution, certain points have to be taken into account.

Index of Ability to Pay

1. At one time, property or accumulated wealth was considered as the best index of ability to pay. A family's well-being would depend upon the accumulated wealth possessed by it. Wealth was considered a better index of ability than income, wealth provided security and insurance against risk. But with the progress of industrial society and the development of a money economy, there was a shift from property to income as the index of ability.
2. Consumption expenditure has been suggested as an index of calculating tax paying capacity on the assumption that such expenditures measure the true utility or satisfaction derived from income. It is true that income is earned to satisfy consumption needs but income is not utilized for consumption only. It will be recognized by all that saving which becomes investment in a very important aspect of spending, both significant and urgent. There is no sense in taking consumption expenditure as index of ability to pay and ignoring saving and investment expenditure.

NOTES

3. Income has come to be accepted as an index or criterion of a person's ability to pay. While considering income as an index of ability, the classical writers recognized the arbitrariness in defining income. They believed that the low income groups should be given a more favourable treatment but at the same time they were not inclined to accept progression as a principle. Adam Smith advocated that wages and necessities that compose the real subsistence income should be exempted from taxation. Thus, taxable income should be defined as clear income or income above subsistence.

Although, income has come to be accepted as the proper index of ability, for instance, income tax on personal income is regarded as the most equitable of all taxes, it is said to be defective. Modern society has become increasingly complex and the income index of ability is not adequate. Besides, consumption is regarded as better index of ability.

Concept of Equal Sacrifice

Equal absolute sacrifice implies that the total loss of utility as a result of tax should be equal for all tax payers. If there are two tax payers but with different incomes, the one who has more income will pay more tax and the one who has less will pay less tax, but the sacrifice to both as a result of the tax should be equal. This principle received the greatest support at one time because of its apparent fairness.

Equal proportional sacrifice implies that the loss of utility as a result of a tax should be proportional to the total income of tax payers. Here too, tax payers with a higher income will pay more but the ratio of sacrifice to the income will be the same for all. This can be expressed as:

$$\frac{\text{Sacrifice of tax payer A}}{\text{Income of A}} = \frac{\text{Sacrifice of tax payer B}}{\text{Income of B}}$$

This proportional sacrifice principle attempts to relate the sacrifice of tax payment to the capacity of enjoyment or satisfaction resulting from income. Every tax payer's loss in proportion to his income should be the same as everyone else.

2.8 SUMMARY

1. Public expenditure is that expenditure incurred by the public authorities.
2. Public expenditure is the value of goods and services bought by the State and its articulations.
3. Public expenditure is determined by political will of the leading forces in the state, their priorities, their desired state model, and their interpretation of current economic and political phase.
4. In underdeveloped nations, the State has assumed according to the spirit of the age, responsibility for rapid economic development.
5. Modern state is a welfare state whose main objective is to promote economic, political and social well-being of citizens.

2.9 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1. Public expenditure can be classified according to the _________ at which it is directed.

NOTES

2. According to _________ of Increasing State Activity, in the course of the economic development process, public expenditure increases more than proportionately with the increase in per capita output.

II. True and False

1. Adolf Wagner, German fiscal theorist of the 19th century, presented his law of 'increasing expansion of public and particularly state activities' which is referred to as the law of 'increasing expansion of fiscal requirement' – this is known as Wagner's Law.
2. Secular growth of population calls for increase in public expenses as all the state functions are to be performed more extensively.

III. Multiple Choice Questions

1. Major objectives of public expenditure are _________.
   (a) Administration of law and order and justice
   (b) Maintenance of police force
   (c) Maintenance of army and provision for defence goods
   (d) All of the above
2. Principles of Public Expenditure includes _________.
   (a) Canon of Growth
   (b) Canon of Social Welfare
   (c) Canon of Prior Permission (Sanction)
   (d) All of the above

Short Answer Questions

1. Explain the term Public Expenditure.
2. What is the importance of Public Expenditure?
3. What are the effects of Public Expenditure on Production and Distribution?

Long Answer Questions

1. Explain in detail about the normative view of the Public Expenditure.
2. Explain the principles of Public Expenditure.

2.10 KEY TERMS

- Equi-marginal Utility
- Socialism
- Urbanization

2.11 KEY TO CHECK YOUR ANSWER

I. 1. Macro-function, 2. Wagner's Law.
II. 1. True, 2. True.
III. 1. (d), 2. (d).

3

Chapter

IMPACT OF BUDGETARY MEASURES AND ECONOMIC GROWTH

Objectives

This Chapter is focused on the following objectives:

- The Effects of Budgetary Measures on Resources Allocation
- Distribution of Income and Wealth
- Aggregate Expenditure
- Economic Growth

Structure:

3.1 THE EFFECTS OF BUDGETARY MEASURES ON RESOURCES ALLOCATION [PLAN OUTLAY 2014-2015] (!)

Total Budget support for Plan in Main Budget 2014-15 is higher by an amount of ₹ 19,678 crore in comparison to Interim Budget. Additional amount in Main Budget 2014-15 is targeted towards specific sectors of the economy, viz., agriculture, capacity creation in the areas of education and health, railways, national highways, rural roads, clean energy, improvement of irrigation, river conservation and renewable and development.

(!) **Source:** Expenditure Budget, Vol. I, 2014-2015, Government of India.

NOTES

(₹ in crores)

	Actual 2012-13	Budget Estimates 2013-2014	Revised Estimates 2013-2014	Budget Estimates 2014-2015
Budgetary Support for Central Plan	304739.05	419068.00	356492.88	236591.51
Internal and Extra Budgetary Resources of Public Enterprises	193736.99	261055.39	257641.13	247940.94
Central Plan Outlay	498476.04	680123.39	614134.01	484532.45
Central Assistance for State and Union Territory Plans	108885.68	136254.00	119038.93	338408.49

Agriculture and Allied Activities

Crop Husbandry: Strategy for increasing production of agricultural commodities focuses on providing incentive to farmers through various development programmes. Outlay for programmes under Crop Husbandry is ₹ 4400.40 crore under the Central Plan for restructured schemes, viz., Sub-mission on Agriculture Extension, Sub-mission on Seeds and Planting Material, National Food Security Mission, Sub-mission on Agricultural Mechanisation, Integrated Scheme on Agriculture Census and Statistics and National Crop Insurance Scheme, etc. Provision of ₹ 16,463.00 crore has been provided for State or UT Plan schemes — National Food Security Mission, National Mission on Oilseeds and Oil Palm, National Mission for Sustainable Agriculture, National Mission for Agriculture Extension and Technology, Mission for Integrated Development of Horticulture and Rashtriya Krishi Vikas Yojana.

Soil and Water Conservation: Outlay under this head is ₹ 18.00 crore, which is for Soil and Land Use Survey of India. This is being implemented as a central sector component under National Mission for Sustainable Agriculture.

Cooperation: Outlay under this head is ₹ 124.90 crore. Provision is mainly for Integrated Scheme on Agricultural Cooperation, which is for co-operative education and training, assistance through NCDC for developmental activities, etc.

Other Agricultural Programmes: The outlay for this head is ₹ 647.09 crore, which is for restructured scheme Integrated Scheme on Agriculture Marketing.

North East Areas: ₹ 566.70 crore is provided for North Eastern States.

Animal Husbandry: The outlay of ₹ 1021.57 crore is for development of Livestock Health and Disease Control Programme, National Livestock Mission, National Programme for Bovine Breeding, Cattle Development and one new scheme of Indigenous Breeds.

Dairy Development: The outlay of ₹ 504.47 crore is for National Dairy Plan, Dairy Entrepreneurship, National Programme for Dairy Development and Delhi Milk Scheme.

Fisheries: The outlay of ₹ 422.56 crore is for National Fisheries Development Board, Development of Marine Fisheries Infrastructure and Post-harvest Operations, National Scheme of Welfare of Fishermen, Development of Inland Fisheries and Aquaculture and Assistant to Fisheries Institutes and the new scheme of Blue Revolution – Inland Fisheries.

North East Areas: ₹ 217.40 crore is provided for North Eastern States including Sikkim.

Forestry and Wild Life: The Plan outlay of Ministry of Environment and Forests is ₹ 2043.00 crore. An amount of ₹ 873.80 crore is allocated for Ecology and Environment, which *inter alia* includes ₹ 288.80 crore for Conservation of Natural Resources and Ecosystems, including Research and Development, ₹ 98.73 crore for Environmental

NOTES

Monitoring and Governance and ₹ 75.00 crore for National Plan for Conservation of Aquatic Ecosystems. Provision of ₹ 100.00 crore has been made for National Mission on Himalayan Studies aimed at contributing to the sustainable development of Indian Himalayan Region. An amount of ₹ 1169.20 crore has been allotted for Forestry and Wildlife and includes ₹ 318.15 crore for National Afforestation Programme, ₹ 78.50 crore for Integrated Development of Wildlife Habitats, ₹ 185.02 crore for Project Tiger and ₹ 23.20 crore for Animal Welfare. ₹ 181.17 crore has been provided for the North Eastern Region, including Sikkim, ₹ 40.06 crore for SCSP and ₹ 16.00 crore for TSP under the Plan Budget of the Ministry.

Agricultural Research and Education: The Department of Agricultural Research and Education (DARE) is responsible for Agricultural Research and Education through Indian Council of Agricultural Research (ICAR), which is an apex scientific organization at the national level. The key constituents of the Central Plan outlay are to strengthen agricultural research in terms of quality seed production, development of high yielding varieties/hybrids, application of biotechnology, addressing climate change impact, resource conservation, input use efficiency, production technology for organic farming, gender related issues. The Plan outlay for the Department is ₹ 3715.00 crore.

Food Storage and Warehousing: The Department of Food and Public Distribution is implementing schemes for the procurement of foodgrains and its distribution for ensuring food security. A sum of ₹ 181.00 crore has been allocated in 2014-15 for the scheme "Construction of Godowns by Food Corporation of India (FCI) and State Governments" for implementation in Jammu & Kashmir, North East and in newly emerging major procurement States.

Rural Development

The Central Plan outlay for 2014-15 of the Department of Rural Development is ₹ 80,043.00 crore. Key constituents of the Central Plan outlay are Special Programmes for Rural Development, Rural Employment, Rural Housing, Roads and Bridges, and Social Security and Welfare.

Rural Employment: The Central outlay for Mahatma Gandhi National Rural Employment Guarantee Scheme (MNREGS) is ₹ 34000.00 crore. Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) is a flagship programme of Government of India implemented by Ministry of Rural Development from 2nd February, 2006. The main objective of the programme is to provide for the enhancement of livelihood security of the rural households by ensuring a legal right for at least 100 days of unskilled wage employment to willing adult members.

Other Rural Development Programmes: The total of Central Sector Schemes for 2014-15 is ₹ 1,017.00 crore, which includes provision for National Institute of Rural Development (NIRD) (₹ 50.00 crore), RURBAN Mission (₹ 100.00 crore) and Village Entrepreneurship 'Start-up' Programme (₹ 100.00 crore). Out of this, ₹ 95.70 crore has been kept separately for North.

Social Security and Welfare: The total outlay for 2014-15 for National Social Assistance Programme (NSAP) is ₹ 10,635.00, out of which ₹ 1063.50 crore have been earmarked for North Eastern Region and Sikkim. Assistance to States under NSAP covers the Indira Gandhi National Old Age Pension Scheme, Indira Gandhi National Widow Pension Scheme, Indira Gandhi National Disability Pension Scheme, National Family Benefit Scheme and the Annapurna Scheme.

NOTES

Panchayati Raj: The Central Plan outlay of Ministry of Panchayati Raj for the year 2014-15 is ₹ 7,000.00 crore out of which ₹ 700.00 crore has been earmarked for North Eastern Areas including Sikkim. Backward Regions Grants Fund (BRGF) has been included in Centrally Sponsored Scheme. An important function of the Ministry of Panchayat Raj is to monitor the implementation of Part IX of the Constitution inserted by the Constitution (73rd Amendment) Act, 1992, provisions of the Panchayats (Extension to the Scheduled Areas), Act, 1996 and Article 243 ZD in Part IX-A of the Constitution relating to District Planning Committees.

Land Reforms: For land reforms, financial assistance is being provided to the States or UTs under the National Land Records Modernization Programme (NLRMP), *inter alia*, for computerization of the Records of Rights (RoRs), digitization of maps, survey resurvey using modern technology, computerization of registration, training and capacity building of the concerned officials and functionaries, connectivity amongst the land records and registration offices and modern record rooms or land records management centres at tehsil or taluk or circle or block level.

Irrigation and Flood Control

Major and Medium Irrigation: The outlay of ₹ 100.90 crore under this sector is meant for development of Water Resources Information System, Hydrology Project, Investigation of Water Resources Development Scheme, Research and Development Programme for Water Sector, National Water Academy, Information, Education and Communication, River Basin Organization or Authority and Infrastructure Development, Implementation of National Water Mission, Irrigation Management, Polavaram Project Authority and Bodwad Sinchan Yojana.

Minor Irrigation: The outlay of ₹ 410.28 crore is for programmes that are to be implemented under this sector including, (i) Ground Water Management and Regulation, (ii) Rajiv Gandhi National Training and Research Institute for Ground Water, and (iii) Infrastructure Development.

Flood Control: The outlay of ₹ 446.60 crore for flood control sector comprises of two categories of programmes, viz., (i) flood control schemes/programmes, and (ii) assistance to various States for flood control works. The provision under this sector is for Flood Forecasting, River Management Activities in Border Areas, Brahmaputra Board and Infrastructure Development. The programme provides for systematic collection of data on floods, close monitoring and issue of flood forecasts and warnings through the network of flood forecasting and warning centres, established by the Central Water Commission.

Transport Services: There is an outlay of ₹ 150.00 crore in this sector. It includes Farraka Barrage Project intended to preserve and maintain Kolkata Port by improving the design and navigability of the Bhagirathi Hooghly River System.

Ecological and Environment: New schemes under this head are National River Conservation Plan, National Ganga Plan, Ghat Works and Beautification of River Front and Water Project of NCT.

Energy

Power: The total outlay for the power sector is ₹ 60,384.02 crore, out of which ₹ 9,642.00 crore is budgetary support for schemes or projects – North Eastern Electric Power Corporation (₹ 142.10 crore), Scheme or Projects of Tehri Hydro Development Corporation India Limited (THDCIL) (₹ 62.92 crore) and Restructured Accelerated Power

NOTES

Development Resource Programme (₹1261.04 crore including an amount of ₹ 52.95 crore for NER and ₹ 90 crore for Schedule Caste Sub Plan).

Nuclear Power: The total outlay under Power Sector for 2014-15 is ₹ 213.42 crore. The Plan outlay consists of ₹ 970.00 crore by way of budgetary support and ₹ 7243.42 crore by way of Internal and Extra Budgetary Resources (IEBR).

Petroleum: The Plan outlay of Ministry of Petroleum and Natural Gas is ₹ 80,677.82 crore including ₹ 43.00 crore of Gross Budgetary Support and ₹ 80634.82 crore of Internal and Extra Budgetary Resources (IEBR) of Oil and Gas PSUs. The scheme of one-time assistance for domestic LPG connection to BPL families will be funded from CSR funds of PSUs in the Petroleum and Natural Gas Sector.

Coal and Lignite: Keeping in view the importance of energy sector for infrastructure support to the Indian economy, the Plan outlay for Coal and Lignite for the year 2014-15 has been projected at ₹ 12,561.00 crore.

New and Renewable Energy: The Plan outlay for the Ministry of New and Renewable Energy (MNRE) is ₹ 5,519.00 crore (inclusive of ₹ 3,000.00 crore as IEBR and ₹ 1578.00 crore from National Clean Energy Fund) for the year 2014-15. The following physical targets/activities have been set under the various programmes during the financial year:

(a) Grid-interactive and Distributed Renewable Power: Provision of Central Financial Assistance for about 3770 MW Grid-interactive Power capacity addition from Wind, Small Hydro, Biomass Power or Cogeneration, Urban and Industrial Waste to Energy and Solar Power; and deployment of about 150 MW equivalent Off Grid or Distributed Renewable Power Systems.

(b) Renewable Energy for Rural Applications: The provision will be used for construction of 1.10 lakh family type Biogas plants and start of a new programme on Cook stoves. It also includes provision for Scheduled Castes beneficiaries.

(c) Renewable Energy for Urban, Industrial and Commercial Applications: Deployment of Solar Thermal Systems and Promotion of Energy-efficient buildings and master plans for Solar Cities.

Industry and Minerals

Iron and Steel Industries: Total outlay of the Ministry of Steel is ₹ 15393.22 crore, out of which, an amount of ₹ 9,000.00 crore representing IEBR for Steel Authority of India Limited (SAIL) for various ongoing and new schemes/projects and research work. An outlay of ₹ 1724.17 crore has been provided for Rashtriya Ispat Nigam Ltd. for expansion of production capacity besides for Addition, Modification and Replacement (AMR) schemes.

Non-ferrous Mining and Metallurgical Industry: The outlay for 2014-15 is ₹ 2379.39 crore, which includes Internal and Extra Budgetary Resources of ₹ 1729.39 crore and DBS of ₹ 650.00 crore including ₹ 83.00 crore for construction programmes included in the demand of Ministry of Urban Development.

Chemical and Petrochemical Industries: The outlay for Department of Chemicals and Petrochemicals is ₹ 207.00 crore, out of which ₹ 102.98 crore is for the Central Institute of Plastics Engineering and Technology for skill development, establishment of new centres and infrastructure development.

Department of Heavy Industry: The Plan outlay for the Department of Heavy Industry is ₹ 2,588.85 crore including IEBR of ₹ 1,788.85 crore and budgetary support of ₹ 800.00 crore. ₹ 100.00 crore has been earmarked for a new scheme, 'Development of

NOTES

Advanced Ultra Super-critical (Adv. USC) Technology for Thermal Power Plants', a token provision of ₹ 0.01 crore for another new scheme in Automotive sector,

Micro, Small and Medium Industries: The outlay for Ministry of Micro, Small and Medium Enterprises (MSME) is ₹ 3,699.00 crore (including ₹ 372. 00 crore as IEBR). This includes outlay for Prime Minister's Employment Generation Programme (₹ 1418.28 crore), Assistance to Training Institutions (₹ 132.00 crore), National Small Industries Corporation Ltd. (₹ 372.00 crore) (IEBR), Performance and Credit Rating (₹ 70.00 crore), Marketing Assistance (₹ 14.00 crore) etc.

Textiles: The outlay for Ministry of Textiles is of ₹ 4831.00 crore (including ₹ 483.10 crore for NER, ₹ 241.55 crore for SCSP and ₹ 57.97 crore for TSP) which is mainly for: (i) Technology Upgradation Fund Scheme (₹ 2300.00 crore), (ii) Human Resource Development (₹ 268.00 crore), (iii) Integrated Textiles Parks (₹ 240.00 crore), (iv) Catalytic Development Programme (₹ 230.00 crore), etc.

Transport

Railways: Railways' annual plan outlay is ₹ 65,445.00 crore. Of this, ₹ 31,596.00 crore is met out of the Gross Budgetary Support, which includes ₹ 1,496.00 crore as Railways' share out of cess on diesel. The targets proposed to be achieved are 2100 km of track renewal, 1300 km of electrification, 450 km of gauge conversion, 300 km of new lines, 700 km of doubling and manufacture of additional 625 locos.

Road Transport and Highways: Development and proper maintenance of road network is crucial to accelerating the process of economic development and removal of inter-regional disparities.

Shipping: The Plan outlay of the Ministry of Shipping is ₹ 4543.32 crore for the year 2014-15 including ₹ 906.00 crore as GBS. This is for development of Indian Shipping, Ports, Inland Waterways Sector and Shipbuilding Industry.

Civil Aviation: Budgetary support of ₹ 6500.00 crore has been earmarked for equity infusion in Air India Limited. Budgetary support of ₹ 50.00 crore has been earmarked to meet expenditure towards the Plan schemes of Ministry. Airports Authority of India has been provided with budgetary support of ₹ 79.70 crore, out of which ₹ 22.00 crore has been earmarked for its project at Pakyong, Sikkim (North Eastern Region).

Rural Roads (Roads and Bridges): The total outlay for 2014-2015 is ₹ 4,391.00 crore, out of which ₹ 1089.10 crore has been earmarked for North Eastern Region and Sikkim.

Communications

Postal Services: Outlay approved for the Department of Posts for 2014-15 is ₹ 800.00 crore (including ₹ 80.00 crore for the North Eastern Region). The main thrust of the Plan is on the schemes relating to: (i) Mail Operations (₹ 78.83 crore), (ii) IT Induction and Modernization (506.39 crore), (iii) Estates Management (₹ 55.40 crore), (iv) Premium Services ₹ 17.50 crore), and (v) Postal Life Insurance (₹ 10.15 crore).

Telecommunication Services: The Plan outlay for Department of Telecommunications for 2014-15 is ₹ 13,500.65 crore, comprising ₹ 7,500.00 crore as budgetary support and ₹ 6000.65 crore as Internal and Extra Budgetary Resources (IEBR) and ₹ 2.25 crore for Tribal Sub Plan has been made for C-DOT as budgetary support.

Information Technology: The vision and mission for IT sector for the 12th Plan is e-Development of India through a multi-pronged strategy of e-Infrastructure creation to facilitate and fast-track e-Governance, Promotion of Electronics Hardware Manufacturing

NOTES

and Information Technology-Information Technology enabled Services (IT-ITeS) industry, providing support for creation of innovation/research and development (R&D), building knowledge network and securing India's cyber space.

Science, Technology and Environment

Atomic Energy Research: The Plan outlay for 2014-15 is ₹ 3430.00 crore for Research and Development Sector which is for pursuing the continuing schemes of 11th Plan and the new schemes of 12th Plan and also for the continuing schemes of the Atomic Energy through its Research Centres such as, Bhabha Atomic Research Centre, Indira Gandhi Centre for Atomic Research, Raja Ramanna Centre for Advanced Technology, Atomic Minerals Directorate for Exploration and Research and Fully Aided or Grant-in-aid Institutions such as Tata Institute of Fundamental Research, Saha Institute of Nuclear Physics, etc.

Space Research: The Annual Plan Outlay (proposed) for the Department of Space for 2014-15 is ₹ 6000.00 crore, which include provisions for the following: (i) ₹ 545.63 crore for Space Technology, (ii) ₹ 561.89 crore for Space Applications and (iii) ₹ 1412.98 crore for INSAT Operational.

Oceanographic Research and Meteorology: Overall Plan outlay for the Ministry of Earth Sciences (MoES) for the year 2014-15 is ₹ 1,281 crore. The Ministry implements a gamut of policies and programmes in the areas of Weather (General), Weather advisories specific to agriculture, aviation, shipping, sports, etc, Coastal and Marine Ecosystems and Climate Change, UT through use ocean science and technology.

Science and Technology: The outlay for Plan schemes of the Department of Science and Technology is ₹ 3,125.00 crore, which is for programmes and activities under six major objectives, namely: Policy Formulation, Strengthening Human Capacities, Strengthening Institutional Capacities, Technology Development Programmes, Partnerships and Alliances and Societal Interventions of S&T. The Department has planned to commission policy research and forecast studies in various knowledge domains related to Science and Technology.

Other Scientific and Industrial Research: The Plan outlay for Department of Scientific and Industrial Research is ₹ 2100.00 crore, including Grants-in-aid of ₹ 1980.00 crore for Council of Scientific and Industrial Research (CSIR) to undertake R&D in diverse fields. The Plan activities are proposed to be pursued through ten schemes, six of which are ongoing and four are new. Under the National Laboratories Scheme (ongoing), R&D activities would be undertaken across the Biological Sciences, Chemical Sciences, Engineering Sciences, Information Sciences and Physical Sciences clusters. Scaling and validating of leads for product/process development will be a focused activity.

Biotechnology: Outlay for Department of Biotechnology for the year 2014-15 is ₹ 1500.00 crore. Key initiatives will be taken up towards innovation and promotion of excellence in system biology, synthetic biology, computational sciences, nano-biotechnology and other emerging areas.

Pharmaceuticals: The outlay for Department is ₹ 207.00 crore, out of which ₹ 87.00 crore has been allocated to the 8 National Institute of Pharmaceutical Education and Research (NIPER), having its centres at Mohali, Kolkata, Ahmedabad, Rae Bareilli, Hyderabad, Hajipur, Madurai and Guwahati. An amount of ₹ 30.00 crore has been allocated to Jan Aushadhi Scheme.

Tourism: Outlay for the Ministry of Tourism is ₹ 1882.00 crore (including ₹ 189.00 crore for NER and Sikkim). The total outlay for the schemes is towards Product or

NOTES

Infrastructure Development for Destination and Circuits, Assistance for Large Revenue Generating Projects, Domestic Promotion and Publicity including hospitality, Overseas Promotion and Publicity including Market Development Assistance etc.

Foreign Trade and Export Promotion: Outlay for Department of Commerce is ₹ 2,226.00 crore, which includes provision of ₹ 800.00 crore (₹ 60.00 crore for Scheduled Caste Sub Plan) for Development of Export related Infrastructure; ₹ 30.00 crore for Agricultural and Processed Food Products Development Authority; ₹ 200.00 crore under Export Market Access Initiative to act as a catalyst to promote India's export on sustained basis.

Other General Economic Services

Corporate Affairs: The Plan outlay of the Ministry of Corporate Affairs for 2014-15 is ₹ 24.00 crore, which is mainly for conducting long-term and short-term courses in various disciplines of corporate affairs, establishment of NGO hub and providing other CSR related services to corporates, etc

Financial Services: A provision of ₹ 13,450.00 crore has been made in 2014-15 for recapitalization of Public Sector Banks, National Bank for Agriculture and Rural Development, Export-Import Bank of India and a provision of ₹ 650.00 crore for Grants-in-aid to NABARD for Women's Self Help Groups (SHGs) Development Fund, Small Industrial Development Bank of India (SIDBI) for India Microfinance Equity Fund and National Credit Guarantee Trustee Company for Credit Guarantee Fund for Skill Development.

Ministry of External Affairs: Outlay for the Ministry of External Affairs is ₹ 5,100.00 crore. The provision is mainly for technical and economic cooperation with other countries to cater to India's bilateral aid and assistance programmes to neighbouring countries.

Social Services

General Education: In keeping with priority of the Government for social sector programmes, an allocation of ₹ 51,828.00 crore has been provided for Department of School Education and Literacy and ₹ 16,900.00 crore for Department of Higher Education.

Sarva Shiksha Abhiyan (SSA): The SSA has been launched for universalizing elementary education, being implemented in partnership between the Central and State Governments/Union Territories. The programme seeks to provide access, equity, retention and quality in the area of elementary education.

Mid-day Meal Scheme (MDM): The National Programme of Mid-day Meals in Schools, popularly known as Mid-day Meal (MDM) scheme, has emerged as the world's largest school programme for children of primary and upper primary stage.

Secondary Education: An allocation of ₹ 8,579.00 crore has been made for Secondary Education, which is inclusive of ₹ 857.30 crore for NER and Sikkim.

Adult Education: An allocation of ₹ 111.00 crore has been made for Adult Education (₹ 11.10 crore for NER and Sikkim). This allocation, *inter alia*, includes allocation of ₹ 100.00 crore for support to NGOs or Institutions or SRCs for Adult Education and Skill Development.

Higher Education: The Department of Higher Education has been provided an allocation of ₹ 16,900.00 crore. This amount also includes provision for various higher and technical institutions.

NOTES

Technical Education: There is a provision of ₹ 7,138.97 crore (₹ 753.98 crore for NER) for Technical Education that includes assistance to Indian Institutes of Technology (IITs), Indian Institutes of Management (IIMs), etc. Out of this, a provision of ₹ 2,500.00 crore (₹ 180.00 crore for NER) has been made for IITs including new ones.

Sports and Youth Services: The Plan outlay of the Ministry of Youth Affairs and Sports is ₹ 1643.00 crore. In the area of Youth Affairs, the provision is mainly for the Nehru Yuva Kendra Sangathan, Young Leaders Programme, National Service Scheme and National Youth Corps.

Art and Culture: The outlay of Ministry of Culture for 2014- 15 is ₹ 1,835.00 crore. This includes provisions for Zonal Cultural Centres, Sangeet Natak Akademi, Archaeological Survey of India, National Archives of India, National Museum, etc.

Medical and Public Health: The Plan outlay for 2014-15 of the Department of Health and Family Welfare is ₹ 30,645.00 crore (CSS – ₹ 24,490.88 crore and CS – ₹ 154.12 crore) inclusive of ₹ 3,064.50 crore for the benefit of the Schemes or Projects in the NER and Sikkim.

Health Research: The Plan outlay of the Department of Health Research is ₹ 726.00 crore inclusive of ₹ 72.60 crore for the benefit of the schemes/projects in the NER and Sikkim.

Department of AIDS Control: The Department of AIDS Control implements National AIDS Control Programme (NACP), a 100 percent Centrally Sponsored Programme, which in Twelfth Five Year Plan has phased out to National AIDS Control Programme Phase IV (NACP-IV) with a goal to accelerate reversal of HIV epidemic in the country by integrating programmes for prevention, care, support and treatment. The approved outlay for 2014-15 is ₹ 1,785.00 crore.

Women and Child Development: The Plan outlay of the Ministry in 2014-15 is ₹ 21,100.00 crore including ₹ 2,110.00 crore for the benefit of North Eastern Region.

Water Supply and Sanitation: The National Rural Drinking Water Programme (NRDWP) is a flagship programme of the Ministry of Drinking Water and Sanitation, and a component of the 'Bharat Nirman'. The objective of programme is to ensure provision of safe and adequate drinking water supply through hand pumps, piped water supply schemes etc. to all rural areas and household. Under the programme, financial assistance is provided to States or UTs for provision of drinking water supply to rural areas of the country under the components of: (i) coverage of partially covered rural habitations with water supply, (ii) overage of quality affected rural habitations with water supply, (iii) taking up source and system sustainability measures, and (iv) support activities like IEC, training, MIS, computerization, R&D, etc.

Nirmal Bharat Abhiyan (NBA): To accelerate the progress of sanitation in rural areas, Government of India has designed a paradigm shift in Total Sanitation Campaign (TSC), which is now called the Nirmal Bharat Abhiyan (NBA), in the XII Five Year Plan.

Housing

Rural Housing: The outlay for 2014-15 for Rural Housing is ₹ 16,000.00 crore, out of which ₹ 1,601.00 crore is earmarked for North Eastern Region and Sikkim. The objective of Indira Aawas Yojana (IAY) is primarily to provide assistance for construction of dwelling units and upgradation of existing unserviceable kutcha houses for Scheduled Castes or Scheduled Tribes and non-SC or ST rural families living below the poverty line. From 1995-96, the IAY benefits have been extended to the families of the members of armed and

NOTES

paramilitary forces killed in action. A minimum of 60 percent of the funds under the scheme are earmarked for assistance to SC or ST families living below the poverty line. 3 percent of funds are reserved for disabled living below the poverty line in rural areas. The IAY funds and physical targets are also earmarked for the BPL Minorities (15 percent). In case there is no eligible female member in the family, house can be allotted to a male member.

The financial assistance provided under the scheme for each house will be enhanced to ₹ 70,000/- in plain areas and ₹ 75,000/- in hilly or difficult areas from 1st April, 2013.

Urban Development: Total Plan outlay for this sector is ₹ 20,463.53 crore, inclusive of a sum of ₹ 7,060.00 crore for mission for development of 100 smart cities and ₹ 3,616.53 crore through IEBR. This provision is for contribution to National Capital Region Planning Board, for achieving balanced and harmonized development of National Capital Region to reduce the pressure of population of NCT of Delhi and National Capital Region (NCR), and other Urban Development Schemes.

Information, Publicity and Broadcasting: The budgetary allocation for Ministry of Information and Broadcasting is ₹ 1205.00 crore including ₹ 200.00 crore from IEBR. This includes ₹ 247.82 crore for Information Sector, ₹ 111.15 crore for Film Sector and ₹ 846.03 crore for Broadcasting Sector.

Welfare

Welfare of Scheduled Castes: An allocation of ₹ 6165.00 crore has been made for schemes or programmes of the Ministry of Social Justice and Empowerment. There is a provision of ₹ 1500.00 crore for Post-matric Scholarship for Scheduled Castes, which would benefit about 55 lakh students.

Disability Affairs: An allocation of ₹ 565.00 crore has been made for schemes or programmes of the Department of Disability Affairs of which ₹ 110.00 crore has been made for the scheme of Assistance to Disabled Persons for purchase or fitting aids and appliances.

Tribal Affairs: The allocation of ₹ 4479.00 crore includes provisions for Grants-in-aid to Voluntary Organizations for Scheduled Tribes (ST) including Coaching and Allied Schemes and Award for Exemplary Services (₹ 36.50 crore), Vocational Training in Tribal Areas (₹ 3.00 crore), Strengthening of Education among ST Girls in Low Literacy Districts (₹ 40.00 crore), etc.

Minorities: The Plan outlay of the Ministry of Minority Affairs is ₹ 3711.00 crore including provisions of NER and Sikkim. The outlay includes 18 schemes, viz., Grant-in-aid to Maulana Azad Education Foundation, Free Coaching and Allied Schemes for Minorities, Monitoring and Evaluation of Development Schemes for Minorities including publicity, etc.

Labour and Employment: The Plan outlay of Ministry of Labour is ₹ 496.00 crore on gross basis. Emphasis is on employment and training of labour, social security for unorganized sector workers, improving working conditions and safety of child/women labour.

General Services

Statistics and Programme Implementation: The Central Plan outlay of the Ministry of Statistics and Programme Implementation for the year 2014-15 is ₹ 528.00 crore including ₹ 52.80 crore for NER. Besides, the outlay for Members of Parliament Local Area Development Scheme (MPLADS) for the year 2014-15 is ₹ 950.00 crore.

Planning: A sum of ₹ 2039.64 crore has been provided for 2014-15 to execute the task of implementing Unique Identification as entrusted to the Unique Identification Authority of India. ₹ 369.57 crore has been provided for Public Finance Management System to put in

NOTES

place suitable Management Information System or Decision Support System for tracking and reporting expenditure along with generation of State-wise or District-wise reports on the expenditure, outputs and the unutilized amount under each Plan Scheme.

3.2 DISTRIBUTION OF INCOME AND WEALTH

Economic Inequality

Economic inequality (or gap between rich and poor, income inequality, wealth disparity, wealth and income differences or wealth gap) is the state of affairs while assets, wealth or income are distributed unequally among individuals in a group, among groups in a population or among nations. Issue of economic inequality can implicate notions of equity, equality of outcome and equality of opportunity.

Extent

A study entitled “Divided we Stand: Why Inequality Keeps Rising” by the Organisation for Economic Co-operation and Development (OECD) reported its conclusions on the causes, consequences and policy implications for the ongoing intensification of the extremes of wealth and poverty across its 22 member nations (OECD 2011-12-05). Income inequality in OECD countries is at its highest level for the past half century. The average income of the richest 10 percent of the population is about nine times that of the poorest 10 percent across the OECD, up from seven times 25 years ago. In the United States, inequality has increased further from already high levels. Referring to median incomes for the upper 10 percent contrasted with medians for the lowest 10 percent, other traditionally more egalitarian countries like Germany, Denmark and Sweden have seen the gap between rich and poor expand from 5 to 1 in the 1980s, to 6 to 1 today.

Causes

There are many reasons for economic inequality within societies. Recent growth in overall income inequality, at least within the OECD countries, has been driven mostly by increasing inequality in wages and salaries. Economist Thomas Piketty, who specializes in the study of economic inequality, argues that widening economic disparity is an inevitable phenomenon of free market capitalism when the rate of return of capital (r) is greater than the rate of growth of the economy (g). Common factors thought to impact economic inequality includes:

Labour Market

Major cause of economic inequality within modern market economies is the determination of wages by the market. Some small part of economic inequality is caused by the differences in the supply and demand for different types of work. However, where competition is imperfect; information unevenly distributed; opportunities to acquire education and skills unequal; and since many such imperfect conditions exist in virtually every market, there is in fact little presumption that markets are in general efficient. It implies that there is an vast potential role for government to correct these market failures.

Taxes

Another cause is the rate at which income is taxed coupled with the progressivity of tax system. A progressive tax is a tax by which tax rate increases as the taxable base amount increases. In a progressive tax system, level of the top tax rate will often have a direct impact on the level of inequality within a society, either increasing it or decreasing it, provided that

NOTES

income does not change as a consequence of change in tax regime. Additionally, steeper tax progressivity applied to social spending can result in a more equal distribution of income across the board. Difference between the Gini index for an income distribution before taxation and the Gini index after taxation is an distinct indicator for the effects of such taxation.

Education

One prominent factor in the creation of inequality is variation in individuals' access to education. Education, in particular in an area where there is a high demand for workers, creates high wages for those with this education, increases in education first increase and then decrease growth as well as income inequality. As a result, those who are unable to afford an education or choose not to pursue optional education, generally receive much lower wages.

Deregulation and Decline of Unions

John Schmitt and Ben Zipperer (2006) of the CEPR point to economic liberalism and reduction of business regulation along with the decline of union membership as one of the causes of economic inequality. In an analysis of the effects of intensive Anglo-American neoliberal policies in comparison to continental European neoliberalism, where unions have remained strong, they believed that, the US economic and social model is associated with substantial levels of social exclusion, including high levels of income inequality, high relative and absolute poverty rates, poor and unequal educational outcomes, poor health outcomes and high rates of crime and incarceration.

Globalization

Trade liberalization may shift economic inequality from a global to a domestic scale. When rich countries trade with poor countries, the low-skilled workers in the rich countries may find reduced wages due to competition, while low-skilled workers in the poor nations may see increased wages. Trade economist Paul Krugman estimates that trade liberalization has had a measurable effect on the rising inequality in the United States. He attributes this trend to increased trade with poor nations and the fragmentation of the means of production, causing low skilled jobs becoming more tradeable. However, he concedes that effect of trade on inequality in America is minor while compared to other causes like technological innovation, a view shared by other experts.

Gender

In many countries, there is a gender income gap that favours males in the labour market. For instance, the median full-time salary for US women is 77 percent of that of US men. Several factors other than discrimination may contribute to this gap. On average, women are more likely than men to consider factors other than pay while looking for work and may be less willing to travel or relocate.

Economic Development

Economist Simon Kuznets stated that levels of economic inequality are in large part the result of stages of development. According to Kuznets, countries with low levels of development have relatively equal distributions of wealth. As any country develops, it acquires more capital, that leads to the owners of this capital having more wealth and income and introducing inequality. Eventually, by various possible redistribution mechanisms like social welfare programmes, more developed countries move back to lower levels of inequality.

NOTES

Individual Preferences

Related to cultural issues, diversity of preferences within a community may contribute to economic inequality. When faced with the choice between working harder to earn more money or enjoying more leisure time, equally capable individuals with identical earning potential may choose different strategies.

Wealth Concentration

Wealth concentration is a theoretical process by which, under certain conditions, newly created wealth concentrates in the possession of already wealthy individuals or entities. According to this theory, those who already hold wealth have the means to invest in new sources of creating wealth or to otherwise leverage the accumulation of wealth, therefore are the beneficiaries of the new wealth.

Rent Seeking

Economist Joseph Stiglitz argues that rather than explaining concentrations of wealth and income, market forces should serve as a brake on such concentration, that may better be explained by the non-market force known as rent-seeking. While the market will bid up compensation for rare and desired skills to reward wealth creation, greater productivity, etc., it will also prevent successful entrepreneurs to earn excess profits by fostering competition to cut prices, profits and large compensation.

Finance Industry

Jamie Galbraith argues that nations with larger financial sectors have greater inequality and the link is not an accident.

Mitigating Factors

Countries with a left-leaning legislature have lower levels of inequality. Many factors constrain economic inequality – they may be divided into two classes, i.e., government sponsored and market-driven. Relative merits and effectiveness of each approach is a subject of debate.

Typical government initiatives to reduce economic inequality include:

Public Education

It implies increasing supply of skilled labour and decreasing income inequality due to education differentials. Progressive taxation, i.e., the rich are taxed proportionally more than the poor, reducing the amount of income inequality in society, if the change in taxation does not cause changes in income. Market forces outside of government intervention that can reduce economic inequality include:

Effects

Effects of inequality researchers have found include – higher rates of health and social problems and lower rates of social goods, a lower level of economic utility in society from resources devoted on high-end consumption and even a lower level of economic growth when human capital is neglected for high-end consumption. 2013 Economics Nobel Prize winner Robert J. Shiller said that increasing inequality in the United States and elsewhere is the most important problem. Increasing inequality harms economic growth. High and persistent unemployment, in which inequality increases, has a negative effect on subsequent long-run economic growth.

NOTES

Health and Social Cohesion

British researchers Richards G. Wilkinson and Kate Pickett have found higher rates of health and social problems (obesity, mental illness, homicides, teenage births, incarceration, child conflict, drug use) and lower rates of social goods (i.e., life expectancy by country, educational performance, trust among strangers, women's status, social mobility even numbers of patents issued) in countries and states with higher inequality.

In recent years, the characteristic that has strongly correlated with health in developed nation is income inequality. Creating an index of Health and Social Problems from nine factors, authors Richard Wilkinson and Kate Pickett found health and social problems more common in countries with bigger income inequalities and more common among states in the US with larger income inequalities. Other studies have confirmed this relationship. The UNICEF index of child well-being in rich countries, studying 40 indicators in 22 countries, correlates with greater equality but not per capita income. Pickett and Wilkinson argue that inequality and social stratification lead to higher levels of psychosocial stress and status anxiety which can lead to depression, chemical dependency, less community life, parenting problems and stress-related diseases.

Social Cohesion

Research has shown an inverse link between income inequality and social cohesion. In more equal societies, people are much more likely to trust each other, measures of social capital (the benefits of goodwill, fellowship, mutual sympathy and social connectedness among groups who make up a social units) suggest greater community involvement and homicide rates are consistently lower.

Crime

Crime rate has also been shown to be correlated with inequality in society. Most studies looking into the relationship have concentrated on homicides – since homicides are almost identically defined across all nations and jurisdictions. There have been over fifty studies depicting tendencies for violence to be more common in societies where income differences are larger. Research has been undertaken comparing developed countries with that of undeveloped nations as well as studying areas within countries.

Social, Cultural, and Civic Participation

Higher income inequality led to less of all forms of social, cultural, and civic participation among the less wealthy. When inequality is higher, the poor do not shift to less expensive forms of participation.

Utility, Economic Welfare, and Distributive Efficiency

Following the utilitarian principle of seeking the greatest good for the greatest number economic inequality is problematic. A house that provides less utility to a millionaire as a summer home than it would to a homeless family of five, is an instance of reduced distributive efficiency within society, that decreases marginal utility of wealth and thus the sum total of personal utility. An additional dollar spent by a poor person will go to things providing a great deal of utility to that person, such as basic necessities like food, water, and healthcare while an additional dollar spent by a much richer person will very likely go to luxury items that provides relatively less utility to that person. Therefore, the marginal utility of wealth per person (additional dollar) decreases as a person becomes richer. From this standpoint, for any given amount of wealth in a society, a society with more equality will have higher aggregate utility. Few studies have found evidence for this theory, noting

NOTES

that in societies where inequality is lower, population-wide satisfaction and happiness tend to be higher.

Aggregate Demand, Consumption and Debt

Income inequality lowers aggregate demand, leading to increasingly large segments of formerly middle class consumers unable to afford as many luxury and essential goods and services. It pushes production and overall employment down. Conservative researchers have argued that income inequality is not significant because consumption, rather than income should be the measure of inequality, and inequality of consumption is less extreme than inequality of income in the US.

Monopolization of Labour, Consolidation, and Competition

Greater income inequality can lead to monopolization of the labour force, resulting in fewer employers requiring fewer workers. Remaining employers can consolidate and take advantage of the relative lack of competition, leads to less consumer choice, market abuses, and relatively higher real prices.

Economic Incentives

Some modern economic theories, such as the neoclassical school, have opined that a functioning economy entails a certain level of unemployment. These theories argue that unemployment benefits must be below the wage level to provide an incentive to work, thereby mandating inequality. Such theories state additionally that the unemployment rate cannot reduce to zero. Many economists believe that one of the main reasons that inequality might induce economic incentive is because material well-being and conspicuous consumption relate to status. In this view, high stratification of income (high inequality) creates high amounts of social stratification, leads to greater competition for status.

Economic Growth

During 1960s, economist Arthur Melvin Okun argued that there was a "trade-off" between economic growth and equality. Pursuing equality could reduce efficiency the total output produced with given resources by reducing incentives to work, save, and invest and through the "leaky bucket" of wasteful government efforts to redistribute such as a progressive tax code and minimum wages. Some resources will simply disappear in transit, so the poor will not receive all the money that is taken from the rich. Along the same lines, earlier writers had argued that wealthier individuals save proportionally more of their incomes, so that more inequality would lead to higher overall savings and therefore capital accumulation and growth.

Cross-country Evidence

Many authors have empirically examined the relationship between economic growth and income inequality in a large group of countries. Following the broader economic growth literature, the typical approach was to relate countries' real GDP per capita growth over a long period of time to the income distribution at the start of the period, simultaneously taking into consideration other standard determinants like initial level of real GDP per capita. A typical conclusion was that more unequal countries tend to grow slower though the evidence was contested.

Mechanisms

According to economist Branko Milanovic, while traditionally economists thought inequality was good for growth, the view that income inequality harms growth or that improved equality can help sustain growth – has become more widely held in recent years. Major reason for this shift is the increasing importance of human capital in development. The credit market imperfection approach, developed by Galor and Zeira (1993), demonstrates that inequality in the presence of credit market imperfections has a long lasting detrimental impact on human capital formation as well as economic development.

The political economy approach, developed by Alesian and Rodrik (1994) and Persson and Tabellini (1994), argues that inequality is harmful for economic development because inequality generates a pressure to adopt redistributive policies that have an adverse effect on investment and economic growth.

Housing

A number of researchers such as David Rodda, Jacob Vigdor argue that shortage of affordable housing is caused in part by income inequality. David Rodda noted that from 1984 and 1991, the number of quality rental units decreased as the demand for higher quality housing increased.

Aspirational Consumption and Household Risk

Firstly, certain costs are difficult to avoid and are shared by everyone like costs of housing, pensions, education and health care. If the state does not provide these services, then for those on lower incomes, costs must be borrowed and often those on lower incomes are those who are worse equipped to manage their finances. Secondly, aspirational consumption describes the process of middle income earners aspiring to achieve the standards of living enjoyed by their wealthier counterparts and one method of achieving this aspiration is by taking on debt. Thus, the result leads to even greater inequality and potential economic instability.

Poverty

Oxfam asserts that worsening inequality is impeding the fight against global poverty. A 2013 report from the group stated that the $240 billion added to the fortunes of the world's richest billionaires in 2012 was enough to end extreme poverty four times over.

Perspectives

Neoclassical economics views inequalities in the distribution of income as arising from differences in productivity and attribute rising inequality to rising differences in the productivity of different groups of workers. In this perspective, wages and profits are determined by marginal productivity of each individual in the economy. Therefore, rising inequalities are merely a reflection of the productivity gap between highly paid professions and lower-paid professions.

Socialism and Marxism

Socialists attribute the vast disparities in wealth and income to the private ownership of the means of production by a class of owners, resulting in a situation where a small portion of the population receives unearned income in the form of property income by virtue of ownership titles in capital equipment, financial assets and corporate stock. In contrast, vast majority of population is dependent on income in the form of a wage or salary. To rectify this situation, socialists argue that the means of production should be publicly owned, so that income differentials would be reflective of individual contribution to the social product.

In Marxist economic analysis and Marxian economics, rising income inequality is structural to capitalism. In this analysis, capitalist firms increasingly substitute workers for capital equipment under competitive pressures to reduce costs and maximize profit. Over the

NOTES

long term, this trend increases the organic composition of capital, meaning that less labour inputs (i.e.,workers) are required in proportion to capital inputs, increasing unemployment and increasing the size of the reserve army of labour. This process exerts a downward pressure on wages.

Meritocracy

Meritocracy favours an eventual society where an individual's success is a direct function of his merit, or contribution. Economic inequality would be a natural consequence of the wide range in individual skill, talent and effort in human population.

Liberal Perspectives

Most modern social liberals, including centrist or left-of-center political groups, believe that the capitalist economic system should be fundamentally preserved, but the status quo regarding the income gap must be reformed. Social liberals favour a capitalist system with active Keynesian economics macroeconomic policies, neoliberalism and progressive taxation to even out differences in income inequality.

Social Justice Arguments

Patrick Diamond and Anthony Giddens (Professors of Economics and Sociology, respectively) hold that 'pure meritocracy is incoherent because, without redistribution, one generation's successful individuals would become the next generation's embedded caste, hoarding the wealth they had accumulated'.

They also state that social justice requires redistribution of high incomes and large concentrations of wealth in a way that spreads it more widely, in order to recognize the contribution made by all sections of the community to building the nation's wealth.

Affects on Social Welfare

In most western democracies, the desire to eliminate or reduce economic inequality is generally associated with the political left. One practical argument in favour of reduction is the idea that economic inequality reduces social cohesion and increases social unrest, thereby weakening the society.

It has also been argued that economic inequality invariably translates to political inequality, which further aggravates the problem. Even in cases where an increase in economic inequality makes nobody economically poorer, an increased inequality of resources is disadvantageous, as increased economic inequality can lead to a power shift due to an increased inequality in the ability to participate in democratic processes.

Capabilities Approach

The capabilities approach – sometimes called the human development approach – looks at income inequality and poverty as form of "capability deprivation". Unlike neoliberalism, that defines well-being as utility maximization, economic growth and income are considered a means to an end rather than the end itself. Its goal is to widen people's choices and the level of their achieved well-being through increasing functioning, capabilities and agency, i.e., the ability to pursue valued goals.

Policy Responses Intended to Mitigate

Progressive taxation reduces absolute income inequality when the higher rates on higher-income individuals are paid and not evaded and transfer payments and social safety nets result in progressive government spending. Wage ratio legislation has also been

NOTES

proposed as a means of reducing income inequality. The OECD asserts that public spending is vital in reducing the ever expanding wealth gap.

3.3 AGGREGATE EXPENDITURE

In economics, Aggregate Expenditure is a measure of national income. Aggregate Expenditure is defined as the current value of all the finished goods and services in the economy. The aggregate expenditure is, thus, the sum total of all the expenditures undertaken in the economy by the factors during a given time period. It refers to the expenditure incurred on consumer goods, planned investment and the expenditure made by the government in the economy. In an open economy scenario, the aggregate expenditure also includes the difference between the exports and the imports.

Aggregate Expenditures (AE) = $C + I_p + I_u + G + X_n$

where, C = Household Consumption

I_p = Planned Investment

I_u = Unplanned Investment

G = Government spending

X_n = Net Exports (Exports – Imports)

Components of AE

Various school of thoughts use various components to come up with the Aggregate Expenditure. The major school of economic thoughts which are the classical and Keynesian economists use the following components:

Consumption Expenditure (C)

Consumption refers to the household consumption over a given period of time. The total household consumption can be divided into two parts, they are: Autonomous Consumption and Induced consumption. Autonomous Consumption refers to the amount of consumption regardless of the amount of income. Hence, even if the income is zero, the autonomous consumption would be the total consumption. Induced Consumption refers to the level of consumption dependent on the level of income.

Y = Income

Investment (I)

Investment is the amount of expenditure towards the capital goods. Investment refers to the expenditure towards goods that are expected to yield a return or increase their own value over time. The investment expenditure can be further divided into two parts, planned investment and unplanned investment. Over the long run, the sum of differences in the unplanned investment would equal to zero as economy approaches equilibrium.

Government Expenditure (G)

The Keynesian model propagates an active state to control and regulate the economy. The government can make expenditure in terms of infrastructure or through transfers and thus increase the total expenditure in the economy as advocated by Keynes.

Net Exports (NX)

In an open economy, the total expenditure of the economy also includes the components of the net exports which is the total exports minus the total imports.

NOTES

Classical Economics

Classical economists relied on the Say's law which states that supply creates its own demand, which stemmed from the belief that wages, prices and interest rates are all flexible. This comes from the classical thought that the factor payments which are made to the various factors of production during the production process, would create enough income in the economy to create a demand for the products produced.

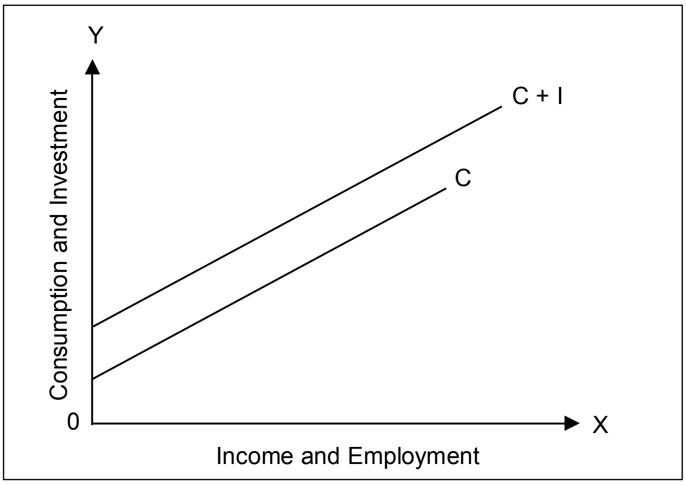


Figure 3.1: Classical Aggregate Expenditure

This supports the classical thought which revolves around Adam Smith's invisible hand which states that the markets would achieve equilibrium via the market forces that impact economic activity and thus there is no need for government intervention. Moreover, the classical economists believed that the economy was operating at a full employment. Hence, the classical Aggregate expenditure model can be expressed as

Aggregate Expenditure = Aggregate Consumption + Planned Investment

Therefore, AE = C + I

where, C = Consumption Expenditure

I = Aggregate Investment (Savings = Investment)

Classical economics has been criticized for its assumptions that the economy works on a full-employment equilibrium which is a false assumption as in reality, the economy operates at an under-employment equilibrium which provides the foundation for the Keynesian model of Aggregate Expenditure.

Keynesian Economics

Keynesian Economics believes, contrary to the classical thought that the Wages, Prices and interest rates are not flexible and hence violating Say's Law, which provided the foundation for the maxim that "supply creates its own demand". Keynes believed that the economy was subject to Sticky Prices and thus the economy was not in a state of perpetual equilibrium and also operated at an under-employment equilibrium.

NOTES

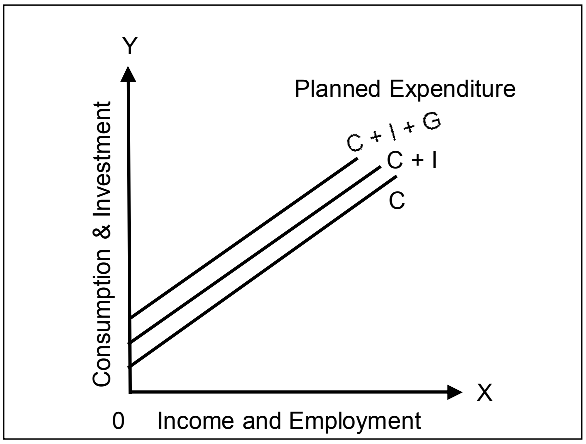


Figure 3.2: Keynesian Aggregate Expenditure

Keynesian economics calls for a government intervention and is called demand side economics as it believes that aggregate demand and not the aggregate supply determines the GDP because of the difference between the Aggregate Supply and Planned expenditure in an economy. Hence, Keynes believed that the government played an important role in the determination on the Aggregate Expenditure in an economy and was thus included Government Expenditure in the Aggregate Expenditure Function.

Hence,

AE = C + I + G + NX

where, C = Household Consumption Expenditure

I = Investment (Planned)

G = Government Expenditure

NX = Net Exports (Exports – Imports)

Keynesian economics preaches that in times of a recession, the government must undertake the expenditure to compensate for the lack in the components of household expenditure (C) and private investment (I) so as to ensure that the demand is maintained in the markets. This also leads to the Keynesian Multiplier which suggests that every dollar spent on investment creates a multiplier effect and leads to an increased expenditure of more than one dollar.

Aggregate Expenditure and Aggregate Supply

An economy is said to be in an equilibrium when aggregate expenditure is equal to the aggregate supply (production) in the economy. According to Keynes, the economy does not stay in a perpetual state of equilibrium but the Aggregate expenditure and Aggregate Supply adjust each other towards equilibrium. When there is an excess supply over the expenditure there is an inventory leftover with the producers, which leads to a reduction in either the prices or the quantity of output and hence reducing the total output (GDP) of the economy. On the other hand, if there is an excess of expenditure over supply, then there is excess demand leading to an increase in prices or output. Hence, the economy constantly keeps shifting between excess supply (inventory) and excess demand. Thus, the economy is constantly moving towards an equilibrium between the aggregate expenditure and aggregate supply. In an under-employment equilibrium, the Keynesian Cross refers to the point of intersection of the Aggregate Supply and the Aggregate Expenditure curve. The rise in the expenditure by either Consumption (C), Investment (I) or the Government (G) or an increase

NOTES

in the exports or a decrease in the imports leads to a rise in the aggregate expenditure and thus pushes the economy towards a higher equilibrium and thus reaching a higher level towards the potential of the GDP as shown in Figure 3.3.

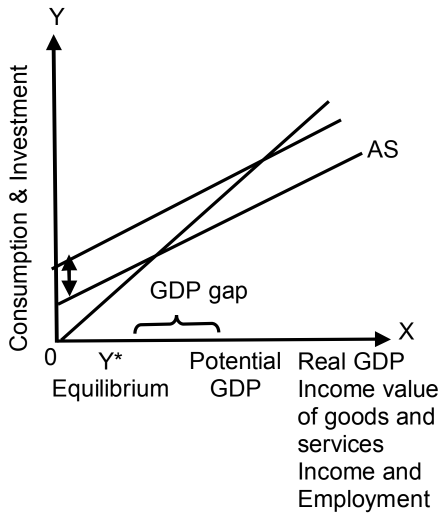


Figure 3.3: Effect of Increase in Expenditure

3.4 ECONOMIC GROWTH

Economic growth is the key to a higher standard of living. Redistribution of income will improve welfare of poor at the expense of those better off and it will be a gain once and for all. Due to the significance of this growth rate, every country is making its best efforts to maximize its growth rate. Here, we shall analyze the sources of growth and through them try to explain as to why the income levels and growth rates vary across nations during a given period and over time in a particular country. The concept of growth may be explained through the economists' tool of the production possibility curve as in Figure 3.4.

In economics, a production-possibility frontier (PPF), sometimes called a production-possibility curve, production-possibility boundary or product transformation curve, is a graph that represents production trade offs of an economy given fixed resources. The graph represents various combinations of quantities of two commodities an economy can produce (e.g., number of automobile vs quantities of cement produced) using a fixed amount of each of the factors of production. Graphically bounding the production set for fixed input quantities, PPF curve indicates maximum possible production level of one commodity for any given production level of the other, given the existing state of technology. By doing so, it defines productive efficiency in the context of that production set, i.e., a point on the frontier indicates efficient use of the available inputs, while a point beneath the curve indicates inefficiency. Here, period of time is specified along with production technologies and quantity of available inputs. Thus, the commodities compared can either be goods or services.

Efficiency: A PPF typically takes the form of the curve on the right. An economy that is operating on the PPF is said to be efficient, meaning that it would be impossible to produce more of one good without decreasing production of the other good. In contrast, if an economy is operating below the curve, it is said to be operating inefficiently as it could reallocate resources to produce more of both goods as shown in Figure 3.4.

NOTES

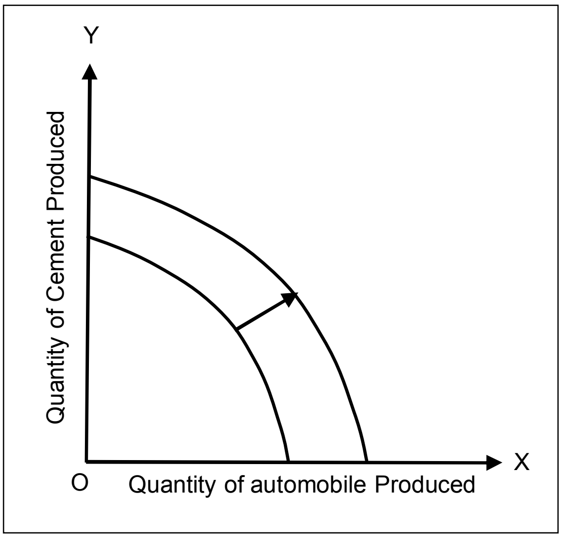


Figure 3.4: Production Possibility Curve (PPC)

Differences between Economic Growth and Economic Development

Growth and development are often used synonymously in economic discussion. But question is — What is economic growth? What is economic development? Thus, before explaining in detail about economic growth in this chapter, let us first of all clear the basic concept of this two important terms here.

Economic Growth: Economic growth is a long-term process involving a period of many decades. Economic growth is accompanied by substantial rise both in the total population as well as real national income. In other words, Economic Growth implies transformation of an economy from a state of underdevelopment to a state of development, from an agrarian to a highly industrialized society, from a low saver to a high saver and from a predominantly rural to a highly urbanized society.

Economic Development: The term economic development is a process whereby an economy's real national income increases over a long period of time. Alternatively, the term economic development may be defined with reference to a set of criteria or values or desired conditions in society. So, economic development is a normative concept. Let us study point wise distinctions between economic growth and economic development in a tabular form as hereunder:

Basis	Economic Growth	Economic Development
1. Applicability	Economic growth refers to the problems of developed countries.	Economic development refers to the problems of underdeveloped countries.
2. Maddision View	Raising of income levels is called as economic growth in rich countries.	Raising of income levels is called as economic development in poor countries.
3. Schumpeter View	Growth is a gradual and steady change in the long run which comes about by a gradual increase in the rate of savings and population.	Development is a discontinuous and spontaneous change in the stationary state.
4. Kindleberger View	Economic growth implies more output.	Economic development implies both more output and changes in the technical as well as institutional arrangements by which it is produced and distributed.

NOTES

5. **Basic Strategy**	Growth may well involve not only more output derived from greater amounts of inputs but also greater efficiency.	Development goes beyond this to imply changes in the composition of output and in the allocation of inputs by sectors.
6. **Friedman's View**	Growth as an expansion of the system in one or more dimensions without a change in its structure.	Development as an innovative process leading to the structural transformation of social system.
7. **Conceptual Difference**	Economic growth is related to a quantitative sustained increase in the country's per capita output or income accompanied by expansion in its labour force, consumption, capital and volume of trade.	Economic development is related to qualitative changes in economic wants, goods, incentives and institutions. It describes underlying determinants of growth like technological and structural changes. Development embraces both growth and decline.

Factors Affecting Economic Growth

The primary driving force of economic growth is the growth of productivity, which is the ratio of economic output to inputs such as capital, labour, energy, materials and business services. Increase in productivity lower the cost of goods, which is called a shift in supply.

Demographic factors influence growth by changing the employment to population ratio and the labour force participation rate. Because of their spending patterns, the working age population is an important source of aggregate demand. Other factors affecting economic growth include the quantity and quality of available natural resources, including land.

Measuring Economic Growth

Measures of national income and output: Variety of measures of national income and output are used in economics to estimate total economic activity in a country or region, including gross domestic product (GDP), gross national product (GNP), net national income (NNI), and adjusted national income (NNI adjusted for natural resource depletion).

National accounts: National accounts or national account systems (NAS) are implementation of complete and consistent accounting techniques for measuring economic activity of a nation, which include detailed underlying measures that rely on double-entry accounting.

Economic Growth versus the Business Cycle

Economists differentiate between short-run economic changes in production and long-run economic growth. Short-run variation in economic growth is known as business cycle. Business cycle is made up of booms and drops in production that takes place over a period of months or even years. Usually, economists attribute the ups and downs in the business cycle to fluctuations in aggregate demand.

In contrast, the topic of economic growth is concerned with the long-run trend in production due to structural causes like technological growth and factor accumulation. Business cycle moves up and down, creates fluctuations around the long-run trend in economic growth.

Theories and Models of Economic Growth

Classical Growth Theory: In classical (Ricardian) economics, the theory of production and the theory of growth are based upon the theory (law) of variable proportions — where raising either of the factors of production, i.e., labour or capital, while holding the other factors constant and further assuming no technological change will raise output but definitely at a diminishing rate, that eventually will become zero.

Criticisms of Classical Growth Theory: Criticisms of classical growth theory are that technology, the most important factor in economic growth, is held constant and that economies of scale are ignored.

The Neoclassical Growth Model: The idea of growth as increased stocks of capital goods was codified as the Solow-Swan Growth Model, which involved a series of equations that showed the relationship between labour-time, capital goods, output as well as investment. According to this view, role of technological change became crucial, even more important than that of accumulation of capital. This model, developed by Robert Solow and Trevor Swan in the 1950s, was the first attempt to model long-run growth analytically.

Criticisms: Criticisms of the neoclassical growth model are that: (1) it does not account for differing rates of return for different capital investments and (2) increasing capital creates a growing burden of depreciation. It is also observed that the economic life of capital assets has been declining.

Endogenous Growth Theory: Growth theory advanced again with theories of economist Paul Romer and Robert Lucas Jr. in the late 1980s and early 1990s. Unsatisfied with Solow's explanation, economists worked to 'endogenize' technology in the 1980s and developed the endogenous growth theory which includes a mathematical explanation of technological advancement. This model also incorporated a new concept of human capital, skills as well as knowledge that make workers productive.

Energy and Energy Efficiency Theories: There are several energy theories of economic growth. Energy economic theories recognize that energy consumption as well as energy efficiency were important historical causes of economic growth and at the same time energy consumption remains highly correlated with economic growth. Various ways in which energy efficiency were increased included are hereunder:

1. Increased efficiency of conversion of heat to work, as in more efficient steam engines, the steam turbine and the combined cycle of a gas turbine and steam turbine.
2. Reduction of friction including rail roads and hard surfaced roads, anti-friction bearings and petroleum and synthetic lubricants.
3. Electricity as a means for transmission of power and used by efficient electric motors.
4. Efficient processes for making basic materials like steel (Bessemer process, open hearth furnace, basic oxygen steelmaking), ammonia (Haber process), Solway process for soda ash, fractional distillation.
5. The reuse of heat in industrial processes. Important instances include hot blast, the Siemens-Martin furnace and widespread use of heat exchangers and other means of reusing or efficiently using heat in industrial processes such as refineries, pulp and paper mills, cement kilns and various chemical processes.

Unified Growth Theory: Unified growth theory was developed by Oded Galor and his co-authors to address inability of endogenous growth theory to explain key empirical regularities in the growth processes of individual economies and the world economy as a whole.

Unified growth theories are endogenous growth theories — those are consistent with the entire process of development, and in particular the transition from the epoch of

NOTES

Malthusian stagnation that had characterized most of the process of development to that of contemporary era of sustained economic growth.

The Big Push: In the theories of economic growth, the mechanisms that let it takes place and its major determinants are abundant. One most popular theory in the 1940s was that of the Big push, which suggested that countries needed to jump from one stage of development to another through a virtuous cycle, where large investments in infrastructure and education coupled with private investments would move the economy to a more productive stage, by breaking free from economic paradigms appropriate to a lower productivity stage.

Schumpeterian Growth: Schumpeterian growth is an economic theory named after the 20th century Austrian economist Joseph Schumpeter. Unlike other economic growth theories, his approach explains growth by innovation as a process of creative destruction that captures the dual nature of technological progress.

The Post-Keynesian Model of Economic Growth

A common feature of the Post-Keynesian growth models (PKGM) is that they assume the existence of independent investment function, a heritage from Keynes and saving functions which depends in income distribution, i.e., a Kaldorian approach.

The Post-Keynesian growth model has passed by main principle phases that are labelled by means of generations. Major assumptions that are behind this model were – while the economy is closed and produces only one good, i.e., both consumption and capital good. As the technology is of fixed coefficients and constant returns to scale is assumed. Further, there is no government and also the monetary side is ignored. Besides, all firms are equal.

First Generation Model: The model of the first generation is due to Kaldor (1956) and Robinson (1956, 1962). Though there are certain differences between the approaches developed by these authors, yet the core of the model may be described as follows. It is assumed that workers do not save and that the economy operates at full capacity or at a constant level of capacity utilization. Growth rate of investment g_i can be expressed by:

$$g_I = g_0 + \alpha r \qquad ..... (1)$$

where α measures influence of investment to the interest rate, r and g_0 stands for growth rate of autonomous investment. By using the formula $r = \pi u$, where π is the profit share and u measures the capacity utilization expression (1) may be rewritten as:

$$g_I = g_0 + \alpha\pi u \qquad ..... (1a)$$

Growth rate of savings g_s is given by the Cambridge equation:

$$g_s = sr \qquad ..... (2)$$

where s is saving propensity with $0 \leq s \leq 1$. By equalizing (1a) to (2) and after necessary algebraic manipulation, we get rate of profit as:

$$r^* \ \frac{g_0}{s-} \qquad ..... (3)$$

Point is to noted here that, necessary condition to obtain positive profit is $s > \alpha$, which states that savings are more sensitive to income than investment. By replacing it into expression (1) or (2), we conclude that the balanced growth rate can be expressed as:

$$g^* \ \frac{Sg_0}{s-} \qquad ..... (4)$$

From expressions (3), we get an inverse relationship between the rate of profit and the rate of accumulation of capital:

NOTES

$$\frac{\delta r^*}{\delta s} = \frac{g_0}{s-\alpha} < 0 \qquad \text{..... (3a)}$$

Again, from expression (4), we also get an inverse relationship between growth rate and the saving rate:

$$\frac{\delta g^*}{\delta s} = \frac{g_0 \alpha}{(s-\alpha)^2} < 0 \qquad \text{..... (4a)}$$

Expressions (3a) and (4a) indicate that higher savings propensities implies both lower growth rates and smaller profitability. These two results indicate that being the economy at its production possibility frontier there is a trade-off between wages and profits.

Second Generation: The Neo-Kaleckian Model [Dutt (1984) and Rowthorn (1982)]: Now, as we know that capacity utilization is an endogenous variable that can be different from the full capacity utilization, it gives rise to the main difference in relation to the first generation model, i.e., the variable that measures the capacity utilization that enters the equation of growth rate of investment (Steindl, 1952) according to the expression as follows:

$$g_I = g_0 + \alpha r + \beta u = g_0 + \alpha \pi u + \beta_u \qquad \text{..... (5)}$$

where β measures the sensibility of the growth rate of investment to the capacity utilization and captures the accelerator effect, i.e., high utilization induces firms to expand its capacity more quickly so as to keep up with anticipated demand. Growth rate of savings is also given by the Cambridge Equation where workers do not save.

$$g_s = sr \qquad \text{..... (6)}$$

By equalizing (6) to (7) after algebraic computation that the rate of capacity utilization is given by:

$$u^* = \frac{g_0}{\pi(s-\alpha)-\beta} \qquad \text{..... (7)}$$

Now, by replacing expression (7) into relation $r = \pi u$, we can say that the rate of profit can be expressed as:

$$r^* = \frac{g_0}{\pi(s-\alpha)-\beta} \qquad \text{..... (8)}$$

and the balanced growth rate can be expressed as:

$$g^* = \frac{g_0}{\pi(s-\alpha)-\beta} \qquad \text{..... (9)}$$

Now, by taking the derivative of expression (8) in relation to π, we get:

$$\frac{r^*}{\pi} = \frac{g_0}{[\pi(s-\alpha)-\beta]^2} \quad 0 \qquad \text{..... (10)}$$

It indicates that a redistribution of income towards wages may result towards wages may result in a higher rate of capacity utilization as explained by Blecker (1989) and subsequently known as the stagnationist view.

Third Generation [Bhaduri and Marglin (1990)]: Investment function now consists of an autonomous part and thereby reacts positively to profits and capacity utilization, being the profit share used as a measure of profitability, i.e.,

$$g_I = g_0 + \alpha\pi + \beta u \qquad \text{..... (11)}$$

According to Bhaduri and Marglin, influence of existing capacity on investment can not be captured satisfactorily by simply introducing a term for capacity utilization. Investment function should also consider profit share and capacity utilization as independent

NOTES

and separate variables in the lines as shown by expression (11). Growth rate of savings is given by the Cambridge Equation. Adopting the similar procedure of earlier subsections, it is possible to establish the rate of capacity utilization, the profit rate and also the growth rate of the economy as follows—

$$u^* = \frac{g_0 + \alpha\pi}{s\pi - \beta} \qquad \text{..... (12)}$$

$$r^* = \frac{(g_0 + \alpha\pi)}{s\pi - \beta} \qquad \text{..... (13)}$$

$$g^* = \frac{s\ (g_0 + \alpha\pi)}{s\pi - \beta} \qquad \text{..... (14)}$$

Major difference in the results of the Bhaduri-Marglin (1990) and the neo-Kaleckian approach of the previous subsection is that now the derivative of the profit rate in relation to the profit share may be positive or negative as follows by the differentiation of expression (12) in relation to π.

$$\frac{\delta r^*}{\delta\pi} = \frac{-\beta u^*}{s\pi - \beta} < \text{or} > 0 \qquad \text{..... (15)}$$

Any increase in the profit share will decrease capacity utilization but its effects on the growth rate of capital stock is ambiguous. There may be a positive capacity effect as well as a negative profit share effect on investment. Therefore, two regimes are possible depending upon the relative magnitudes of capacity utilization and profit share effects in the investment function. So, if the profit effect is stronger than that of capacity effect, in that case the growth is profit led. On contrary, we have a wage led regime.

A Multi-sector Version of the Post-Keynesian Model of Economic Growth: The Pasinetti's model of structural change and economic dynamics is carried out, not in terms of input-output relations, as in the multi-sector models, instead in terms of vertically integrated sectors. This device is used to focus on final commodities rather than on industries.

In case of a multi-sectoral version of the Post-Keynesian growth model, let us consider that X_i denotes the domestic physical quantity produced of consumption good i and X_n represents the quantity of labour in all internal production activities; per capita demand of consumption goods is represented by a set of consumption coefficients, i.e., a_{in}. The former refers to domestic and the latter to foreign demand. Similarly, a_{kin} stands for the investment coefficients of capital goods ki. Thus, the production coefficients of consumption and capital goods are respectively a_{ni} and a_{nki}. The family sector is denoted by n. The physical system may be expressed as:

$$X_i - a_{in} X_n = 0$$

$$X_{ki} - a_{ki,n} X_n = 0 \qquad \text{..... (16)}$$

$$X_n - \sum_{i=1}^{n-1} a_{ni} X_i - \sum_{i-1}^{n-1} a_{nki} X_{ki} = 0$$

Sufficient condition to ensure non-trivial solutions of the system for physical quantities is:

$$\sum_{i=1}^{n-1} a_{in}\, a_{ni} + a_{ki,n} a_{nki} = 1 \qquad \text{..... (17)}$$

This is also a condition for full employment of the labour force. The solution of the system for physical quantities may be expressed as:

$$X_i = a_{in} X_n$$

NOTES

$$X_{ki} = a_{ki,n} X_n \qquad ..... (18)$$

Considering that pi is price of commodity i (i = 1, 2, ..., n – 1) and w is wage rate (uniform), the monetary system may be written as:

$$P_i - a_{ni}w - r_i p_{ki} = 0$$

$$p_{ki} - a_{nki}w = 0$$

$$W + \sum_{i=1}^{n-1} (a_{in} p_{ki} r_i - a_{in} p_i - a_{ki,n} P_{ki}) = 0 \qquad ..... (19)$$

The set of solution for prices may be expressed as:

$$p_i = (a_{ni} + r_i a_{nki}) w$$

$$p_{ki} = a_{nki} w \qquad ..... (20)$$

Now, if the rates of profit, r_i (i = 1, ..., n – 1) are positive and the capital intensity is different from one production process to another, relative prices of consumption goods will depend both on labour inputs and also on the rate of profit. Here, a pure labour theory of value is no longer valid, as price of commodity, i.e., depends not only upon quantities of direct and indirect labour but also on the rate of profit. Therefore, to develop a theory in terms of pure labour, Ricardo (1817) and Marx (1887) assumed a uniform organic composition of capital in a static framework and to avoid this simplification let us assume, as Pasinetti (1981) did, that the price of consumption goods are given by a mark-up rule as hereunder:

$$p_i = (1 + \tau_i) a_{ni} w \qquad ..... (21)^*$$

A possible departing point to establish a bridge between two approaches is to check the validity of relationship r = πu in a sectoral environment. From the first expression of system (19), we get:

$$X_i p_i - a_{ni} w X_i = r_i p_{ki} Ki \qquad ..... (22)$$

where, right hand side is nothing but the profit, i.e., $\pi = r_i p_{ki} K_i$. Thus, above expression (22) may be rewritten as:

$$\pi_i = X_i p_I - a_{ni} w X_i \qquad ..... (23)$$

By replacing the mark-up expression into the expression above, we get:

$$\pi_i = X_i (p_i - a_{ni}w) = X_i [(1 + \tau_i) a_{ni}w - a_{ni}w] = \tau_i a_{ni} wX_i \qquad ..... (24)$$

The profit share in sector i, π_i, can be expressed as:

$$\pi_i = \frac{\pi_i}{p_i X_I} = \frac{\tau_i a_{ni} WX_i}{(1+\tau_i) a_{ni} WX_i} = \frac{\tau_i}{1+\tau_i} \qquad ..... (25)$$

Besides π = rPK, which implies, by using (25) and (24) that:

$$r_i = \frac{\pi_i}{p_i K_I} = \frac{\tau_i Wa_{ni} X_i}{piKi} = \frac{\tau_i Wa_{ni} X_i}{(1+\tau_i) Wa_{ni} K_i} = \pi_i u_i \qquad ..... (26)$$

Now, assuming that, $u_i = \frac{X_i}{K_i}$, relationship r = πu remains valid for a multi-sectoral economy but it has to take into account that π_i is the sectoral profit share and u_i is the sectoral rate of capacity utilization. Following table sums up the results obtained for a multi-sector economy:

* τ: Tau (t), conventionally denotes treatment effect.

NOTES

	Kaldor-Robinson	Neo-Kaleckian	Bhaduri- Marglin
Sectoral Growth Rate of Investment	$g^iI = g^i0 + \alpha_i r_i$	$g^iI = g^i0 + \alpha_i r_i + \beta_i u_i$	$g^iI = g^i0 + \alpha_i \pi_i + \beta_i u_i$
Sectoral Growth Rate of Savings Rate of Capacity Utilization	$g^is = s_i r_i$ $u^*_i = 1$	$g^is = s_i r_i$ $u^*i = \frac{g^i0}{\pi_i (s_i - \alpha_i) - \beta_i}$	$g^is = s_i r_i$ $u^*i = \frac{g^i0 + \alpha_i \pi_i}{S_i \pi_i - \beta_i}$
Profit Rate	$r^*_i = \frac{g^i0}{s_i - \alpha_i}$	$r^*_i = \frac{\pi_i g^i0}{\pi_i (s_i - \alpha_i) - \beta_i}$	$r^*_i = \frac{\pi_i (g^i0 + \alpha_i \pi_i)}{S_i \pi_i - \beta_i}$
Growth Rate	$g^*_i = \frac{S_i g^i0}{S_i - \alpha_i}$	$g^*_i = \frac{S_i \pi_i g^i0}{\pi_i (s_i - \alpha_i) - \beta_i}$	$g^*_i = \frac{s_i \pi_i (g^i0 + \alpha_i \pi_i)}{S_i \pi_i - \beta_i}$

The Pasinettian approach provides us with the concept of natural rate of profit, i.e., a rate of profit that must be adopted to endow each sector with the capital goods required to allow every sector to at least fulfil the demand requirements of that sector. This rate is expressed by:

$$R^*_i = n + \theta_i \qquad ..... (27)$$

where, n is growth rate of population and θ_i is growth rate of demand. As shown by Araujo and Teixeira (2003), proportionality between rate of profit to the sectoral rate of growth emerges as a natural requirement to endow the economic system with necessary productive capacity to fulfil expansion of demand. Thus, a growing economy implies a natural rate of profit. Indeed, the concept of natural rate of profit coined by Adam Smith, was reinterpreted by Pasinetti (1981, 1988). Whereas Adam Smith (1776) opines that, due to competition amongst capitalists ordinary rate of profit is during the long run remains uniform across sectors. Further, Pasinetti also postulates that there are as many natural rate of profit as there are rates of expression of demand and production of various consumption commodities.

Now, while comparing the Pasinettian solution with the solutions of the previous generations of approaches already explained above; it is important to remember that the Pasinettian model has a strong normative taste, i.e., it shows the requirements for an economic system to be in equilibrium but it does not say that this equilibrium will prevail. Here, equilibrium in every sector necessitates that $u_i = 1$. Apart from that, the capital accumulation condition requires that:

$$a_{nki} = (n + \theta_i)\, a_{ni} \qquad ..... (28)$$

Now, it is possible to determine the rate of saving that ensures that the capital accumulation condition is satisfied.

Table 3.1

	Kaldor-Robinson	Neo-Kaleckian	Bhaduri-Marglin
Saving Rates	$S_i = \frac{g^i0}{n + \theta_i} + \alpha_i$	$S_i = \frac{\beta^i}{\pi_i} + \frac{g^i0}{n + \theta_i} \alpha_i$	$S_i = \frac{\beta^i}{\pi_i} + \frac{g^i0 + \alpha_i \pi_i}{n + \theta_i} \alpha_i$

Here, saving rate in the Kaldor-Robinson model has been expressed as hereunder:

$$S_i = \frac{g^i0}{n + \theta_i} + \alpha_i \qquad ..... (29)$$

NOTES

It is a requirement since the model assumes full employment as well as full capacity utilization. Therefore, to retain the system in its equilibrium state it is required that the rate of saving by capitalists must be the one given by expression (29). Again, in the Neo-Kaleckian and the Bhaduri-Marglin version the rate of saving mentioned in Table 3.1 above are a normative criterion — as these models do not require full equilibrium.

Thus, to conclude, the key differentiation between the orthodox view and the Post-Keynesian growth models is the importance given on the supply and demand determination of economic growth.

Post-Keynesian Analysis and a Comparative Account of Development Theories (The Harrod-Domar Model – Steady States and Stability)

R.F. Harrod (1939) and E. Domar (1946) have made a distinct contribution in evolving dynamic one sector model of economic growth based on the experiences of advanced economies to suit the changing conditions of an economy. Both these models are very similar and thereby try to answer questions raised by the post-Keynesians. Domar's model is the American version of Harrod's Model and Harrod's Model is the English version of Domar's Model. Both these models are primarily addressed to an advanced capitalist economy and attempt to analyze the requirements of steady growth in such economy.

Requirement of Steady Growth: Harrod and Domar assign an important role to investment in the process of economic growth. But they lay emphasis on the dual character of investment. First of all, it creates income and secondly it arguments the productive capacity of the economy by increasing its capital stock. The former may be regarded as the demand effect and the latter the supply effect of investment. Hence, so long as the net investment is taking place, real income and output will continue to expand.

However, to maintain full employment equilibrium level of income from year to year, it is necessary that both real income and output should expand at the same rate at which productive capacity of the capital stock is expanding. This further necessitates continuous growth in real income at a rate sufficient to ensure full capacity use of a growing stock of capital. This required rate of income growth may be termed as the warranted rate of growth or the full capacity growth rate.

Assumptions: Following are the important assumptions of the Harrod-Domar Model:

1. There is an initial full employment equilibrium level of income.
2. There is the absence of government interference in functioning of the economy, i.e., policy of laissez-faire prevails.
3. These models operate in a closed economy which has no foreign trade. Thus, there are no exogenous factors or forces that influences the growth variables of the economy. Alternatively, government restrictions on trade and complications caused by international trade are ruled out.
4. There are no lags in adjustments between investment and creation of productive capacity, i.e., economic variables like savings, investment, income and expenditure adjust themselves in the same period of time. Alternatively, any change in savings brings about corresponding changes in the level of investment in the same period of time.
5. The average propensity to save is equal to the marginal propensity to save. Alternatively, APS = MPS or $S/Y = \delta S/\delta Y$. It implies that, absolute change in saving is equal to relative change in saving.

NOTES

6. The marginal propensity to save remains constant. Indeed, propensity to save and capital coefficient, i.e., capital-output ratio are constant, as the law of constant return operates in the economy.
7. The capital coefficient, i.e., the ratio of capital stock to income is assumed to possess infinite life.
8. Saving and investment relate to the income of the same year.
9. Income, investment and saving are all explained in the net sense, i.e., they are over and above depreciation. Alternatively, depreciation charges are not included in these variables.
10. There is no change in interest rates.
11. Saving and investment are equal in ex-ante and ex-post sense, i.e., there is accounting and also functional equality between saving and investment, that can be expressed as:

$$S_0 = I_0 \text{ (accounting equality)}$$
$$S_e = I_e \text{ (functional equality)}$$

Here, S_0 = Observed saving;
I_0 = Observed investment;
S_e =Expected saving;
I_e = Expected investment.

12. There is only one type of product.

Domar's Model: Prof. Evsey D. Domar of the M.I.T. (USA) has presented his model mainly in relation to the problems and experiences of industrially developed economies in his book 'Essays in the Theory of Economic Growth'. According to him, net investment has dual role, i.e., (i) it adds to production capacity and (ii) it generates income. In fact, Domar was concerned with the income growth required for fuller utilization of a growing capital stock along with the dual employment and stable prices.

Functional Relations

Demand Side or Required Increase in Aggregate Demand: Actually, Domar was emphatic about necessity of viewing growth from the demand and supply side as well. According to him, pre-Keynesian analysis emphasized the capacity, i.e., supply side of the problem and on contrary, the Keynesian approach (Keynesian multiplier) emphasized upon the demand side. As demand is itself a function in investment multiplied by the multiplier, any increase in the investment level increase national income and *vice versa*. Further, the effective demand is inversely related to Marginal Propensity to Save (MPS), i.e., any increase in MPS will reduce the level of effective demand and *vice versa*. But, Domar emphasized upon dual nature from investment (i.e., capital) point of view was more promising. In fact, investment increases the productive capacity and also generates income. It gives both sides of the equation, solution of which yields required rate of growth. Indeed, it is interesting to explain Domar's model with the help of equations used by K.K. Kurihara and thus can be expressed as:

$$Y_d = \frac{1}{\alpha} \times I \qquad \text{..... (30)}$$

where, Y_d = Level of effective demand at full employment, i.e., demand side or level of net national income
I = Net investment that results in the increase of real capital (ΔK)
α = Marginal propensity to save (reciprocal of multiplier) or 1/Multiplier

NOTES

Above equation explains: (i) level of effective demand Y_d is directly related to the level of investment I. Any increase in investment level will directly increase level of effective demand and *vice versa*. (ii) Effective demand is inversely related to the marginal propensity to save (α), i.e., any increase in MPS will decrease the level of effective demand and *vice versa.*

Supply Side: Supply is also a function of investment. Supply of output (Ys) at full employment depends on two two important factors, i.e., productive capacity of capital (σ) and amount of real capital (K). Thus, any increase or decrease in any of these two factors will increase or decrease the supply of output and thus it can be expressed as:

$$Y_s = \sigma K \qquad ..... (31)$$

where, Y_s = Level of productive capacity or supply at full employment level (supply side) or supply of output at full employment

σ = Sigma or productivity of capital or of net investment or productive capacity of capital or net potential social average productivity of investment (i.e., δY/I)

K = Real capital or amount of capital or annual rate of investment.

Therefore, if productivity of capital increases, it will favourably affect supply, as in case of effect of real capital on supply of output.

Equilibrium: To maintain equilibrium demand or supply should be equal or to maintain full employment equilibrium level of income aggregate demand should be equal to aggregate supply, i.e.,

$$Y_d = Y_s => \gamma\alpha \times I = \sigma k => I = \alpha\sigma k \qquad ..... (32)$$

This is the condition to achieve steady growth. Now let us study requisite condition to maintain this steady growth and it is possible only while investment is equated with the product of saving income ratio, capital productivity and capital stock. Now, this model requires increment to demand and supply equation and accordingly, let us make addition in both demand as well as supply equation (incremental form), i.e., 30 and 31 above and we get

$$\delta Y_d = \gamma\alpha \times \delta I \qquad ..... (33)$$

Necessary addition have been made in the level of effective demand and investment as they are variable, except α, as it is assumed constant and hence, we can express it as:

$$\delta Y_s = \sigma\delta K \qquad ..... (34)$$

where, δY_s = Change in the supply of output.

Here, change in supply of output occurs due to change in real capital, i.e., δK, whereas, productivity of capital σ remains constant. However, change in real capital is equivalent to net investment. So, by substituting value of δK in above equation (34), we get,

$$\delta Y_s = \sigma I \qquad [\because \delta K = 1] \qquad ..... (35)$$

where, Iσ = total net potential increase in output of the economy and is termed as the sigma effect.

Finally, equality between expressions (35) and (36) will gives us requisite conditions to maintain steady growth. By equating these two equations, we get:

$$\delta Y_d = \delta Y_s \quad \text{or} \quad \delta I/\alpha = \sigma I => \delta I/I = \sigma\alpha \qquad ..... (36)$$

Above expression indicates that, rate of growth of net autonomous investment, i.e., δI/I should be equivalent to product of marginal propensity to save α and productivity of capital, i.e., σ and it is inevitable for stable and steady growth of an economy. According to Kurihara, it is an increase in productive capacity, i.e., δYs because of addition of real capital δK, that must be invariably matched by an equal rise in effective demand δYd as a consequence of increase in investment δI, provided any growing economy with an expanding stock of

NOTES

capital is to maintain continuous full employment. Henceforth, inevitable as well as sufficient condition to maintain steady growth of any expanding economy is:

$$I\delta/I = \sigma\alpha \text{ or } \delta Y/Y = \sigma\alpha \qquad [\text{as, } \delta Y/Y = \delta I/I]$$

According to Meier and Baldwin, basic answer of the issue of what rate of growth is needed to maintain continuous state of full employment is that,investment as well as real income must grow at a constant annual percentage rate or else compound interest rate equal to product of the propensity to save and average productivity of investment, i.e., inverse of capital coefficient or accelerator.

Diagrammatic Presentation (Domar's Model)

Domar's model may be explained with the help of Figure 3.5.

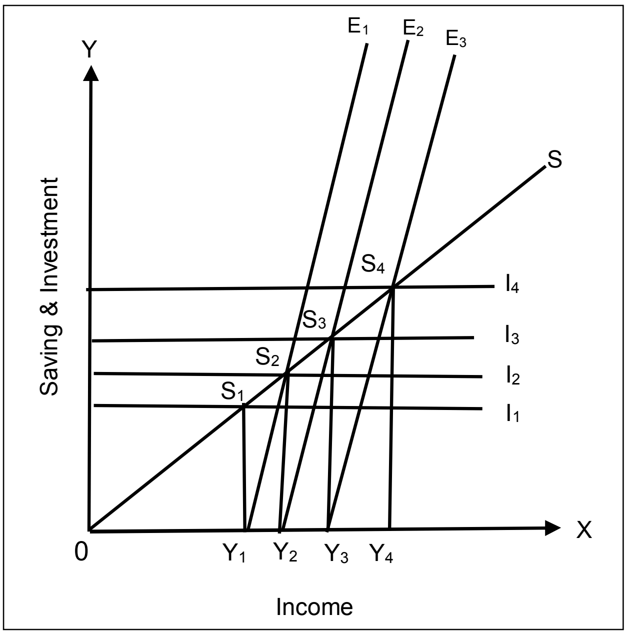


Figure 3.5: Domar's model

As shown in Figure 3.5, income is shown along X-axis and saving, investment along the Y-axis. OS indicates propensity to save. Slope of this line indicates equality between average propensity to save and marginal propensity to save. Now, suppose OY_1 is initial level of full employment. Here, I_1 is the investment, which is autonomous level of income and thus it is a straight line. Now, at full employment, S_1Y_1 is the investment level. E_1 shows the effect of this investment upon productive capacity, whose slope is the marginal output capital ratio. Now, after investing S_1Y_1 income level raised by the amount of Y_1Y_2 and here, investment is represented by I_2. If investment increases to S_2Y_2, income also raised to Y_2Y_3. As shown in Figure 3.5, steady state of full employment there occurs continuous increase in investment.

According to Prof. Domar, maintenance of a continuous state of full employment requires that investment as well as income grow at a constant annual relative rate, equal to the product of the propensity to save and revenue productivity of investment also.

Path of Disequilibrium: Now, suppose, if investment grows at a constant rate $\sigma\alpha$, productive capacity though growing continuously will be used completely. On contrary, if investment grows at a greater or lesser rate than $\sigma\alpha$, then following situations will arise:

NOTES

1. **when Iδ/I or δY/Y > σα:** Here, inflation will appear in economy because, while at higher rate of income purchasing power of people will increase that leads to expansion of demand. As a consequence thereof, it necessitates emergence of inflation, because σα, i.e., productive capacity will not cope up with that of increased income level of investment.
2. **when Iδ/I or δY/Y < σα:** Here, growth rate of income or investment, i.e., Iδ/I or δY/Y lags behind the productive capacity, i.e., σα, which will result overproduction. Lesser growth rate of income will put constraint upon purchasing power oof people. It decreases level of demand and also overproduction of goods. Therefore, to overcome such circumstances, the economy definitely under constant strain of inflation, overproduction and unemployment for maintaining stable and steady growth.

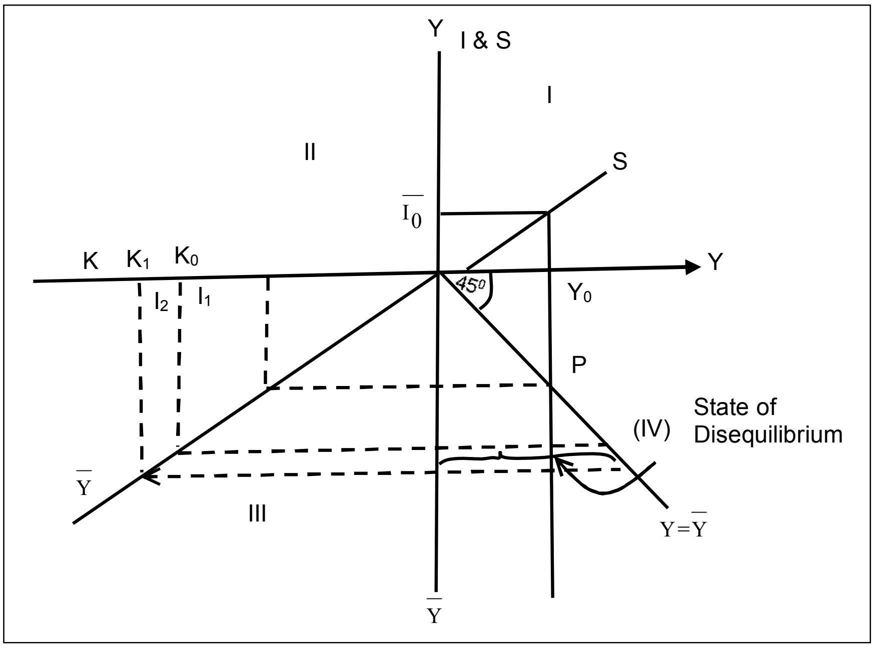


Figure 3.6: State of Disequilibrium

As shown in Figure 3.6, Income 'Y' is shown on the right side of the origin on X-axis and capital stock 'K' on the left side of the margin Saving and investment (S and I) are shown on the Y-axis above the origin and productive capacity $\overline{Y}$ on the Y-axis below the origin. Here, in the quadrant I, income level is Y_0, which is determined by saving-investment equality, a Keynesian approach. Let us begin with initial capital K_0 and subsequent investment, i.e., I_1 and I_2 as in Figure 3.6. Now, as additional investment takes place, initial capital K_0 becomes K_1.

Again, in quadrant III, relationship between capital stock as well as productive capacity has been shown. As it has been mentioned above that, in Domar's model, productive capacity is proportional to capital (i.e., $\overline{Y} = \sigma K$). Therefore, as capital stock increases from K_0 to K_1, productive capacity also increases, which in turn income level also. But, under such circumstances, income level remains sticky at Y_0 like quadrant I, but productive capacity growing continuously due to successive investment. Now, suppose if initial situation were at 'P' in Figure 3.6, i.e., full use of capacity, growth of idle capacity or state of disequilibrium can be measured by means of horizontal distance between PQ and 45° line

NOTES

$Y = \overline{Y}$. But, interestingly this state of disequilibrium will disappear, provided income level does not stick to Y_0, rather rises along with the increase in investment level.

Harrod's Model: The Harrod (R.F. Harrod) Model is based upon three distinct rates of growth:

1. There is the actual growth rate represented by G which is determined by the saving ratio and the capital-output ratio. It shows short-run cyclical variations in the rate of growth.
2. There is the warranted growth represented by G_w which is the full capacity growth rate of income of an economy.
3. There is the natural growth rate represented by G_n which is regarded as 'the welfare optimum' by Harrod. It may also be called the potential or the full employment rate of growth.

To discuss these three sets of issues, Harrod has explained these three growth rates, i.e., Actual growth rate, Warranted growth rate as well as Natural growth rate. Let us explain these here separately.

(i) Actual Growth Rate (G): Actual growth rate is determined by the actual amount of saving and investment of any country. Alternatively, actual growth rate refers ratio of change in income, i.e., δY to total income Y in any specified given period. Now, suppose if actual growth rate is denoted by G, then $G = \delta Y/Y$. In fact, Harrod thinks that, actual growth rate G is determined by two factors, i.e., (i) saving-income ratio and (ii) capital-output ratio that remains fixed in a given period. In the Harrodian model, relationship between actual growth rate and its determinants can be expressed by following fundamental equation:

$$GC = s \qquad \text{..... (37)}$$

where, G = Rate of growth of output in a given period of time (actual growth rate) and can be expressed as $\delta Y/Y$

C = Net addition to capital and is defined as the ratio of investment to the increase in income (capital-output ratio), i,e., $\delta K/\delta Y$

S = Average propensity to save or saving-income ratio, i.e., S/Y

Thus, equation (37) explains the simple truism that, in the ex-post sense, saving and investment are equal to each other.

Here, as $G = \delta Y/Y$ and $C = \delta K/\delta Y = I/\delta Y \quad [\because \delta K = I]$

$s = S/Y$

Now, substituting these ratios or values of G, C and s in equation (37), we get,

$$\delta Y/Y \times I/\delta Y = S/Y => I/Y = S/Y \text{ or } I = S$$

Therefore, from above equation (37), it is evident that, condition to achieve the steady growth rate or dynamic equilibrium is that ex-post saving must be ex-post investment. Alternatively, there must be accounting equality between saving and investment to attain dynamic equilibrium.

(ii) Warranted Growth Rate (G_w): According to Harrod, the warranted rate of growth implies, the rate at which producers will be content with what they are doing. It is, thus, termed as the entrepreneurial equilibrium. Alternatively, it refers to that growth rate of an economy while it is working at its full capacity by optimum use of machinery as well as manpower. So, it is also called as Full Capacity Growth Rate or Full Employment Growth Rate or Potential Growth Rate. In fact, it is the advanced line which if achieved will satisfy profit takers that they have done the right thing. According to Meier and Baldwin, Warranted Growth Rate (G_w) refers the rate of income growth needed for full utilization of a growing stock of capital, so as to ensure entrepreneur that they have taken appropriate decision as regards amount of investment they have made actually.

Warranted growth rate G_w is determined by two factors, i.e., capital-output ratio and saving-income ratio and this relationship can be expressed by following equation:

$G_w C_r = s$

where, G_w = Warranted rate of growth or the full capacity rate of growth of income

C_r = Capital requirements denotes the amount of capital needed to maintain warranted rate of growth, i.e., required capital-output ratio or the growth rate of output. It is the value of $I/\delta Y$ or C

S = Saving-income ratio, i.e., S/Y

Now, taken into consideration both actual and warranted rates of growth, question arises – How to achieve steady growth?

I. According to Harrod, an economy can achieve stable growth provided $G = G_w$ and $C = C_r$, i.e., actual growth rate must be equal to the warranted growth rate. Alternatively, growth rate of income must be equal to the growth rate of output.

II. Capital-output ratio required required to attain G must be equal to the required capital-output ratio to maintain G_w, and is given the saving coefficient 's'. Thus, ex-post investment or capital investment must be equal to the expected investment or ex-ante investment to active objectives of stable growth.

But this type of equality (i.e., $G = G_w$ and $C = C_r$) is rarely found in an economy, even though planned and regulated it may be.

Instability of Growth: Under following situations (according to Harrod), above equality conditions are not satisfied:

I. When $G > G_w$, then $C < C_r$

II. When $G < G_w$, then $C > C_r$

Proof:

$GC = S$

$C = s$ or $G = s/C$

$G_w C_r = s$ or $G_w = s/C_r$

If, $G > G_w$ then, $s/C > s/C$ or $1/C > 1/Cr$

Cross multiplying $C_r > C$ or $C < C_r$.

Likewise, it can also be proved that, when $G_w < G$, then, $C > C_r$.

Let us consider the first situation when $G > G_w$, growth rate of income is greater than growth rate of output. Demand for output due to higher income level will exceed supply of of output for lower output level. Consequently, economy will face a chronic inflation. Alternatively, such circumstances can also be explained in other way, i.e., when $C < C_r$. Under this condition, actual amount of capital falls short of required amount of capital, which will cause deficiency of capital and it will affect adversely volume of goods to be produced. This decline in output level will lead to scarcity of goods. So, it is evident that, inflation and growth of economy under inflation can never be stable.

Again, on contrary, while $G < G_w$, growth rate of income will be less than the growth rate of of output, there will be more goods for sale, but the income will not be sufficient to purchase those goods. In the Keynesian terminology, there would be deficiency of demand and consequently, economy will experience chronic deflation. Alternatively, such circumstances can also be explained in other way, i.e., when $C > C_r$. Under this condition,

NOTES

actual amount of capital is more than than the required amount of capital for investment purposes, which will dampen marginal efficiency of capital. It causes chronic depression and also in employment. Therefore, growth of economy under such circumstances of chronic depression can never be stable.

From above explanation, it is thus safe to conclude that stable growth or steady state growth takes place when $G = G_w$, i.e., equilibrium state or the steady state equilibrium or knife-edge equilibrium (otherwise economy will be in a state of instability). Any deviation of G from G_w will result cumulative departure from the path of steady growth.

Harrod also states that, deviations from G from G_w indicates instability of an economy. If G departs from G_w, then it will depart farther and farther from it, as departure from the path of steady growth is self-sustaining. On contrary, $G < G_w$, then desired saving will exceed desired investment, entrepreneurs will be pessimistic about the future and they will keep the level of output below G_w and it would further retard the growth.

(iii) Natural Growth Rate (G_n): If it is assumed that, propensity to save or capital-output ratio does not change, then what will stop income from shooting up or down without limit? According to Harrod, natural rate of growth is the trend in production with full employment and no inflation. It is the rate of advance which the increase of population and technological advancement allow. The natural rate of growth depends on the macro variables such as population, technology, natural resources, capital equipment and so on. Indeed, Natural Growth Rate is the maximum possible growth rate of an economy. However, there is an upper limit as regards expansion of output set by the macro variables and this limit is termed as 'full employment ceiling'. This limit is changed as factors of production grow and technological advancement takes place. According to Harrod, this growth of the upper full employment ceiling is the 'Natural Growth Rate'. There is no involuntary unemployment in this situation. Alternatively, it is the maximum growth rate which an economy can achieve with its available natural resources and beyond which expansion of output is not feasible. Equation for the natural rate of growth can be expressed as:

$$G_n C_r = \text{or} \neq s$$

where, G_n = Natural or full employment rate of growth

C_r = Capital required to maintain warranted growth rate or capital-output ratio

s = Saving income ratio

State of Equilibrium: According to Harrod, the state of equilibrium is the one where all the three growth rates, viz., Actual Growth Rate (G), Warranted Growth Rate (G_w) and Natural Growth Rate (G_n) are equal and thus we can express it as:

$$G = G_w = G_n \text{ or } s/C_r = (n + 1)$$

Above equations can be illustrated graphically as in Figure 3.7.

NOTES

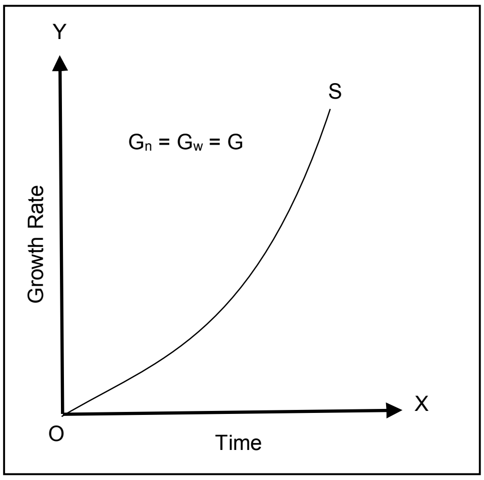


Figure 3.7: State of Equilibrium

As shown in Figure 3.7, OS curve shows the steady state of growth and therefore represents equality between actual growth rate, warranted growth rate and natural growth rate. When these growth rates are not equal, there is an imbalance in the system.

Growth Process: As shown in Figure 3.8, shows the growth process of Harrod's model. Here, OS is saving line, which indicates different levels of saving and corresponding to varying levels of income. Slope of this line indicates equality between average propensity to save and marginal propensity to save. Slope of Y_1L_1, Y_2L_2 and Y_3L_3 represent capital-output ratio.

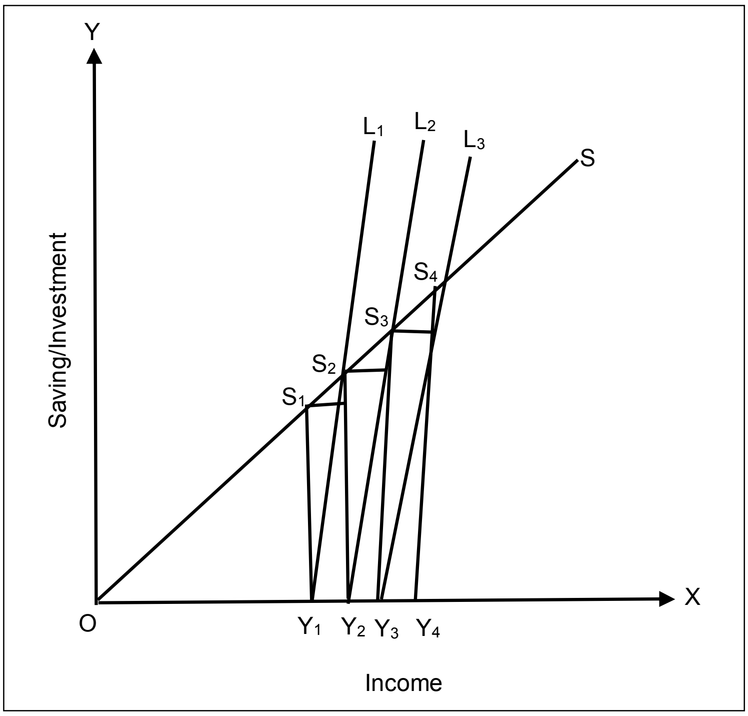


Figure 3.8: Growth Process

In the beginning, income is OY_1 and S_1Y_1 is saving. Investing this savings, income would increased to Y_1Y_2. At OY_2 level of income, savings increases to Y_2S_2. It will stimulate investment and income. Income level now would be OY_3. Here, saving will be

NOTES

S_3Y_3. Again, by making further investment, there would be further increase in income and henceforth this growth process continues repeatedly.

Interaction between G, G_w and G_n: To attain full employment equilibrium, it is essential that, actual growth rate, warranted growth rate and natural growth rate must be equal to each other, i.e., $G = G_w = G_n$. But, it is knife-edge equilibrium and therefore, there can be deviation from the steady path. In this context, following imbalances or deviations may take place. These are as hereunder:

(i) Natural Rate of Growth is greater than Warranted Rate of Growth, i.e., $G_n > G_w$ and the economy is growing at the desired rate of growth, i.e., $G_w = G$: As shown in Figure 3.9, this rate of growth fails to provide employment to all and there will be unemployment in the economy.

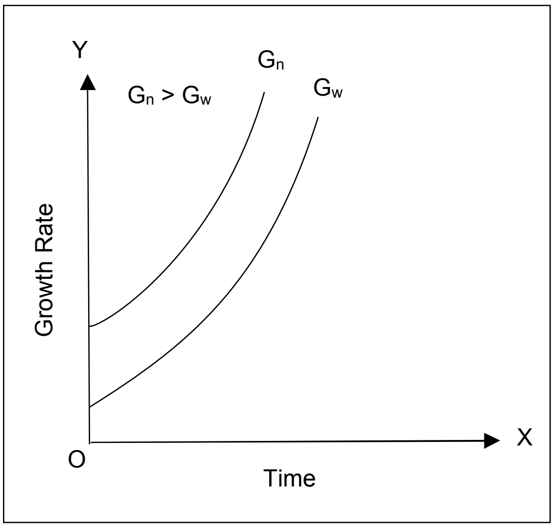


Figure 3.9: Natural Rate of Growth is Greater than Warranted Rate of Growth, i.e., $G_n > G_w$

(ii) Natural Rate of Growth is less than the Warranted Rate of Growth ($G_n < G_w$): On contrary, if $G_n < G_w$, there will be deflation, as in this case the natural resources or labour supply will not be adequate. Entrepreneurs get depressed over the fact that they want a higher rate of growth but the circumstances do not allow this. It implies that $G_n < G_w$. As shown in Figure 3.10, it is evident that growth Rate of capital formation is greater than the growth rate of labour supply. There would be excess capacity in this system, which adversely affects investment. Entrepreneurs would not be ready to undertake fresh investment. Consequently, there will be a set back to the rate of capital formation that causes depression in the entire system. Consequently, the warranted rate of growth will fall short of the natural rate of growth. So that in practice there is no possibility that the warranted rate of growth remains higher than the natural rate of growth as shown in Figure 3.10. Here, G_n curve shows natural rate of growth and G_w curve shows the warranted rate of growth. Desired rate of growth rises steeply, but as it approaches to the natural rate of growth, its steepness is checked. This is because, the warranted rate of growth can not be greater than the natural rate of growth. Under such circumstances, there would be excess capacity to check or restrict the rate of capital formation and also the growth rate, as there are trade cycles in the system and thus the steady state of growth is violated.

NOTES

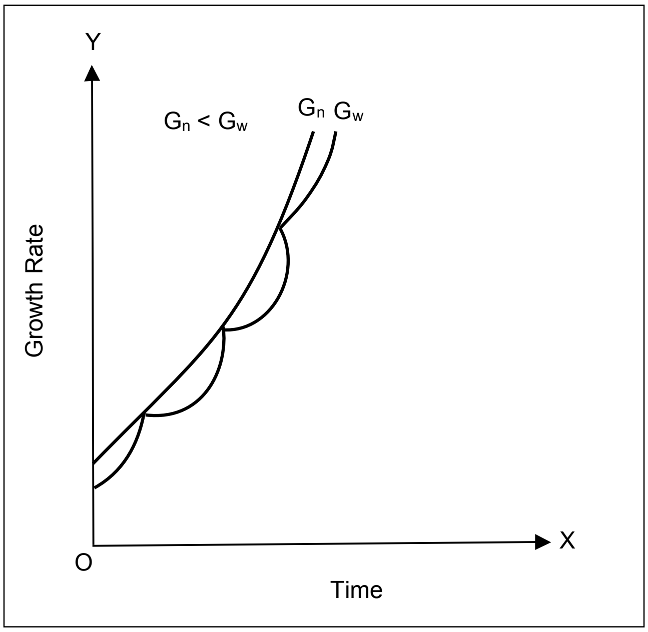


Figure 3.10: Natural Rate of Growth is Less than the Warranted Rate of Growth ($G_n < G_w$)

(iii) Actual Rate of Growth is greater than Warranted Rate of Growth ($G > G_w$): In such a case, in a state of equilibrium, warranted rate of growth and the actual rate of growth are equal to each other, so that

$$G_w \times C_r = G \times C$$

Now, if actual growth rate exceeds the warranted growth rate, there will be inflation. Under such circumstances, the actual capital will become short of the warranted capital. More orders will be placed for capital goods—which will induce upswing.

Again, if actual growth rate is greater than the desired growth rate, it indicates that required capital-output ratio, i.e., $C_r < C$, Ex-ante investment will be greater than actual investment. Alternatively, total demand will be greater than total supply and thus there will be shortage of capital. Entrepreneurs are willing to to make more investment. Consequently, production under such circumstances will increase, but total demand would increase faster than total supply and inflation occurs. Gradually, gap between desired rate of growth and actual rate of growth would keep on widening. Harrod considered that, it is difficult to maintain the steady state of growth, as it is difficult to walk on the Razor's Edge Model.

(iv) Actual Rate of Growth is less than Warranted Rate of Growth: Here, if actual rate of growth is less than the warranted rate of growth (G_w), capital-output ratio (C) would be greater than the desired capital-output ratio (C_r), i.e., $C > C_r$. In this condition, planned investment is less than the actual investment. Total demand in the economy will be less than that of total supply. Entrepreneurs will make less investment and thus total demand also reduces further. As a result, the economy moves towards the situation of secular stagnation.

Features: Following are the major features of Harrod-Domar model:

1. Harrod-Domar model explains about conditions of steady state of growth for advanced economies already in the state of full employment.
2. Investment acts dual role, i.e., increases production capacity and level of income and demand.
3. According to these models, investment or capital formation is the principal determinant of the growth process.

NOTES

4. It is very difficult to maintain the situation of steady state growth. Trade cycles in the economy are inevitable.
5. Domar believe that, if $\delta I/I = \sigma\alpha$ and according to Harrod, $\delta I/I = s/C$ and thus, in turn, the steady state of equilibrium growth is maintained.

Importance: The Harrod-Domar models shows a stimulating attempt to dynamize and secularize static Keynesian theory of saving and investment. They are flexible as regards fiscal policy parameters.Following are major importances of Harrod-Domar model:

1. Main objective of steady growth model is investment. It is evident from the fact that, it generates income and creates productive capacity.
2. This model explains that increased capacity result in greater output or greater unemployment depending upon behaviour of income.
3. Equality between G, G_w and G_n ensure full employment of labour and full utilization of capital stock.
4. Behaviour of income is expressed in terms of growth rates.
5. Trade cycles are incurred as the deviations form the path of steady growth. Such deviations cannot continue for indefinite period of time. They have upper and lower limits. Full employment ceiling is operated as upper limit and autonomous consumption and investment act as lower limit. Actual growth rate fluctuates between these two limits.
6. In fact, Harrod-Domar model emphasizes that actual growth rate may be different from warranted growth rate. Consequently the economy will face cumulative deflation.

Comparison of Harrod and Domar Models: Let us now study the grounds as regards similarities and dissimilarities of this two models:

Similarities:

(i) Both models employ the Keynesian saving-investment equality as the equilibrium condition for steady growth of economy.

(ii) Both models are based on similar assumptions and thus both names Harrod and Domar are bracketed together in this growth model.

(iii) Both models concerns themselves in the context of full employment steady growth rate in the context of advanced economies, as capital is abundance there, but backward and poor economies are deprived to attain steady growth rate due to deficiency of capital.

(iv) Harrod's warranted growth rate G_w implies similar thing as the product of marginal propensity to save (α) and productivity of capital (σ) in Domar's model. Alternatively, $G_w = \alpha\sigma$.

(v) Both models emphasized upon knife-edge equilibrium path for an economy which is unstable, which is a natural feature of any capitalist economy.

(vi) Domar's fundamental equation is turns out to be identical with that of Harrod's as follows:

Domar's Fundamental Equation

$$\delta I \,.\, {}^{1}\!/\,{} = I\sigma$$

But, $\sigma = \delta Y/I$ and $\alpha = \delta S/\delta Y$

Thus, we get,

$$\delta I.\frac{1}{\delta S/\delta Y} = I.\delta Y/I => \delta I \,.\, \delta S/\delta Y = \delta Y => \delta I \,.\, \delta Y = \delta S \,.\, \delta Y => \delta I = \delta S$$

NOTES

Harrod's fundamental equation:

$GC = s$

where, $G = \delta Y/Y$

$C = I/\delta Y$ $[\because \delta K = I]$

$S = S/Y$

Therefore, we can express it as:

$\delta Y/Y.\ I/\delta Y = S/Y => I/Y = S/Y => I = S$

Harrod's saving (s) is equal to Domar's marginal propensity to save and the Domar's full employment rate of growth (i.e., $\alpha\sigma$) is similar to Harrod's warranted rate of growth.

Hence, Harrod's $G_w = s/C_r$ = Domar's $\alpha\sigma$

Proof:

Let $\alpha = S/Y$ or, $S = \sigma.Y$ ..... (1)

$=> \sigma = \delta Y/I => \delta Y = I.\sigma$ ..... (2)

Since, S = I, substituting s for I in equation (2), we get,

$\delta Y = S.\sigma => \alpha.Y.\sigma$ $[\because S = \alpha.Y]$

or, $\delta Y/Y = \alpha\sigma$ or, $G_w = \alpha\sigma$ $[\because G_w = \delta Y/Y]$

Dissimilarities:

(i) Harrod and Domar work out various relationship between income and investment. Domar thinks that, in the beginning there is an increase in investment which engenders increase in income. But Harrod believes that, first of all, there is an increase in income and increase in investment takes place subsequently.

(ii) Harrod highlights the importance of psychological factors in motivating entrepreneurs. But, Domar attached importance to technological factors.

(iii) Harrod denotes MPS to save by α, while Domar denotes it by σ.

(iv) Domar's model is based upon the principle of multipliers, but Harrod model is based upon the principle of acceleration.

(v) According to Domar, increase in planned investment is inevitable for economic growth. But, according to Harrod, induced investment is inevitable for economic growth.

Criticisms or Limitations: Few assumptions made by these models make it quite unrealistic. Main points of criticisms are as under:

1. **Constancy of propensity to save and capital-output ratio:** Constancy of propensity to save and capital-output ratio are unrealistic, because these tend to change in the long run.
2. **Price level is not constant:** Both these models overlook changes in price levels. According to Meier and Baldwin, if allowances decline for price changes and also for variable proportions in production. In that case, the said system may have much stronger stability than that of suggestions made by Harrod model.
3. **No fixed proportion of labour and capital:** Assumptions that labour and capital are used in fixed proportions is indeed untenable. Normally, labour and capital enjoy a certain degree of substitutability.
4. **No distinction between capital and consumer goods:** Both these models have not dealt with the distinguishing factors between capital as well as consumer goods.

NOTES

Application of Harrod-Domar Models to Underdeveloped (LDC) Economies: The Harrod-Domar models are based on the saving function, autonomous vs. induced investment and the productivity of capital as well. In fact, these concepts were primarily developed to illuminate secular stagnation that was threatening the advanced economies in the post-war period facing uncertainties of trade cycles and involuntary unemployment. However, in the words of Prof. Kurihara, there are certain useful elements of these models relevant for the less developed countries too. First five year plan in India was formulated getting useful tips from these model. Let us study here application of these models to know up to what extent these models have been extended to deal with the development problems of under developed or less developed economies in the following directions:

1. Importance to investment: Investment has been accorded a very high priority in Harrod-Domar model and this priority is to be doubtlessly recognized for less developed countries as well. In the first five years plan in India, let us see how these models can be used for planning in underdeveloped countries.

Suppose the capital-output ratio is assumed to be 4 : 1 and the full capacity growth rate or the warranted growth rate is estimated at 3 percent per annum for the economy. Now, by applying either the Harrod or the Domar formula, the planners can find out the saving-income ratio required to sustain the growth rate of 3 percent per annum.

In Harrod's mode,: $G_w C_r = s$ and by applying the assumed rates, we get $3/100 \times 4/1 = 12/100$ or 12 percent which is the saving-income ratio.

Likewise, in Domar's model, $\delta I/I = \sigma\alpha$, i.e., $3/100 \times 4/1 = 12/100$ or 12 percent.

Therefore, if the capital-output ratio is assumed as 4 : 1 in an economy, the community will have to save 12 percent of its annual income, if its annual growth rate of output is to be 3 percent.

Again, given the saving ratio and capital-output ratio, the Harrod formula for computing growth rate is:

$$G_w = s/C_r$$

If s =12 percent and the value of $C_r = 4$, then $G_w = 12/4 = 3$.

2. Significance of Government Interference or Fiscal Policy: According to Prof. Kurihara, Harrod-Domar model do not accord any significance directly to the role of the government. As advanced economies faces trade cycles in their growth process, positive interpretation of this assertion is that less developed nations should make use of their fiscal instruments for their development programmes, so that, indirectly, these models recognized the significance of government interference.

In fact, these two models show that underdeveloped economies should promote economic development by decreasing growth rate of population and increasing growth rate of income. Harrod-Domar models are not mere mathematical solutions but they also suggest policy implications for underdeveloped nations. Hirschman opined that, the core objective of the economies of development to equip the underdeveloped countries (UDCs) in a manner so as to enable themselves to walk on their own feet and also they should eradicate their own obstructions.

NOTES

3.5 SUMMARY

1. Strategy for increasing production of agricultural commodities focuses on providing incentive to farmers through various development programmes.
2. Development of Inland Fisheries and Aquaculture and Assistant to Fisheries Institutes and the new scheme of Blue Revolution – Inland Fisheries.
3. The Department of Agricultural Research and Education (DARE) is responsible for Agricultural Research and Education through Indian Council of Agricultural Research (ICAR), which is an Apex Scientific Organization at the national level.
4. The Department of Food and Public Distribution is implementing schemes for the procurement of foodgrains and its distribution for ensuring food security.
5. The National Institute of Food Technology Entrepreneurship and Management (NIFTEM) and Indian Institute of Crop Processing Technology (IICPT) will continue to receive support from the Government for development as centres of excellence to cater to the human resource development and research and development needs of the rapidly growing food processing sector.

3.6 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1. Total budget support for Plan in Main Budget 2014-15 is higher by an amount of __________ in comparison to Interim Budget.
2. The Plan outlay of Ministry of Environment and Forests is __________.

II. True and False

1. The Department of Agricultural Research and Education (DARE) is responsible for Agricultural Research and Education through Indian Council of Agricultural Research (ICAR), which is an Apex Scientific Organization at the national level.
2. The allocation of funds for development of food processing industries is ₹ 770.00 crore for 2014-15.

III. Multiple Choice Questions

1. The central outlay for Aajeevika or National Rural Livelihood Mission (NRLM) is ₹ 4,000.00 crore, out of which ₹ 335.00 crore has been earmarked for __________.
   (a) North Eastern Region and Sikkim
   (b) Manipur
   (c) Assam
   (d) None of the above
2. The Central outlay for Mahatma Gandhi National Rural Employment Guarantee Scheme (MNREGS) is __________.
   (a) ₹ 34000.00 crore

NOTES

(b) ₹ 40,000.00 crore

(c) ₹ 42,000.00 crore

(d) ₹ 38,000.00 crore

Short Answer Questions

1. Define the term Budget.
2. Explain the term 'Aggregate Expenditure'.

Long Answer Questions

1. Critically analyze in detail about the impact of budgetary measures on resources allocation according to the Union Budget 2014-15.
2. Critically analyze in detail about the Post-Keynesian analysis and a comparative account of development theories (The Harrod-Domar Model – Steady States and Stability).

3.7 KEY TERMS

- Animal Husbandry
- Crop Husbandry
- Warehousing

3.8 KEY TO CHECK YOUR ANSWER

I. 1. ₹ 19,678 crore, 2. ₹ 2043.00 crore.

II. 1. True, 2. True.

III. 1. (a), 2. (a).

Unit III: Union Budget and Fiscal Policy

4 Chapter

GOVERNMENT BUDGET AND NATIONAL PLAN

Objectives

- The Relation between Government Budget and National Plans
- Role of Fiscal Policy in Resource Mobilization for Development

Structure:

4.1 THE RELATION BETWEEN GOVERNMENT BUDGET AND NATIONAL PLANS

Since annual budgets are the principal means by which government authorize and control most of the expenditures, most outlays provided for in the public sector portion of a development plan must be incorporated into these budgets if the plan is to be carried out. From a practical point of view, conversion of public development plan into a series of annual budgets is likely to be the most important stage in the planning process. It is by examining the link between a plan and a budget that can tell whether or not a government means to carry out a plan.

Where relationship between a plan and budget is close, the budget is, as far as it goes, the financial counterpart of the public sector plan. To perform this role adequately, the budget must provide not only for planned capital expenditures but also for associated current expenditures, as well as for revenue and other domestic financial resources which, in combination with available external financial resources, will support the required outlays.

An annual plan reaches its conclusions after consideration of the totality of the resources available to a country. These include physical factors like natural resources, manpower and existing productive capacities as well as financial resources in domestic currency and foreign exchange. The annual plan apportions these physical and financial resources among the various sector programmes and projects included in the plan. It sets savings, investment, export, import, output and other targets that involve utilization of these resources in a manner which is consistent with the institutional administrative and

NOTES

managerial set-up in a country. An annual plan for the public sector includes the programmes of autonomous and simultaneous agencies, state, regional and local bodies as well as those of ministries and departments. If the plan is comprehensive, it must also provide a framework for development in the private sector.

Finally, an annual plan incorporates those instruments of economic policy and organizational and institutional measures required to mobilize resources and attain plan objectives.

An annual plan is, therefore, broader in scope than a conventional administrative budget which is almost limited to the domestic funds required for general government activities, usually the only part of the public sector which is covered by the government budget. An annual plan takes a broader view than a budget in another sense. It is likely to be expressed in more general terms than a budget. An annual plan is mostly concerned in broad outline with the objectives, priorities of utilization of these resources and expected outputs from proposed inputs of physical, human and financial resources. While an annual plan indicate how financial and other resources are to be allocated about projects and programmes, a budget must be concerned much more specifically with receipts from various taxes and other sources, the availability and commitment of funds, cost estimates for projects and programmes, administrative feasibility of individual projects and programmes and the cannons of financial custodianship and control.

It is possible for a budget to substitute for an annual plan and *vice versa.* But for most countries, especially less developed nations, annual plans and budgets and their co-ordination are virtually *sine qua non* for putting medium term plans into effect. The task of implementing a medium term plan without first phasing it in annual plans, appears to be well beyond the capacity of most less developed nations. Indeed, budgets based on annual plan are an integral part of planning process. With retained process of enterprises, they are in fact the principal source of investment funds to implement annual development plans. But financial budgets are subordinate to development plans. Actually, finance is conceived as an instrument of proper implementation of a development plan and not as an independent factor limiting the rate of economic development. The only limits to economic development are set by the nature and given the historic heritage of the society. They consist of limitations in natural resources, human skills and organizing power. To allow finance to act as a limit would introduce a man-made limit on economic development which has no justification in the state of available natural as well as human resources.

In India, budgets are prepared on the basis of annual plans – this is a recent innovation. Many problems other than the traditional independence of a Ministry of Finance impede the integration of plans and budgets. One of the most important problems is the failure of most less developed countries with medium term plans to prepare annual developmental plans. In the absence of annual plans, many less developed nations with medium term plan result to annual budgets to co-ordinate their development efforts. Where annual plans are prepared, they often do not relate proposed expenditures to physical targets. Many annual plans are little more than lists of projects with amounts to be included in a budget.

Planning and budgeting, thus, constitute a two-way process in which the data of each feed the other. It is, therefore, unavoidable that much of the work of preparing an annual plan and a budget must proceed simultaneously and with the close collaboration of the planning and budget officials. In federal government like that of India, annual plans and budgets must also be prepared by every political subdivision and dovetailed

NOTES

with both the annual plan and budget of the federal government. It necessitates the establishment of a timetable with deadlines for submission of new projects and programmes by political subdivisions and provision of date on other aspects of their plans.

Further, the foreign exchange allocations to be co-ordinated with the domestic currency component of financing required for projects. At the same time, it is also inevitable that the preparation of an annual foreign exchange budget be synchronized with the preparation of an annul government budget and that both to be presented for simultaneous consideration and approval as well by the appropriate authorities. Otherwise, shortages of foreign exchange are likely to develop which will delay the execution of projects.

Inadequacies of Conventional Budgets: Even when a budget is ready in time, it often is not an effective instrument to allocate financial resources in accordance with a plan. In many countries, it is an incomplete statement of government receipts and expenditures, with significant exclusions; in some countries, there are a multitude of segregated funds which complicate and restrict the usefulness of a budget and in other countries, formalistic controls take the place of efficient budget management.

Budgetary Fragmentation: The conventional administrative budget normally used by governments does not encompass all public sector activities. Few exclusions result from political organization. Conventional budget does not include public sector transactions carried out by states or other political subdivisions, even when the national budget makes large contributions to their activities. Nor should a national budget include the expenditures and receipts of state and local governments which have a degree of independence. But since budgetary transactions for development at subordinate levels of government may be substantial, especially in countries with a federal constitution, their exclusion from a central government’s budget reduces the budget’s comprehensiveness and may thereby reduce its capacity to implement public sector programmes. Other exclusions from national budgets are less understandable or defensible.

It is the failure to include transfers or other transactions of public or quasi-public agencies in the conventional administrative budgets commonly used in less developed countries that constitutes the most serious omission in these budgets. While public and semi-public agencies, whose transactions are outside the budget, account for substantial proportions of public income and expenditure, usefulness of the budget to allocate financial resources in accordance with a plan is greatly diminished.

Absence of information about transfer between a budget and public or semi-public agencies generally implies a lack of adequate government control over other activities. While the omission of items which should be included in a budget is the more common weakness, some budgets are impaired by the inclusion of unnecessary or largely meaningless receipts and expenditures which reflect mainly the transfer of funds between accounts.

Usefulness of a budget as an instrument to implement a development plan may also be impaired by excessive earmarking of tax receipts or other revenues for specific purposes. Few earmarking such as a payroll tax to finance social security payments, gasoline taxes to finance road construction or toll revenues from a bridge or retire indebtedness incurred to finance its construction is economically and politically justifiable as it ties a government service to a tax or payment which made the service possible. There are other instances for which a case could be made for setting revenues

NOTES

aside in a special fund to be used for a designated purpose. Earmarking of taxes may make people less reluctant to pay increased taxes while they know that the proceeds from a tax will be used for a purpose from which they will benefit. Moreover, when taxes are increased and earmarked to pay for more or better government services approved by a legislature, there is more or better government services approved by a legislature, there is increased assurance that the additional services will not require inflationary financing.

But when a substantial proportion of total budgetary revenues is segregated into special funds earmarked for specific use, a budget loses flexibility for development as it becomes difficult if not impossible to allocate financial resources according to the priorities called for by a plan.

Fragmentation of a budget into a series of separate funds or accounts because of earmarking of receipts and expenditures or because of a proliferation of more or less autonomous agencies whose transactions are extra budgetary, normally results in unduly complex budgeting and accounting systems. It also makes it difficult for a government to follow a coherent budgetary policy and to determine how much money is available for development and other expenditures.

Consequences of Staff Inadequacies: Largely due to a lack of qualified staff and poor organization, budget agencies in most less developed nations are little more than bookkeeping offices. Budget personnel frequently lack the stature and prestige needed to review the submissions of operating organizations.

Deficiencies in Budget Procedures: Procedure for preparing the annual budget is deficient. Government departments request appropriations with only vague justification and in amounts that are consciously set beyond any expectation of achievement. Ministry of Finance lacks personnel with the required competence and detailed knowledge of departmental requirements to evaluate adequately the reasonableness and priority of requests. Under such situations, it is almost axiomatic that requests for appropriations will be cut, but the nature and extent of cutting involves substantial elements of arbitrary judgment and political pressure. Hence, few appropriation may be unrealistically low and in important cases almost certain to be exceeded, while others may well in excess of any of any reasonable justification. Consequently, the result was invariably been the enactment of total appropriations substantially beyond the available non-inflationary sources of financing.

Paradoxically, laxness in major budgetary matters is often accompanied by excessively rigid and formalistic controls over details of budget execution. Sometimes, unduly detailed systems of expenditure control are often a substitute for ideal budget practice. Need for preaudit of expenditures by a budget authority or a general accounting office before authorized funds are disbursed and involved rules which ministries, agencies or departments are expected to apply, result in cumbersome procedures which place great stress on legal niceties but put little emphasis on prudent economic use of resources.

Poor Accounting: Out-of-date, complex, confusing, otherwise inadequate accounting systems widely used in less developed countries and poor accounting practices. It also diminish the effectiveness of national budgets, either as instruments of financial control or as means for giving effect to development plans.

Classification Systems: The system used to classify account and the form in which they are presented in conventional budgets may also make it difficult or impossible to obtain information required for development planning purposes. Among other things, accounts may be so detailed and voluminous that it becomes difficult or impossible to group them into categories relates to specific projects, programmes or activities or they may be insufficiently itemized for this purpose.

For a budget to be a reasonably efficient instrument for plan execution, it must have a classification system which: (i) allows allocation and expenditures to be related to specific projects, programmes and also other purposes in a plan, (ii) distinguishes between capital and current expenditures and receipts and depicts the extent of public savings in the form of a surplus on current account available for investment and (iii) differentiate between development and non-development expenditures on both capital and current account. Classification system employed on both conventional administrative budgets does not fulfill these needs. Primarily, it was designed as a framework to make appropriations to government ministries and departments, facilitate internal management and control, insure accountability usually to a legislature and thereby help in execution of government policies under circumstances that antedate post-war development planning, which virtually precludes an assessment of the full cost of most of the government functions or services.

Conventional budget is divided into separate sections for every ministry, department or agency. Under each spending organization, expenditures are classified according to object accounts, i.e., wages and salaries, travel allowances, purchases of specified materials and equipment etc. Within a spending organization, expenditures for every of these object accounts may be lumped together under a single head. It may be done for administrative convenience to insure centralized control or for other reasons, though the expenditures relate to different functions, programmes, projects or activities. Therefore, a partial or no breakdown of wages and salaries by purpose, programme or project may be available in the budget of a ministry of public works – whose responsibilities include the construction and maintenance of highways, ports, railways and air transport facilities. It may, therefore, be difficult if not impossible to determine the costs allocable to each of these fields or to individual projects or programmes within every field.

Budgetary Reforms: Many shortcomings of conventional administrative budgets a instruments of financial management, greatly aggravated by the requirements of development planning, have given rise to widespread demands for budgetary reforms. If a budget were only a document for giving effect to a country's development plans, problems of budgetary reform and modernization while difficult, would be much easier to resolve than they are. But, since budget is an instrument through which government carries out the full range of its activities, budget has many functions. Besides being a device to implement development plans, it must be a means for financial control and management of government operations. It must also provide data required to make basic decisions on fiscal and economic policy, a suitable vehicle to carry out the decisions which are made, must be designed to provide for accountability to a national legislature or other body and to the public.

Budgetary Comprehensiveness: There is universal agreement that a consolidated set of figures encompassing all financial transactions in the public sector is a useful tool for both development planning and formulation of financial policy. This set of figures should include pertinent transactions of quasi-autonomous and autonomous public agencies usually outside a government budget and those of governments at national and subordinate levels.

For planning purposes, it matters little whether the combination of public sector transactions takes the form of a budget prepared by a budget authority or a consolidated

NOTES

table prepared by a central planning agency or other government office. What is important here is that, where the budget of a central government incompletely reflects development activities in the public sector, a government body can and regularly assemble and also consolidate all required information in one document.

Complementarity of Capital and Current Expenditure: As important for development planning as the consolidation of all public sector transactions is the relationship of capital and current expenditures. Capital expenditures for development always require increases in current expenditures, but there is a widespread failure among planners and budgeters to recognize their complementarity.

Order of Priority: Experience shows that there is no one budget system which meets the planning and other needs of all countries. The kind of budget which a country requires is determined not only by the objectives of the budgetary process but also by its institutional structure and stage of development. Therefore, though the introduction of programme and performance, budgeting may be desirable for one country. It is by no means the only reform or even the most immediate reform required in the budgeting of most countries engaged in development planning.

Thus, to conclude, government budget is a key element in giving effect to a development plan. The ideal connecting link between a medium term plan and an annual budget is an annual plan. An annual plan is generally broader in scope than a conventional administrative budget. There is only a tenuous relationship between plans and budgets in most mixed economy countries. Where budgets are prepared on the basis of annual plans which is a recent innovation and where annual plans are prepared, they are often little more than lists of projects with amounts to be included in a budget.

4.2 ROLE OF FISCAL POLICY IN RESOURCE MOBILIZATION FOR DEVELOPMENT

Importance of fiscal policy as a tool of economic control was first of all pronounced by Keynes in his publication "General Theory of Employment, Interest and Money". Before Keynes, earlier economists clarified impacts of individual fiscal measures. But complete implication of public finance for entire economic situation were not followed by those economists. While government spent money as relief works, money so spent were collected by way of special taxes.

Fiscal policy, thus, comprises of public borrowing, taxes and public spending. It is linked to public finance and it implies use of taxation, public borrowing and public expenditure by government of a sovereign nation for attaining economic stabilization as well as economic growth.

Relative Merits

For accelerating growth of the economy, public finance or fiscal policy is utilized. Following are relative merits of fiscal policy:

1. To promote savings is an economy and minimize current consumption.
2. To mobilize human and material resources of an economy and maximize their flow.
3. To restrain inflationary forces to attain economic stability.
4. Equitable distribution of income and wealth in any country so that benefits of development are neutrally distributed. Eradicating economic inequalities and

restricting concentration of economic power are two main objectives of fiscal policy in developing countries.

5. To protect an economy from unhealthy developments from abroad, i.e., to reduce exposure of an economy to ebbs and flows of world markets and to eliminate dependence on foreign food or foreign investments.

Objectives of Fiscal Policy

It will not be proper to opine dogmatically objectives of fiscal policy as it will differ from economy to economy and also from time to time. But, however, fiscal policy as a tool of economic growth have the following principal objectives:

1. Efficient and Rational Allocation of Economic Resources: Primary task of fiscal policy in an underdeveloped economy is allocation of scarce resources and mobilizing in desirable channels of productive investment. Available resources must locate their way towards socially desirable lines of development. Distribution of resources is to be determined depending upon priorities of the plan. Productive resources are within such limits, so that capable of being used in various ways which accelerates economic growth. Hence, fiscal policy should gravitate towards productive areas of investment.

2. Accelerating Rate of Capital Formation: Fiscal policy is used as a tool of capital formation in developing countries. First of all, it expands investment in public and private enterprises and by directing flow of resources from socially less desirable to more desirable investment. Secondly, changes content of total investment in an economy and creates capital by bringing a qualitative improvement in it.

Fiscal policy is an important tool which stimulates investment in private sector by providing depreciation in company taxation, provision of finance, development rebates, tax holidays, subsidies and other incentives. So, fiscal incentives are utilized to make diversion in utilization of resources from socially less desirable to more desirable directions. Therefore, capital formation in private sector enjoys a great help as well as encourages from public finance operations.

3. Resources Mobilization: Underdeveloped countries suffer from low rate of voluntary private savings. Propensity to consume is high and propensity to save is low, due to low level of income. Therefore, it necessitates government intervention to mobilize resources and fiscal policy plays a crucial role here. Fiscal policy stimulate private saving and encourage public saving by fiscal incentives by way of tax concessions for saving and investment and creating and implementing small savings scheme. Government borrowing programmes also possess similar objective. Success of small savings scheme, government borrowing programmes depends upon monetary incentives offered, relative yield of several investments, confidence of state and psychological behaviour of capital market. As some of these conditions are beyond government control, thus effect of government policy upon private savings are uncertain.

4. Development of Private Sector: In mixed economy, private sector occupies an important place of that economy. Therefore, object of fiscal policy is to maximize mobilization of resources with the object of financing expansion of public sector. Private sector should make significant contribution in the development of the economy and is to be encouraged. Capacity of state to make economic growth is limited. Hence, expansion of private sector is also necessary for viability of economy.

NOTES

Major Fiscal Functions of a Modern Government

1. Fiscal Policy and Economic Development: Attitude of various economists and governments about role of fiscal policy has changed as an outcome of Keynesian theory. Earlier, concept of neutrality of public finance has got a new term, viz., functional finance. Public finance in its fiscal measures has assigned a positive and dynamic role for promotion and acceleration of rate of economic development.

Keynesian analysis of fiscal policy is especially applicable to advanced countries but less suitable in case of underdeveloped nations. Problem of developed countries is to stabilize economic growth rate by maintaining effective demand at its fullest extent possible and for this purpose, fiscal policy tries to reduce savings of people and rise propensity to consume. But in case of underdeveloped nations, the people require more savings to raise rate of capital formation and to attain higher rate of economic development. But ironically, people of underdeveloped country have low rate of income and saving but have high propensity to consume. According to the view of Nurkse, there is no doubt regarding Keynes' General Theory possess a bias against saving and in favour of spending. But while transplanted in the situations of underdeveloped nation, it is found to be pernicious.

Thus, this analysis of problem in connection with voluntary saving shows that because of low per capita income and savings in underdeveloped economies, question of voluntary savings does not arise.

Backward nations suffers from vicious circle of low income, high consumption, low savings, low rates of capital formation and also low income level. To come out from this vicious circle of poverty, fiscal policy plays a constructive as well as dynamic role for economic development of underdeveloped countries. According to UN study, to break this circle without any foreign aid requires vigorous taxation and also government development programme. Thus, in poor nations, necessity of fiscal policy lies in increasing rate and volume of savings and divert those saving towards desired channels.

Shortcomings and ineffectiveness of monetary policy for accelerated rate of economic growth has further realized us regarding essentiality of fiscal policy. Fiscal policy generally designed to supplement monetary policy but it seems to have supplanted monetary policy altogether.

Importance of fiscal policy as a tool of economic development was first considered by Keynes in his General theory where he depicted total national income was an index of economic activity and established relationship of economic activity to total spending. Direct as well as indirect effect of fiscal policy on aggregate spending in the society were distinctly established and consequently budgetary policy of government as a device of economic control and development become prominent.

2. Fiscal Policy and Rate of Saving: Shortage of capital resources is major obstacle in the process of economic development of underdeveloped nations. There are certain forces functioning in these economies which enhances consumption and decline savings. Population pressure is first among them. Apart from high income groups, those spend much of their earnings on conspicuous consumption and which is further reinforced by demonstration effect. Besides, major part of their meagre savings are absorbed in unproductive channels like real estate, hoarding, jewellery, speculation etc. Aim of fiscal policy is to divert savings of people into productive directions. Its aim is to increase incremental saving ratio by taxation and forced loans and creates funds available for investment in both public and private sectors. It is possible only by reducing

NOTES

conspicuous consumption and restricting flow of funds for unproductive investments. Thus, high rates of tax both on personal and corporate incomes and commodity taxation on articles of maximum use and simultaneously conspicuous consumption should be discourage to the extent of actual and potential consumption of people. In this context, report of the Taxation Enquiry Commission, Government of India, states that, a tax system, which promotes capital formation by two aspects saving and investment fulfills an essential condition. It must be remembered that object of taxation must not be mere transfer of funds from private to public use but also enlargement of total volume of savings for investment purposes.

Thus, it necessitates curtailing and restrain consumption and rising volume of savings in the economy. For instance, in Japan, productivity of agriculture was doubled between 1885 and 1915 and device of taxation was utilized effectively and much of increase was taken away from farmers in the form of additional rents and taxes and thereafter that amount were diverted towards productive investment. Forced loans were also imposed on businessmen to collect surplus funds for economic development. In USSR, collective farms were taxed highly and agricultural surpluses were siphoned off by increased prices of manufacturers related to farm products. The Economic Bulletin for Asia and the Far East states, noticed that, taxation is only effective instrument for curtailing private consumption and investment and transfer of resources to government for the purpose of economic development. In the words of Prof. Kurihara, fiscal policy is a desiderate for underdeveloped countries having lack of private initiative, voluntary saving and innovation. According to him, fiscal role of government is as an additional saver, investor, innovator as well as income redistribution.

As an additional saver, government should maintain persistent budgetary surplus by:

(a) Reduction in government average propensity to spend,

(b) Rise in average propensity to tax,

(c) Reduction in government average propensity to make transfer payments.

Prof. Kurihara says, in underdeveloped economies, budgetary surplus is relevant position to be achieved and maintained. For that, it necessitates to supplement private saving — a fiscal role of government as a saver which is to be performed.

As an additional investor, government should rise productive capacity of the economy to establish an accelerated rate of economic growth by modifying pattern of investments and should emphasize on capacity building instead of income generating aspects, by curtailing government consumption and rising investment and also by increasing tax rates which leaves its impact on reducing private consumption expenditures and enhance that portion of real income which is available for the purpose government investment.

As an innovator, government should encourage research and experiments and encourage innovations, i.e., new process of production. It will reduce production cost which encourage investment. Further, government should also encourage innovation by providing subsidies and tax relief to those firms which may introduce them of their own.

As income redistributor, government tries to eradicate economic inequalities upto maximum extent possible. A progressive tax structure may serve as a potent instrument its the hands of the government, to enable effectively equitable distribution of income and wealth to the fullest extent possible.

NOTES

But taxation can be carried for resource mobilization upto a certain limit. If taxes are excessive, it will affect adversely people's desire and ability to work, save and invest, which will definitely retard pace of economic development. To avoid this type of conditions, gap in resources required for economic development may be covered by mobilizing savings by voluntary loans. Financing of economic development by borrowing is not harmful provided loans are utilized for productive projects. Again, unlike taxes, borrowing from public does not spoil people's desire to work, save and invest, as lending voluntary and lenders not only will receive back the principal amount but additionally earn interest. Therefore, public borrowing may add incentives of people to save and invest more for earning interest.

But, it is true that public borrowing has several limitations in underdeveloped countries and as such, much reliance cannot be placed upon it. People are poor and their propensity to consume is very high and thus have no lending capacity. On the other hand, rich people generally do not lend to government rather divert resources towards speculative investment to earn more from there.

Besides absence of organized money and capital markets, inadequate banking facilities, lack of confidence both in financial market and stability of government are obstacles in public borrowings programme. So, necessary steps may be initiated to remove these drawbacks and at the same time, efforts should be made to educate people and motivate them to save more for broader interest of the community.

But inspite of all efforts, sufficient resources are not forthcoming and as such, government may resort to compulsory borrowing for financing economic development. In this context, Nurkse says, as individuals are interested not only in consumption but also on asset holdings and thus forced loans are alternate to taxation. These may be slightly excess than tax receipts and yet it makes a difference to the incentive to work and to produce as was found during war while unspendable cash reserves accumulated due to rationing made to people to feel better off. Hence, forced loans instead of taxation would be a method of forced saving.

However, individual who spend major part of their earning on conspicuous consumption and divert resources towards unproductive channels, may be forced to invest in government bonds. But this process of forced loan technique is application for short period only especially in a democratic set-up and as such, it is again voluntary lending that matters and government also must be ready to increase domestic borrowing while income and saving of people rises due to economic development and thus public borrowing become an important instrument of resource mobilization.

In case of laissez-faire system, role of public expenditure in economic life of people and the society remain neglected. Its impact on production and distribution were not considered and public expenditure were kept at minimum level. But, along with the changing the functioning of state to a welfare state, public expenditure has been increased gradually.

Public expenditure is one important instrument of state to attain economic development of of underdeveloped countries, as there is deficiency of power, irrigation, transport, education and key industries — which is essential for economic development. But ironically, these facilities cannot be provided by private sector because of lack of resources and entrepreneurial ability. So, public expenditure tries to overcome these hurdles and motivates development or progress of agriculture and other key industries by way of providing grants, loans, subsidies etc.

Therefore, systematic and planned expenditure creates social and economic overheads and creates suitable environment for growth of economy. Public enterprises should follow the economic efficiency principle to curtail cost and enhances profit.

Special care should be initiated so that public expenditure does not spoil individual's interest to work, save and invest and for that, services should be provided like free medical facilities, free education etc. It will improve efficiency and productive capacity of people.

Dr. R.N. Tripathy, in his book 'Public Finance in Underdeveloped Countries' has mentioned following measures to follow by government to raise volume of domestic saving to fulfill financial requirements for economic development. These are:

(i) Direct physical controls.
(ii) Imposition of new taxes.
(iii) Surplus from public enterprises.
(iv) Deficit financing.
(v) Increase in rates of existing taxes.
(vi) Public borrowing of a non-inflationary nature.

Technique of economic development leads to inflationary pressures in an economy as it creates excess effective demand without production of consumable commodities. Direct physical controls are used to reduce consumption and to restrict socially undesirable investment. Although it may be difficult to administer, yet it is necessary for a developmental fiscal policy.

For fulfillment of financial requirement of economic development, introduction of additional variety of taxes both direct as well as indirect are required due to lack of voluntary savings. In few states, profits of public enterprises have been used up in financing economic development. State enterprises bring government in close contact to economic realities and enable it to estimate efficiency as well as tax paying capacity of private sector. But due to lack of large surplus of public enterprises because of high cost of production at initial stages of development and also for limited number of enterprise, mild dose of deficit financing becomes essential, which generates inflationary pressure resulting from deficiency of supply of consumer goods Similarly, public borrowing cannot be deserved to bring adequate resources in absence of properly developed capital markets in underdeveloped economies. At the same time, public borrowing may rise interest rates and affect required investment adversely. Thus, among all these measures, taxation is the best measure to mobilize resources for the purpose of economic development. Under fiscal policy, several fiscal concessions like depreciation allowance, provision of finance and foreign exchange, tax holiday, development rebates, subsidies etc. contribute much to the growth of investment in private sector of the economy. So, role of fiscal policy is to make available for the object of economic development by maximizing resources and minimizing current consumption.

3. Fiscal Policy and Optimum Pattern of Investment: An underdeveloped economy can hardly succeed to divert limited resources into socially desirable channels. Hence, it becomes mandatory to impose pattern of investment which will be sufficient enough to attain social marginal productivity. Heavy taxes on land value increments and capital gains etc. should be imposed to restrict flow of funds into unproductive channels like land, buildings, inventories or investment of speculative nature, etc. Taxation possess positive inducement for productive and socially desirable investment in private sector. It

NOTES

may be done by differential rates of taxation in one hand and grant of tax relief in certain areas on the other.

Investment in economic and social overhead like power, soil conservation, transport, education, technical training facilities, public health etc. is of great importance for optimum pattern of investment to speed up the development process. It widens the extent of market, curtail cost of production and enhances productivity by forming external economics. Private sector cannot provide such basic aminities for huge expenditure and low-yielding returns. So, government should undertake such projects financed through taxation system but not with borrowed debts. Increase of compulsory saving by taxation for such development programmes is very popular nowadays. Therefore, fiscal measures must be targeted to attain optimum pattern of investment for accelerating pace of economic development of underdeveloped countries.

4. Fiscal Policy to Counteract Inflation: Process to economic development in underdeveloped economies suffers from inflationary pressure because of imbalances between demand for and supply of real resources. Pressures of wages on prices, market imperfections, structural rigidities, bottlenecks, etc. hinders supply of commodities and services and price levels begin to inflate. As a result, when inflation goes beyond control, ruins entire economy and progress becomes standstill. Because of the above stated facts, economic growth and stability are treated as combined objectives for underdeveloped nations to accomplish. But, nowadays, choice is not between economic growth and stability but over interrelationships and policies to attain it.

Fiscal measures must be for counteracting undue inflationary pressure by reducing effective demand. To attain this objective, tax structure is to be modified and greater emphasis should be on progressive direct taxes and commodity taxes. Besides, special anti-inflationary taxes on excess profits, capital gains and other windfalls and also taxes on articles of conspicuous consumption in nature may also be imposed.

Besides, fiscal policies of government removal of market imperfections, removal of structural rigidities, subsidies, and protection of essential consumer goods industries are also required. But even if inflationary pressure goes on increasing further, capital levy on cash balances and liquid assets may be imposed to fight with inflation.

5. Fiscal Policy and Alternative Measure to Curb Inflation: Inflationary pressure creates because of excess demand, while spending on consumption and investment goods and foreign spending on commodities of home country in total exceed full employment and output. It indicates, true inflation begins only after full employment, but in reality it starts even before full employment due to rigidities of factor supply, bottlenecks and pushes of profits, costs and wages.

Fiscal remedies of inflation are as follows:

(i) Reduction in government spending and no change in tax rates: Such policy will provide a budget surplus and drain out purchasing capacity of community and will set a reverse process of government expenditure multiplier and brings contraction in national income and employment and leads to control on inflation.

(ii) Reduction in government spending and increase in tax rates: This sort of fiscal measures is more effective than earlier one as rise in tax rates accompanied with a decline in government spending generates huge budget surplus and larger reduction will be affected or observed in national income and employment.

(iii) Rigid government spending and increase in tax rates: While government spending becomes rigid, for example, at the time of war, reduction in aggregate spending

NOTES

is only possible by increasing tax rates — which in turn reduces private disposable income consequently declined private consumption and investment expenditure to curb inflation. By this process during Second World War, USA could siphon off purchasing capacity by a measure capable of finance more than 48 percent of cost of war out of tax proceeds.

(iv) Reduction in government spending and equivalent reduction in taxes: As, if there is a rise in government expenditure and also an equal rise in tax revenue increases, national income due to functioning of balanced budget multiplier, likewise, similar effect may also be observed due to reverse operation of balanced budget multiplier. It implies, a decrease in government spending and equal decrease in tax revenue brings reduction in national income and expenditure because of reverse operation of balanced budget multiplier. If these fiscal changes leads to redistribution of income between beneficiaries of government expenditure and tax payers such that net propensity to consume decreases, then reduction in national income will be more in comparison to reduction in government expenditure. Balanced budget multiplier is greater than unity and then an anti-inflationary effect will prevail in that economy.

Above discussions clearly reveals the fact that variation in taxes is most effective device of an anti-inflationary fiscal policy. Although, a controversy arises regarding relative anti-inflationary effect of income tax and consumption tax, claims to have an equal yield, yet latter is sometimes proved itself as more effective as it causes reduction in consumption absolutely. On the other hand, income tax falls partly on saving and partly on consumption.

6. Fiscal Functions and Economic Stability: Underdeveloped nations are susceptible to economic instability because of deficiency of effective demand in short run and fluctuations in demand for their commodities in world markets. Underdeveloped nations normally export agricultural as well as mineral products, demand for which is generally less elastic. On contrary, countries import capital goods, finished manufactured products, whose demand is elastic in nature. While price level of exported commodities declines in world market, terms of trade turns to unfavourable, earnings of foreign exchanges decreases, consequently national income declines and depression prevails in the economy. Underdeveloped nations are incapable to enhance their export to avail benefits of reduced prices due to limited production capacity. Likewise, due to boom conditions in international market, price of export increases, rise in foreign earnings does not result to increased output and employment, rather, it is dissipated in speculative investment as well as conspicuous consumption which create inflationary pressure in that economy.

Fiscal remedies can be adopted to offset international cyclical fluctuations in prices of exports. For instance, during boom period, heavy import and export duties should be imposed. Import duties will reduce conspicuous consumption and export duties will neutralize windfall gains from increase in international market price levels. Earnings from such duties will be helpful in capital formation. At the time of depression, subsidies may be provided to boost export and government should maintain level of effective demand by public works programme. Therefore, contra-cyclical fiscal measures should be used to mitigate impact of world's cyclical movements and for the upliftment of entire economy and to curtail too much dependability exclusively on primary sector. So, a well planned fiscal policy is essential to promote economic stability.

7. Fiscal Functions and Price Stability: Another type of instability in a developing economy is presence of inflation. It is a tendency to rise price level due to huge

NOTES

development expenditure accompanied by corresponding rise in production. Production of basic consumable commodities especially foods fails to maintain pace with increased income and as such, inflationary gap is formed and price level goes up. Pressure created by demand pull are reinforced by cost-push. Increase price are strengthened by increase wage rates and thus a spiral is set up between wage and price. If the condition is not effectively administered, it may turn to hyper-inflation.

Therefore, anti-inflationary, fiscal policy has an crucial role in a developing economy. It involves reduction in public expenditure and rise in taxation as well as public borrowing. Decrease in government expenditure leads to decline in total spending in an economy and brings down total demand. Reduction may also be effected in unnecessary spending on the part of government but at the same time, it will be difficult to differentiate between necessary and unnecessary outlay. However, emphasis should be ultimately laid on taxation and public borrowing. Increase in these may help government to increase income and keep total demand at lower level and which in turn will provide resources to government for economic development. Progressive taxation will be helpful in this context.

8. Fiscal Functions and Distributive Justice or Equitable Distribution: Underdeveloped countries normally suffer from inequalities in income and wealth. In a feudal economy, there exists a huge gap between economic position of lord and serf.

Thus, it is required for government to implement a fiscal policy to decrease inequalities. Most important element in this context is progressive taxation of income as well as wealth. There is also a requirement for tightening administrative machinery to collect tax and reducing tax evasion scope which will help to accumulate huge capital resources. Next element of suitable fiscal policy is the public expenditure programme — which has to be flowed or directed towards progress of human and physical capital. Human resource development possess desirable redistributive effects. Public expenditure policy also brings regional balances in a particular economy.

Limitations of Fiscal Policy

Effectiveness of fiscal policy depends upon measures adopted, their timing, exact variation effected in revenue of national income which is dependent on change in expenditure made by authority. It is also difficult to predict that a boom or slump is approaching. Measures adopted may be slow in taking effect. Thus, fiscal policy often becomes absolutely in appropriate instrument for economic stabilization and growth. Following are some of the limitations of fiscal policy:

1. There may be a clash among several objectives of fiscal policy. Fiscal measures for decreasing income, inequalities or curbing inflation may affect adversely capital formation and rate of economic growth.
2. Anti-inflationary and redistributive fiscal measures also possess their limitations. Likewise, there is also a limit to which taxes as well as deficit financing can be used for the purpose of resource mobilization without affecting an economy adversely.
3. Considerable part of public expenditure is likely to be wasted in case of underdeveloped economies for undesirable, unproductive activities or swallowed by corrupt officials.
4. Fiscal policy sometimes become absolutely inaccurate tool for economic stabilization and growth.

5. Political and administrative delay in making decisions especially while legislative sanction is required for modifying rates of changing expenditures on various programmes.

Role of Fiscal Policy in Developing Countries

Public finance in developing countries differs from that of advanced nations both its objects as well as its contents. Following are the four important objectives of fiscal policy of a developing nation:

1. Promoting and accelerating capital formation both in public and private sector.
2. Creating conditions for a reasonable degree of stability in an economy according to the requirement of economic development.
3. To ensure social justice by redistribution of national income and wealth.
4. Mobilizing real and financial resources for public sector without affecting expansion of resources for private expenditure.

Thus, there exists contradiction in objectives and achieving one may create difficulties in respect of other. For example, policy for rapid rise in capital formation may create inflationary conditions and widen inequalities of income. Again, an attempt to decrease inequalities may cause low rate of saving and capital formation. Hence, a suitable fiscal policy is required to bring harmony among all these targets or objectives.

Fiscal Policy for 2014-15: General Budget 2014-15 is being presented against a backdrop of less than 5 percent growth rate in the last two financial years. However, there are early signs of recovery with the growth rate having bottomed out at 4.5 percent in 2012-13 that has registered marginal improvement at 4.7 percent in 2013-14. It is anticipated to recover further in this fiscal, with varied estimates pegging growth between 5.5 to 6 percent. Government has retained the fiscal deficit target of 4.1 percent of the interim budget in the General Budget. Higher allocation to meet social and welfare objectives while providing for development has been provisioned. Having tamed the twin deficit, on the fiscal and current account, challenge lies in reviving the growth while retaining inflation under check. Thrust of fiscal policy in the General Budget is guided by need to steer the economy on higher growth trajectory with emphasis on equitable sharing of the fruits. Special emphasis is laid upon promoting sectors with potential for higher employability and skill upgradation to meet the requirements of emerging job demand. With revival of market sentiment, it is expected that the positive and pro-active action on the policy will boost the prospects of growth in the current fiscal. Fiscal policy of 2014-15 has been calibrated with twofold objectives, i.e., first, to aid economy in growth revival and second to continue on the path of fiscal consolidation by containing fiscal deficit so as to leave space for private sector credit as the investment cycle picks up. Having contained the spending within sustainable limits in the previous financial year, budget 2014-15 provides 3.5 percent increase in the plan expenditure over the budgeted estimates of FY 2013-14. Against the actual expenditure in 2013-14, this allocation marks an increase of 26.9 percent and is anticipated to adequately fulfill developmental need. A growth of 9.9 percent has been provided for non-plan expenditure in BE 2014-15 over 2013-14 keeping in view the requirements for defence, subsidies, interest payments, finance commission grants and increase in salaries and pensionary payments etc. It would result in overall expenditure increase of 14.8 percent in BE 2014-15 over provisional actuals of 2013-14. As a result of these measures, fiscal deficit is estimated to come down to 4.1 percent of GDP, improving over the target set in the roadmap for fiscal consolidation announced by government.

NOTES

Tax Policy: During fiscal consolidation period, the tax-GDP ratio improved significantly from 9.2 percent in 2003-04 to 11.9 percent in 2007-08. It has been achieved through rationalization of the tax structure, widening of the tax base and reduction in compliance costs through improvement in tax administration. Extensive adoption of information technology solutions and reengineering of business processes has also fostered a less intrusive tax system and encouraged voluntary compliance. These measures resulted in increased buoyancy in tax revenues till 2007-08 and helped in achieving fiscal consolidation through revenue measures alone. Due to the stimulus measures undertaken largely on the tax side during global economic crisis in 2008-09 and 2009-10, as a measure to insulate Indian economy from the adverse impacts of global economic crisis and slowdown in domestic growth, the gross tax revenue as percentage of GDP declined sharply to 9.7 percent in 2009-10. Further, due to high international prices and as a measure to insulate consumers and also to reduce under recoveries government had to further reduce taxes or duty on petroleum products in 201-12. As a result, the gross tax receipts as percentage of GDP in 2011-12 declined to 9.9 percent from 10.2 percent in 2010-11. With partial roll back of stimulus measures in indirect taxes and additional revenue measures, it was estimated that tax receipt as percentage of GDP would improve to 10.9 percent in 2013-14. However, global uncertainties and exchange rate volatility and growth rate lower than expectations in 2013-14, the tax-GDP ratio as per provisional actuals was 10 percent.

Indirect Taxes: With the turnaround in economic activity expected in FY 2014-15, growth in exports and better industrial and manufacturing and also expectation of recovery of growth rate provides scope for achieving the targets. While the performance in 2013-14 was subdued with marginal growth over the previous year, it is expected that with the revival of growth in 2014-15, the budgeted target of 4.8 percent of GDP will be achieved. Again, in the medium term, most significant step from the point of view of broadening the tax base and improving revenue efficiency through better compliance is the introduction of Goods and Services Tax (GST). As far as Central taxes, viz., Central Excise duties and Service Tax are concerned, fair amount of integration has already been achieved, mainly through the cross-flow of credits across the two taxes. It would be possible to realize full integration of the taxation of goods and services only when the State VAT is also subsumed and a full-fledged GST is launched. In recent years, as a preparation for introduction of Goods and Service Tax (GST), Government has been taking consistent policy steps to expand the scope of service tax. To broaden this tax base, negative list approach to taxation of services was introduced with effect from 1st July, 2012. In the same direction, to further broaden the service tax base by bringing stop filers and non-filers within the tax net, a Voluntary Compliance Encouragement Scheme (VCES) was proposed in the Budget Exercise, 2013. This Scheme came into effect from 10th May, 2013. Under this scheme, one-time amnesty by way of: (i) waiver of interest and penalty; and (ii) immunity from prosecution, was extendable to the stop filers, non-filers or non-registrants or service providers who have not disclosed true liability in the returns filed by them during the period from October 2007 to December 2012, provided they declare and pay the tax dues. The VCES scheme was open for the declarants till 31st December, 2013. Approximately, 65,000 Declarations involving ₹ 7500 crore of service tax approximately had been received by the filed formations of Central Excise and Service tax, till 31st December, 2013. In FY 2013-14, the total amount paid under VCES was around ₹ 4000 crore. There are various specific proposals in the Budget 2014-15 to recalibrate the tax effort on indirect taxes so that fiscal consolidation may be achieved in the short term. Important and revenue significant proposals include:

1. Basic Customs Duty on stainless steel flat products is being increased from 5 percent to 7.5 percent.
2. Export duty on bauxite is being increased from 10 percent to 20 percent.
3. Basic Customs Duty on half-cut or broken diamonds is being increased from NIL to 2.5 percent and Basic Customs Duty on cut and polished diamonds and colored gemstones is being increased from 2 percent to 2.5 percent. Basic Customs Duty on specified telecommunication products not covered by the Information Technology Agreement is being increased from NIL to 10 percent.

Direct Taxes: Government policy on direct taxes has been to achieve growth in direct taxes by widening tax base while maintaining a regime of moderate tax base. Tax collection is the product of two factors tax rates and tax base. There will be no change in the rate of personal income tax ,the rate of tax for the domestic and foreign companies in respect of income earned during the financial year 2014-15. Rate of surcharge will continue to be the same as in the last year. Widening of tax based to achieve growth in tax collection is a continuous process which involves both legislative as well as administrative measures. Major policy proposals, intended to broaden the tax base and augment revenue, in the Union Budget 2014-15 are as follows:

1. It is proposed to include the investment linked deduction within the ambit of alternate minimum tax (AMT) after making adjustment for depreciation.
2. It is proposed to tax any advance received by the seller during the course of negotiations for transfer of capital assets if the transfer does not take place and such amount is forfeited.
3. It is proposed to levy dividend distribution tax instead of only the actual amount paid to shareholders.

Further, the administrative and technological initiatives to augment revenue are as hereunder:

1. Extensive use of technology is being made for collection of information without intrusive methods. Information technology tools are being developed for exhaustive collection of information and maintenance of database.
2. Data warehouse and business intelligence project has been undertaken for developing a comprehensive platform for effective utilization of information to enhance voluntary compliance and deter non-compliance.
3. Centralize processing centre (Compliance management) is also proposed to be set up for handling resource intensive repeated tasks to increase greater efficiency.

Contingent and Other Liabilities: In terms of Article 292 of the Constitution, Central Government gives guarantees for the repayment of borrowings upon the security of the Consolidated Fund of India. The FRBM Act mandates the Central Government to specify the annual target for assuming contingent liabilities in the form of guarantees. Accordingly, the FRBM Rules prescribe a ceiling of 0.5 percent of GDP for incremental guarantees that Government can assume in a particular financial year. Central Government extends guarantees primarily for the purpose of improving viability of projects or activities undertaken by the Government entities with significant social and economic benefits, to lower the cost of borrowing and to fulfill the requirement where sovereign guarantee is a precondition for bilateral or multilateral assistance.

NOTES

Government Borrowings, Lending and Investments: Status Paper on Government Debt is published annually to improve transparency in dissemination of information related to public debt. Third edition of the document was published in July, 2013. Prudent debt management is cornerstone of good economic policy and experience in the other parts of the world has shown that vulnerability of debt profile to international shocks needs to be closely monitored in emerging global economic order. In India, debt policy is driven by the principle of gradual reduction of public debt to GDP ratio so as to further reduce debt servicing risk and also to create fiscal space for developmental expenditure. Indian debt profile is characterized by reliance on domestic market borrowings, with market determined rates rather than administered rates. Development of deep and wide secondary market for Government securities is one of the key reforms in this regard. Another major decision is to establish an independent Debt Management Office (DMO) in Ministry of Finance. While government is in the process of introducing necessary legislation, Middle Office has been established in the interlude. The office is assisting government in issuance of calendar for borrowing and advice on selection of instruments and other related matters. One of the key features on country's debt profile is diminishing proportion of external debt as percentage of total borrowing. External borrowing is limited to bilateral or multilateral loans from select development partners for financing development projects. This has been decreasing in view of their exposure norms and income norms and the only significant bilateral partner as on date is Japan. External funding has reduced significantly from ₹ 10,560 crore in BE 2013-14 to ₹ 5440 crore in RE 2013-14, as many projects are in inception stage and could not come up for payments while repayments were as per schedule, resulting in decline of net financing. The BE 2014-15 for external debt has therefore been kept at ₹ 5,734 crore. With gradual decline in net inflow from Multilateral Institutions in the coming years, government would have the option of exploring other sources of external debt, for example, in the form of sovereign bond issuance to maintain a reasonable mix of domestic and external debt in its portfolio. However, a low share external debt in the total debt insulates the debt portfolio from external sector shocks and currency risks. Low interest rates in the international financial markets in recent past suggested that it may be beneficial to borrow from international financial market. The decision to issue foreign currency denominated sovereign bonds, however, cannot be based upon relative cost alone. Further need to access international capital markets should be justified in the context of overall savings and investment requirements of any economy. Thus, decision to issue sovereign bonds would require setting up a regular and predictable schedule of issuance leading to a build up of interest and redemption payments, keeping in view balance of payments (BoP) implications.

Again, in view of redemption pressures in coming years, particularly during 2015-16 to 2017-18, Government in co-ordination with the Reserve Bank made progress during 2013-14 in putting in place an active debt management strategy to manage its debt portfolio. Government adopted the policy of passive consolidation of dated securities during 2013-14. To ease out the short-term redemption pressure in 2014-15, switch operation in dated securities (G-Secs) was carried out with institutional investors. It is expected that switching or buybacks will ease redemption pressure in the initial part of ensuing financial year. Moreover, with redemption pressure rising over next three financial years, active debt management synchronized with cash management will help in managing redemptions with optimal costs.

Initiatives in Public Expenditure Management

NOTES

Direct Releases to State or UTs with Legislature: All Plan schemes under which central assistance is provided to States or UTs are to be classified and budgeted as Central assistance to State or UT plans w.e.f. 2014-15 BE onwards. For all such schemes, funds will be placed with the Administrative Ministries for transfer to the States through the Consolidated Fund of the States or UTs with Legislature concerned. Mode of transfer may be implemented in a phased manner in 2014-15 (BE). Routing of money through State Treasury will infuse greater ownership of Plan schemes to State or UT governments and greater accountability on them to make timely and need based releases to local Implementing Agencies (IEs) and also to monitor the implementation of schemes more closely.

Restructuring of Plan Schemes: In a major initiative towards improving the efficacy of plan schemes, Planning Commission implemented restructuring of centrally sponsored schemes and direct releases through State Treasury. As a part of streamlining, 126 CSS haven restructured into 66 schemes that includes 17 flagship programmes. Restructuring of schemes to be affected from this financial year 2014-15 onwards, shall add to more effective application of resources as plan allocations shall be more concentrated. It will also result into more focused monitoring of implementation of schemes by the administrative ministries. In another major initiative, government decided to earmark at least 10 percent of the outlay of CSS on flexi funds. Central Ministries was carried out with institutional investors. Accordingly, securities from 2014-15 and 2015-16 maturity buckets for face value of about ₹ 31,000 crore were successfully switched to longer tenor securities with institutional investors during January and February 2014. Securities amounting to ₹ 15,590 crore were bought back in March 2014 to smoothen the maturity profile of outstanding dated securities in 2014-15. While continuing further with active debt management strategy, it is proposed to undertake buyback or switch of another ₹ 50,000 crore securities of shorter tenor during 2014-15. Buyback of debt serves twin purposes of effective cash management and also smoothening of maturity profile.

Direct Benefit Transfer: In a move to ensure accurate targeting of the beneficiaries, cut down wastage, duplication and leakages, enhance efficiency in disbursal of funds and efficacy of use of government money, it was decided in October, 2012 that individual benefits from the government would be directly transferred into the Aadhar linked bank account of the concerned beneficiaries. Accordingly, the scheme of Direct Benefit Transfer (DBT) was rolled out from 1 January 2013 in 43 selected districts in 25 identified schemes of 8 Ministries. Approximately 97 lakh beneficiaries in 121 districts stand to benefit under DBT till the end of the year 2013. Once DBT-LPG is rolled out completely across the 291 districts, it will cover over 7 crore consumers making it one of the largest cash transfer programmes in the world.

Expenditure Management Commission: While Government has managed to control the expenditure through rationalization in the fiscal consolidation phase, quality of expenditure remains an area that requires to be addressed. Ongoing fiscal consolidation has been successful in taming the fiscal deficit; however, there is still imbalance in the public finance on the revenue side. Concerted efforts are required to accomplish the target set for the revenue deficit and effective revenue deficit in the new FRBM regime. Government will constitute an Expenditure Management Commission to supervize into various aspects of expenditure reforms to be undertaken by the Government.

NOTES

Railway Budget: Though Railway Budget is presented separately, yet, earnings and expenditure and all other major financial figures are incorporated in the General Budget. Government support is provided to Railways by means of Gross Budgetary Support (GBS) and a return on this investment termed as Dividend is paid every year. Rate of Dividend is determined by the Railway Convention Committee which is 5 percent at present. There has been no default in the payment of dividend in the last ten years. Railway Revenues are primarily earned through two major traffic streams, passenger and freight. Certain earnings are also contributed by parcels, commercial utilization of land, siding charges, advertisement and dividend paid by Railways' PSUs and these earnings are used to meet operating expenses, i.e., Ordinary Working Expenses (OWE) and pensionary charges. Remaining surplus is used to pay dividend and balance is ploughed back as plan investment to meet safety and development needs of the system. Railway Finances improved in the last decade in as much as that it achieved the Operating Ratio of 75.9 percent in 2007-08, primarily because of buoyancy in the national economy getting reflected in railway traffic and the average growth in railway expenditure. However, after 2007-08, the OWE and pension payment soared consequent upon implementation of the 6th Central Pay Commission (CPC), whereas the momentum of growth in earnings witnessed earlier could not be maintained. As a consequence, the Operating Ratio deteriorated to the extent of 95 percent. The Railway Plan could be sustained by drawing down from the Railway Reserves Funds. Actually, balances in Railway Reserve Funds become negative to the extent of ₹ 2,100 crore and ₹ 385 crore during 2010-11 and 2011-12 respectively. General Reserves provided a loan of ₹ 3,000 crore in 2011-12 to bridge the negative balances in the Railway Funds.

Therefore, it is imperative that augmentation of capital expenditure is financed through greater mobilization of resources including investments from Public Private Partnership as well as Foreign Direct Investments.

Policy Evaluation: The General Budget 2014-15 reaffirms Government's commitment to continue the process of fiscal consolidation. The fiscal deficit target set out in Interim budget has been adopted in the main budget. Government has reprioritized expenditure and made additional allocations in consonance with policy for equitable growth, providing fillip to growth while focussing on the social and welfare sector. On the expectation of moderate global recovery, modest recovery in manufacturing, improved sentiments witnessed in recent months and absence of large upshots in international energy prices, the economy can be expected to recover the growth rate, after sub 5 percent level witnessed in last two years.

Adoption of the fiscal consolidation targets also set the guiding principles for fiscal policy from the medium term perspective. It entails constriction of fiscal space over the period 2014-15 to 2016-17. Now, with weakening of growth rate, government revenues have been under stress and consequent fiscal consolidation hitherto was essentially through expenditure management. However, there is need to increase the tax to GDP ratio progressively to garner greater resources. This in turn would require comprehensive review of tax structure including widening the tax base in the direct taxes and also duty structure in the indirect taxes in coming years. Apart from that, expenditure management has to be fine tuned further to meet the challenge of inclusive growth which caters to the development of poor while providing impetus to economic growth. Another important aspect of the fiscal consolidation pertains to the capital spending. Ratio of capital expenditure as proportion of total expenditure has come down from a high of

NOTES

23.2 percent in 2003-04 to 12 percent in 2012-13. Imbalance in the revenue expenditure of the government also indicates problem of classification of government spending.

Roadmap of fiscal consolidation adopted by the government in FY 2012-13 is aligned with the fiscal deficit targets as laid down in the amended FRBM Rules, 2012. Government has been steadfast in adhering to these targets. With the General budget 2014-15, fiscal deficit roadmap is on track and expected to attain 3 percent goalpost in next two fiscal. So, the task of fiscal consolidation is half done with respect to fiscal deficit. However, performance on revenue deficit and effective revenue deficit has not matched the targets as laid down in the amended FRBM Act, principally because of vulnerable global economic situation and high inflation in the domestic economy has limited government's maneuverability to curb subsidies as well as other welfare measures. Therefore, it is expected that the revival of growth and stabilization of external economic conditions will provide necessary space to rectify the balance on revenue side in the ensuing years.

4.3 SUMMARY

1. Annual budgets are the principal means by which government authorize and control most of the expenditures, most outlays provided for in the public sector portion of a development plan must be incorporated into these budgets if the plan is to be carried out.
2. A government's budget is, therefore, a key element in converting a development plan into a programme for action.
3. Where relationship between a plan and budget is close, the budget is, as far as it goes, the financial counterpart of the public sector plan.
4. The conventional administrative budget normally used by governments does not encompass all public sector activities.

4.4 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1 An annual plan reaches its conclusions after consideration of the _________ to a country.

2. Finance is an accounting device which shows whether the total requirement of _________ with the available quantity.

II. True and False

1. An annual plan incorporates those instruments of economic policy and organizational and institutional measures required to mobilize resources and attain plan objectives.
2. An annual plan is, therefore, broader in scope than a conventional administrative budget.

NOTES

III. Multiple Choice Questions

1. Budgets based on annual plan are an integral part of _________.
   (a) Planning process
   (b) Administrative process
   (c) Accounting process
   (d) None of the above
2. In India, budgets are prepared on the basis of _________.
   (a) Annual plans
   (b) Mid-term plans
   (c) Quarterly plans.
   (d) None of the above

Short Answer Questions

1. Define the term budget.
2. Explain in brief about the inadequacies of Conventional Budget system.

Long Answer Questions

1. Explain in detail about the relation between government budget and national plan.
2. Critically analyze the role of fiscal policy in resource mobilization for development.

4.5 KEY TERMS

- Budgetary Fragmentation
- Conventional Budget
- Resource Mobilization

4.6 KEY TO CHECK YOUR ANSWER

I. 1. Totality of the Resources Available, 2. Physical Resources Balances.
II. 1. True, 2. True.
III. 1. (a), 2. (a).

5

Chapter

BUDGETARY UNDER FEDERAL SET-UP

Objectives

- Budgetary under Federal Set-up
- Budgeting at National Level and Regional Levels and their Co-ordination
- Performance Budgeting
- Budget Classification
- Analysis and Interpretation of Budgeting and Plans

Structure:

5.1 BUDGETARY UNDER FEDERAL SET-UP

Financial relation between centre and state units is a major problem of public finance in a federal state. There are several countries of world which have federal form of government. USA, Canada, Australia and Switzerland are older ones. Modern concept of federalism was evolved in USA during the year 1776-1789. Thus, federation is often spoken of as an American invention. Founding fathers of the US Constitution drew their ideas from ancient Greece, united Netherland and the British Empire. According to K.C. Wheare, the federal principle may be defined as, a method of dividing powers so that the general and the regional governments are each within its sphere co-ordinate and independent.

Countries like India, Pakistan, Nigeria, West Indies and Malaysia also adopted certain form of federalism to fulfil their respective requirement. Division of financial functions between the central and the state governments holds a special significance in these states.

NOTES

Federal state is a union of states where authority is divided between federal and state governments, Here, both centre and states are independent in exercising their authority. The constitution which demarcates states from federal jurisdiction is the supreme law of the land. There lies a distinction between powers of two sets of authorities and is very little interference in each other's affairs except where there is specific provision for it in the constitution.

The principles upon which distribution of powers are as follows:

(i) Those matters have importance for the country as a whole are entrusted to rational government, i.e., communication foreign relations, defence etc.

(ii) Those matters like education, agriculture, public health etc. — which are considered to be of local significance are assigned to the units (states).

Distribution of powers on a permanently satisfactory basis may be difficult and dispute arises on the ground of competence of state and rational governments in any specific issue. Hence, judicial authority like the supreme court in India settle these disputes and interpret our constitution such a situation.

Exact distribution of functions depends upon how a federation came into being and thus differs from country to country. In cases, while a large number of independent states combine and constitutes a federation, the federal centre was given only most essential functions of a national character and units of a large member of functions. Powers of every layer of government are known as 'enumerated powers' and others are 'residuary powers'. In Indian federal constitution, centre possess residuary powers while states possess enumerated powers. Sometimes, federations come into existence, as unit government devolves certain powers to provinces by decentralization. Here, centre has retained maximum powers while units are comparatively weak. Whatever the case may be, in both situations, relationship between centre and units are distinctly defined and exercise authority in their respective demarcated spheres.

In federations, there is also a concurrent field of authority, i.e., certain functions are exercised both by the centre as well as units. Alternatively, there is an overlapping of authority in these matters. For instance, in education, laws may be framed both by federal and state legislatures and in this regard partly may be controlled by centre and others may be within the jurisdiction of states. Although centre is empowered to co-ordinate administrative activities of the units. During emergencies like wars, centre acquires overriding authority even in the state matters. In developing countries like India, development scheme in the state sphere may be influenced by respective central policies. It may also be possible that states may surrender certain powers to federal government. On many occasions, centre become so strict that it exercises its authority in matters which usually lies within the jurisdiction of the states.

Above mentioned developments can be categorized into:

(i) Co-operative federalism, where sharing powers is confined to tax sharing.

(ii) Coercive federalism, where central government assumes superior sources of revenue and is motivated by expanding ideas.

(iii) Co-ordinate federalism involves deliberate action by government to shoulder responsibility by way of co-ordinating decision making processes.

Source: Please see p. 80 to p. 94 of B.T. Pvt. Ltd. {[ECON/IIIC] of UGC(H)}. For details of Federal Finance, please refer p. 73 to p. 94 of Econ/IIIC of UGC(H).

NOTES

So far as allocation of functions are concerned to keep it manageable, adopts threefold division of fiscal functions as advised by Richard Musgrave, i.e.,

(i) Allocation

(ii) Distribution

(iii) Stabilization

An ideal distribution of tax payments is one, where every individual pays tax equal to his marginal benefit. Alternatively, if marginal benefit to tax payer is greater than marginal cost in rendering service, thus distribution of tax payments are considered ideal.

From division of powers in a federal state follows division of financial operations. The centre and states have their separate lists of functions and must have separate powers of spending and taxing. Our constitution lays down provisions for different levels of government, for incurring expenditure within respective assigned fields and to raise revenues for this purpose.

Principles of Federal Finance

There is no uniform principles that determines allocation of various functions among different components of government to constitute a federal structure. However, for satisfactory working of a system of federal finance, four principles or norms have suggested. These are as follows:

1. Fiscal Autonomy: In this capacity, every government should be free to raise revenue and to spend them. Responsibility of collecting taxes and also freedom to spend them ought to go hand in hand. So, Government should enjoy autonomy in fiscal matters.

2. Adequacy of Means and Flexibility: Fiscal independence is possible only when government has adequate resource of revenue at its disposal. As requirements of government are likely to change from time to time, hence sufficient flexibility is required in resources available to every government. Hence, certain regulatory devices have to be adopted to ensure an efficient use of resources on the part of every government.

3. Equity: Equity can be treated from two points:

(i) Resources should be distributed among components so as to give fair share of revenue.

(ii) Allocation of resources should be done in such a manner so as to provide equal treatment individuals as well as business firms in different places. Where different taxing authorities get due share of revenue from common base, different rates indicates inequity and thus it is advisable that financial relations should be so arranged that it minimizes this types of problem.

4. Economy: It is an important criteria to determine efficiency in any system of public finance. It possess special significance in resource allocation in case of a federal system. For maximum economy to be realized, there should be some kind of co-ordinating machinery for integrating as well as harmonizing inter-government fiscal policy.

Resource Allocation

As mentioned above regarding demarcation of sources of revenue between centre and state, yet, financial arrangement between two are utmost important. As governments have their own allocated functions, thus they must possess sufficient or adequate resource

NOTES

to fulfill those needs. Alternatively, division of function pre-supposes division of resources. Constitutions of each federal state has distinct provision in this regard.

So far as basis of such division of resources are concerned, taxes and other sources provides the base extending over entire nation, which mark its impact upon economic life of a country included in the federal list. But, on contrary, other taxes those are based in individual states and impacts of that seldom crosses beyond boundaries of a state are allocated in that respective state only. For instance, suppose customs duties which is related to trade of entire country are generally a central head of revenue. But taxes on land and other immovable property which is concerned to states only are usually sources of revenue in the hands of respective states only.

Distribution of resources in all federations aim at providing fiscal independence to all governments. Central and state authorities are given sources of income to fulfill their needs. Government should manage its resources efficiently to make its optimum utilization. Along with this, it should also maintain expenditure at a specific level so that it remains within the mean available to it. It shows a sense of responsibility at the hand of units which is inevitable for effective operations of federal system.

Financial arrangement in most federation, in fact, are desirable from both economic as well as political point of view. It makes units dependent upon centre and reduces fiscal autonomy to a mere ideal, which is difficult to achieve. Therefore, various adjustments are required. Besides, a mere distribution of revenue resources have to be in financial relations between centre and state units.

Financial Adjustments

Complete financial autonomy has never been realized in reality even in older federations like USA, Australia and Canada. In resources distribution system, allocation and division of resources do not go hand in hand. It may also be possible that states having more responsibilities but less resources and *vice versa*. Hence, fiscal imbalance shows its presence in almost all federations. As a consequence thereof, few adjustments are required to bridge gap between functions and resources. These adjustments take various forms, which are as follows:

1. Division of Tax Revenues (A System of Shared Revenue): Transfer of resources from centre to state may take form of distribution of tax yields to states. In addition to taxes levied and collected by states, constitution has provided that revenues from certain taxes in Union List to be allocated partly or wholly to states. These provisions fall into following categories:

(a) Certain duties like stamp duties, excise duties, narcot's duties are levied by the Union but are collected and appropriated by the states.

(b) Certain taxes like terminal taxes on goods and passengers, succession duties, taxes on purchase and sale of newspapers and advertisements therein etc. are levied and collected by the union but entire proceeds are assigned to the states in proportion determined by Parliament.

(c) Certain taxes like proceeds of excise duties on mill made textiles which are levied by the Union in 1957 in replacement of States' sales taxes on these commodities were fully distributed among the states so as to guarantee their incomes from displaced sales tax.

2. Surcharge on Taxes: Another possible arrangement is for an authority to levy surcharge on some taxes imposed by the other. Centre may levy additional rates on state taxes and state may also do that on central taxes. But, centre may not make up its financial shortages by depending upon surcharge on state taxes. There may be different rates and coverage of same tax in different states and a uniform additional levy by centre is not appropriate. But reverse may be possible as a method of financial adjustment by states.

3. State's Contributions: In case, while states are financially strong and centre is weak, contributions to central revenues by units may become necessary. But such kind of dependence of centre on units is wrong in principle and are not desirable either. Above all, central policies are affected by pulls and pushes of units, which is seldom in our national interest.

4. Central Grants to States: Sometimes, centre makes certain grants to states for influencing states policies and also compel them to adopt certain welfare and development activities. Further, States are made to conform their principles to national purposes.

5.2 BUDGETING AT NATIONAL LEVEL AND REGIONAL LEVELS AND THEIR CO-ORDINATION

Transfer of Resources from Centre to States

In all federations of the world, the centre is financially stronger than the states. Allocation of resources has been done in a manner as to give the centre a proportionately much larger share of revenues than that of states. Further, sources of revenue at the disposal of the federal authority are more elastic than those with the states. This has been so in older federations and almost all the new federations have copied this arrangement. The central government has responsibility for economic development and stability. Financial stability and strength at centre is necessary for discharge of these functions. Centre has, therefore, been given fiscal powers appropriate for this purpose.

Under such circumstances, transfer of resources from centre to states are essential part of the financial arrangements in a federation. There are three problems which give rise to the need for such transfers. Firstly, there is an imbalance of revenue between the centre and the states. Allocation of the sources of revenue is such that those with the centre are more paying, e.g., customs and excises. Secondly, all states in a federation have not reached the same stage of development. There is not enough base for taxation in some states. Thirdly, welfare and development activities have to be undertaken by states, for which means available to them are not adequate and transfer of resources from centre become indispensable. Transfers usually take three forms: (1) Division of proceeds of certain taxes, (2) Grants by the centre to states and (3) Loans given by the centre to the states.

1. Division of the Proceeds of Certain Taxes: Proceeds of certain taxes are shared between centre and states. In India, this is done in respect of income tax and excise. In many cases, there are certain taxes levied and collected by centre but proceeds of those are wholly distributed to states. These taxes could as well be levied and collected by states but central management is for uniformity in rates and coverage. Estate duty in India is a standing example. There are certain other taxes which are levied by centre but which are collected and appropriated by states.

NOTES

The sharing is so done that the centre has a larger share sufficient for its requirements and rest is distributed among states. There are three principles which are suggested for distribution:

(i) States' share may be on the principle of compensation for loss of revenue on account of federalization and federal policies. This is difficult to determine, particularly in the case of federations that have come into being as a consequence of devolution of powers by a unitary centre.

(ii) Another principle is requirement needs of the states. These may be measured in terms of population or policies and schemes adopted by states.

(iii) Backwardness of a state may also be a criterion for which some kind of an index of backwardness has to be worked out.

Complete justice and satisfaction to all states is impossible under any system of distribution. There are always pulls and pushes from states for the adoption and rejection of specific criteria. It is difficult to estimate requirements of states by any objective criterion. Perhaps, best scheme is for a commission to go into the state budgets, examine their plans for development and welfare and only thereafter suggest a suitable basis for distribution.

Distribution of tax revenues has certain disadvantages. Sometimes, rates of federal taxes have to be kept unduly high to meet financial requirements of states. Other effects of these taxes are ignored. Further, while collecting, government incurs all unpopularity while states that receive shares get benefits. There is also no inducement for states to effect economies in their expenditure.

2. Grants by the Centre to the States: Sometimes transfers take the form of grants. These are given primarily on the basis necessity of the states. Requirements have to be carefully estimated in relation to the resources of the states and grants are given to them. Requirements are measured in terms of population, percentage of collection, plans for welfare and development, and backwardness of states. These grants bring about a certain measure of uniformity in resources available to states.

Grants are given to enable centre to exercise a certain measure of influence upon policies and schemes adopted by states. Centre can persuade units to adopt measures which serve certain national purposes. Centre may also encourage grant receiving states to adopt schemes for their own benefit but which fit into general national plan.

Grants are based on two principles. One is authority transferring resources may retain responsibility for their proper use. These are called 'Conditional Grants' and are given for specific purposes. Other, 'Unconditional Grants' are given unconditionally but are to be spent in conformity with general principles of sound finance. Actual arrangements may be between these two extremes. Centre gives both these grants. There are some grants to which no specific conditions are attached. There are others which have to be spent by states for specific purposes such as education, public health, housing, improvements of certain industries, etc. In developing countries, some grants are given to implement specific programmes of development.

3. Loans Given by the Centre to the States: States raise loans in the capital market, but they also get short-term and long-term loans from the central government. Loans may be for specific schemes or for general purposes. Like other kinds of transfer of resources, this form also necessitates a central watch over the purpose and use for which states borrow.

Problems of Centre-State Financial Relations in India

India has a federal form of Government, and hence federal finance system. Essence of a federal form of Government is that Central and State Governments should be independent of each in their respective, constitutionally demarcated spheres of action. Once the functions of the Governments are spelt out, it becomes equally important that each Governments should be provided with sources of raising adequate revenue to discharge functions entrusted to them. For successful operation of federal form of Government, financial independence and adequacy form the backbone.

Evolution of the finance system in India can be traced to the Government of India Act, 1935. This Act was based upon general principle of financial independence for provinces. The Constitution of India accepted this basic principle of federal finance and apart from that tried to achieve a few more principles. Among them, first and the foremost is achievement of a financially strong Centre. This is done by adopting the following measures: (a) Powers of concurrent taxation has been avoided; (b) Centre has been assigned more elastic and high yielding sources of revenues; (c) Centre has been given the subjects of money and banks, currency and coinage; and powers to resort to deficit financing; (d) Centre has been provided with certain exclusive sources of revenue; and (e) Residuary powers lies with the centre.

Secondly, the constitution has divided the various functions into three lists, viz., (a) Union List, (b) States List and (c) Concurrent List. Financial powers have likewise been divided between the Centre and the States.

Thirdly, the constitution has made provision for transfer of resources. This is to be achieved by three means, viz., (a) tax-sharing, (b) grants and (c) loans. These are sometimes referred to as "balancing factors" to correct inter-regional inequalities of income. One basic principle of federal finance is functions and resources should go together. However, in most federation, there is always a gap between functions to be discharged and financial resources needed to discharge them. Hence, regional imbalances constitute a source of conflict and this conflict is solved by the use of the balancing factors.

Fourthly, there exists a flexibility in transfer of resources. The reason is, resource are transferred from the Centre to the States according to recommendations of the Finance Commission constituted by the President under the provisions of Article 280 of the Constitution. The commission does not have any set procedure to go by. It has to make its own choice. It lends flexibility to the system. Appointment of the finance commission is of great importance for it enables the financial relation between the Centre and the States to be altered in accordance with changes in need and circumstances.

Constitutional provisions relating to federal finance are segregated into three broad heads, i.e., (A) distribution of financial powers; (B) mechanism of resource transfers and (C) finance commissions.

A. Distribution of Financial Powers: The constitution makes a clear division of financial resources between Centre and States. Sources of revenue can be grouped under two heads, viz., (1) Sources of revenue for Centre and (2) Sources of revenue for States.

Sources of revenue to Centre are: (a) sources of tax revenue; and (b) sources of non-tax revenue. Sources of tax revenue include 12 items like taxes on income other than agricultural income, corporation tax etc. The non-tax resources are: (1) borrowings; (2) income from Government undertakings and monopolies; (3) income from Government property and income arising out of the exercise of various Governmental

NOTES

functions and rights; (4) interest earnings on loans as well as advances to State Governments' commercial and non-commercial undertakings; (5) gifts, donations etc.; (6) fees in respect of any of the matters in the Union List but not including fees taken in any court; and (7) fees taken in the Supreme court.

Similarly, the sources of revenue to the State Governments can be divided into: (a) sources of tax revenue; and (b) sources of non-tax revenue. Under constitution, States have been given independent tax powers and the State list contains 19 items like land revenue, taxes on agricultural income, sales tax etc. The non-tax revenue includes: (a) fees taken in all courts except the Supreme court; (b) income from undertakings owned partly or fully by respective State Governments; (c) income earned from property owned by State Governments; (d) borrowings from within the country; (e) royalty from mines, forests, etc.; (f) grants-in-aid from centre; and (g) other grants from the Central Government.

Various taxes imposed by the Central Government are divided as follows:

1. Taxes and duties which accrue wholly to the Union Government, e.g., customs duties including export duties, corporation taxes etc.
2. Taxes levied and collected by the Union but which may be shared with States (Article 272 of the constitution).
3. Taxes and duties levied and collected by centre but the proceeds of which are assigned to States (Article 269 of the constitution), e.g., succession duty in respect of property other than agricultural land, terminal tax etc.
4. Taxes and duties levied by Centre but collected and appropriated by State concerned (Article 268 of the constitution), e.g., stamp duties and excise duties, duties on medicinal and toilet preparations etc.

This sort of the division of tax powers reflects on operational distinction made between levying, collection and appropriation of tax proceeds. Each part has been decided on the basis of maximum efficiency expected under the constitution.

B. Mechanism of Resource Transfer: Important means of resource transfer are: (a) assignments, (b) tax sharing, (c) grants-in-aid and (d) loans.

C. Finance Commissions: Specific provision has been made in the constitution for the appointment of a finance commission every five years or earlier. Under Section 280 of the constitution, the President is empowered to appoint a finance commission at the expiry of every fifth year or earlier which shall consist of a chairman and four other members.

The Finance Commission makes recommendations to the President regarding: (1) Distribution of net proceeds of taxes to be shared between Union and States and allocation of shares of such proceeds among States; (2) Principles which should govern the grants-in-aid to the revenues of States out of consolidated Fund of India; (3) Any other matter the finance commission may deem fit. Important recommendations of all the Ten commissions so far reported have been accepted and acted upon by the Central Government, in the spirit of the constitution.

Centre-State Conflict on Finances

Financial relations between Centre and States are of vital importance for smooth functioning of a federation. Since last few years, there has been growing conflict and tension between Indian Union and States. This conflict has been aggravated by political and ideological differences among different parties governing the Centre and States. In the first place, the financial provisions of the constitution gave very extensive financial resources to the Union and on the other hand, State Governments were given important responsibilities but inelastic and unproductive resources. This has been a major reason of conflict between the Centre and States.

Secondly, under the weight of successive plans of economic and social development, there is a growing divergence between responsibilities arising from original distribution of powers and fiscal capacities between the Union and States.

Thirdly, there have been serious regional imbalances in economic development so much so that some States have been left behind while others have made considerable economic progress. However, it must be stated that the amount of imbalance between regions is inevitable in a large country like ours. But Central Government did not use its financial resources or its policy of economic planning to bring about balanced development of all regions. Naturally, the backward and neglected States clamour for more powers and more financial resources.

Finally, the Indian Constitution provided for inter-governmental grants and loans, so that the Centre might come to the help of those States which were in difficulties and also to bring about balanced development among different regions. Use of grants and loans in the last 40 years or so, however, has resulted in complete domination and control of the States by the Centre and utter dependence, and to a certain extent even financial irresponsibility and indiscipline on the part of the States. A stage has now been reached that while Centre-States financial relations will have to be reviewed thoroughly. The Thavaraj Committee (Report of the Taxation Enquiry Committee, Kerala Government), the Rajamannar Committee on Centre-State relations appointed by the DMK Government of Tamil Nadu and the document on Centre-State relations adopted by the West Bengal cabinet led by the CPI(M) United Front — all these have the same theme, i.e., political and financial autonomy for States and drastic restriction upon power as well as financial resources of the Centre.

Responsibility and Resources of the Centre and of the States

According to our Constitution, the Centre has to concern itself with the most generalized features of the Indian economy like creation and maintenance of banking system, railways and ports and facilities for national economic planning with necessary regulations and development of large-scale industries, exploitation of mineral resources, regulation of foreign trade, etc., besides, defence of our country from foreign aggression. On the other hand, States are concerned with certain important aspects of life of our people, e.g., maintenance of law and order, construction and maintenance of irrigation, power, road transport, etc. development of educational and health facilities, promotion of primary sector like agriculture, fisheries, forests and secondary sector, viz., small and medium industries.

To carry out these responsibilities, our Constitution provided for different types of financial resources. The Union is entrusted with taxes on personal incomes and profits of companies, excise duties and customs duties. In a rapidly developing economy, these are precisely most productive taxes in any country. In the case of the States, land constitutes an important base of taxation. In a densely populated country like India, volume of land coming under tax remains almost stationary. Therefore, land as a source of revenue has been responsible for the inelastic nature of State revenues to a considerable extent.

NOTES

Various taxes on commodities and services like sales tax, State excise duties, duties in electricity rates, motor vehicles tax, etc. can be quite productive.

On contrary, taxation of industrial and commercial properties has been preserved by the Centre and tremendous expansion of base of industrial and commercial property, income and wealth as a consequence of economic development is responsible for raising the financial resources of the Centre. Further while rapid industrial development boosted excise duty collection, expansion of imports pushed up customs duty collections. It seems to have given a buoyancy to central revenues which is not available to any tax head assigned to States.

The period since 1951 has witnessed enormous expansion of financial powers of the Central Government whose dimensions have progressively increased in relation to the combined resources of all State Governments put together. For example, current tax revenues of the Centre have risen from ₹ 360 crore in 1950-51 to ₹ 65,000 crore in 1994-95 and current tax revenues of the States (excluding transfers from the Centre) have risen from ₹ 280 crore in 1951-52 to ₹ 53,400 crore in 1994-95. Rate of growth of revenues of Centre is much faster as compared to that of State. But then, Centre has limited functions to perform while functions of States are almost unlimited.

In a way, the Constitution itself is responsible for the existence of a financially strong-Centre and weak States. Before independence, there was a growing consensus in favour of the corporation tax and export duties to be included in the divisible pool. This was the case made out before the Sircar Committee known as the Expert Committee on Financial Provisions. It was partition which alerted the Constituent Assembly against possible dangers to the unity of India arising from the divisive forces. Its effect is reflected in the strong-Centre theme which runs through the Constitution. Financial provisions of the Constitution clearly reflect this strong-Centre bias.

Sources of Conflict Listed by the States

West Bengal, Jammu and Kashmir, Punjab, Maharashtra and other Southern states are very agitated over the question of state's autonomy. Centre-State conflict on financial relations is only a part of the overall Centre-State relations and demand for political and fiscal autonomy. Sources of conflict as listed by states are as mentioned below:

(i) Basic assumption of our Constitution in favour of a strong Centre and weak and dependent states is no longer acceptable and States like West Bengal insisted that a strong Centre requires equally along with strong and autonomous States.

(ii) Nature of functions to be performed by States and necessity to promote cultural, linguistic and special conditions of each State require States should be autonomous.

(iii) Since Independence, Centre has been gradually extending its functions in such a way as to keep the States completely dependent on it. This process has been encouraged in the first two decades after Independence by the Congress Party which was in power both, at the Centre, and at the States. This process was further strengthened during the period of Emergency, i.e., 1975-77.

(iv) Centre has been duplicating unnecessarily a number of departments which have no real functions to perform, i.e., education, public health, etc. which are all State subjects. There is even a move that these subjects should be put on the concurrent list.

(v) Centre has been interfering in affairs of State, i.e., law and order which is absolutely State subject by setting up the Central Reserve Police, the Border Security Force, the Industrial Security Force, etc.

(vi) Centre, with too little to do, is entrusted with too much financial resources when State Governments with so many vital functions to perform are starved of financial resources.

(vii) Financial resources of the Centre are highly elastic, while that of States are relatively inelastic. Henceforth, States have been compelled to depend upon Centre to a large extent for their required financial requirements.

States' Complaint on Financial Arrangements

As share of taxes and duties was inadequate to meet growing revenue and capital expenditure (especially before the Seventh Plan award) states had to resort more and more to grants-in-aid and loans from Centre. There was a growing feeling of uncertainty and indecision, loss of initiative as well as irritation on the part of the States. States have become further suspicious regarding behaviour and motives of Centre so far as question of raising and sharing of tax revenues with the States are concerned.

(i) Centre has not taken sufficient initiative to impose all taxes under Article 269 whose proceeds would go to States.

(ii) Corporation tax was excluded from the scope of sharing with the States from the very beginning. States feel sore because their contribution to the development of the corporate sector is quite large, i.e., they incur considerable expenditure in providing direct infrastructural facilities, e.g., power, water, raw materials, lands, etc. Apart from that, they provide considerable financial incentives for setting up of industries. It is, therefore, fair and appropriate that States should have a share in the proceeds of corporation tax as well.

(iii) Central excise duties have been expanded by including under it a growing number of items previously taxed by States.

(iv) Divisible pool of excise duties has been limited to basic duties and additional excise duties; special and auxiliary duties have been kept out of the divisible pool. Rates of additional excise duties which have to be shared with States were kept low, while raising steadily the rates of excise duties and of special and auxiliary duties which are not to be shared with States or to be shared only in smaller proportions.

(v) Railway passenger tax whose proceeds were to go to States was abolished and Centre fixed arbitrarily a grant in lieu of railway passenger tax. This grant is much less than what railway passenger tax would have brought to States.

(vi) Surcharges on income tax were imposed by Central Government but proceeds were not shared with States. Central Government raised the exemption limit of income tax gradually now ₹ 60,000 and reduced the divisible pool. Central Government, now ever, did not suffer much loss, as loss was more than offset by the increase in surcharge.

(vii) Main source of revenue of the States is sales tax which accounts for 60 percent of States' own tax revenue. Centre wants to abolish sales tax also. There are also proposals to abolish octroi duties and state excises. Again, the Planning Commission had asked the states to raise resources by enhancing electricity

NOTES

charges. But in 1978-79 budget, Centre decided to tap this source also by imposing excise duties on electricity, thereby removing scope for raising electricity tariff by States (this was given up later). States are, therefore, left with no proper resources to raise their revenues. By depending upon the Centre, States are running risk of losing their economic independence.

While revenues of States are increasing only gradually, expenses of the States are increasing at a fast rate. For instance, state plan outlays are increasing with every five year plan. Besides, various policies of the Central Government (monetary, fiscal and general economic policies) affect price situation in any country. While there is an increase in prices, demand for increased D.A. arises from the Government as well as semi-government employees. As the Central Government has vast financial resources to fulfil such demands, but for State Governments it becomes difficult to fulfil such periodical demands from their staff. Therefore, Centre should consult states before agreeing to the grant of additional D.A. and also provide adequate resources to the States for this purpose.

Too much dependence of States upon Centre in the form of grants-in-aid and loans has four serious adverse consequences. Firstly, Centre could be generous or mean to different States. Some of the States have felt it humiliating to make frequent visits to New Delhi for funds. Second difficulty is uncertainty in budgeting of States. For example, in the absence of firm commitments of Central Government about grants-in-aid, it is difficult for States to decide about the various projects of development they have to undertake. Third difficulty is that States are not able to fulfil various electoral promises because of inadequacy of financial resources. Finally, mostly States resort to unauthorized overdrafts to finance plan projects.

Regional Imbalances as a Source of Conflict

A serious complaint of some of the States like Kerala is about regional imbalance in industrial development. The complaint is that Centre has not used its fiscal dominance over States to correct regional imbalances. Nor has the Centre used other instruments at its disposal to narrow down the unevenness in regional development. In the absence of integrated approach for the development of the backward regions, location of the Central sector projects and even location of private industries through licensing policy have not created much of an impression on the problem of regional imbalances. In fact, regional disparities have worsened during the plans. When the Planning Commission was set up, it was thought that it would bring about a closer economic integration of the country by rapid increase in national income, higher standards of living of the masses, reduction of inequalities between regions, expansion of agriculture, industry, power and transport. While some degree of economic development has been achieved in every direction, yet from the point of view of balanced regional development, planning may be said to be a dismal failure.

Now, with the acceleration of planning process, responsibilities and commitments of States have increased more than that of their financial resources. The result was a kind of centralization at the federal level bringing the economic functioning of State Governments under Central directive and control through the mechanism of grants and loans. Correspondingly, the financial powers of States are far too meagre in relation to their clearly defined responsibilities. It was really unfortunate that framers of the Indian Constitution could not visualize financial implications of large-scale programmes of planned development.

The States' Demand

NOTES

The Rajamannar Committee on Centre-State relations (it submitted its report in May 1971) and the West Bengal Memorandum have come out with a string of suggestions and recommendations aiming at autonomy of the states, consistent with the integrity of the country. Suggestions of the West Bengal Memorandum, which have revived the controversy on the question, are as follows:

(i) Powers and functions of the Centre and the States should be clearly marked and specified, and if necessary, the Constitution should be amended suitably.

(ii) Centre's jurisdiction should be restricted to defence, foreign affairs and foreign trade, communications, currency and economic coordination. All other powers should be exclusively reserved for the States. There should be no interference or control by the Centre in the exercise of its powers by the States.

(iii) Present instrument of Centre's control and interference in the affairs of the States, viz., the Indian Administrative and Police Services, the Central Reserve Police, the Border Security Force, the Industrial Security Force etc. should be removed forthwith.

(iv) The Planning Commission and the National Development Council which have an important role in planning and economic coordination should be specifically referred to in the Constitution.

(v) 75 percent of central revenues should be automatically transferred by Centre to divisible pool of States and the Finance Commission should have power only to the extent of recommending principles for distribution of this divisible pool among States.

Other important suggestions made by the West Bengal Memorandum and the Rajamannar Committee on Centre-State relations include equal representation for all States in the Rajya Sabha, maintenance of the special status of Kashmir in the Indian Union, retention of English as link language between Centre and States. The right to use mother tongue at all levels, industrial licensing to be vested with the States, except for large companies of national importance, inter-state water disputes to be settled by the Supreme Court, etc.

Problem of Centre-State financial relations is, thus, a part of the general and more important problem of Centre-State relations. Let us now consider the problems from the angle of the Central Government.

The Centre's Case

All those, who are in favour of a strong Centre, reject the case of States for more functions and financial resources. The West Bengal Memorandum would allow the Centre to perform only three or four functions and leave rest of the functions to the States. States also would like to have a say, at least indirectly, even in the limited powers and functions of the Centre. For example, the States would like to influence the location and distribution of defence industries, use of foreign exchange reserves, allocation for projects of communication and also monetary and fiscal policies, etc. At the same time, Centre should be left with only 25 percent of revenue raised while 75 percent of revenue should go to the States automatically. All these things clearly indicate that ultimate intention is to have strong states and a weak and emaciated Centre.

NOTES

Danger to National Integrity: There is also the fear that some of the States ideologically different from others might like to break away from the federation on some pretext or the other. The DMK ideology at one time, the Khalistan movement in Punjab and Assam agitation all these have separatist tendencies. Supporters of strong states cite the example of USSR. It was the presence of a common political ideology and Supreme Central authority which held together the culturally diverse autonomous states in the USSR when the common political ideology and the strong Central authority disappeared, USSR disintegrated. State autonomy can, thus, be dangerous to the national integrity. India cannot be allowed to go the USSR way.

The argument that 'State autonomy' would liberate creative energies at present inhibited by constant central interference and domination and that state autonomy would promote rapid economic growth is highly questionable in the Indian context. It is the Centre's case that except for communist parties who are wedded to an economic ideology, other regional political parties are very parochial in their outlook. Most of them are financed by big business in industry, trade, transport, films, etc. They are corrupt to the core and destinies of these states are controlled by men, among whom some have very close links with smugglers and anti-social elements. These politicians cannot see beyond their noses and want to use state autonomy to further their selfish ends so as to remain in power. In any case, there is no positive correlation between state autonomy and the rapid development of different states.

In this connection, it should be emphasized that the States do already enjoy considerable autonomy. They have exclusive control over such key sectors as agriculture, irrigation and power, administration, social welfare, law and order etc. But not all States have performed these functions properly in any appreciable degree. The advanced states have continued to march ahead and the backward states have remained backward.

States complaint about inadequate financial resources and their demand for large taxation powers would sound more reasonable if they had fully exploited the resources they command. They are not only reluctant to tax agricultural incomes but have been abolishing land levies despite the gaping deficits in their budgets. The financial difficulties, thus, arise in part from their own lack of political courage. It is also an accepted fact, State tax administration is hopelessly corrupt and inefficient. Still the Centre has been sympathetic to their pleas for assistance and their share of the divisible pool of Central taxes has progressively increased over the years.

States generally resort to alternative methods for overcoming their budgetary gaps and this was mostly done through grants-in-aid and loans from the Centre before 1967. After 1967, the non-Congress dominated States and even the Congress-controlled States were in a rebellious mood and they resorted to unauthorized overdrafts on the Reserve Bank, which they insisted should be converted into regular loans. In spite of pressure from the Reserve Bank, these overdrafts continued to create inflationary pressure in the economy and constituted serious financial indiscipline.

Inadequacy of financial resources was sought to be made up by the use of Central grants-in-aid. Grants-in-aid were also meant to help backward States to come up to the level of others. Besides grants, the States approach the Centre for loans and advances. Resources transferred from the Centre have accounted for over 45 percent of total expenditure of the States.

It is, thus, clear that States have become increasingly dependent on the Centre for their expenditure. Such dependence is natural consequence of the enormous command

NOTES

enjoyed by the Centre over relatively larger and expanding revenue resources. Massive indebtedness of States had led to a kind of creditor-debtor relationship between Centre and States breeding a sense of irresponsibility among the borrowing States. In a sense, the position of dependence on the Centre has suited the States well. It has enabled them to avoid taking unpopular tax measures and to attribute their inefficiency and failure to the Centre.

By 1983, Centre-State relations were almost at a breaking point — with Khalistan demand for a separate Sikh state, and Southern States forming a regional council, and so on. It was to settle this problem once and for all that Central Government appointed the Sarkaria Commission, with comprehensive terms of reference covering constitutional, legislative, financial and administrative aspects of Centre-State relations.

The Sarkaria Commission submitted its report to the Government in January 1988. According to the Commission, it is necessary to preserve unity and integrity of country and accordingly, the Commission has rejected various suggestions made before it either to reduce the functions of the Centre or else modify them. The Commission has rejected the suggestion of transfer of subjects like preventive detention, education, labour and electricity to the state list or concurrent list on the ground that it would disturb basic scheme of the Constitution. The Commission has called for a process of consultation by Centre of all concurrent subjects. It has also made a strong case for inter-state councils, for retention of National Development Council (NDC) and for activation of zonal councils.

In the financial sphere, the Sarkaria Commission has favoured the amendment of the Constitution to provide for sharing of corporation tax between the Centre and the States but has rejected all other suggestions for enlarging the divisible pool. The Commission has also rejected suggestion that devolution of funds from Centre to States should be automatic. The Commission recommended setting up of expert committees to scrutinize taxation reforms and resource mobilization to study in depth the agricultural income tax and to review the loan grant pattern. The Commission has accepted that present division of functions between the Finance Commissions and the Planning Commission as reasonable and that it should continue. However, it has suggested that the terms of reference of the Finance Commission should be drawn up in consultation with the State Governments. Finally, the Commission has recommended legislation to levy consignment tax and constitutional amendment to enable levy of tax on advertisements in broadcasting.

The Central Government has not accepted all the recommendations of the Sarkaria Commission. In any case, the Sarkaria Commission's recommendations are not last word on the question of Centre-State relations. The question is still wide open. However, on the question of Centre-States financial relations, States welcome one recommendation of the Sarkaria Commission — viz., the inclusion of corporation tax in the divisible pool. This has been a long standing demand of the States before every Finance Commission till now. The Central Government has not accepted this important recommendation because of its own heavy revenue deficits in the last few years.

The Tenth Finance Commission (1995) has suggested a vertical devolution of all control taxes and has recommended constitutional amendment to that effect. If this recommendation was accepted, much of the conflict between centre and states would disappear.

NOTES

Rajamannar Committee on Centre-State Relations

The DMK Government of Tamil Nadu appointed a Committee under the Chairmanship of Dr. P.V. Rajamannar (former Chief Justice of Madras High Court and Chairman of the Fourth Finance Commission) to go into the whole gamut of Centre-State relations and to suggest measures to make State autonomy real and purposive. The Rajamannar Committee submitting its report in May 1971 came out with a string of far-reaching recommendations aiming at autonomy of the State consistent with the integrity of the country.

The Rajamannar Committee recommended that the base of devolution of revenues to States need be widened by including corporation tax, customs and export duties and a tax on the capital value of assets in the divisible pool to be shared by Centre and States. In other words, 80 percent of the Centre's tax revenue were recommended to be brought into the divisible pool.

The Committee suggested that surcharge on income tax should be merged with basic rate of income tax so that it could be shared with the States. In future, the Committee opined that no surcharge should be levied except with the consent of a substantial majority of the States. All excise duties and cesses (special, regulatory or otherwise) which were shareable at the option of the Union should be made compulsorily divisible. Additional excise duties should be continued only with the concurrence of the States. Even if States abolish the additional duties of excise and replace them by sales tax, restrictions imposed on the levy of sales tax by Sections 14 and 15 of the Central Sales Tax Act, 1956, regarding rate and stage of levy should be totally repealed. The Committee recommended that Article 87 of the Constitution which restricted power of the States to levy taxes on electric power consumed by or sold to the Union Government and the Railways should also be omitted. Regarding Central grants to the States, the Committee recommended that such grants should be made only on the recommendation of an independent and impartial body like the Finance Commission or a similar statutory body.

Though recommendations relating to financial relations were most important of the Committee's report, there were other equally important recommendations such as:

(i) Abolition of the Planning Commission and its reconstitution as a statutory body.

(ii) Setting up of a permanent Finance Commission with its own secretariat.

(iii) English to function as a link language between the Centre and the States.

(iv) Industrial licensing to be vested with States except for large companies of national importance.

(v) Inter-state water disputes to be settled by the Supreme Court.

(vi) Representation to all regions in the Central Cabinet.

(vii) Setting up of an Inter-state Council with the Prime Minister as Chairman and all Chief Ministers as members to take all important decisions affecting more than one State.

The Committee's recommendations amounted to a demand for rewriting many of the basic provisions of the Constitution. The Committee claimed that the fantastically large measure of autonomy suggested by it for the States is consistent with the integrity of the country and will make India an ideal federation. The Committee's argument seems to be that an ideal federal system is one which provides for a weak Centre. This is not true and for a country like India, a strong Centre is necessary in the interests of national unity.

As it is, the States already enjoy considerable autonomy. They have exclusive control over such key sectors as agriculture, irrigation and power, education, social welfare, and law and order. The State Governments complaint about inadequate financial resources and their demand for larger taxation powers would sound more reasonable if they had fully exploited the resources they command. They are not only reluctant to tax agricultural incomes but have been abolishing land levies despite the gaping deficits in their budgets. Their financial difficulties, thus, arise in part from their own lack of political courage. Still the Centre has been sympathetic to their pleas for assistance, and their share of the divisive pool of central taxes has progressively increased over the years. The Rajamannar Committee's suggestion that divisible pool should be enlarged to include in it revenue from export duties, customs and such levies as the corporation tax takes no account of the large financial needs of the Centre. The D.M.K. Government of Tamil Nadu obviously wanted a weak Centre. The Rajamannar Report could not be treated as a prescription for an ideal federal set-up.

Problem of Centre-State financial relations has to be solved keeping in mind certain fundamental facts. In the first place, the unity of the country is of a paramount importance and a strong Centre is absolutely essential. Secondly; financial resources must be compatible with administrative responsibilities. States have, therefore, to be provided with more financial resources to enable them to meet their commitments. Thirdly, Centre should give up those functions which strictly belong to the states, the parallel empires which have been built up in the Centre in agriculture, health, education, police and so on must be removed. Similarly, useless and unproductive expenditures upon democratic institutions, viz., the legislatures, ministries, etc. should be severely curtailed by the States. Fourthly, number of divisible taxes should be increased. Finally, principles should be worked out for Central assistance in the form of grants.

By 1983, the Centre-State relations were almost at a breaking point with Khalistan demand for a separate Sikh State and Southern States forming a regional council, and so on. It was to settle this problem once and for all that the Central Government appointed the Sarkaria Commission even when the Eighth Finance Commission was functioning. The Sarkaria Commission was given comprehensive terms of reference covering constitutional, legislative, financial and administrative aspects of Centre-State relations.

It is necessary to emphasize that the Union Government cannot function on the usual assumption of a very strong Centre and highly dependent States. Simultaneously, States may not be so correct in demanding complete financial autonomy and independence. This, in fact, may not be possible for a number of States. A compromise will have to be worked out so that there is a powerful Centre on the one side and more or less fully autonomous States which do not depend upon the generosity of the Centre, on contrary. It may be that the Constitution will have to be amended to this effect.

5.3 PERFORMANCE BUDGETING

Performance-based Budgeting

Performance-based budgeting is the practice of developing budgets based upon relationship between programme funding levels and expected results from that programme. Performance-based budgeting process implies a tool that programme

NOTES

administrators can use to manage more cost-efficient as well as effective budgeting outlays.

Nowadays, while the management of money is utmost important than ever for public and private entities, budgeting plays a prominent role to control operations efficiently and effectively. Budgeting is a familiar process to even the smallest economic unit, i.e., the household, but it requires to be divided into two different classes — budgeting for public entities and private entities. This distinction is important as public bodies need to go through many processes before moving into budget execution phase and post-execution analysis. Entire process involves collaboration of different bodies throughout government and this collaboration is not only for budget preparation, negotiation and approval processes, but also for the spending approval after the whole budget allocation is finalized. Though compared to private sector, this process is cumbersome. Another factor is the increasing awareness of the policies of the World Bank in pursuit of restructuring the budgeting and spending processes of developing nations via the World Bank Treasury Reference Model. This new model has led the public sector to understand, digest and also to adopt a new style. According to this new budgeting methodology, traditional methods of analyzing and utilizing budget figures are insufficient. In traditional terms, organizations start building up their long-term plans and break those plans into annual budgets that are known as forecasts. At the end of the year, budget figures are compared with actual results and a simple actual budget variance comparison is computed. As this analysis is simple, it lacks any sophistication in terms of adjusting similar budget items for forthcoming periods by increasing or decreasing the expenditure estimates. Actually, variance results are generally used for revising monetary amounts for the next planning and budgeting cycle and also for very simple departmental performance tracking. This new strategy of budget analysis and utilization is many steps ahead than that of traditional methods. For instance, a governmental project to enhance social welfare of children in a remote area can help to clarify the performance-oriented approach. For such projects, which are normally composed of long-term plans, governments decide on objectives and the activities that are required to be accomplished to achieve them. Practical ways of enhancing social welfare of children in a rural area might include increasing the job skills of parents in that area. Further, in order to achieve such objective, government may plan to set up schooling infrastructures in several locations, complete with the necessary equipment and plan to assign trainers to those, schools to implement educational programmes. All such activities have a cost aspect and long-term plans are broken down into annual budgets that incorporate the monetary figures. Once the long-term plans are accomplished, traditional way to gauge the effectiveness of this whole project would be to assess the gap between the budget and the actual money spent. However, with the new budgeting approach, the questions to answer are indeed difficult, i.e., Did we really succeed in increasing the social welfare of children? Did this project cost what we expected? Have we done what we should have done to increase the social welfare of children?

According to Peter van der Knaap (from the Ministry of Finance in the Netherlands), general purpose of the proposals is to make budget documents and hence the budgetary process more policy-oriented by presenting information on (intended and achieved) policy objectives, policy measures or instruments and their costs. Furthermore, van der Knaap also explains that this type of budgeting has the following major performance indicators:

1. Quantity, quality and costs of products and services (output) produced by government;
2. Government services in order to achieve certain effects, and
3. Intended effects of those measures (outcome).

Within this type of planning and budgeting set-up, lack of reliable information on the effects of policies emerges as a serious issue. Therefore, it is important to approach the planning and budgeting cycle in a holistic and integrated manner, with collaboration across the areas of policy design, performance measures definition as well as policy evaluation. Besides, from a conceptual point of view, performance-based budgeting systems are a sub-set of what are also known as 'outcomes systems', i.e., outcomes systems are any systems designed to identify, prioritize, measure, attribute and hold parties to account for outcomes. The technical principles for developing and implementing sound performance-based budgeting systems as a type of outcomes system are described in outcomes theory.

Performance-based Budgeting (PBB)

This entire framework points us to a newer way of budgeting, i.e., the performance-based budgeting. As defined by Carter, Performance budgets use statements of missions, goals and objectives to explain–why the money is being spent? It is a way to allocate resources to attain specific objectives based upon programme goals as well as measured results. In fact, the key to understanding performance-based budgeting lies beneath the word 'result'. In this technique, entire planning and budgeting framework is result-oriented. There are objectives and activities to achieve these objectives and these constitute the foundation of this overall evaluation. According to the more comprehensive definition of Segal and Summers, performance budgeting comprises following three elements:

1. The result (final income);
2. The strategy (different ways to achieve the final outcome);
3. Activity/outputs (what is actually done to achieve the final outcome).

Segal and Summers thinks that within this framework, a connection exists between the rationale for specific activities and also the end results and further, if the result is not excluded, while individual activities or outputs are. With this information, it is possible to understand which activities are cost-effective in terms of attaining the desired end result. Performance-based Budgeting is a way to allocate resources to achieve certain objectives. In the words of Harrison, PBB sets a goal or a set of goals to which monies are allocated. From these goals, specific objectives are delineated and funds are accordingly subdivided among them.

Achieving PBB: Adopting public sector's performance-based budgeting to the private sector using the Corporate Performance Management (CPM) framework. In performance-based budgeting, first the goals and objectives of organization or department are identified, then measurement tools are developed and the last step is reporting. For this type of advanced budgeting, it requires the definition of Key Performance Indicators (KPIs) at the outset, linking these performance indicators to resources becomes the vital part of the entire set-up. This is similar to the CPM framework, i.e., where strategy and planning meet execution and measurement, according to John Hagerty from AMR Research. So, this is a sort of a Balanced Scorecard approach in which KPIs are defined and linkages are built between causes and

NOTES

effects in a tree-model on top of a budgeting system which should be integrated with the transactional system, in which financial, procurement, sales and similar types of transactions can be tracked. However, linking resources with results provides information on how much it costs to provide a given level of outcome. Various public bodies fail to figure out how much it costs to deliver an output, primarily for indirect cost allocation. It puts the Activity-based Costing framework into the picture. Both the concepts of scorecards, as first introduced by Kaplan and Norton and subsequently activity-based costing as of today well-known concepts in the private sector, but it is much less so for the public sector bodies. Until the advent of Performance-based Budgeting, another conceptual framework that has gained ground is the relatively recently introduced CPM, again more popular in the private sector. The CPM framework has not much touched on the topic of Performance-based Budgeting, although the similarities in policies offered by these frameworks are too worth a deeper look. However, the technical foundation what the CPM framework shows may well be a perfect means to rationalize the somewhat tougher budgeting approach, not only for the public sector but for commercial companies as well.

The Way to CPM and PBB

Leading companies integrate different business intelligence applications and processes so as to attain corporate performance management. The very first step is for senior management to formulate the organization's strategy and articulation of specific strategic objectives supported by the key financial and non-financial metrics. In fact, these metrics and targets feed the next step in the process, Planning and Budgeting and are eventually communicated to the front-line employees that will carry out the day-to-day activities. Targets and thresholds are loaded from the planning systems itself into a Business Activity Monitoring engine which will automatically notify responsible persons of potential problems in real time. Status of business is reviewed at a regular basis and reforecast and if required, budget changes are being made. If the business performance is significantly off plan, executives may require to re-evaluate the strategy as some of the original assumptions may have to changed accordingly. Optionally, activity-based costing efforts can boost the strategic planning process for deciding to outsource key activities, for example.

Further, ability to adapt CPM to increase control on budget, depends upon to achieve a better understanding of the business through unified, consistent data to provide the basis for a 360-degree view of the organization. Again, the unified data model permits one to resort a single repository of information where users can quickly access consistent information related to both financial as well as management reporting, easily move between reporting the past and projecting the future and drill to detailed information. In this manner, one will be ready to plug in on the unified data—the applications that support consolidations, reporting, analysis, budgeting, planning, forecasting, activity-based costing and also profitability measurement. Thereafter, the applications are then integrated with the single repository of information and delivered with a set of tools that allow users to follow the assessment path from strategy, plans and budgets and also the supporting transactional data. CPM and the adoption of more public sector oriented PBB are not easy to tackle, but in the ever-changing business and political climate, no doubt they are indeed worth a closer look as well.

5.4 BUDGET CLASSIFICATION

NOTES

I. Why is a Budget Classification System Important?: Budget classification is one of the fundamental building blocks of a sound budget management system, as it determines the manner in which the budget is recorded, presented and reported and as such has a direct impact on the transparency and coherence of the budget. In countries where the budget nomenclature is weak, upgrading the budget classification system should itself be considered a basic step or rather, a pre-condition before embarking on other reforms of public financial management (PFM) like introducing a computerized financial management information system, a medium term expenditure framework (MTEF) or a results based budgeting system. A budget classification system, thus, provides a normative framework for both policy decision making and also accountability. Classifying expenditures and revenues accurately, thus, is utmost important for: (1) policy formulation as well as performance analysis; (2) allocating resources efficiently among sectors; (3) ensuring compliance with the budgetary resources approved by the legislature; and (4) day-to-day administration of the budget. Once established on a sound basis, a classification scheme should not be substantially changed unless there are strong reasons; a stable classification facilitates both the analysis of trends in fiscal policy over time and inter-country comparisons as well.

II. What are the Main Features of a Sound Budget Classification System?: In order to meet the requirement of providing accurate information to policy makers, government, managers, the legislature, and the broader public, the basic aim of a classification scheme should be to ensure that the budget complies with three key principles of sound budget management, i.e.,

1. The principle of comprehensiveness requires that the budget cover all government entities and institutions undertaking government operations and thereby present a consolidated and complete view of these operations.
2. The principle of unity requires that the budget includes all revenues and expenditures of all government entities undertaking government operations. This principle is important to ensure that the budget is effective in constraining total as well as sectoral government expenditure and also to promote greater efficiency in the allocation of resources.
3. The principle of internal consistency between different components of the budget requires that the current expenditure required for operations and maintenance of past investment projects be fully reflected in the budget. However, this principle indicates that there should be a unitary budget system in which responsibilities for preparing and also executing the budgets for current and capital (or development) spending are to be consolidated within a single central fiscal agency, i.e., Ministry of Finance.

Different strategies to budgeting often have a strong influence on the structure and organization of the classification system. For instance, compliance budgeting focuses on ensuring that the collection and use of resources are consistent with that of budget laws, which in turn depend upon having an accurate classification of these transactions, organizations responsible receiving such revenues or incurring such expenditures. Policy formulation and allocative efficiency concerns are the basis of a classification of expenditure by function and programme. Detailed classification of programmes by activity or output is required if operational performance is being assessed. Fiscal control

NOTES

requires at least an economic classification based on clear concepts (e.g., separating borrowing from receipts). Meeting these different and conflicting requirements needs for a pragmatic and flexible approach.

A sound system of budget classification should at a minimum comprise of a classification of revenues into different categories and administrative, economic and functional classifications of expenditures: (i) The administrative classification identifies the entity that is responsible for managing the public funds concerned, like the Ministry of Education and Health or at a lower level — schools and hospitals. (ii) The economic classification identifies the type of expenditure incurred, for instance, salaries, goods and services, transfers and interest payments or capital spending. (iii) The functional classification categorizes expenditure in accordance with the purposes and objectives for which they are intended.

All three classifications are inevitable for users of budget information.

Many countries use additional classification schemes to increase transparency as well as accountability and to better manage their finances. However, thus, it is required to be careful while expanding the different types of classification to be used. Such expansion could possibly lead to unreliable information, because of complexity of budget nomenclature. Hence, it also needs more capacity and resources to generate the required information and also to maintain the system. Some of these analytic needs can be addressed through ad hoc data, directly into the budget classification.

The following features are considered to be critical to a system of budget classification if it is to generate useful, timely, and reliable information:

1. Distinction between administrative and economic classifications: Economic and administrative classifications provide various kinds of information. The former provides data on types of revenues or expenditures (for instance, salaries or goods and services), while the latter provides data on the public sector organizations that incur expenditures or receive revenues. An administrative classification of expenditure is required to identify responsibilities for the main blocks of public expenditure and also for day-to-day administration of the budget. Expenditures may be divided into separate subcategories for every ministry, department or public entity.

2. The independence of economic and administrative categories: It is important to the soundness of a classification system that the economic and administrative categories be independent of each other. For instance, the economic classification may be used to indicate whether government receipts derive from tax revenues or the sale of goods or services, but not whether this income should be attributed to a central government ministry or department, or to a subnational entity.

3. Use of the functional classification: A functional classification organizes government activities in accordance with their broad objectives or purposes like education, social security, housing and so on. It is independent of the government's administrative or organizational structure.

Such classification is especially helpful while analyzing the allocation of resources among sectors. It may also be utilized to track poverty-reducing expenditures. A sound and stable functional classification is needed to generate the data that are required to produce historical surveys as well as analysis of government spending and also to compare data from different fiscal years. Classification of the Functions of Government (COFOG) as set up by the United Nations is a widely accepted international standard in this field.

4. Mutual exclusivity: Every line item in a well-designed budget classification system should be independent of all other line items.

III. The Structure of a Budget Classification System: Detailed structure of a budget classification system needs to be well designed if meaningful and reliable information is to be extracted and the system is also to be capable of modification in future. These core features are embedded in its coding system. IMF's Government Finance Statistics Manual provides a standard framework for developing a new budget classification structure or improving an existing one. The Government Finance Statistics Manual (GFSM), however, was developed primarily as a statistical reporting framework and thus not adequate to develop a budget classification system. It focuses on revenues, economic and also functional reporting for statistical purposes, while a budget classification system is also an instrument of policy formulation, administration of the budget as well as accounting. Therefore, the classification system for both expenditures and revenues may need to be adapted to meet the needs of budget preparation and its execution. Some countries like Brazil have developed satisfactory budget classifications, adapted according to their needs and constraints, without using the GFS framework.

Classification of Revenues: Following the GFSM 2001 framework, revenue is classified according to the following categories: (1) taxes, (2) social contributions, (3) grants, and (4) other revenues. For taxes, classification scheme is determined mainly by the base on which the tax is levied (e.g., income, expenditure, property assets, savings and so on).

The GFSM framework permits revenues to be recorded on an accrual basis, i.e., creating a future claim or entitlement for government to receive taxes or other types of revenue at the time that activities, transactions or other events takes place. Application of this general rule to different types of revenue should be indicated in every section of the classification as required.

IV. Additional Forms of Budget Classification: In addition to the administrative, economic, and functional classifications, other forms of classification may too provide complementary information, in particular:

1. Classification by geographical location of the administrative unit, tax payer or the recipient of government transfers and subsidies,
2. Classification of the beneficiaries of government transfers and subsidies,
3. Classification of the sources of financing and counterpart funds used for recording external loans and grants.

Using the Budget Classification Scheme to Track Poverty-reducing Expenditures: A sound budget classification scheme should make it possible to determine the budget lines affected by poverty reducing expenditure. In several nations, poverty-reducing strategy programme (PRSP) or other government documents define pro-poor expenditures. The task, thus, relates to poverty-related spending identified in a PRSP to the government's existing budget classification scheme, so that timely as well as periodic accounting reports can be made to track purposes. In fact, a programme classification should be used for this purpose or if this is not available, a functional classification at least to the sub-function level. A challenge to this approach may be the level of detail to which a PRSP identifies spending. In few cases, e-spending categories may also be too general or broad for intended purpose, viz., primary education or improved health. In other cases, they may be too narrow, i.e., a new bore-hole in village Y. Based upon the PRSP, pro-poor spending may be identified by adopting a binary

NOTES

rating system for every transaction, i.e., by assigning the score '0' for non-poverty-reducing expenditures and '1' for poverty-reducing expenditures. However, the use of such a system gives only global information. It must be combined with the other classifications to give relevant data on poverty reducing expenditures. Use of the functional classification has various benefits to track poverty-reducing expenditures. These expenditures can be evidently identified from the budget data and necessary links between the PRSP and the annual budget can be analyzed accordingly. Identification can be made by using Programme Classification:

A programme is a set of activities that meets specific policy objectives of the government such as: pre-primary education or the development of crop production. In contrast to a functional classification, a classification by programme takes into consideration – the government's policy objectives and also how these policies will be implemented. Programmes may be subdivided into homogeneous categories called activities, i.e., vaccination activity within a disease prevention programme, which in turn may encompass a series of related initiatives and projects as well.

Classifying expenditures by programme can serve two purposes: (1) identifying and clarifying goals and objectives of government spending and (2) monitoring operational performance through performance indicators, which may relate to the inputs, outputs or outcomes of a particular programme. A classification by programme can contribute to improved transparency as well as accountability and thereby help to link inputs to objectives or outcomes.

While establishing a programme classification, it is important to ensure that: (1) clear responsibility for managing the programme and accountability for its results are allocated to a specific unit and programme manager within the ministry or department concerned and (2) requirements for data collection and analysis are kept within reasonable bounds. Therefore, a programmatic approach has the advantage of encouraging managers in every organization to clearly define their objectives and thus to consider what results have been attained. It is, therefore, generally linked to the development of a performance-related strategy to budgeting. As regards the administrative classification, there is no specific international norm for codifying the programmes. The programme classification depends upon the requirement in each country.

V. Relationship between the Budget and Accounting Classifications: In most countries, it is generally considered to be a good practice for the budget classification and the accounting classification or financial reporting classification or chart of accounts, to be absolutely integrated. An integrated budget and accounting classification would incorporate relevant asset and liability accounts. These are mainly comprised of financial accounts to record government operations with the central bank, commercial banks and other financial entities and also suspense accounts. This approach is used in particular in the Anglophone countries, where the chart of accounts (COA) is a coding framework for recording budgetary as well as financial data in the government accounts.

In some countries, the accounting and budgeting classifications are absolutely separate or merely partially integrated. They can differ in terms of structure and information content. In such cases, the absence of one-to-one correspondence between entries or transactions recorded against the budget and accounting classifications generates a loss of information. Thus, it is impossible to identify with certainty the accounting implications of a given budgetary operation and reciprocally identical accounting transactions may not reflect systematically equivalent to budgetary operations. In practice, this issue can be solved in different ways as follows:

1. Implementing a central database to record budgetary and accounting transactions, so that any entry in the budgetary classification is systematically associated with such an entry in the accounts.
2. Introducing a separate presentation in the accounting classification to ensure the proper recording of budgetary transactions through a specific class of operations.
3. Harmonizing the structure and coverage of both classifications and developing bridge tables between them.

Preconditions for the Successful Implementation of a New Budget Classification

Political Ownership: Without commitment and leadership at a high political level, it is unlikely that the reform process will be successfully implemented. Further, support of the legislature is also desirable, not only to ensure passage of any new financial management regulations that may be needed to implement the reform, but also for endorsing and utilization the changed budget presentation and financial reporting that will follow.

Technical Capacity: Building capacity to implement the reform is another critical success factor. If the finance ministry has inadequate skilled and trained staff and other resources, a new budget nomenclature is unlikely to be effective. Thus, strengthening the capacity within the budget departments of line ministries and also other budgetary institutions, i.e., the treasury, the external audit authority and the national professional accounting bodies is also an inevitable requirement. Outside consultants may be used to supplement in-house resources to develop the new systems as well as procedures, but by no means, are a substitute to build up adequate internal capacity.

IT Systems: Though a modern budget classification scheme can be implemented manually, in practice, it is preferable to make use of an electronic system which does not need to be sophisticated. Computer processing of budgetary transactions allows a reclassification of entries in accordance with the main classification schemes and thereby strengthen functionality in areas like administrative accounting and reporting. In various countries, a revision of the budget classification has been introduced as part of the development of an integrated and automated financial management information system (IFMIS).

VI. Critical Steps and Milestones in the Budget Classification Reform Process: Depending upon the scope of the reform process and also the conditions prevailing in a country, reform of the budget classification can be a lengthy process to achieve complete integration of the budget classification and the COA. Changes are likely to be required in the legal as well as regulatory framework for the budget, the government's financial management and information system and training and outreach programmes to increase awareness and also to upgrade skills of staff in the ministry of finance and also other government entities.

Generally, in most of the countries, work on preparing new classification should be completed at least six months prior to the start of the budget year and in the case of the COA, at least two months before its implementation. A transitional period of adequate length should be permitted before the new classification system become fully operational,

NOTES

so that: (1) the new system can be reviewed by key stakeholders, i.e., line ministries, external audit authority and the legislature; (2) operational guidelines can be developed and training performed for staff in line ministries, local budget institutions and also other entities involved in that particular reform, and (3) the legal framework can be amended accordingly, if inevitable. Further, transfer of knowledge and also ownership are key or major elements if the new classification is to be used as a foundation for preparing and execution the budget.

5.5 ANALYSIS AND INTERPRETATION OF BUDGETING AND PLANS

India Budget Analysis

The new Government has unveiled the Union Budget 2014-15 with a pragmatic recognition of macroeconomic woes and a thrust towards structural reforms. The Finance Minister has laid out his vision aimed at reinforcing confidence through a slow but steady rebuilding of the economy. His acknowledgment that the prevailing economic situation posed a challenge, provides an opportunity to introspect. The Economic Survey revealed that considerable work is required to bring the economy back on track. Growth had stabilized to a consistent sub 5 percent over the past few years. Sticky inflation, populist subsidy measures, oil price shocks and devaluating currency has left the economy in want of a much-needed boost. Implementation of several reforms is required if the Indian economy wants to fulfill its potential. While there was no expectation of big bang measures, the Finance Minister's speech was keenly watched to understand his chosen path to recovery and direction of things to come. In line with expectations, he prefers fiscal prudence over populist measures and outlined his vision of controlling inflation, simplifying tax laws, reviving manufacturing growth and improving infrastructure health of the economy. Amongst other administrative changes, allowing facility of advance rulings to resident tax payers and increasing scope of settlement commission will aid in effectively reducing disputes in the future. Whereas there are no significant changes in the tax rates, transfer pricing proposals including introduction of 'roll back' APA provisions, multiple year comparability and arm's length range concept are welcome. Further, sops in the form of additional investment allowance for manufacturing companies and also extension of tax holidays in the power sector are also likely to get plaudits from the corporates.

State of the Economy

A snapshot of recent performance over the past few years, the Indian economy has experienced one of its most challenging periods. GDP has continued to remain at a sub 5 percent level while inflationary pressures have been unceasingly high. Moderation in growth has been primarily due to contraction in industry (comprising the mining and quarrying, manufacturing, electricity amongst others) and a sluggish services sector. Further, sticky inflation, populist subsidy measures, oil price shocks and a devaluating currency have left the economy in requirement of a much-needed boost. However, there were some noteworthy positives. The external economic situation saw a dramatic improvement as the current account deficit (CAD) declined considerably after two years of worryingly high levels. The fiscal deficit of the central government as a proportion of GDP also declined for two consecutive years in line with the announced medium term policy stance.

NOTES

While the government has a number of issues to focus on, three key areas stand out in relation to the economy, viz.:

1. Reviving economic growth;
2. Containing inflation; and
3. Achieving fiscal prudence.

With improving economic fundamentals and a clear electoral mandate, the Budget has presented a well-timed opportunity for the new government to diligently work out a long-term plan and achieve better prospects for 2014-15 and beyond.

GDP growth below 5 percent for consecutive two years: The Indian economy experienced a second successive year of weak performance with the Gross Domestic Product (GDP) growing at 4.7 percent in 2013-14. The economy was marred by structural factors such as persistent high inflation, moderation in the overall fixed capital formation as well as low business confidence leading to subdued domestic activity. Moderation was primarily affected by the sluggish service sector and contraction in the industrial sector. Though robust performance of the agricultural sector somewhat offset the moderation, overall growth was still depressed. Aided by favourable monsoons, the agricultural sector registered a growth of 4.7 percent in 2013-14. The industrial sector has experienced a rough year with the Index of Industrial Production (IIP) contracting by 0.1 percent, its first contraction in over three decades. The annual IIP contracted in relation to capital goods by around 3.6 percent and in respect of consumer durable goods by around 12.2 percent, indicating contraction in both investment and domestic demand.

Despite giving one of its worst performances in recent quarters, the services sector has still shown resilience, particularly in the light of tough global conditions. Earlier, India has had the second fastest growing services sector with its CAGR at 9 percent during 2001 to 2012.

On the expenditure side, government expenditure, which contributes about 11 percent towards the GDP, grew by a meagre 3.8 percent in 2013-14 on account of the strict stance taken by the government on fiscal prudence. Private Expenditure, which contributes around 60 percent of the GDP, grew by 4.8 percent in 2013-14, indicating the lack of domestic demand on the back of moderating income. Capital formation, which contributes around 32 percent of the GDP, experienced a contraction of 0.1 percent. Further, other structural issues such as ill-targeted subsidies, low agricultural productivity and the presence of a large informal sector need to be tackled in order to revive current growth prospects.

High inflation is an untiring threat to consumers: Inflationary pressures have eased recently as the average headline Wholesale Price Index (WPI) inflation moderated to a four year low of around 6 percent in 2013-14 after averaging 8.6 percent in the previous three years. However, retail inflation still remained sticky as the annual Consumer Price Index (CPI) for the financial year 2013-14 averaged at 9.5 percent. Policymakers have recently moved from monitoring the WPI to a targeted CPI, based on the recommendations of the expert committee, headed by Dr. Urjit Patel. Particularly in the light of targeting a CPI anchor of 6 percent by 2016, prevailing inflation seems beyond the comfort level.

Key factors contributing to the heightened inflation are food and fuel prices, primarily on account of structural factors such as large wastages in the supply chain (e.g., storage facilities), multiple layers of intermediaries and seasonal factors such as the El Nino effect. On a positive note, food prices have recently moderated resulting in

NOTES

decline in the food inflation from as high as 13.2 percent in January 2013 to 9.1 percent in March 2014. This is mainly because of a good kharif crop harvest leading to price correction in vegetable prices. However, this moderation is expected to slow down as vegetable prices appear to have run their course of seasonal correction.

Similar to food prices, the fuel prices have also contributed significantly to the high inflationary pressure because of rationalization of tariff for electricity in many states, the policy of allowing greater passthrough in diesel prices and high import prices as an impact of depreciation of the Indian rupee against the US dollar. Fuel inflation has experienced a significant moderation from highs of 11.2 percent in April 2012 to 6.3 percent in March 2014. This has been due to stabilization of global crude oil prices. Also, the presence of administered prices of fuels has kept fuel inflation in check, but the effects of deregulation in fuel prices are yet to be observed.

CPI excluding food and fuel has also been sticky due to housing, transportation, communication component and the services component which includes medical care, education and stationery.

The rise in wages has played a contributory part in the rise of CPI in services. The RBI has responded to these situations by maintaining a high policy rate (repo rate), current at the rate of 8 percent. A combination of reflective monetary policy and strong economic fundamentals has assured contraction in inflationary pressures in recent months.

Improved Balance of Payment situation can lead the charge towards economic revival: The external sector has been the saving grace in an otherwise sluggish year for the economy. Trade deficit, CAD and exchange rates have all shown signs of heading in the right direction. One of the highlights of economic performance last year has been the significant decline in trade deficit due to the dual effect of reasonable rise in exports and a substantial decline in imports. The cumulative growth of exports for 2013-14 was 4.1 percent and the imports contracted by 8.1 percent leading to an overall contraction of the trade deficit in 2013-14 of more than 20 percent as compared to the previous year. This favourable trend has continued even in the current financial year with cumulative growth of exports in 2014-15 (April-May) of around 8.9 percent and contraction in import by around 13.2 percent with overall trade deficit declining by around 42 percent in the first two months.

Overall, favourable trade conditions have led to a significant drop in CAD. CAD/GDP ratio in 2012-13 has reached record lows of 1.7 percent during the last year. An added boost of improved terms of trade, decline in CAD and recent stabilization of the rupee has been higher foreign currency reserves. At US$ 304.2 billion, reserves experienced a growth of US$ 12.2 billion or 4 percent during 2013-14. On June 20, 2014, the foreign exchange reserves have further burgeoned to US$ 314.9 billion. This is an important development as high foreign currency holdings can assist in shielding the economy from external shocks.

Fiscal consolidation process continues with focused efforts: After the adoption of the Fiscal Responsibility and Budget Management (FRBM) Act, the fiscal deficit was brought down to 2.5 percent of GDP in 2007-08, well below the threshold target of 3 percent of GDP. It was proactively expanded in 2008-09, in the aftermath of the global financial crisis to shore up aggregate demand and raise growth. However, post the financial crisis, fiscal consolidation has been difficult. While the government has done well to stick to the fiscal road map, short-term measures have often been resorted to in

NOTES

bringing the deficit down. This has led to less than ideal fiscal numbers and currently the fiscal deficit remains at 4.5 percent of GDP.

The fiscal policy for 2013-14 was calibrated with twofold objectives of aiding growth revival while reaching the target fiscal deficit levels. The contraction in fiscal deficit during the year has been a combination of recovery in revenue towards the end of the year and substantial cutbacks in government expenditure mainly in the second half of the year.

The government attempted to curb expenditure by targeting subsidies and avoiding leakages by monitoring the actual subsidy disbursed and its effective implementation. A majority of the proposed cuts were achieved through the planned expenditure route. During the interim budget, the government cut ₹ 79,790 crore from planned expenditure, primarily by reducing government expenditure on social sector schemes like Bharat Nirman, Rural Employment Guarantee Scheme and the National Rural Health Mission. Further, control on subsidies has also been a contributory factor to reduced expenditure. During the year, slashing subsidies on phosphates and fertilizers have saved expenditure to the tune of ₹ 5,000 crore. However, despite such reduction, there has been a sharp increase in total subsidies from 1.4 percent of GDP in 2007-08 to 2.3 percent of GDP in 2013-14; hence, further subsidy rationalization measures are required.

Capital markets have shown a bullish performance: Indian capital markets have been fairly positive during the last year, primarily in anticipation of the change in government and optimism about consequent change in business sentiments and investment policies. During the year, the government decided to further open up new sectors such as petroleum and natural gas, defence, telecom services, single brand retail, etc. have aided in reinforcing global investor sentiments and keeping the SENSEX at high levels. The Indian markets fared much better as compared to other developing economies due to highly responsive monetary policy and strong fundamentals of the financial markets which instilled confidence in the global investors. In terms of Foreign Institutional Investment (FII), the first and second halves of the year depicted completely contrasting pictures. First two quarters experienced a net outflow of US$ 7.1 billion as compared to a net inflow of US$ 12 billion in the second half. During the first half of the year, the decision by the US Federal Reserve to taper its asset buying programme resulted in a surge of capital outflow from emerging markets, including India. With an already volatile currency, FII investors fled the Indian market. The first half of 2013-14, when FIIs became net sellers, was depicted by volatility, depreciation of the currency as well as loss of investor confidence. The markets, however, rallied back in the second half of the year, as the government further opened up existing sectors to foreign investors.

Financial intermediation and human development: Along with the economic parameters, it is pertinent to specifically look upon certain other aspects of the Indian society. With the presence of a large and young population, India has a great demographic advantage as the proportion of working-age population is likely to increase from approximately 58 percent in 2001 to more than 64 percent by 2021. However, according to the United Nations Human Development Report (HDR) 2013, India with a human development index (HDI) of 0.554 in 2012 slipped down the global ranking to 136 from 134 as per HDR 2012. Considering the same, it needs to be kept in mind that this potential demographic dividend can't be reaped unless a timely action is taken for human development through education and health. Also, the most important aspect in this would be providing adequate employment opportunities for the upcoming youth, which is going to be a challenge in itself.

NOTES

Budget announcement and priorities for reviving growth: With sluggish GDP growth, high inflationary pressures and fiscal imbalances, there are serious issues which need to be addressed by the new government. Over the past few months, the government has started on the path of structural reforms which will start having an effect only gradually. Therefore, reachieving a growth rate of 7-8% is ambitious in the short term and having a lower mid-term target is necessary. In this regard, the Economic Survey has done a commendable job in having a lower but realistic growth target of 5.4 percent to 5.9 percent. With an improving manufacturing sector, better balance of payments situation and modest global growth revival, the economy is expected to slowly recover. On the inflation front, albeit moderation being expected in the coming months, the adverse impact of El Nino cannot be discounted and hence the overall performance will hinge on how the government resolves supply side issues which include storage and transportation. In addition, improved conditions in the external sector may be expected to continue as export-oriented policies are executed in the coming years and import of oil and gold is contained at reasonable levels. Similarly, the fiscal consolidation strategy is expected to reap dividends through a more focused and calibrated Fiscal Responsibility and Budget Management (FRBM) Act. The economy is in dire need of rationalization of subsidies and a balanced expenditure outlay will help improve the quality and impact of public expenditure. However, to achieve the above goals, immediate implementation of certain reforms and speedy resolution of bottlenecks is critical. The Economic Survey acknowledges the current challenges of reviving growth and creating employment opportunities. It further lays down the priorities for such revival:

1. Accelerate project clearances and streamline implementation procedures in order to revive investments;
2. Implement structural reforms to boost productivity;
3. Simplify tax policy and administration, repeal archaic laws to create an environment of policy certainty, continuity, and transparency to help boost business sentiment;

To maintain this positivity through proactive policy implementation is of key importance. The Finance Minister's Budget speech was an important step in this regard. He acknowledged the need for growth particularly in manufacturing and infrastructure sectors. In this regard, setting up of the National industrial Corridor Authority focused on development of industrial corridors and smart cities including boost towards public private partnership ventures will provide a fillip. Further, the Finance Minister highlighted that the backbone of manufacturing is the SME sector for which a Committee will be set up to review the financial architecture and remove bottlenecks.

A major boost was also given on promoting FDI in select sectors by introducing a composite cap of 49 percent on foreign investment.

The efforts of the Finance Minister to initiate structural reforms are commendable and align with the overall objectives highlighted in the Economic Survey. As seen in the past, benefits will only accrue if such plans are credibly implemented. Boosting GDP growth while keeping macroeconomic variables in check is an important goal for any government and India is no exception. Whether success is achieved or not will ultimately depend on policy execution and implementation at the ground level. Importantly, he reiterated his commitment to meet the fiscal deficit target of 4.1 percent and improve the quality of public expenditure. Planned expenditure increases were towards agriculture, capacity creation, infrastructure, clean energy focused on reducing supply side

NOTES

inefficiencies and giving boost to infrastructure development. This is important as the immediate benefit of such a plan if implemented will result in reduction of inflation while aiding growth. A major boost was also given on promoting FDI in select sectors by introducing a composite cap of 49 percent on foreign investment.

Budget Highlights: Direct Taxes (Personal Taxation): The personal tax exemption limit has been increased by ₹ 50,000 which will result in a tax benefit of ₹ 5,000 (excluding surcharge and cess).

Tax Rate	Current Slabs (₹)	Proposed Slabs as per Finance Bill 2014 (in ₹)
Nil	Up to 200,000*	Up to 250,000
10%	200,001 to 500,000	250,001 to 500,000
20%	500,001 to 1,000,000	500,001 to 1,000,000
30%	1,000,001 and above	1,000,001 and above

* ₹ 300,000 for senior citizens who are of the age of 60 years or more but less than 80 years.

The monthly wage ceiling under the Employee's Provident Fund Scheme increased from ₹ 6,500 to ₹ 15,000 per month to extend social security coverage for more employees. Minimum monthly pension to be increased to ₹ 1,000.

Corporate Taxation: Dividend or Income Distribution Tax computation base revised as follows:

1. Tax on dividends to be distributed by domestic companies and on income to be distributed by specified mutual funds to be computed on the grossed up amount of dividend/income, instead of the net amount paid – applicable from 1 October 2014, investment allowance to a manufacturing company extended.
2. The benefit of investment allowance of 15 percent of the cost of new assets in case of manufacturing companies investing more than ₹ 100 crores in new plant and machinery is extended to investments made till 31 March 2017.
3. In addition to the above, investments exceeding ₹ 25 crore in new plant and machinery on or after 1 April 2015 eligible for investment allowance of 15 percent of such investment extension of sunset clause for power sector undertakings.
4. Sunset date for the power sector undertakings to commence eligible activity extended from 31 March 2014 to 31 March 2017.

Concessional Rate of Withholding Tax on Interest

1. The concessional withholding tax rate of 5 percent is applicable to interest on monies borrowed in foreign currency upto 30 June 2017 under any loan agreement, or on all long-terms bonds.

Dividends from specified foreign company: Beneficial tax rate of 15 percent on dividend income from specified foreign company extended indefinitely.

Presumptive taxation: Presumptive income for all type of goods carriages now uniform and increased to ₹ 7,500 per vehicle, per month.

Capital Gains Taxation

1. Exemption from capital gains tax provided on transfer of Government security outside India by a non-resident to another non-resident.

NOTES

2. Maximum exemption from capital gains tax on account of investment in specified bonds capped to ₹ 5,000,000 in aggregate even if investment made in two different financial years.

3. Unlisted security and mutual fund units (other than equity oriented fund) to be treated as long-term capital asset only if held for more than 36 months instead of 12 months.

New Taxation Regime for Real Estate Investment Trust (REIT) and Infrastructure Investment Trust (Invit)

1. Taxation regime introduced for REIT and Invit to be set up in accordance with SEBI regulations.
2. Investment model of REITs and Invits (referred to as Business Trusts) will have the following elements:
   (i) Business trust to raise capital through issue of listed units or may raise debt from resident and non-resident investors
   (ii) Business trust to acquire controlling or other specific interest in the Indian SPV from sponsor.

Salient features of the tax regime are as under: Listed units of business trust when traded on stock exchange shall be liable to STT and subject to the same treatment for capital gains as that of equity shares, i.e., long-term capital gains exempt and short-term capital gains taxable at the rate of 15 percent. If such units are traded outside stock exchange (non-STT paid), then long-term capital gains will be taxable @ 10 percent and short-term capital gains will be taxable @ 30 percent − Capital gains arising to sponsor on exchange of shares in SPVs for the units in business trust deferred till disposal of such units in the business trust. On disposal of such units:

(a) Cost of units shall be the cost of shares in SPV to the sponsor.

(b) The period of holding of shares by sponsor shall be included in calculating the period of holding for units in the business trust − Interest income received by business trust from SPV will not be taxable, i.e., passthrough. However, business trust to withhold tax on the interest component of income distribution @ 10 percent, when distributed to resident unit holders and @ 5 percent when distributed to non-resident unit holders:

   (i) Benefit of reduced withholding tax rate of 5 percent on interest on external commercial borrowings available to business trust − Dividend distributed by SPV subject to dividend distribution tax but exempt in the hands of the business trust − Capital gains arising on disposal of assets of the business trust taxable in the hands of the business trust.

   (ii) Dividend/capital gains portion of the income distributed by business trust to unit holders exempt in the hands of unit holders.

   (iii) Any other income of the trust is taxable at maximum marginal rate.

Advance Received for Aborted Transfer of Capital Asset

Presently, advance received for transfer of capital asset when forfeited is reduced from cost of acquisition of such capital asset. Such forfeited advance will now be taxable as income under the head ‘income from other sources’.

Taxability of Enhanced Compensation on Compulsory Acquisition of Capital Asset

Enhanced compensation received on compulsory acquisition of capital asset in pursuance of an interim order of Court, Tribunal or other authority taxable in the previous year in which final order of such Court, Tribunal or other authority is made.

Others

It includes:

1. Central Government to notify accounting standards for computation of income and disclosures for particular class of tax payers or class of incomes.
2. Central Government to provide rules for applicability, registrations, and compliance in respect of annual information statement.
3. Powers of income tax authorities in survey and for calling information enhanced.
4. Detailed procedure introduced for reference by the assessing officer to valuation officer for estimating the value of investments, fair market value of property, etc.
5. Acceptance/repayment of loans and deposits through electronic clearing systems recognized as acceptable mode of payment.
6. Rigorous imprisonment upto 1 year and fine in case of willful failure to produce accounts and documents.
7. Time limits barring order on withholding tax default extended to seven years from the end of the financial year in which withholding tax obligation arises.

Transfer Pricing: Roll-back of Advance Pricing Agreement (APA) to prior years. Under current provisions, APAs entered into between tax payers and Indian tax authorities apply prospectively, i.e. for a maximum period of future five years. It is proposed that APAs could now also have retrospective effect to cover up to four past years prior to the first prospective year covered under the APA. Under the roll-back provisions, the APA could provide for determination of the arm's length price or the methodology of determination of arm's length price for the international transactions of the prior years. Roll-back provisions could, thus, enable tax payers to attain certainty in their transfer prices of international transactions for upto nine years in total. The provisions are proposed to be applicable from 1 October 2014 and the detailed conditions, procedure, etc. would be prescribed later. Deemed international transactions include transactions with residents. The current Transfer Pricing (TP) regulations contain a deeming provision covering transactions with unrelated parties within the ambit of TP law in certain circumstances. There were doubts on the interpretation of the deeming provision and its applicability in case of transactions with resident third parties in such circumstances. It is proposed to amend the said provision to provide that the deeming provision would also apply to cases where the third party is an Indian resident, once the currently prescribed conditions are fulfilled.

Introduction of Range Concept for Determination of Arm's Length Price:

1. Range concept is proposed to be introduced for determination of arm's length price to align the Indian TP regulations with international best practices.
2. Current concept of arithmetic mean is proposed to be continued in cases where the number of comparables is inadequate.
3. Detailed rules in this regard would be notified subsequently.

NOTES

Use of Multiple Year Data for Comparability Analysis

1. It is proposed that use of multiple year data (instead of single year data) would be allowed for comparability analysis.
2. The detailed rules in this regard would be notified subsequently.

Transfer Pricing Officer (TPO) Also Empowered to Levy Penalty

It is proposed that the TPOs would also be authorized to levy penalty for non-furnishing of Transfer Pricing documentation by tax payers.

Budget Highlights

Indirect Taxes

Customs Duty: Standard rate of BCD is maintained at 10 percent. BCD is being increased on import of the following goods:

- Half-cut or broken diamond from 'Nil' to 2.5 percent.
- Cut and polished diamonds including lab-grown diamonds and colored gemstones from 2 percent to 2.5 percent.
- Specific stainless steel flat products from 5 percent to 7.5 percent.
- Specified telecommunication products, which are not covered under the Information Technology Agreement, from 'Nil' to 10 percent.

BCD is being reduced on import of the following goods:

- Fatty acids, crude palm stearin, RBD and other palm stearin and specified industrial grade crude oil for manufacture of soaps subject to actual user condition from 7.5 percent to 'Nil'.
- Crude glycerine for manufacture of soaps from 12.5 percent to 'Nil' and for any other purpose subject to actual user condition from 12.5 percent to 7.5 percent.
- Denatured ethyl alcohol from 7.5 percent to 5 percent.
- Steel grade dolomite and steel grade limestone from 5 percent to 2.5 percent..
- Crude naphthalene from 10 percent to 5 percent.
- Machinery, equipments, etc. required for initial setting up of compressed biogas plant (Bio-CNG) to 5 percent.
- Ships imported for breaking up from 5 percent to 2.5 percent.
- LCD and LED TV panels of below 19 inches from 10 percent to 'Nil'.
- Colour picture tubes for manufacture of cathode ray TVs from 10 percent to 'Nil'.
- E-Book readers from 7.5 percent to 'Nil'.

Custom duty on import of various types of agglomerated coal is rationalized to BCD of 2.5 percent and CVD of 2 percent to keep the rate of customs duty uniform. BCD and CVD on machinery, equipment, etc. required for initial. Setting up of solar energy production projects is reduced to 5 percent and 'Nil' respectively. Full exemption from BCD is provided on import of specified parts of LCD and LED panels for TVs.

Exemption from Special Additional Duty is being provided on following:

- Parts and raw materials required for use in the manufacture of 'wind operated' electricity generators–inputs or components used in the manufacture of

NOTES

Personal Computers (laptops/desktops) and tablet computers, subject to actual user condition.

– Specified inputs (PVC sheet and Ribbon) used in the manufacture of smart cards.

Export duty on bauxite is being increased from 10 percent to 20 percent. Free baggage allowance is increased from ₹ 35,000 to ₹ 45,000. Inputs or raw materials imported by an EOU and cleared into DTA as such or used in the manufacture of final products and cleared into DTA to attract safeguard duty, as was leviable when the same was imported into India. Customs duties on mineral oils including petroleum and natural gas extracted or produced in the continental shelf of India or the exclusive economic zone of India shall not be recovered for the period prior to 7 February 2002.

Mandatory fixed pre-deposit of 7.5 percent of duty demanded or penalty imposed or both for filing appeal with the commissioner (Appeal) or the Tribunal at the first stage and – Additional 10 percent of the duty demanded or penalty imposed or both for filing second stage appeal before the Tribunal The amount of pre-deposit payable would be subject to a ceiling of ₹ 10 crore. The scheme of 'Advance Ruling' is extended to Resident Private Limited Companies.

Central Excise Duty

- Standard rate maintained at 12 percent.
- Excise duty increased on the following:
  - On cigarettes in the range of 11 percent to 72 percent
  - Unmanufactured tobacco from 50 percent to 55 percent
  - Recorded smart cards from 2 percent (without CENVAT credit) and 6 percent (with CENVAT credit) to uniform 12 percent.
- Additional duty of excise at 5 percent on aerated water containing added sugar.
- Clean Energy Cess increased from ₹ 50 per tonne to ₹ 100 per tonne.
- Excise duty reduced on the following:
  - Branded Petrol from ₹ 7.50 per litre to ₹ 2.35 per litre
  - Footwear of (retail price between ₹ 500 per pair to ₹ 1000 per pair) from 12 percent to 6 percent.

Concessional excise duty of 2 percent (without CENVAT credit) and 6 percent (with CENVAT credit) is extended to following products:

– Gloves specially designed for use in sports.

– Polyester Staple Fiber and Polyester Filament Yarn.

Education cess and secondary and higher education cess (customs component) is exempted on goods cleared by an EOU into DTA. Third Schedule to the Central Excise Act, 1944 aligned with notification issued for assessment based on Retail Sale Price (RSP). Central Government to prescribe an authority or agency to whom the information return shall be filed by the specified persons.

Mandatory fixed pre-deposit of – 7.5 percent of duty demanded or penalty imposed or both for filing appeal with the Commissioner (Appeal) or the Tribunal at the first stage and additional 10 percent of the duty demanded or penalty imposed or both for filing second stage appeal before the Tribunal.

The amount of pre-deposit payable would be subject to a ceiling of ₹ 10 crore.

NOTES

Appeal against Tribunal orders in matters relating to taxability or excisability of goods would lie before the Supreme Court.Transfer of credit by a Large Tax Payer Unit (LTU) from one unit to another unit discontinued. Subject to certain exceptions, e-payment mandatory for all assesses. In case of default in payment of duty, assessee shall on his own pay a penalty of 1 percent per month on the amount of duty not paid for each month or part thereof. Assessment of excise duty to be done on transaction value in the cases where excisable goods are sold at a price below the manufacturing cost and profit and there is no additional consideration flowing from the buyer to the assessee directly or from a third person on behalf of the buyer. Scheme of Advance Ruling extended to Resident Private Limited Companies.

Definition of 'place of removal' *pari materia* to definition given in Section 4 of Central Excise Act, 1944 included in the CENVAT Credit Rules, 2004. In case of service tax paid under full reverse charge, the condition of payment of invoice value to the service provider for availing credit of input services is being withdrawn. Recredit of CENVAT credit reversed on account of non-receipt of export proceeds within the specified period or extended period, to be allowed, if export proceeds are received within one year from the period so specified or the extended period. This can be done on the basis of documents evidencing receipt of export proceeds. With effect from September 2014, a manufacturer or a service provider shall take credit on inputs and input services within a period of six months from the date of issue of invoice, bill or challan.

Service Tax

Service Tax rate remains unchanged.

Changes Made with Immediate Effect

(i) Exemption available to services provided by way of renting of immovable property to educational institutions stands withdrawn certain services received by educational institutions providing services specified in negative list will only be eligible for service tax exemption.

(ii) Exemption granted to services provided to Government or local authority or governmental authority has been restricted to specified functions ordinarily performed by municipality.

(iii) Services provided by a Director to a body corporate have been brought under the reverse charge mechanism.

(iv) Services provided by recovery agents to banks, financial institutions and NBFC have been brought under the reverse charge mechanism.

(v) Services provided by goods transport agency in relation to transportation of goods will be eligible for abatement on fulfilment of stipulated condition of non-availment of CENVAT credit by service provider. Service recipient will not be required to establish satisfaction of the condition by the service provider.

(vi) Service of transportation of passengers by air-conditioned contract carriage has been made taxable and an abatement of 60 percent shall be available subject to fulfilment of conditions.

(vii) Resident private limited company is being included as a class of persons eligible to make an application for Advance Ruling in service tax.

(viii) SEZ procedures for claiming exemption for procurement of input services have been simplified:

NOTES

(a) Service tax exempted on loading, unloading, storage, warehousing and transportation of cotton, whether ginned or baled.

(b) Exemption available for specified micro-insurance schemes expanded to cover all life micro-insurance schemes where the sum assured does not exceed ₹ 50,000 per life insured.

Changes Made w.e.f. 1 October 2014

1. Abatement for all works—contract services, except those in relation to original works, will be restricted to 30 percent.
2. Variable rates of interest have been notified depending upon the extent of delay in discharge of service tax. The rates vary from 18 percent to 30 percent.
3. E-payment of service tax has been made mandatory except where relaxation is allowed by Deputy Commissioner or Assistant Commissioner on case-to-case basis.
4. Under the Place of Provision of Services Rules, 2012, the following changes have been made:
   – Rule regarding place of performance of service shall not apply to goods imported for repair which are exported after repair without being put to any use other than that which is required for such repair;
   – Definition of intermediary has been amended to include intermediary of goods;
   – Place of provision of services in respect of services consisting of hiring of vessels (excluding yachts) or air crafts will be the location of recipient of service;
5. Point of taxation in respect of reverse charge will be the payment date or the first day that occurs immediately after a period of three months from the date of invoice, whichever is earlier.
6. CENVAT credit shall be available for rent-a-cab services received by the main contractor from a sub-contractor. Where service provider avails abatement, whole CENVAT credit would be allowed and in case where service provider does not avail abatement, the credit shall be restricted to 40 percent of the credit of the input service.
7. Tour operator service providers are also being allowed to avail CENVAT credit on the input service of another tour operator, which are used for providing the taxable service.
8. Taxable portion in respect of transport of goods by vessel is being reduced from 50 percent to 40 percent.
9. Service provider and recipient of rent-a-cab services would be liable to discharge 50 percent each of service tax liability in cases where service provider does not take abatement.

Changes Which Would be Made Effective upon Enactment of the Finance Bill

1. Services provided by the Employees' State Insurance Corporation for the period prior to 1 July 2012, exempted from service tax.

NOTES

2. Certain Sections of Central Excise have been made applicable to the provisions of service tax
   - Mandatory fixed pre-deposit of –7.5 percent of service tax demanded or penalty imposed or both for filing appeal with the Commissioner (Appeal) or the Tribunal at the first stage and – Additional 10 percent of the service tax demanded or penalty imposed or both for filing second stage appeal before the Tribunal The amount of pre-deposit payable would be subject to a ceiling of ₹ 10 crore.
3. Time-limits for completion of adjudication prescribed.
4. Withdrawal of power to waive 50 percent penalty imposable in cases where extended period of limitation is invokable but details of transactions are available in specified records.

Changes Which Will Become Effective from a Date to be Notified after Enactment of the Finance Bill

1. Sale of space or time for advertisements in broadcast media, extended to cover such sales on other segments like online and mobile advertising. Sale of space for advertisements in print media would, however, remain excluded from service tax.
2. Services provided by radio taxis brought under service tax.
3. Rules for determination of rate of exchange for calculation of taxable value in respect of certain services will be prescribed in due course.

Budget Proposals: Direct Taxes

Rates of Income Tax (Individuals/HUF): It is proposed to increase the basic exemption limit from ₹ 200,000 to ₹ 250,000 for individuals/HUF.

Table 1: Tax Rates for Individuals/HUFs

Income Slabs (₹)	Rate of Tax (%)
Upto 250,000	Nil
250,001 to 500,000	10
500,001 to 1,000,000	20
1,000,001 and above	30

– For resident senior citizens of 60 years but less than 80 years of age, the basic exemption limit is proposed to be increased from ₹ 250,000 to ₹ 300,000.

– For resident very senior citizens of 80 years or more, the basic exemption limit remains unchanged at ₹ 500,000.

– Surcharge of 10 percent on taxable income above ₹ 10 million will continue to be levied.

– Education cess will continue to be levied at the rate of 3 percent of Income Tax (including surcharge).

Unless otherwise stated, the proposed provisions will be applicable from the financial year 2014-15.

Personal Taxation

NOTES

Deduction for Self-occupied House Property: Currently, the deduction of interest on housing loan taken on or after 1 April 1999 for self-occupied property is restricted to ₹ 150,000 subject to other conditions. It is proposed to increase the aforesaid limit to ₹ 200,000.

Long-term Capital Gains Exemption on Sale of Residential House or Other Asset: Currently, exemption for long-term capital gain arising on sale of residential house or other long-term capital asset is available if 'a' residential house is purchased or constructed within the specified period. It is proposed to amend the law to restrict the exemption to investment made in respect of only one residential house property situated in India.

Corporate Taxation

Deduction for investment in new plant and machinery: Currently, a deduction of 15 percent of the cost of new plant and machinery (other than ship or aircraft) is allowed to a company engaged in the business of manufacture, if it invests more than ₹ 100 crore in new asset in two consecutive years, viz., financial year 2013-14 and 2014-15. It is proposed that 15 percent of the cost of new plant and machinery be allowed as deduction in each of the financial years 2014-15, 2015-16 and 2016-17 in which such investment exceeds ₹ 25 crore respectively. For the financial year 2014-15, the tax payer may claim such deduction under either of the two beneficial provisions.

1. **Dividend/Income Distribution Tax:** Currently, tax on dividend distributed by a domestic company and income distributed by a mutual fund is payable on the amount so distributed. It is now proposed that such tax payable shall be grossed up in a manner that it shall be 15 percent/25percent/30 percent of the aggregate of the dividends or income declared or distributed, as the case may be. The proposed amendment will be applicable from 1 October 2014.
2. **Non-resident Taxation (Taxation of FII):** It is proposed to amend the definition of 'capital asset' to provide that any securities held by an FII which have been invested in accordance with the regulations made under the SEBI Act will be considered as capital asset. Consequently, the income arising from the transfer of such securities will be subject to tax as capital gains.

Special Rates for Foreign Currency Borrowing: Currently, income of a non-resident by way of interest from moneys lent in foreign currency upto 30 June 2015 to an Indian company under a loan agreement or by way of long-term infrastructure bonds approved by the Central Government is taxable at the rate of 5 percent (plus applicable surcharge and education cess). It is proposed to extend the said benefit for further two years, i.e., moneys lent upto 30 June 2017.

Transfer Pricing

Rollback of Advance Pricing Agreement to Prior Years: Currently, provisions relating to APA empower CBDT to enter into APA with any person for determining ALP, or specifying the manner in which ALP is to be determined in relation to an international transaction to be entered into by the person. At present, the APA may be entered into for a period not exceeding five years. It is proposed to introduce the rollback mechanism whereby the terms of APA may be applied to years prior to the period for which APA is

NOTES

applicable. However, such rollback cannot extend beyond four years preceding the first year for which APA is applicable.

Taxability of Charitable Trust or Institutions: Applicability of registration granted to a trust or institution to earlier years Currently, charitable trust or institution can claim exemption under Section 11 of the Act only after obtaining registration under Section 12A/12AA of the Act. It is proposed that the benefits of exemption will be available to such trust or institution in respect of its income for any earlier financial year for which assessment proceedings are pending before the Assessing Officer as on the date of registration, provided that objects and activities in such earlier years are the same as those for which the registration has been granted.

Budget Proposals Indirect Taxes

Customs Duty

Import Duty Rate Changes: Peak rate of Basic Customs Duty for non-agricultural products maintained at 10 percent.

Exemptions Withdrawn: BCD on specified telecommunication goods which are not covered under Information Technology Agreement. CVD on portable X-ray machine or system. Education Cess and Secondary and Higher Education Cess leviable on CVD on certain electronic goods.Such changes will be effective from 11 July 2014.

Miscellaneous Changes: Baggage Allowance for duty free import raised from ₹ 35,000 to ₹ 45,000.

- Mechanism for refund enabled for Customs Duty paid while importation of scientific or technical instruments subject to certain conditions.
- Indian Silk Export Promotion Council (ISEPC) has been authorized to issue entitlement certificate for duty free import of goods when used for manufacture of export products.

Changes in Customs Act, 1962: Filing of bill of entry before the arrival of vehicle permitted. Consequential change made in the provision relating to date of determination of rate of duty and tariff valuation The above change will be effective from the date of enactment of the Finance Bill, 2014.

Changes in Customs Tariff Act, 1975: Inputs or raw materials imported by an EOU and cleared into DTA as such or used in the manufacture of final products and cleared into DTA to attract safeguard duty as was leviable when the same was imported into India. Such change will be effective from the date of enactment of the Finance Bill, 2014.

Changes in the Central Excise Tariff Act, 1985: Following changes are made in the Central Excise Tariff Act, 1985.

(i) Tariff items related to cigarettes of length exceeding 75 mm but not exceeding 85 mm and cigarettes of length exceeding 85 mm are being merged into a single tariff item.

(ii) The unit quantity code against certain entries is changed to reflect current industry practices. The above changes are effective from 11 July 2014.

Amendments in the Central Excise Rules, 2002

(i) E-payment is made mandatory for all assessees except in specific cases approved by Assistant or Deputy Commissioner of Central Excise. The above change will be effective from 1 October 2014.

(ii) In case of default in payment of duty, the assessee shall on his own pay a penalty of 1 percent per month on the amount of duty not paid for each month or part thereof. The above change will be effective from 11 July 2014.

Changes in Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000

The subject rules are amended so as to provide that the value for the assessment of duty shall be deemed to be the transaction value in the following cases:

1. Price is not the sole consideration for sale of such excisable goods and excisable goods are sold at a price below the manufacturing cost and profit; and
2. There is no additional consideration flowing from the buyer to the assessee directly or from a third person on behalf of the buyer. The above change will be effective from 11 July 2014.

Service Tax: There is no change in the Service tax rate.

Common Provisions for Customs Duty, Central Excise Duty and Service Tax

1. Scheme of Advance Rulings extended to Resident Private Limited Companies in respect of proposed transactions with effect from 11 July 2014.
2. 'Customs and Central Excise Settlement Commission' to be renamed as 'Customs, Central Excise and Service tax Settlement Commission'.
3. Discretionary powers of the Tribunal to refuse admission of appeal extended to cases involving fine or penalty upto ₹ 200,000.
4. For filing appeals, the appellant will be required to make a mandatory pre-deposit, not exceeding ₹ 10 crore.

Policy Proposals (Direct Taxes)

1. Government to review the Direct Taxes Code (DTC) in its present shape and take a view in the whole matter after considering the comments received from the stakeholders on the revised DTC.
2. Committing to provide a stable and predictable taxation regime, it is proposed that ordinarily no new retrospective tax would be levied.
3. Resident tax payers enabled to obtain an advance ruling in respect of their income tax liability above a defined threshold.
4. A High Level Committee is proposed to be set to interact with trade and industry on a regular basis and ascertain areas where clarity in tax laws is required.

Capital Markets

1. Enactment of the Indian Financial Code based on the recommendations of the Financial Sector Legislative Reforms Commission.
2. Modern monetary policy framework to be put in place in close consultation with the RBI.

Banking and Finance

1. Financial Inclusion Mission to be launched on 15 August for providing banking services to all households in the country with particular focus to empower the weaker sections of the society, including women small and marginal farmers.

NOTES

2. Banks would be encouraged to extend long-term loans to infrastructure sector with flexible structuring to absorb potential adverse contingencies.

Infrastructure

1. Real Estate Investment Trusts (REITS) to be provided a complete pass through for the purpose of taxation.
2. A modified REIT type structure for infrastructure projects is announced as Infrastructure Investment Trusts, which would have a similar tax efficient pass through status.
3. It is proposed to set up an institution to provide support to mainstreaming PPPs called 3P India.

Insurance

1. Composite cap of FDI proposed to be increased up to 49 percent from the current level of 26 percent through the FIPB route, with full Indian management and control.
2. Insurance Laws (Amendment) Bill to be taken up for the consideration of the Parliament.
3. It is proposed to bridge the regulatory gap under the Prize Chits and Money Circulation Scheme (Banning) Act, 1978 to facilitate effective regulation of companies and entities which have duped a large number of poor and vulnerable people of the country.

Indian Planning Analysis(*)

12th Five Year Plan to Spend Highest Ever on Development: The National Development Council (NDC) is meeting on December 27 to approve the 12th Five Year Plan (2012-17). The Plan draft recommends "immediate" steps to counter the economic slow down. It has made plan goals conditional to these steps. But delay has marred the Plan's rolling out. According to Planning Commission sources, it is only in the budget of 2014 that the Plan will be reflected. However, government has the freedom to take economic revival steps that are outside the domain of the Commission. The NDC approves the Plan a year late as it was not ready. Going by official procedures of incorporating the Plan suggestions into programmes of various ministries and then into national budget, only the budget for 2014-15 will reflect the Plan completely. This means we will be losing another two years of the Plan. The third year is usually the year when mid-term evaluation is done. The new plan starts effectively from April 2014, says a member of the Commission. Delay in rolling out plans has been observed in the last three periods.

The current Plan has high stakes in terms of consultations and the public funds being promised for expenditure. By far, this is most debated and consulted Plan – some 900 civil society groups gave inputs while 165 steering and working groups deliberated over its details for over two years. It is also a grand plan with an available public resources of ₹ 37,16,385 crore to spend. The budgetary allocation under the 12th Five Year Plan is 125 percent more than that of the 11th Five Year Plan.

(*) Source: Twelfth Five Year Plan (2012-17), Government of India.

NOTES

Major Sectors	11th Plan (₹ crore) Realization	% Share	12th Plan (₹ crore) Projections	% Share	Increase Over 11th Plan (in %)
Agriculture and Water Resources	1,16,554	7.3	2,84,030	7.96	143.69
Rural Development and Panchayati Raj	3,97,524	25.01	6,73,034	18.86	69.31
Scientific Departments	58,690	3.69	1,42,167	3.98	142.23
Transport and Energy	2,04,076	12.84	4,48,736	12.57	119.89
Education	1,77,538	11.17	4,53,728	12.71	155.57
Health and Child	1,12,646	7.09	4,08,521	11.45	262.66
Urban Development	63,465	3.99	1,64,078	4.60	158.53
Others	4,58,849	28.87	9,94,333	27.86	116.70
Total Plan Allocation	15,89,342	100.00	35,68,626	100.00	124.53

The Policy Challenge: The policy challenge in the Twelfth Plan is, therefore, twofold. The immediate challenge is to reverse the observed deceleration in growth by reviving investment as quickly as possible. This calls for urgent action to tackle implementation constraints in infrastructure which are holding up large projects, combined with action to deal with tax related issues which have created uncertainty in the investment climate. From a longer term perspective, the Plan must put in place policies that can leverage the many strengths of the economy to bring it back to its real growth potential. This will take time but the aim should be to get back to 9 percent growth by the end of the Twelfth Plan period.

Vision and Aspirations: The broad vision and aspirations which the Twelfth Plan seeks to fulfill are reflected in the subtitle: 'Faster, Sustainable, and More Inclusive Growth'. The simultaneous achievement of each of these elements is critical for the success of the Plan.

The Need for Faster Growth: Planners are sometimes criticised for focusing too much on GDP growth, when the real objective should be to achieve an improved quality of life of the people across both economic and non-economic dimensions. The Twelfth Plan fully recognizes that the objective of development is broad-based improvement in the economic and social conditions of our people. However, rapid growth of GDP is an essential requirement for achieving this objective.

There are two reasons why GDP growth is important for the inclusiveness objective. First, rapid growth of GDP produces a larger expansion in total income and production which, if the growth process is sufficiently inclusive, will directly raise living standards of a large section of our people by providing them with employment and other income enhancing activities. Our focus should not be just on GDP growth itself, but on achieving a growth process that is as inclusive as possible. For example, rapid growth which involves faster growth in agriculture, and especially in rainfed areas where most of the poor live, will be much more inclusive than a GDP growth that is driven entirely by mining or extraction of minerals for exports. Similarly, rapid growth which is based on faster growth for the manufacturing sector as a whole, including MSME, will generate a much broader spread of employment and income earning opportunities and is therefore more inclusive than a growth which is largely driven by extractive industries.

NOTES

The second reason why rapid growth is important for inclusiveness is that it generates higher revenues, which help to finance critical programmes of inclusiveness. There are many such programmes which either deliver benefits directly to the poor and the excluded groups, or increase their ability to access employment and income opportunities generated by the growth process. Examples of such programmes are the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), Sarva Siksha Abhiyan (SSA), Mid-day Meals (MDMs), Pradhan Mantri Gram Sadak Yojana (PMGSY), Integrated Child Development Services (ICDS), National Rural Health Mission (NRHM), and so on. This is also relevant for the sustainability objective since programmes aimed at making development more sustainable also involve additional costs.

Growth Prospects: The Approach Paper to the Twelfth Plan, approved by the National Development Council (NDC) in 2011, had set a target of 9 percent average growth of GDP over the Plan period. That was before the Eurozone crisis in that year triggered a sharp downturn in global economic prospects, and also before the extent of the slowdown in the domestic economy was known. A realistic assessment of the growth prospects of the economy in the Twelfth Plan period. It concludes that the current slowdown in GDP growth can be reversed through strong corrective action, including especially an expansion in investment with a corresponding increase in savings to keep inflationary pressures under control. However, while our full growth potential remains around 9 percent, acceleration to this level can only occur in a phased manner, especially since the global economy is expected to remain weak for the first half of the Plan period. Taking account of all these factors, the Twelfth Plan should work towards bringing GDP growth back to an inclusive 9 percent in the last two years of the Plan, which will yield an average growth rate of about 8 percent over the entire Plan period. The outcome is conditional on many policy actions as is described in scenario one.

Within the aggregate GDP growth target, two sub-targets are especially important for inclusiveness. These are a growth rate of 4 percent for the agricultural sector over the Twelfth Plan period and around 10 percent in the last two years of the Plan for the manufacturing sector.

The Twelfth Plan's strategy for growth depends crucially on productivity gains as one of the key drivers of growth. Productivity is the additional contribution to growth after taking count of the effect of capital accumulation and growth in labour. These traditional sources of growth are not likely to be enough for India in the coming years and we must, therefore, focus much more on productivity improvements among all constituents: big businesses, MSMEs, farmers and even government. This can be done by improving the business regulatory environment, strengthening the governance capacity of States, investing more in infrastructure rather than subsidies, and by using Science and Technology (S&T) to drive innovation.

Key Policy Initiatives Needed

Immediate Priorities: Reviving Investor Sentiments: An immediate policy objective in the very first year of the Plan must be to revive animal spirits, which have suffered for a variety of reasons. Some of the reasons for a downturn in investor sentiment can be easily corrected. For example, the perception among investors, that some of the tax changes introduced in the Budget are anti-investor need to be allayed as quickly as possible. The Finance Ministry has appointed two expert committees to look into these issues and it is hoped that the recommendations of these committees will provide a reasonable basis for reviving investor confidence on these issues. A firm

NOTES

decision on the recommendations of the Committee should be announced as early as possible.

Fuel Supply to Power Stations: The fuel supply problem affecting electric power generation stations that have been commissioned but do not have adequate assurance of supply of coal or gas, and the problems of power stations currently under implementation which have yet to tie up fuel supply agreements, need to be addressed urgently. Coal India is the dominant domestic producer of coal because of nationalization. It must take on the responsibility of making coal available to all power plants which are governed by regulated tariffs or have entered into PPAs based on competitive bidding for tariffs.

The Size of the Public Sector Plan: Although planning should cover both the activities of the government and those of the private sector, a great deal of the public debate on planning in India takes place around the size of the public sector plan. The Twelfth Plan lays out an ambitious set of government programmes, which will help to achieve the objective of rapid and inclusive growth. These programmes add up to a total plan size for the Centre of ₹ 43,33,739 crore including both budget resources and the resources of the public sector enterprises which comes to about 6.35 percent of GDP. This compares with ₹ 20,25,130 crore in the Eleventh Plan, which was 5.96 percent of GDP. The total plan size of the States is ₹ 37,16,385 crore or 5.45 percent of GDP, as compared to ₹ 17,25,848 crore in the Eleventh Plan, which was 5 percent of GDP.

Longer Term Increase in Investment and Saving Rates: Bringing the economy back to 9 percent growth by the end of the Twelfth Plan requires fixed investment rate to rise to 35 percent of GDP by the end of the Plan period. This will require action to revive private investment, including private corporate investment, and also action to stimulate public investment, especially in key areas of infrastructure especially, energy, transport, water supply and water resource management.

The Need for Fiscal Correction: Decline in public savings in the past few years is largely a reflection of the stimulus policies that were followed, which are reflected in the expansion in the fiscal deficit. The Central Government fiscal deficit was 5.9 percent of GDP in 2011-12. Allowing for a fiscal deficit of just under 3 percent for the States, the combined deficit of the Centre and the State Governments, which had fallen to 4.7 percent in 2007-08, expanded to just under 9 percent in 2011-12. This has to be reversed through a credible correction over the medium term. The Finance Ministry has set up an Independent Expert Committee to advise on a credible medium-term road map for fiscal correction. The Committee has recommended a new road map for fiscal deficit reduction to bring the Central Government deficit down to 3 percent by the end of the Twelfth Plan.

Economic Reforms and Efficiency of Resource Use

While higher investment is necessary for faster growth, it is equally important to ensure efficiency in resource use, both in the public and private sectors. The implementation of the reform relating to CSSs mentioned above will help achieve greater efficiency to implement in the public sector.

In the private sector—which accounts for over 70 percent of total investment—the main instrument available for improved efficiency of resource use is to continue economic reforms, which increase competitive pressure in the system and give producers the flexibility and freedom they need to upgrade technology and expand capacity. In this context, it is worth noting that the global experience with the financial crisis, and the policy rethinking it has

NOTES

triggered, a backlash against market based reform in the financial sector. We need to consider what implications this has for our own policies of economic reforms.

The principal lesson we should learn is that we should continue with our strategy of gradual liberalization in the financial sector. There is no case for reversing this process of gradual liberalization, or even stopping it. Countries that had gone too far towards adopting 'light touch regulation' are quite correctly tightening their regulatory standards though it should be noted that concern is beginning to be expressed in these countries that this process may be going too far. India was never at that end of the spectrum. In fact, we were if anything at the other end where control over banks and financial institutions is much stronger than in most other jurisdictions and is sometimes excessive.

However, there is one aspect that does require attention. The global financial crisis highlights the moral hazard problems of following universal banking principles and has brought back into prominence the issue of segregating the commercial and investment banking functions. Our efforts to liberalize the financial sector in the past have meant that Indian banks are today required to undertake investments lending less by design than by default. With the demise of development finance institutions (DFIs), the function of term lending has devolved on the commercial banking sector, which may not be entirely prepared to carry out this function. First, it is not clear whether the Indian banking sector has acquired the requisite risk assessment and project appraisal skills for term loans, without which financing long duration projects can be hazardous.

Second, the entire sector is now more vulnerable to asset-liability imbalance, requiring more frequent recapitalization particularly as global regulatory norms tighten following the crisis. Third, since there has been no change in the sources from which banks can raise their resources, all increases in term lending are at the cost of funds available for working capital purposes. This leads to smaller and weaker clients being crowded out from the credit space whenever norms stiffen or investment increases. This makes our banking system less inclusive than it would otherwise have been. It is an opportune time, therefore, to blend further gradual liberalization with a broader consideration of the design of our banking sector and ensure that the laws are consistent with the intentions.

Looking beyond the financial sector, to the real sector, there is no reason to backtrack on the use of market mechanisms to achieve efficiency or from an open economy, including a freer flow of foreign direct investment. No such reversal is taking place anywhere in the world and we should act no differently.

Energy Policies for Long-term Growth: A growth rate of 8 percent in GDP requires a growth rate of about 6 percent in total energy use from all sources. Unfortunately, our capacity to expand domestic energy supplies to meet this demand is severely limited. We are not well endowed with energy resources except for coal and the existence of policy distortions make management of demand and supply more difficult. Some of these problems have already been discussed earlier in this Chapter in connection with the immediate need to revive investor sentiment.

5.6 SUMMARY

1. Federal State is a union of states where authority is divided between federal and state government.
2. In Indian federal constitution, centre possess residuary power while states possess enumerated powers.

NOTES

3. In federation, there is also a concurrent field of authority, i.e., certain functions are exercised both by the centre as well as units.
4. Co-operative federalism, where sharing powers is confined to tax sharing.
5. Coercive federalism, where central government assumes superior sources of revenue and is motivated by expanding ideas.
6. Co-ordinate federalism involves deliberate action by government to shoulder responsibility by way of co-ordinating decision making processes.
7. Fiscal autonomy implies every government should be free to raise revenue and to spend them.

5.7 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1. Performance budgets use statements of __________ to explain why the money is being spent.
2. A programme is a set of activities that meets __________ of the government such as pre-primary education or the development of crop production.

II. True and False

1. Performance-based budgeting is the practice of developing budgets based upon relationship between programme funding levels and expected results from that programme.
2. The principle of comprehensiveness requires that the budget cover all government entities and institutions undertaking government operations and thereby present a consolidated and complete view of these operations.

III. Multiple Choice Questions

1. Performance budgeting comprises following three elements_______.
   (a) The result (final income)
   (b) The strategy (different ways to achieve the final outcome)
   (c) Activity/outputs (what is actually done to achieve the final outcome)
   (d) All of the above
2. A sound system of budget classification should at a minimum comprise of a classification of revenues into different categories and administrative, economic and functional classifications of expenditures.
   (a) The administrative classification identifies the entity that is responsible for managing the public funds concerned, like the ministry of education and health or at a lower level schools and hospitals
   (b) The economic classification identifies the type of expenditure incurred, for instance, salaries, goods and services, transfers and interest payments or capital spending
   (c) The functional classification categorizes expenditure in accordance with the purposes and objectives for which they are intended
   (d) All of the above

NOTES

Short Answer Questions

1. Why is a Budget Classification System important?
2. What are the main features of a sound Budget Classification System?

Long Answer Questions

1. Critically analyze federal finance.
2. Analyze problems of centre-state financial relations in India.

5.8 KEY TERMS

- Allocation
- Coercive Federalism
- Concurrent Field
- Co-operative Federalism
- Distribution
- Federal State
- Residuary Power
- Stabilization

5.9 KEY TO CHECK YOUR ANSWER

I. 1. Missions, goals and objectives, 2. Specific policy objectives.
II. 1. True, 2. True.
III. 1. (d), 2. (d).

Unit IV: Overview of Indian Budget and Orissa Budget

6 Chapter

TRENDS OF INDIAN BUDGET AND ORISSA BUDGET

Objectives

- Broad Trends of Indian Budget and Orissa Budget During the Plan Period
- Budgetary Trends
- Important Testure, Major Components of Revenue and Expenditure
- Budget as an Instrument of Social and Economic Policy

Structure:

6.1 BROAD TRENDS OF INDIAN BUDGET AND ORISSA BUDGET DURING THE PLAN PERIOD

Broad Trends of Indian Budget Budgets During the Plan Period

Overview of the Economy: Growth of gross domestic product (GDP) at factor cost at constant 2004-05 prices declined from 8.9 percent in 2010-11 to 6.7 percent in 2011-12 and further to 4.5 percent in 2012-13. Among the factors that contributed to the slowdown included structural constraints, i.e., delays in projects, bottlenecks in environmental approvals and land acquisition, elevated inflation and external imbalances, in addition to uncertain global economic situation. There was a marginal improvement in 2013-14 with GDP growing at 4.7 percent. The phase of sub 5 percent growth in the last two years is characterized by moderation in services growth and protracted slowdown in industry. Higher growth in agriculture on the back of a steady monsoon and robust growth in financial as well as business services helped the modest up tick in growth in 2013-14. Macroeconomic stabilization in 2013-14 had to balance the concerns of containing elevated inflation and

NOTES

promoting growth as well. It also involved managing a volatile external situation characterized by a sharp depreciation of the rupee witnessed till the second quarter of 2013-14, while the balance of payment situation has improved to an extent, achieving higher growth by enhancing investment level and price stability along with fiscal consolidation will be major priority areas in 2014-15. Further, the turnaround in the external situation (characterized by a decline in the current account deficit to 1.7 percent of GDP in 2013-14 from 4.7 percent in 2012-13 and gradual strengthening of the rupee in the second half of 2013-14 and improvement on the fiscal front with the fiscal deficit to GDP ratio declining from 4.9 percent of GDP in 2012-13 to 4.5 percent in 2013-14 augur well for macroeconomic stabilization. During 2013-14, the monetary policy stance of the RBI was driven by the imperatives of retaining inflation in check and supporting growth revival apart from managing a complex external economic situation. With moderation in overall headline inflation, according to the Wholesale Price Index (WPI), during 2012-13 and during the first two quarters of 2013-14, there was a reduction in the repo rate by 25 basis points in May 2013. Due to growing uncertainties in global financial conditions, monetary easing was paused in June 2013 and subsequently tightened to contain inflation. Headline WPI inflation averaged 5.98 percent during 2013-14 as compared to 7.35 percent in the previous year. In 2014-15, i.e., in June, 2014, the RBI, *inter alia*, kept the policy repo rate under the Liquidity Adjustment Facility (LAF) unchanged at 8 percent.

GDP Growth: As per the provisional estimates released by the Central Statistics Office (CSO), Indian economy grew at 4.7 percent in 2013-14 in terms of GDP at factor cost at 2004-05 prices. The sub 5 percent growth of the economy in 2013-14 was primarily because of slowdown in industry for the second successive year and registered a growth rate of 0.4 percent in 2013-14 and significantly lower growth in the trade, hotels, transport and communications segment of the services sector. On contrary sectors, viz., agriculture, electricity, gas and water supply, financial, insurance, real estate and business services have grown at faster rates in 2013-14 *vis-à-vis* 2012-13. According to the quarterly estimates of GDP, growth in GDP recorded a modest pick-up in second quarter of 2013-14 with a growth of 5.2 percent, compared to 4.7 percent in first quarter of 2013-14. This declined to 4.6 percent each in third and fourth quarter of 2013-14. Contraction in manufacturing observed in all quarters, except second quarter of 2013-14, remains a cause for concern. On the demand or expenditure side, GDP at constant 2004-05 market prices registered a growth of 5.0 percent in 2013-14 as against a growth of 4.7 percent in 2012-13. Growth of consumption expenditure, gross fixed capital formation and exports stood at 4.8 percent, (–) 0.1 percent and 8.4 percent respectively in real terms, during 2013-14. Growth in these components was 5.0 percent, 0.8 percent and 5.0 percent respectively in 2012-13. According to the First Revised Estimates released by the Central Statistics Office, gross domestic capital formation as a ratio of GDP at current market prices, i.e., investment rate was 34.8 percent in 2012-13 as against 35.5 percent in 2011-12, while gross domestic savings as a ratio of GDP at current market prices, i.e., savings rate decreased from 31.3 percent in 2011-12 to 30.1 percent in 2012-13. This decline in the latter was because of the reduction in savings of the private corporate sector and household savings in physical assets.

Agricultural Production: During the southwest monsoon season of 2013, our country received 6 percent higher rainfall than the long period average (LPA). According to the 3rd Advance Estimates as on 15.05.2014, production of foodgrains during 2013-14 is placed at 264.38 million tonnes – out of which, rice at 106.29 million tonnes and wheat at 95.85 million tonnes *vis-à-vis* 257.13 million tonnes in 2012-13 final estimates. Production of pulses is estimated at 19.57 million tonnes, sugarcane at 348.38 million tonnes, oilseeds at

32.41 million tonnes and cotton at 36.50 million bales of 170 kg each. Flow of agriculture credit increased to ₹ 6,07,375 crore in 2012-13 in comparison to ₹ 5,11,029 crore in 2011-12 and ₹ 86,981 crore in 2003-04. Agriculture credit flow target for 2013-14 was fixed at ₹ 7,00,000 crore with achievement outstripping the target to reach ₹ 7,30,765 crore.

Prices: Headline WPI inflation moderated to 5.98 percent in 2013-14 due to lower international commodity prices and sharp correction in vegetable prices in December 2013 and January 2014. Overall WPI food inflation comprising primary food articles and manufactured food products remained elevated and averaged 9.43 percent in 2013-14 as compared to 9.28 percent in 2012-13. Core inflation in case of non-food manufactured products, remained mostly benign and decreased to 2.94 percent during 2013-14. While food inflation remained elevated, its drivers have been changing over time. In the year 2012-13, inflation remained elevated across the board for all major subgroups of food including cereals, pulses, vegetables, egg, meat, fish, sugar and edible oils etc. However, in 2013-14, the primary contributors included cereals, vegetables and egg, meat and fish. Food inflation moderated to 6.98 percent in May 2014 from a peak of 13.61 percent in November 2013. All India general inflation for Consumer Price Index-New Series (CPI-NS) averaged 9.49 percent in 2013-14 as against 10.21 percent in 2012-13. Inflation as per CPI-NS has fell from a peak of 11.16 percent in November 2013 to 8.28 percent in May 2014.

Industry and Services: Based upon the index of industrial production (IIP), industrial output declined by 0.1 percent during 2013-14 relatively as compared to a growth of 1.1 percent in the previous year. Further, the contraction during 2013-14 was largely accounted for by the decline in mining, capital goods and consumer goods. Manufacturing, the dominant sector within industry, witnessed contraction of 0.8 percent in 2013-14 than that of a growth of 1.3 percent in the previous year. Output of capital goods sector contracted by 3.6 percent in 2013-14 *vis-à-vis* a contraction of 6.0 percent in the previous year. There are several reasons for sluggishness in manufacturing. Increase in the policy rates, required to control inflation, coupled with the bottlenecks facing large projects impacted investment. Growth rate of gross fixed capital formation (GFCF) has been generally on decline from around first quarter of 2010-11. Overall manufacturing growth suffered for negative spill over from the mining and capital goods sectors, lower demand for consumer durables and so on. Owing to the robust growth in electricity generation from hydel sources growth in overall electricity generation increased to 6.1 percent in 2013-14 as compared to 4.0 percent during the previous year. Therefore, due to structural constraints, the mining sector continued to drag overall industrial recovery.

External Sector: In 2013-14, exports were valued at US$ 312.6 billion, registering a growth of 4.1 percent over the level of US$ 300.4 billion in 2012-13. Value of imports during 2013-14 was US$ 450.1 billion, depicting a decrease of 8.3 percent compared with the level of US$ 490.7 billion in the corresponding period of 2012-13. Petrol, oil and lubricants imports (POL) imports accounted for 36.7 percent of the total import in 2013-14. Non-POL imports during 2013-14 were 12.8 percent lower than the level of US$ 326.7 billion in 2012-13. Higher exports and lower imports causes a contraction in trade deficit for 2013-14 to US$ 137.5 billion *vis-à-vis* US$ 190.3 billion in 2012-13. On Balance of Payment (BoP) basis, the value of exports and imports was US$ 318.6 billion and US$ 466.2 billion respectively in 2013-14, yielding a trade deficit of US$ 147.7 billion. Net invisible receipts increased by 7.2 percent to US$ 115.2 billion in 2013-14 from US$ 107.5 billion in 2012-13. Besides, contraction in trade deficit, coupled with a increase in net invisibles receipts led to a reduction of the current account deficit (CAD) to US$ 32.4 billion

NOTES

(1.7 percent of GDP) in 2013-14 from US$ 88.2 billion (4.7 percent of GDP) in 2012-13. Reduction in Computer Aided Design (CAD) also points out the success of the measures undertaken to contain non-essential imports like gold. Net capital inflows, however, declined to US$ 47.9 billion in 2013-14 from US$ 92.0 billion in 2012-13 owing to lower portfolio inflows, net repayment of loans and trade credit as well as advances. However at the end of March 2014, foreign exchange reserves stood at US$ 304.2 billion, i.e., rise of US$ 12.2 billion over the level of US$ 292.0 billion at end of March 2013. In August 2013, foreign exchange reserves had been reduced to US$ 275.5 billion. Besides the daily exchange rate of the rupee breached the level of 68 per US dollar in August 2013, i.e., 68.36 per US dollar on August 28, 2013). However, it recovered to 60.10 per US dollar on March 28, 2014 reflecting the impact of the steps taken by the Government and the RBI to moderate the CAD and boost capital flows and greater clarity on US Federal Reserve taper. The annual average exchange rate of rupee for 2013-14 was 60.50 per US dollar.

Money, Banking and Capital Markets: The RBI, in its Annual Monetary Policy Statement on May 3, 2013, declared a reduction in the policy repo rate by 25 bps from 7.50 percent to 7.25 percent to support growth in the face of gradual moderation of headline inflation. Apprehensions of likely tapering of Quantitative Easing (QE) by the US Federal Reserve in late May 2013 triggered outflows of portfolio investment. Hence, by recognizing the risks to the economy from external developments and also in taking into account the evolving growth inflation dynamics, the RBI in its First Quarter Review of July 30, 2013 kept the key policy rates unchanged. The RBI began the entire process of calibrated withdrawal of the exceptional liquidity measures in the Mid-Quarter Review on September 20, 2013, observing the improvement in the external environment and also considering the number of measures put in place to narrow the CAD and to ease its financing. The MSF rate was reduced from 10.25 percent to 9.5 percent and the minimum daily maintenance of the CRR was reduced from 99 percent of the requirement to 95 percent effective from the fortnight beginning September 21, 2013. However, while keeping in view the rise in inflation and also the need to provide a nominal anchor to help preserve the internal value of the rupee, the repo rate was increased by 25 basis points to 7.5 percent. Considering the evolving liquidity conditions, the RBI reduced the MSF rate from 9.5 percent to 9.0 percent on October 7, 2013. Provision of additional liquidity through term repos of 7-day and 14-day tenor for a notified amount equivalent to 0.25 percent Net Demand as well as Time Liabilities (NDTL) of the banking system through variable rate auctions on every Friday beginning October 11, 2013 was also announced. In the Second Quarter Review of October 29, 2013, the RBI carried forward the calibrated unwinding of exceptional measures with the reduction of the MSF rate from 9.00 percent to 8.75 percent. The special repo window for mutual funds, instituted in July 2013 to enable banks to fulfill liquidity requirements of mutual funds, was also wound up. With indications that inflation is likely to remain elevated in the months ahead, the key policy repo rate was increased from 7.50 percent to 7.75 percent.

In the Third Quarter Review of Monetary Policy on January 28, 2014, the repo rate was hiked further to 8 percent on account of upside risks to inflation, to anchor inflation expectation and set the economy securely on a disinflationary path. During 2013-14, Indian capital market, in line with global trends, was affected by the market expectation regarding the tapering of quantitative easing of the US Federal Reserve. However, foreign Institutional Investors (FIIs) have reposed confidence in the Indian market, which manifested in positive net FII investment during the last four months of 2013, reversing the earlier trend of net outflows during June-August 2013. In 2013-14, total net FII investment in the Indian markets was US$ 8.9 billion. Net FII investment during January-May 2014 is US$ 15.3

billion as compared to US$ 12.1 billion in 2013. In May 2014 alone, Indian markets have seen a net FII inflow of US$ 5.7 billion.

Central Government Finances: In the post-crisis fiscal consolidation regime, the Government generally abided by the budgeted level of the fiscal deficit except for 2011-12 when the deficit was 5.7 percent of GDP (1.1 percentage point higher than that of budget estimates). Adverse macroeconomic developments, especially elevated level of inflation in 2011-12 and 2012-13, led the Government to push harder on fiscal reforms. Fiscal deficit was contained at 4.9 percent in 2012-13 (below the budgeted level of 5.1 percent) and 4.5 percent in 2013-14 (provisional) (below the budgeted or targeted level of 4.8 percent).

Slowdown in growth, especially in manufacturing and subdued sentiments in financial markets in 2013-14 resulted in lower than budgeted tax collections and disinvestment receipts. As per the data released by the Controller General of Accounts for 2013-14, significant shortfall in growth in revenue receipts *vis-à-vis* envisaged growth in Budget 2013-14 has been observed. Gross tax revenue grew, year-on-year, by 9.9 percent in 2013-14 to reach ₹ 11,38,882 crore. As a proportion of BE, gross tax revenue was 92.1 percent in 2013-14. Non-tax revenue in 2013-14 was placed at ₹ 1,99,233 crore, that was 115.7 percent of BE. In non-debt capital receipts, there was significant shortfall mainly on account of disinvestment receipts, as only ₹ 27,555 crore of the budgeted amount of ₹ 55,814 crore was realized. On the expenditure front, as against the year-on-year growth of 16.3 percent envisaged by BE 2013-14 over RE 2012-13, growth in total expenditure in 2013-14 was 10.9 percent. As a proportion of BE, non-plan revenue expenditure was placed at 103 percent in 2013-14. This was on account of higher outgo on major subsidies that stood at ₹ 2,47,596 crore in 2013-14 (112 percent of BE). According to provisional actual figures of CGA, major subsidies accounted for 2.2 percent of GDP that was above the budgeted level of 1.9 percent. Thus, combined fiscal deficit of Centre and States was 6.9 percent of GDP in 2013-14 (BE) as against 7.4 percent in 2012-13 (RE).

Prospects: There have been few positive developments in 2013-14 that auger well for macroeconomic stabilization, the most significant being the dramatic improvement in the external economic situation with that of current account deficit declining to 1.7 percent of GDP and the economy firmly on trajectory of fiscal prudence. However, inflation, in particular food inflation, require to be reduced further. The urgent task of policy is to kickstart the investment cycle in order to raise the growth rate in manufacturing. On the expectation of moderate global recovery, modest recovery in manufacturing, improved sentiments witnessed in recent months and absence of large upshots in international energy prices, our economy can be expected to register real GDP growth in the range of 5.4 to 5.9 percent in 2014-15.

Broad Trends of Orissa Budgets During the Plan Period

Overall Macro Scenario: Odisha's economy has grown at a modest rate of 5.60 percent at 2004-05 prices in 2013-14, slightly better than that of all India expected growth rate of 4.9 percent. Several factors have contributed to the continuing economic slowdown. The world economy has been witnessing slowdown since 2008-09, which has adversely affected Indian economy resulting in sluggish growth rates. Further, high inflation rates have also resulted in higher interest costs, which have dampened private investment considerably and this has also affected economic growth. Odisha economy experienced severe drought which caused negative growth of agriculture as well as allied sectors during 2011-12. But the sector recovered strongly with a higher growth rate of 8.09 percent in 2012-13. However, the severe cyclone 'Phailin' followed by heavy floods very adversely

NOTES

impacted coastal Odisha during 2013-14, which in turn caused heavy damage to agricultural crops and very adversely impacted the Agricultural sector during 2013-14. Odisha economy has undergone a structural change during the past decade. Industry and services sectors have emerged as main drivers of growth. In real terms at 2004-05 prices, Odisha economy exhibited an average annual growth rate of 8.82 percent during the 10th Plan period against a target of 6.20 percent.

The economy grew in real terms at the rate of 7.01 percent during the 11th Plan. The first revised growth rate of Odisha is estimated to be 8.09 percent in 2012-13, the first year of the 12th Plan. The standard of living in Odisha has improved over the years with the increase in real per capita income. But the continuing gap in real per capita income between India and Odisha is a matter of concern. During the last decade, the State economy has exhibited two important characteristics. First, Odisha economy has been diversifying at a faster rate and second, though the State economy further continues to be adversely affected by frequent natural shocks, it has acquired some resilience to such natural shocks. This has happened due to transformation in the economy from 'agriculture based' to 'industries and service sectors driven'. This changing pattern of the sectoral composition in this State income estimates corroborates these trends. In these estimates, the share of agriculture sector has steadily declined over the years and the share of industry and services sectors have been increasing over the years. According to advance estimates 2013-14, share of the services sector is expected to be about 59.02 percent of the Gross State Domestic Product (GSDP) followed by those of the industry, i.e., 25.40 percent and the agriculture, i.e., 15.58 percent in real terms at 2004-05 prices. Growth pattern also exhibits similar trend. High growth rates recorded by the State in the 10th and 11th Five Year Plans were primarily due to high growth registered by the Industry Sector and the Services Sector as well. Performance of the agricultural sector continues to be highly volatile mainly because of adverse impact of natural shocks like cyclones, droughts and floods. Besides, the Services sector has been growing in a comparatively stable manner. Among the districts, Sundergarh has the highest percentage share of GSDP of Odisha with 8.54 percent followed by Khorda 7.52 percent and Deogarh contributed least share of 0.53 percent of GSDP in 2010-11. In 2010-11, real per capita net district domestic product at 2004-05 prices was highest for Jharsuguda district and lowest for Nabarangpur district. Further, workers' participation ratio in Odisha at 41.8 percent was slightly higher than that of 39.8 percent at the national level in the year 2011. Share of marginal workers in the total workforce enhanced substantially from 33 percent in 2001 to 39 percent in 2011, while the share of main workers declined from 67 percent in 2001 to 61 percent in 2011. Share of total workers in the agricultural sector, i.e., both cultivators and agricultural workers, declined from 64.7 percent in 2001 to 61.8 percent in 2011, which indicates that, although the majority of population in the State still depends upon agriculture directly or indirectly, no doubt, the State economy has been diversifying and there is also a shift moving away from the agricultural sector to non-farm sectors. According to the NSS data, rate of unemployment in the State has been declined lately – from the 61st round, i.e., July 2004-June 2005 to the 68th round, i.e., July 2009-June 2010. This is true for both rural as well as urban areas and among casual workers and also those who have full-time jobs. But the State's unemployment rate in rural area is marginally higher than the national rate of unemployment, while it is lower than all India average in case of urban areas. Share of employment in the public sector continues to be higher than that in the private sector, although the latter has shown steady increase and share of women employees in the organized sector has been steadily increasing and has stood at 16 percent in 2012.

The Agriculture Sector: One notable feature of the State economy is that the cost of living in rural Odisha is one of the lowest in the country. However, cost of living in urban Odisha which used to be lower than the rest of India in the past, is not so any more. Agriculture sector includes agriculture, animal husbandry, fisheries and forestry subsectors and share of this sector in the State's GSDP has been declining over the years and is expected to be 15.6 percent in 2013-14 based upon advance estimates. Despite reduction of the sectoral share of this sector, Agriculture sector is still vital for this State, as it still provides employment and sustenance, either directly or indirectly, to more than 60 percent of the population. Hence, agricultural sector is still the mainstay of the State's economy. It suffers from frequent natural shocks like cyclones, droughts and flash floods. Despite wide annual variations in its growth, agriculture sector grew in real terms at 2004-05 prices, at a rate of 12.72 percent during 2012-13. Though, a negative growth of 3.53 percent is anticipated during 2013-14 because of cyclonic storm Phailin and flash floods in the State in October 2013. To attain susceptibility of the State to natural calamities, foodgrains production generally fluctuates from year to year, i.e., it was 102.10 lakh tonnes in 2012-13 as compared to 63.16 lakh tonnes in 2011-12 and 76.19 lakh tonnes in 2010-11. Paddy still constitutes more than 90 percent of the total production of foodgrains and continues to be the dominant crop in Odisha, although in terms of acreage, there has been a gradual shift from paddy to cash crops. Though rice productivity has been slowly increasing and is of the order of 23.61 quintals/ha in 2012-13, it is much less than that of national average of 24.61 quintals/ha. One positive trend noticed is that the coverage of area under High Yielding Variety (HYV) paddy has increased till the end of 2010-11. After a marginal fall in the area under HYV during 2011-12 , it has been increased again in 2012-13. Production of HYV paddy also increased during 2012-13 with a high yield rate of 37.83 quintals/ha against 23.35 quintals/ha in 2011-12 and 26.89 quintals/ha in 2010-11.

Cropping intensity of Odisha has increased from 166 in 2011-12 to 167 in 2012-13. Sonepur district has reported highest yield rates of HYV paddy in the order of 63.94 quintals per ha. Another 5 districts such as Balangir, Baragarh, Sambalpur, Cuttack and Jagatsinghpur have also been recorded high yield rates of HYV paddy ranging between 45 to 50 quintals/ha during 2012-13. These positive developments augur well for overall improvement of the Agriculture sector and will increase foodgrain production in Odisha. One major constraint in improving agriculture and agricultural production in a sustained manner in the State is inadequate and erratic irrigation facilities. Irrigation intensity in the State was only 31 percent in 2006-07 in comparison to the all India average of 44 percent. However, the situation has been gradually improving. With a view to increasing irrigation facilities as quickly as possible, the State Government launched in 2009-10 two innovative irrigation schemes, i.e., (i) construction of check dams and (ii) sustainable harvesting of groundwater through installations of borewells at a massive scale. This apart, while there has been considerable improvement in the use of fertilizers and other inputs, the rate of fertilizer use and other inputs in the State still remains lower than the national average.

Fertilizer consumption in Odisha during 2012-13 has decreased to 58.74 kgs/ha as against 62.24 kgs/ha during 2011-12. For the purpose of the survey, the industry sector consists of manufacturing, mining and quarrying and electricity-gas-water supply sub-sectors. The sector contributed about 25.16 percent share of Odisha's GSDP in real terms according to the estimates of 2012-13. Share of this sector is anticipated to increase to 25.40 percent according advance estimates for the year 2013-14. In spite of global economic slowdown, disruption and other problems in mining activities, the mining and quarrying sub-sector and manufacturing sub-sector are expected to perform well with anticipated

NOTES

growth rates of 6.16 percent and 7.10 percent respectively during 2013-14. Most large-scale industries in Odisha are mineral-based. In steel production, Odisha has 10 percent of the total capacity of the nation, while it has 25 percent of total iron ore reserves in the country which indicates that there is substantial scope for expansion in steel production in the State. It is, thus, no wonder that Odisha has been a favourite destination for big investments in this Sector in recent years. Various investment proposals of big business houses like Vedant, Jindal and POSCO are in the pipeline. While these investments fully materialize, the steel producing capacity of the State will improve substantially and Odisha will grow at a much faster rate. Odisha occupies the first place in the country in aluminum, both in terms of production capacity as well as actual output. Out of the four big plants producing aluminium in the country, two are in Odisha. These are NALCO and Vedanta Aluminum Limited (VAL).

The Industry Sector: In March 2013, total aluminium production in Odisha was 54 percent of total production by all the four big plants, i.e., NALCO, VAL, BALCO and HINDALCO in the country. Number of "Micro, Small and Medium Enterprises (MSMEs)" in the State has been increasing over time. During 2012-13, maximum number of MSMEs were set up in Sundargarh district, followed by Khorda, Cuttack and Ganjam. Among manufacturing units, largest number of MSME units belong to the repairing and services followed by food and allied sector. Industrial sickness continues to be a problem among MSMEs, but after 2010-11, no new sick unit has been reported. Handicraft and cottage industry in Odisha exhibits a declining trend in terms of the number of units and employment generation. The mining sector contributed on an average about 7.3 percent of real GSDP of Odisha during the 11th Five Year Plan. However, its share has declined during the first two years of the 12th Plan period. During 2012-13, share of this sub-sector was just 5.82 percent and in 2013-14 and it is expected to be 5.85 percent. Being a favoured investment destination of global investors, this sub-sector seems poised for rapid growth. In terms of total value of mineral output, Odisha ranks highest in the country and its share is increasing gradually. This sub-sector has been increasingly employing capital intensive as well as labour saving technologies to enhance its global competitiveness. This sector comprises of sub-sectors like banking and insurance, real estate, public administration, trade, hotels and restaurants, construction, transport and communications and other services. This sector dominates the State's economy, its share in real GSDP being more than 59 percent in 2013-14 and has been constantly growing at higher rates in a comparatively stable manner. This Sector expects to grow at a rate of 7.8 percent during 2013-14. According to the first revised estimates of 2012-13 suggests that the community, social and personal services sub-sector contributed 12.99 percent, the trade, hotels and restaurants sub-sector 13.02 percent, financial and insurance services sub-sector 11.91 percent and construction 10.02 percent in the State's GSDP in real terms at 2004-05 prices. Again, according to the advance estimates for the year 2013-14, trade, hotels and restaurants sub-sector is expected to dominate the GSDP by contributing to it about 13.19 percent share and followed by the transport, storage and communication sub-sector that may contribute almost 10.55 percent, construction sub-sector 9.83 percent and other services contributed about 9.28 percent to the GSDP. The banking and insurance sub-sector is anticipated to contribute about 6.69 percent of the GSDP and provides invaluable indirect benefits to the economy in the form of financial infrastructure. The average population serviced by a bank branch in the State is approximately 12,000, which is better than that of any other states in India. Approximately 80 percent of all bank branches are located in rural and semi-urban areas. One positive outlook of the sub-sector is that the growth rate of total bank deposits in the State is increasing. Odisha is catching up with the nation in terms of per capita bank deposits in

NOTES

commercial banks. Co-operative banks mainly focus on rural areas and the agriculture sector. In an economy, construction sector is closely linked with infrastructure building in a region. Growth and expansion in the sub-sector signifies infrastructure upgradation. Share of the construction sub-sector in the Odisha's GSDP for 2013-14 is expected to be 9.83 percent. This sub-sector is also important from employment perspective, as it absorbs mass casual workers. Despite high growth of Odisha's economy in recent years, this sub-sector recorded a modest growth rate of 6.87 percent per annum during last 10 years. One implication of this could be that infrastructure upgradation in this State is not keeping pace with the growth in the economy.

Tourism has a huge growth potential in Odisha and being a labour-intensive activity, it has the capacity to generate employment on a large scale. However, growth in this subsector has not been very encouraging. The sub-sector remains less developed in comparison to other states. Share of foreign tourists arrival to the State is below one percent of total foreign tourist arrivals at all India level. The only silver lining for this sub-sector is that in absolute numbers, tourist arrivals in the State have been growing over the years. It is worth noting that the hotel industry – in terms of its contribution to the State's GSDP, has grown consistently since independence and its growth rate has improved during the last decade. However, its capacity, measured by the number of rooms and beds, has not kept pace with the growth rate of tourists in this State. It indicates that the growth of this sub-sector stems from a higher rate of utilisation. Good infrastructure is a pre-requisite for accelerated development and higher economic growth. However, Odisha is deficient in infrastructure and there is a felt need for substantially improving the extent and quality of infrastructure in this State. State Government's focus on Bijli, Sadak and Pani, therefore, seems to be in right direction. Odisha has also been pioneering in power sector reforms. In comparison to many other states, availability of power in Odisha is better and continues to improve further. However transmission and distribution (T&D) losses continues to be a matter of serious concern in Odisha. In this perspective, state has embarked upon an ambitious CAPEX programme to substantially improve its grid infrastructure and also to bring down T&D losses. Demand for power in Odisha has been increasing at a faster rate due to increased emphasis on industrialization and expansion in household electrification. Almost over 80 percent of villages in Odisha are now electrified and this situation is likely to further improve soon through project works under the Rajiv Gandhi Grameen Vidyutikaran Yojana, Biju Gram Jyoti and Biju Saharanchal Vidyutikaran Yojana. Several alternative energy programmes and incentive schemes are also in progress. Inspite of this increase in demand for power, Odisha has remained a power surplus State. About 70.4 percent of the power consumers belong to rural areas. Domestic consumers comprise about 88 percent of total consumers, consume approximately 31.4 percent of the total power consumption. Road density in Odisha is better than the all- India average. But the State lags in surface road density. Though the State Government has been making sincere efforts to address this, the Pradhan Mantri Gram Sadak Yojana and Bharat Nirman Yojana have been implemented in the State to build all-weather surface roads.

The State has also taken several initiatives to extend the spread of good quality roads and to improve the road surface quality throughout the State. An ambitious programme for increasing the number of bridges and cross drainage works has also been undertaken to ensure all-weather connectivity to remote habitations.

Railway density in the State is 15 km per thousand square km of area, which is below the national average of 20 km. Cargo shipment activity at Paradeep port has shown consistent growth despite the recent global recession. In May 2011, Dhamra port has started

NOTES

commercial operations. Gopalpur port has been operated by a private developer. Commercial operation of the port has been suspended as the construction work for all-weather port has been started.

Tele-density, which is equal to the number of telephone connections per 100 population, has grown rapidly in this State. However, it is yet to catch up with the national average. Overall tele-density of the State by the end of March 2013 was 60.21 percent as against the all India average of 73.32 percent. In case of urban tele-density, Odisha is far better than the all India level and has reported urban tele-density of 164 percent in comparison to 147 percent at the national level. The rural tele-density in the State was 39 percent as compared to 41percent at all India level. Cell phones constitute about 75 percent of total telephone connections in the State. The State has undertaken massive steps to improve the use of Information Technology, especially in public administration. E-governance has been encouraged and enforced at various levels. Two software technology parks are in operation — one at Bhubaneswar and the other at Rourkela. Their presence results in higher growth of Information Technology sub-sector.

Poverty is a multi-dimensional concept and historically witnessed higher incidence of poverty. In recent years Odisha has been able to reduce poverty at faster rates. According to the estimates made by the Planning Commission based on the Tendulkar Committee methodology, poverty in Odisha declined by 24.6 percentage points from 57.2 percent in 2004-05 to 32.6 percent in 2011-12, which was the highest poverty reduction by any major State in this country. Poverty declined in all NSS regions (i.e., coastal, northern and southern regions) and among all social classes, i.e., ST, SC, OBC and others of Odisha. This shows inclusive growth in Odisha. Although there has been significant poverty reduction among ST and SC communities and in northern as well as southern regions, incidence of poverty in southern and northern regions as well as among ST and SC communities still continues to be high and remains a matter of serious concern.

The State witnesses wide regional, social and general disparities in development. All regions have not shared the gains of development in an equitable manner. With a view to addressing the problem of regional disparities and expediting development of interior tribal dominated districts, Government has implemented a series of development programmes like Revised Long-term Action Plan (RLTAP), Biju KBK Plan, Biju Kandhamal O. Gajpati Yojana, Gopabandhu Gramin Yojana (GGY), Backward Regions Grant Fund (BRGF) and Western Odisha Development Council (WODC). Funding for RLTAP and BRGF has been provided by Government of India. With support from Government of India, State has implemented a new initiative, called Integrated Action Plan (IAP) in 18 tribal and backward districts of Odisha. Such development initiatives aim at faster development of the backward regions of the State. With increased emphasis on human development and attainment of Millennium Development Goals (MDG), social sectors have gained greater focus in the overall development process across the globe. These sectors include education, health, safe drinking water, sanitation as well as development of the marginalized groups and backward regions. Attainments of the State in social sectors have been significant in recent years. In 2011, overall literacy rate of 72.9 percent in Odisha was at par with that of national average of 73 percent. Enrollment ratio in elementary (primary and upper primary) schools has substantially been raised. Dropout rates have come down sharply from 41.8 percent in 2000-01 to 0.37 percent in 2012-13 at primary level and from about 57 percent in 2000-01 to 2.36 percent in 2012-13 at upper primary level.

School infrastructure has also been substantially improved during the recent years. The State Government has been consistently striving to improve literacy levels and quality of

NOTES

education in this State. Several initiatives have been taken. About 1619 schools, girls schools, residential schools, sevashrams, training institutes, educational complex for PTGs function in the State.

Social Sectors: With a view to improving literacy levels among ST and SC communities, especially among girls, this State has been setting up hostels for ST and SC students. There are 5,375 number of hostels for the ST students accomodating residential facilities to about 4.05 lakh students, out of which approximately 3.13 lakh are girl students. In addition there are 468 hostels for SC girls and boys and 25 such hostels are also under construction and are anticipated to be ready soon. There are also 55 hostels (i.e., 44 for SC girls and 11 for SC boys) under Babu Jagjivan Ram Chhatrabas Yojana and 30 ST hostels for girls and boys under CSP scheme are under construction. On completion of these hostels, about 3.5 lakh SC and ST students can be accommodated in these hostels. The ST and SC Development Department has also been constructing 5 numbers of urban hostel complexes, 3 in Bhubaneswar with 200 capacity, one in Rourkela and one in Berhampur city, each with of 300 capacity. Basic education apart, there is an immediate need to impart training on skill development too. A large number of vocational and technical institutions have come up during the last few years to train or equip the youth with employable technical as well as soft skills. National level institutes like IIT Bhubaneswar, National Institute of Science Education and Research, the Central University at Koraput and the National Law University at Cuttack have been also been set up in the mean time. In the healthcare sector, Government has been taking steps to bring about considerable improvement in health infrastructure and delivery and accessibility of healthcare services in this State. But, still there is a lot to be done. Basic demographic variables present a mixed picture. The crude birth rate in the State is 19.9 against the national average of 21.6 in 2012, but the crude death rate stood at 8.5 compared to 7.0 for the country. Life expectancy at birth in the State for male was 64.3 years and 67.3 years for women in 2011-15 and lower than the national average of 67.3 years and 69.6 years respectively. Infant mortality rate has come down to 53 during 2012. The IMR at all India level during 2012 stood at 42. However, the State is expected to narrow down this gap in the next projection period of 2011-15. Besides, the disease burden in the State is quite high. Government has been implementing Panchvyadhi scheme, focusing on five most prevalent diseases such as malaria, leprosy, diarrhoea, acute respiratory infections and scabies that contribute almost 70 percent of patient load. The Panchvyadhi Chikitsa scheme is in operation since 2001 to facilitate free treatment and medicines for above mentioned diseases. The scheme has also prescribed clinical protocols to be followed by all doctors as well as public health institutions. In the KBK and other tribal districts, mobile health units have been launched in service to provide health services to the people in outreach mode in remote regions where connectivity is very poor and consequently posts of doctors and other health personnel lies vacant. A number of new health initiatives, like NRHM, ASHA and other health development programmes, have been initiated in this State. The State Government with support of Central Government has launched Odisha Emergency Medical Ambulance Service free of cost so as to ensure that critical patients requiring urgent medical attention that reach hospitals in time to prevent avoidable fatality. Improvement in people's health and hygiene awareness for their general health condition and better availability of healthcare services account for improvements in several health indicators which includes IMR, maternal mortality ratio (MMR), institutional deliveries and immunization services. Maternal Mortality Ratio (MMR) during 2011-12 was 237 per 1,00,000 live births in Odisha, compared to 178 in India. There has been an improvement in women's health in recent times and consequently more pregnant women

NOTES

have been receiving ante-natal and post-natal care. Institutional deliveries have been increased from about 37 percent in 2005-06 to 84.8 percent in 2010-11. Pregnancy burden of women in the State is lower than their counterparts in the country. During the year 2011, the General Fertility Rate (GFR) in Odisha stood at 79.3 percent compared to 88.0 percent at the all India level. National Rural Health Mission (NRHM) initiatives and achievements are to be credited. Several government health programmes have been brought down the disease burden in this State. Leprosy has declined to less than 1 per 10,000 population and filaria has also been controlled. Malaria is endemic in few parts of this State, but incidence of malaria and number of death as percentage to All India reduced to 24 and 15 respectively during 2012. Number of malaria positive cases in this State also declined to 2.63 lakh in 2012 as against 3.09 lakh in 2011. HIV positive cases have reduced remarkably from 3,765 in 2012 to 3,479 during 2013.

Odisha's performance has been satisfactory in respect of accessing safe drinking water. Coverage of households having access to safe drinking water, i.e., taps, hand pumps and tube wells was 75.3 percent as per the 2011 census. The Integrated Management Information System (IMIS) reports that 2.7 percent rural habitations in Odisha were not covered or included under drinking water supply programmes in 2009. According to the 2011 census about 78 percent of all households do not have sanitation facility in their premises. Total Sanitation Campaign (TSC) has been implemented to install toilets in rural areas and encourage people to improve sanitation conditions. Physical achievements under this programme have been encouraging. By 2013-14, 56.5 percent households, 100 percent schools, 99.3 percent Anganwadis were covered under this programme.

The State Government has been implementing a number of welfare programmes to address malnutrition among children, mothers and old, infirm and destitute persons. These include the Integrated Child Development Scheme (ICDS), rehabilitation of cured leprosy patients, emergency feeding programme and heavily subsidized rice at the rate of ₹ 1 per kg. Apart from that, pension schemes such as the National Old Age Pension (NOAP), Madhu Babu Pension and National Family Benefit Schemes are too in operation to facilitate social security to the poor, old as well as destitute.

Further, there exist gender disparities in Odisha in several human development indicators. Only sixty-four percent of the female population is literate in comparison to about eighty two percent of the male population in Odisha. Male literacy rate in Odisha is little higher than that of national average while female literacy rate is marginally lower. Women constitute about 45 percent of the total workforce in Odisha. Employment of women in the organized sector has however been increasing in recent years. Present strategy of the State to empower and develop women is a step in the right direction. About 5.36 lakh Women Self Help Groups (WSHGs) with 64.37 lakh members have been organized with support from the Mission Shakti Programme. The State Commission for Women works towards protecting interests of women and for preventing violence against them. The Odisha State Social Welfare Advisory Board (OSWAB) provides grants for welfare of women and The ST and SC communities are largely marginalized sections of the society. Their development has been received focused attention by the Central as well as the State governments. The Tribal Sub-plan has been operating in the State with greater focus on tribal dominated 118 blocks of the State. Special Central Assistance (SCA) is provided for accelerated development of tribal communities including Particularly Vulnerable Tribal Groups (PVTG).

Public Finance: Overall fiscal scenario in Odisha continued to be broadly satisfactory through the years 2012-13 and 2013-14 despite a couple of aggregative indicators causing

NOTES

some concern. Basic prudential policy of maintaining revenue account surpluses to finance the capital outlays continued to be successfully implemented, thereby reducing the need to incur fresh debt as also providing the fiscal space to increase capital expenditures for development of this State. Guided by the rolling targets of the Medium Term Fiscal Plan, part of obligations under the fiscal responsibilities legislation of the State, key fiscal parameters were kept within permissible range, to meet an important conditionality of the 13th Finance Commission of India. All this was against the backdrop of the Indian economy refusing to enhance its plodding rate of growth and inflationary condition proving immune to corrective (primarily monetary) policy measures. Despite the macroeconomic worries, which to a limited extent affected the State's finance too, transfers from the Centre did not exhibit any fall; for a State like Odisha that is heavily dependent on the Central transfers, any such fall can have serious consequences. Not withstanding the declining revenue surplus, the policy of gradually increasing developmental capital outlays was persisted with 2.1, 2.2 and 2.7 percent of GSDP in 2011-12, 2012-13 and 2013-14 respectively. This resulted in the small fiscal surplus of 0.3 percent in 2011-12, evaporating in 2012-13 and turning into a fiscal deficit of a little more than 2 percent of GSDP in the budget estimates for 2013-14.

At the time of introducing the fiscal responsibility legislation, total liabilities of Odisha was close to 50 percent of GSDP. Considered with high deficit levels, it raised the spectre of non-sustainability of such a high level of debt because, states in India have no way of financing their deficits except through additional borrowing. The state finances have come a long way from that stage in the intervening years, total liabilities reduced to less than 20 percent of GSDP in 2012-13. With deficits reigned in, there is no apprehension regarding sustainability at all.

In fact, the State has not even made any recourse to the Reserve Bank of India's overdraft facility in recent years. Evidently, this is not an aspect of the State finances that would cause any concern at present. The State has also taken various steps to strengthen appropriate institutional measures for more efficient management of public finances. These measures include maintenance of capital assets through a well conceived annual management plan, cash management system to reduce inefficient and ineffective expenditures and to avoid rush of expenditure in the last quarter of the financial year, improved classification of revenue and capital expenditures, grants meant for creation of capital assets to be treated as capital expenditure, promotion of outcome budgets in select departments in a phased manner, zero-based budgeting with focus on completion of projects as well as other measures.

6.2 BUDGETARY TRENDS

In 2014-15, the Indian economy is poised to overcome the sub 5 percent growth of gross domestic product (GDP) witnessed over the last two years. The growth slowdown in the last two years was broad based, affecting in particular the industry sector. Inflation too declined during this period, but continued to be above the comfort zone, owing primarily to the elevated level of food inflation. Yet, the developments on the macro stabilization front the dramatic improvement in the external economic situation with the current account deficit (CAD) declining to manageable levels after two years of worryingly high levels was the redeeming feature of 2013-14. Fiscal deficit of the Centre as a proportion of GDP also declined for the second year in a row according to the announced medium term policy stance. Reflecting the above and the expectations of a change for the better, financial markets have surged. Moderation in inflation would help ease the monetary policy stance

NOTES

and revive the confidence of investors and with the global economy expected to recover moderately on account of performance in some advanced economies, the economy can look forward to better growth prospects in 2014-15 and beyond. After achieving unprecedented growth of over 9 percent for three successive years between 2005-06 and 2007-08 and recovering swiftly from the global financial crisis of 2008-09, Indian economy has been going through challenging times that culminated in lower than 5 percent growth of GDP at factor cost at constant prices for two consecutive years, i.e., 2012-13 and 2013-14. Sub 5 percent GDP growth for two years in succession was last witnessed a quarter of a century ago in 1986-87 and 1987-88. Persistent uncertainty in the global outlook, caused by the crisis in the Euro area and general slowdown in the global economy, compounded by domestic structural constraints and inflationary pressures, resulted in a protracted slowdown. Slowdown is broadly in sync with trends in other emerging economies, but relatively deeper. India's growth declined from an average of 8.3 percent per annum during 2004-05 to 2011-12 to an average of 4.6 percent in 2012-13 and 2013-14. Average growth in the emerging markets and developing economies including China declined from 6.8 percent to 4.9 percent in this period. What is particularly worrisome is the slowdown in manufacturing growth that averaged 0.2 percent per annum in 2012-13 and 2013-14.

Inflation has Eased but is Still above Comfort Levels: In addition to the growth slowdown, inflation continued to pose significant challenges. Although average wholesale price index (WPI) inflation declined in 2013-14 to 6.0 percent *vis-à-vis* 8.9 percent in 2011-12 and 7.4 percent in 2012-13, it is still above comfort levels. Moreover, WPI inflation in food articles that averaged 12.2 percent annually in the five years ending 2013-14, was significantly higher than that of non-food inflation. Upward trend of inflation that played a part in slowdown in growth, savings, investment and consumption appears to have subsided.

Improvements are Visible on the Fiscal Front and in the Current Account Balance: External sector witnessed a remarkable turnaround after the first quarter of 2013-14 and the year ended with a CAD of 1.7 percent of GDP as against 4.7 percent in 2012-13. After plummeting to ₹ 68.36 to a US dollar on 28 August 2013, triggered by the expected taper of quantitative easing in the United States, the rupee gradually strengthened and the year ended with the exchange rate averaging ₹ 61 per US dollar in March 2014, owing to measures taken by the government and the Reserve Bank of India. Foreign exchange reserves increased by nearly US$ 40 billion from US$ 275 billion in early September 2013 to US$ 314.9 billion on 20 June 2014. These developments on external account have generated some optimism that the Indian economy is better prepared to confront the challenges of global policy reversals, including tapering of quantitative easing in the US. Improvement is also observed on the fiscal front, with the fiscal deficit declining from 5.7 percent of GDP in 2011-12 to 4.9 percent in 2012-13 and 4.5 percent in 2013-14. Much of this improvement has been achieved by reduction in expenditure rather than from increased revenue. Nevertheless, the corrections in fiscal and current account deficits augur well for macroeconomic stabilization.

Sustenance of Early Signs of Growth Pick-up Depends on Amelioration of Structural Constraints: Improvements in the twin deficits would, no doubt, feed into a higher growth in 2014-15, but the pace of recovery may be gradual. After reaching a low of 4.4 percent during the last two quarters, i.e., third and fourth quarter of 2012-13, growth inched up to 4.7 percent in first quarter of 2013-14 and further to 5.2 percent in second quarter of 2013-14, only to decline to 4.6 percent in the next two quarters. The fact that this happened despite a gradual recovery in the global economy shows the importance of

NOTES

addressing the domestic structural constraints that have engendered an undulating and gradual recovery.

Sectoral Growth Trends

Favourable Monsoons Helped Agricultural Growth and Power Generation; Slowdown in Industry Continued: Aided by a favourable monsoons, the agriculture and allied sectors achieved a growth of 4.7 percent in 2013-14 compared to its long-run average of around 3 percent (between 1999-2000 and 2012-13). However, in some other sectors, slowdown has been more pronounced and protracted. Mining and quarrying activities have decelerated since 2011-12. Two prominent components of mining, coal and crude petroleum, have stagnated in the last three-four years. Subsequent to an average growth of 7.1 percent in coal production during the four-year period 2006-07 to 2009-10, its growth declined to an average of 1.6 percent during the next four years ending 2013-14. The slowdown in coal production partly owes to regulatory issues. The compound annual growth rate (CAGR) of crude petroleum was 1.2 percent during 2004-05 to 2013-14. As coal and petroleum are universal intermediates and slack in their production affect the economy adversely.

Last two years were particularly disappointing for the manufacturing sector, with growth averaging 0.2 percent per annum. The decline has been quite broad based, as per data from the index of industrial production (IIP). Decline in the growth rate for basic goods continued for the third year in succession in 2013-14. Output of capital goods declined for the third year in a row starting 2011-12. Contraction of 12.2 percent in the consumer durables segment was observed in 2013-14. Only intermediate and non-durable consumer goods registered higher growth rate in 2013-14 and 2012-13. Following close to double-digit growth between 2004-05 and 2011-12, construction sector that was the major source of employment in this period, lost momentum in the last two years. Taken together with the trends in capital goods, slowdown in construction activity reflects subdued business sentiments.

Data on manufacturing growth during the last two years need to be interpreted with care, given the possibility of revisions by the CSO. The initial estimates of value added in manufacturing sector are based on the IIP, while the second and third revised estimates are based on more detailed data from the Annual Survey of Industries (ASI). For instance, according to the National Accounts Statistics, growth rate of manufacturing for 2011-12 was revised to 7.4 percent in the second revised estimates from 2.7 percent estimated earlier as ASI data for 2011-12 became available only in the second half of 2013.

Slowdown in services, especially the internal trade, transport, and storage sectors, could be attributed to the loss of momentum in commodity-producing sectors. The moderate revival in the global economy may have helped the growth in business services. Bank credit grew by 14.3 percent in 2013-14, indicating buoyant activity in financial services.

Disaggregated sectoral trends may be better understood in terms of movement in sectoral shares in GDP. Share of the agriculture and allied sectors in GDP has been consistently declining. During the eight years between 1999-2000 and 2007-08, the share of agriculture and allied sectors in GDP declined by 6.4 percentage points, while that of industry and services increased by 1.9 and 4.4 percentage points respectively.

The mining and quarrying sector witnessed continuous decline in GDP share for several years, indicating its inability to cater to requirements of high growth, in the absence of comprehensive reforms.

NOTES

In case of manufacturing, most of the gain in share occurred during 2004-05 to 2007-08, when the sector was growing at an annual average rate exceeding 10 percent, along with robust growth in corporate profits, savings, and investment. Activity was buoyant in registered manufacturing, while the share of unregistered manufacturing remained unchanged during the four years ending 2007-08. During 2008-09 to 2012-13, the share of manufacturing remained roughly constant despite an increase in share of the registered segment, as unregistered manufacturing recorded an average annual growth of 3.4 percent.

Revival of growth in services depends on growth revival in commodity producing sectors. Industrial revival is central to sustained revival in overall growth:

Share of services has been consistently increasing, more so since 2004-05. However, the pace of expansion was not balanced. The biggest drivers of the service sector expansion since 2004-05 were communications and banking and insurance. Robust growth in these sectors primarily drove the expansion of the services sector even after 2010-11. Real estate and business services also gained share. Services that witnessed stagnation or decline in share after 2010-11 include domestic trade, hotels, and storage. The inability of some of these employment-intensive sectors to attain sustained momentum is one of the reasons for the less-than commensurate growth in employment in services. In the absence of sufficiently high growth in agriculture and industry, services would be seriously constrained to sustain growth acceleration on auto-pilot mode since many of the services are dependent on buoyancy in the commodity-producing sectors, particularly industry.

Quarterly Trends: Quarterly GDP figures can be helpful in detecting inflexion points within the year. The current episode of a rather protracted growth deceleration commenced in the first quarter 2011-12, while the growth slowdown in manufacturing started in the second quarter 2011-12. The slowdown in mining and quarrying became evident in last quarter 2010-11 and this trend continues. Electricity, gas, and water supply witnessed somewhat higher growth in 2013-14 and 2012-13, owing mainly to higher electricity generation from hydel sources on account of improved water availability in reservoirs.

Aggregate Demand: Aggregate demand, measured in terms of GDP at constant (2004-05) market prices, registered a growth of 5.0 percent in the year 2013-14 as against 4.7 percent in the previous year. Growth in private final consumption, which averaged 7.8 percent during 2003-04 to 2011-12, declined to 5.0 percent in 2012-13 and further to 4.8 percent in 2013-14. In real terms, fixed investment hardly increased between 2011-12 and 2013-14. In terms of share of GDP, the most striking change on the demand side during 2012-13 and 2013-14 was the precipitous decline in the gross fixed capital formation to GDP ratio by 2.1 percentage points. Therefore, the increase in the growth rate of aggregate demand in 2013-14 mainly owes to higher level of net exports (reflected by a reduction in the gap between exports and imports. Major components of aggregate demand are analyzed in the sections that follow.

Share of Private Consumption in GDP has Declined in Recent Years

Consumption: Final consumption expenditure is estimated separately for government as well as private entities. Share of final consumption in GDP has been declining consistently since the 1950s, reflecting the decline in share of private final consumption expenditure (PFCE). This is not surprising, as higher income levels have led to higher savings by households and reduced the share of consumption. This was also inevitable as higher investment required for raising growth had to come from higher domestic savings given the export pessimism that prevailed till the early 1980s. Despite high oscillations in annual growth, government consumption expenditure as a proportion of GDP has exhibited remarkable consistency since the 1980s.

Share of the food items, beverages and tobacco group in total final consumption in real terms declined by 9.5 percentage points of the GDP in the nine years from 2004-05 to 2012-13. However, in nominal terms, this decline was only about half of the decline in real terms, indicating higher inflation for these products during this period.

Apart from the food, beverages and tobacco group, there was a decline in the share of gross rent, fuel, and power, medical care and health services, and transport and communications, while the largest increase was registered in, other miscellaneous services comprising banking charges, legal services, business services and life insurance. There has been a progressive inclination towards the consumption of services and a move away from non-durable goods, especially food items.

Investment

Fixed investment rate declined steeply in 2013-14: Investment comprises fixed capital formation, acquisition of valuables, and changes in stock and inventories, adjusted for errors and omissions. Investment rate (investment to GDP ratio) averaged 24.5 percent over the period 1990-91 to 2003-04 The year 2004-05 marked a break, with the rate of investment exceeding 30 percent for the first time. Between 2004-05 and 2012-13, the rate of investment averaged 35.4 percent, reaching the peak of 38.1 percent in 2007-08. It averaged 35.3 percent during the higher growth phase of 2004-05 to 2007-08 and 35.5 percent between 2008-09 and 2012-13. The investment rate of 34.8 percent in 2012-13 is lower than these two sub-period averages.

Rate of gross fixed investment, which accounts for the bulk of total investment, increased significantly from 2004-05, peaked in 2007-08 and declined thereafter. According to the provisional estimates for 2013-14 released by the CSO, ratio of fixed capital formation to GDP in 2013-14 was 2.1 percentage points lower than in 2012-13. Ratio of valuables to GDP generally increased, even in the period when fixed investment declined, thereby keeping the overall rate of investment at around 35 percent. Changes in stocks are generally subject to wide fluctuations.

Reduced private corporate investment rate is the primary reason for decline in overall investment rate: Increase in investment by the private corporate sector explained the bulk of the increase in overall investment during the upswing phase between 2004-05 and 2007-08. The same sector contributed the most to the current decline in investment rate. The growth in investment by the private corporate sector was sharp during 2004-05 to 2007-08, while it averaged 48.1 percent annually at current prices. Rate of growth declined to 3.4 percent during 2008-09 to 2012-13. Public-sector investment, which grew at an annual rate of 23.9 percent in the former period, also slowed subsequently. Household investment growth, in contrast, increased from an annual average of 12.3 percent during 2004-05 to 2007-08 to an average of 23.5 percent in 2008-09 to 2012-2013. In the high growth phase between 2004-05 and 2007-08, the machinery and equipment segment of fixed investment of the private corporate sector as a ratio of GDP nearly doubled. Similarly, the ratio of construction also registered a sharp increase. The decline in fixed investment rate in the last three-four years can be mainly attributed to decline in the share of the machinery and equipment segment of the private corporate sector.

This decline in the construction segment of fixed investment by the private corporate sector (as a ratio of GDP) has been relatively moderate, as against that in the machinery and

NOTES

equipment segment. This could be on account of the fact that the machinery and equipment segment of investment responds relatively more quickly to business sentiments than the construction segment. Long gestation period for construction indicates that a project once started or shelved would take longer to stop or revive with change in business sentiments. Investing in machinery and equipment during slowdown may also lead to its underutilization, along with the usual wear and tear (obsolescence). Construction activity is less prone to these problems.

Valuables: Valuables include assets that are primarily held as store of value. Net acquisition of valuables covers precious articles, gems and stones, silver, gold, platinum, and gold and silver ornaments. Change in aggregate possession of valuables may not have any direct bearing on the productive capacity of the economy. Acquisition of valuables has been subject to significant fluctuations in recent years. Their share in GDP increased from 1.2 percent in 2006-07 to 2.6 percent in 2012-13 and then declined to 1.5 percent in 2013-14. Value of imports of gold and silver increased from US$ 42.6 billion in 2010-11 to US$ 55.8 billion in 2012-13. In order to restore stability in the foreign exchange market and reduce the CAD, several measures including hike in import duties on gold and silver were declared by the government in August 2013. These measures resulted in reduction in the combined value of import of gold and silver by about 40 percent in US dollar terms, which is largely reflected in the decline in share of valuables in the GDP.

Net Exports

Moderate Revival of Exports, Coupled with Decline in Imports; Helped Improve Net Exports: Net exports in national accounts are defined as the difference between export of goods and non-factor services and import of goods and non-factor services. Though full-fledged recovery in the global economy is still distant, the early signs of global economic strengthening helped India to achieve partial recovery in exports. On the other hand, measures initiated by the government and the RBI to contain the CAD, mainly by dis incentivizing the import of non-essential items, coupled with economic slowdown, helped to reduce imports. Share of exports in GDP increased from 24.0 percent in 2012-13 to 24.8 percent in 2013-14, while the share of imports declined from 30.7 percent to 28.4 percent, resulting in an improvement in net exports by 3.1 percentage points of GDP.

Public Finance: In the aftermath of the adoption of the Fiscal Responsibility and Budget Management (FRBM) Act, the fiscal deficit of the centre was brought down to 2.5 percent of GDP in 2007-08 that was below the threshold target of 3 percent of GDP. Fiscal balances were deliberately expanded in the aftermath of the global financial crisis in 2008-09 to shore up aggregate demand and enhance the growth rate. Gradual fiscal consolidation process was resumed in 2010-11. Further, government unveiled a revised fiscal consolidation roadmap in October 2012 and targeted a fiscal deficit of 4.8 percent of GDP for 2013-14 and through a correction of 0.6 percentage point every year thereafter, a fiscal deficit of 3.0 percent of GDP by 2016-17.

Fiscal Consolidation was Attained with Lower-than Budgeted Expenditure in 2013-14: Fiscal deficit of 4.5 percent of GDP in 2013-14 as compared to the budgeted target of 4.8 percent of GDP is indicative of continued focus on fiscal consolidation. With a shortfall in tax revenues and disinvestment receipts along with higher than budgeted subsidies and interest and pension payments, fiscal consolidation was mainly achieved through reduction in expenditure from the budgeted levels. The outcome in terms of fiscal deficit of the Centre broadly indicates that despite the macroeconomic uncertainties and elevated global crude oil prices, fiscal targets were achieved. Raising the tax-GDP ratio above the currently prevailing levels is critical to sustain the process of fiscal consolidation in the long run as compression of expenditure beyond a certain minimum can be counter-productive.

NOTES

Raising The tax-GDP Ratio and Furtherance of Subsidy Reforms are Essential for Fiscal Consolidation: One of the major factors that has resulted in an increase in the Centre's fiscal deficit after 2008-09 has been the build-up in subsidies. According to the provisional actual figures of the Controller General of Accounts (CGA), major subsidies amounted to ₹ 2,47,596 crore in 2013-14. There has been a sharp increase in total subsidies from 1.42 percent of GDP in 2007-08 to 2.56 percent of GDP in 2012-13, and 2.26 percent of GDP in 2013-14 revised estimate. Food subsidy has been increasing because of widening gap between the economic cost of procurement by the Food Corporation of India and the central issue prices fixed for cereals under the public distribution system (PDS). While there has been partial decontrol of fertilizer subsidy, prices of urea are still sticky; similarly petrol prices have been decontrolled and diesel prices are subjected to monthly increases of ₹ 0.50 per litre. The cap set on the number of subsidized LPG cylinders per annum per family was increased from 9 to 12 from April 2014. In addition, leakages contribute substantially to the overall increase in subsidy burden. In the case of food subsidy, the Performance Evaluation Report of the Planning Commission on Targeted PDS (2005) states that for every kilogram of grains delivered to the poor, the GOI released 2.4 kg from the central pool. This has implications for the delivery cost of PDS foodgrains through the existing delivery mechanism. Higher fiscal deficits usually lead to rising public debt. India's central government liabilities-GDP ratio declined from 61.6 percent in 2002-03 to 49.4 percent in 2013-14 revised estimate. Reduction in this ratio owes to higher nominal GDP growth rate and nominal interest rates.

Domestic Savings

For estimation of gross domestic savings, the economy is classified into three broad institutional sectors, public, private corporate, and households. Savings rate increased from 29.0 percent in 2003-04, the highest achieved till then, to 36.8 percent in 2007-08, which still remains the historic peak. From a high of 36.8 percent, gross savings rate fell by 6.7 percentage points of the GDP in 2012-13. The bulk of the decline can be attributed to the private corporate and public sectors. While the decline in the former owes mainly to lower growth in the industry sector and lower profit margins, lower public savings to GDP ratio can be attributed to reduced savings of non-departmental public enterprises and greater dissavings of public authorities. Savings of the household sector are the sum of financial savings and savings in physical assets. Household savings rate had stabilized around an average of 23 percent of the GDP between 2000-01 and 2006-07 and started fluctuating thereafter. It witnessed strong compositional shifts from financial to physical savings during the period 2007-08 to 2011-12. Net addition to the physical assets of households including investment in construction, machinery and equipment and change in stocks constitutes the saving of households in physical assets. With a significant reduction in the growth of construction activity in 2012-13, physical savings rates by households also declined. The failure of the construction sector to pick up strongly in 2013-14, coupled with sluggishness in machinery and equipment segment indicates that the increase in physical savings of household in the year may have been muted. Retained profits of the private corporate sector adjusted for non-operating surplus or deficit plus depreciation constitutes its gross savings, which increased sharply after 2002-03 to reach over 9 percent of the GDP by 2007-08. It was the significant and consistent improvement in corporate profitability that took the

NOTES

private corporate sector savings rate to above 9 percent in 2007-08 from less than 2 percent during the 1980s. A study by the RBI on the Performance of Non-governmental, Non-financial Companies showed that their profit margins deteriorated in 2012-13. It would possibly have affected the savings of the private corporate sector. With negative growth in manufacturing in 2013-14, savings rate of the private corporate sector is unlikely to have revived.

Prices and Monetary Management

Inflation: The average headline WPI inflation moderated to a four-year low of around 6 percent in 2013-14 after averaging 8.6 percent in the previous three years, with the contribution of the non-food segment moderating significantly on the back of the fall in global commodity prices. However, the pressure from domestic food items remained elevated. WPI inflation remained below 5 percent in the first quarter of 2013-14. However, higher inflation in vegetables and cereals led to a spike, with inflation reaching 6.6 percent and 7.1 percent respectively in the second and third quarters. With some moderation in cereals inflation and correction in vegetable prices, inflation declined to 5.4 percent in the last quarter of 2013-14. Inflation in non-food manufactured products remained benign throughout the year and moderated to a four-year low of 2.9 percent in 2013-14. It indicates that the underlying pressures of broad based inflation may have somewhat eased. Inflation in terms of the new series of consumer price index (CPI) (combined) remained fairly sticky at around 9-10 percent owing to higher food inflation in the last couple of years. However, the CPI inflation started moderating after December 2013 and declined to a 25-month low of 8.0 percent in February 2014, following moderation in inflation for vegetables and egg, meat, and fish. On the other hand, CPI inflation excluding food and fuel, remained sticky due to higher inflation in services-led components such as medical, education, household requisites, etc.

Major Contributors to Headline WPI Inflation

Food inflation has been much Higher than Non-food Inflation: The level of inflation and its movement across major sub-groups varied significantly over the eight quarters up to last quarter of 2013-14. In 2013-14, inflation was confined to food and fuel, that contributed nearly two-thirds of overall inflation. High inflation in the last few years food inflation has been the result of structural and seasonal factors. While inflation in food articles remained persistent, its drivers have been changing over time. For instance, cereals and protein items were the main contributors to food inflation in the first quarter of 2013-14, while vegetables pushed up food inflation in second and third quarter. Within the food group, contribution of the commodity sub-groups, fruits and vegetables and egg, meat and fish has been high. Inflation in these protein-based items is on account of increase in share of consumption of these items arising from growing income levels.

Food inflation partly owes to large wastage of food articles in the supply chain owing to inefficiencies in distribution channels. Further, provisions of the State Agricultural Produce Marketing Committee (APMC) Acts have prevented creation of competitive conditions in the distribution of commodities and creation of a national market for agricultural commodities. Multiple layers of intermediation in the distribution of food articles have also pushed up prices for consumers. It is therefore necessary to focus on distribution channels and on reducing food wastage in the supply chain. Significant investment in marketing infrastructure, including modern warehouses, cold storages, reefer vans, scientific packaging, and handling would help strengthen distribution channels. State governments will have to play a vital role in removing restrictive provisions in the APMC Act and proactively promoting alternative trading options for farmers. Fuel inflation

NOTES

remained in double digits in the last three quarters. Major reason for high inflation in fuel and power items was the rationalization of tariff for electricity in many states, in addition to the policy of allowing greater pass-through in diesel prices and depreciation of the Indian rupee against the US dollar.

Outlook for Inflation: Forecasts by the IMF expect international commodity prices to remain benign. This should help in moderation of WPI headline inflation. However, the major risk arises from sub-normal monsoons during 2014-15 on account of the El Nino effect as well as higher prices of oil due to the geo-political situation in the Middle East. Decisions of the government regarding subsidy on inputs for agriculture including fertilizer and increase in the minimum support prices (MSP) could also have an impact on food inflation.

Monetary Developments: Gradual monetary easing that had started alongside some moderation in inflationary pressures at the beginning of 2013-14 was disrupted by the need to stabilize the foreign exchange market. In May 2013, there were indications of tapering of quantitative easing by the US Federal Reserve. The surge in capital outflows that followed, resulted in sharp depreciation of the rupee. To restore stability in the foreign exchange market, the RBI hiked interest rates and compressed domestic money market liquidity.

Tight Monetary Policy Stance was followed by RBI for Containing Inflation and Restoring Stability in the Foreign Exchange Market: The RBI in the Third Quarter Review of Monetary Policy on 28 January 2014 hiked the repo rate by 25 bps to 8 percent on account of upside risks to inflation. The move was intended to set the economy securely on a disinflationary path. In the second bimonthly Monetary Policy Statement 2014-15, on 3 June 2014, the RBI kept the Policy Repo rate unchanged at 8 percent and reduced the statutory liquidity ratio by 50 bps from 23 percent to 22.5 percent. The RBI, thus, expects banks to reduce their government securities holdings, allowing them to lend more to the private sector.

International Trade, Balance of Payments, and External Debt

International Trade: India's share in world exports and imports increased from 0.7 percent and 0.8 percent respectively in 2000 to 1.7 percent and 2.5 percent respectively in 2013. There has also been marked improvement in India's total merchandise trade to GDP ratio from 21.8 percent in 2000-01 to 44.1 percent in 2013-14. India's merchandise exports reached US$ 312.6 billion in 2013-14, registering a growth of 4.1 percent as compared to a contraction of 1.8 percent during the previous year. In April-May 2014, exports registered a growth of 8.9 percent over the corresponding period of 2013. Exports of petroleum products, engineering goods, chemicals and related products accounted for more than half of total exports in 2013-14. The value of imports declined by 8.3 percent in 2013-14 as compared to 2012-13, owing to a 12.8 percent fall in non-oil imports. Value of imports of petroleum, oil and lubricants (POL) increased by 0.7 percent in 2013-14. Imports of gold declined from 1078 tonnes in 2011-12 to 1037 tonnes in 2012-13 and further to 664 tonnes in 2013-14, on account of several measures taken by the government. In value terms, gold and silver imports fell by 40.1 percent to US$ 33.4billion in 2013-14. Sharp decline in imports and a moderate growth in exports in 2013-14 resulted in a decline in India's trade deficit to US$ 137.5 billion from US$ 190.3 billion during 2012-13, contributing to a lower CAD.

Services Trade: Services exports registered a growth of 4 percent in 2013-14 as against 2.4 percent in 2012-13. Surplus in services trade has been a major source of financing India's growing merchandise trade deficit in recent years. During 2006-07 to

NOTES

2012-13, this surplus on an average financed around 38 percent of merchandise trade deficit. While in 2012-13, net services financed 33.2 percent of the merchandise trade deficit, during 2013-14, with moderate growth in services exports and fall in their imports, net services financed nearly half of merchandise trade deficit.

Balance of Payments

Demand slowdown and restrictions on non-essential imports resulted in reduced trade deficit and lower CAD: India's Balance of Payments (BoP) position improved significantly in 2013-14, particularly in the last three quarters. Stress on BoP observed during 2011-12 as a fallout of the crisis in the Euro area and inelastic domestic demand for certain key imports continued through 2012-13 and the first quarter of 2013-14. The CAD rose sharply to a high of US$ 88.2 billion (4.7 percent of GDP) in 2012-13, surpassing the 2011-12 level of US$ 78.2 billion. After being at perilously unsustainable levels in 2011-12 and 2012-13, the improvement in BoP position in 2013-14 is a relief. However, the outcome in 2013-14 was mixed—high levels of CAD in the first quarter followed by gradual correction thereafter adequate financing through capital flows till May 2013; a sharp correction in June-August 2013 followed by a surge in September-November 2013. The correction in June-August 2013 was on account of market fears of an imminent tapering of asset purchases by the US Fed. Subsequent surge in flows owed to the special swap windows incentivized by the RBI for non-resident deposits and the overseas borrowing programme of banks.

However, government moved swiftly to correct the situation through restrictions in non-essential imports like gold; custom duty hike in gold and silver to a peak of 10 percent; and measures to augment capital flows through quasi-sovereign bonds and liberalization of external commercial borrowings. The RBI also put in place a special swap window for foreign currency non-resident deposit (banks) and banks' overseas borrowings, through which US$ 34 billion was mobilized. Such measures led to a turnaround in the BoP position in the latter three quarters and for the full fiscal 2013-14. With higher exports and lower imports, there was a reduction in trade deficit to 7.9 percent of GDP in 2013-14 from 10.5 percent in 2012-13.

Apart from that, net invisibles' surplus remained stable at US$ 28-29 billion per quarter resulting in overall net surplus of US$ 115.2 billion for 2013-14. Software services improved modestly from of US$ 63.5 billion in 2012-13 to US$ 67.0 billion in 2013-14. Non-factor services increased from US$ 64.9 billion in 2012-13 to US$ 73.0 billion. It was partly on account of business services turning positive with net inflows of US$ 1.3 billion in 2013-14 as against an outflow of US$ 1.9 billion in 2012-13. Thus, the CAD moderated to US$ 32.4 billion in 2013-14 as against US$ 88.2 billion in 2012-13. The CAD at 1.7 percent of GDP in 2013-14, compares favourably with the levels in the pre-2008 crisis years.

Capital flows moderated, but foreign exchange reserves increased in 2013-14: Net Capital flows moderated sharply from US$ 92.0 billion in 2012-13 to US$ 47.9 billion in 2013-14 and this decline essentially reflects slowdown in portfolio investment and net outflow in 'short-term credit' and 'other capital'. There were large variations within quarters partly due to domestic and partly to external factors. Thus, move to augment capital inflows through special swap windows resulted in copious inflows of about US$ 34 billion.

These inflows in tandem with the lower level of CAD led to reserve accretion in 2013-14. Foreign exchange reserves were placed at US$ 304.2 billion at end-March 2014 as against US$ 292.0 billion at end-March 2013. Thus, foreign exchange reserves in nominal terms increased by US$ 12.2 billion as against a reserve accretion of US$ 15.5 billion on

BoP basis at end-March 2014. The difference owed to valuation loss in the non-US dollar assets held due to cross-currency movements and the decline in gold prices. On June 20, 2014, foreign exchange reserves stood at US$ 314.9 billion.

External Debt

The one-off mobilization of deposits by the RBI had implications for India's external debt. India's external debt stock at end-March 2013 stood at US$ 404.9 billion as against US$ 360.8 billion at end-March 2012. This increased further to US$ 426.0 billion at end December 2013. India's external debt consists predominantly of long-term borrowings and has remained within manageable limits owing to prudential restrictions on debt varieties of capital inflows given large interest differentials.

Priorities for Reviving Growth: Priorities for growth revival includes investment revival, strengthening of macroeconomic stability, creation of non-agricultural jobs, strengthening of infrastructure and boost to agricultural development. With the twin deficits reasonably under check, the macroeconomic outcomes of slow growth and inflationary pressures require immediate attention. Short-term stabilization apart, the focus of policy should be on wide-ranging structural reforms to ease supply-side constraints and sector-specific incentives to boost demand. Few specific priorities, with the objective of restoring growth are outlined as hereunder:

1. Revival of investment is crucial for raising the growth rate. It requires acceleration in project clearances and streamlining of implementation procedures, apart from sector-specific investment policies.
2. Over the medium term, structural reforms that boost productivity are crucial to sustain higher growth.
3. Linked to efforts at investment revival are policies needed for rejuvenating growth in manufacturing, which has significant backward and forward linkages. Simplification of tax policy and administration, repeal of archaic laws that govern market access, expansion and entry or exit of firms, revamp of the dispute resolution mechanism for commercial disputes, etc. would lend greater predictability to policy. An environment of policy certainty, continuity and transparency will definitely help boost business sentiments further.
4. Strengthening macroeconomic stability, a non-negotiable instrument for stable and faster growth, is predicated on fiscal discipline, manageable current account balance, and price stability. Policy challenges includes:
   (i) Keeping fiscal deficit in check without compromising on capital expenditure;
   (ii) Maintaining the CAD in the range of 2-2.5 percent of GDP. This may turn out to be challenging if non-oil imports revive upon growth revival and oil prices harden. Therefore, policies that help in sustained export growth remain relevant.
   (iii) Stepping up efforts to further reduce inflation not only to counter the direct macroeconomic consequences but to provide leeway to the RBI for monetary easing and to counter external challenges more effectively.
5. To harness the demographic dividend, the non-agrarian sector must generate employment. With the agrarian sector still employing the bulk of the workforce, policy attention needs to be focused on the rural non-farm sector, manufacturing sector, and labour-intensive segments of services.

NOTES

6. Physical and social infrastructure, both urban and rural, that can accommodate and fuel robust growth, is central to regaining and sustaining economic momentum.

Outlook for 2014-15: The descent into the present phase of sub 5 percent growth has been rather sharp. Interplay of structural constraints alongside delays in project implementation, subdued domestic sentiments, and an uncertain global milieu led to general growth slowdown while rendering macroeconomic stabilization particularly challenging. Inflation also remained at elevated levels. Such factors triggered risk aversion and injected considerable uncertainty in investment activity. Current macroeconomic situation precludes fiscal stimulus to kickstart activity. Likewise, the task of monetary policy calibration for growth revival has been made difficult by persistent inflation and further complicated by uncertainty in international financial conditions and, until recently, by rupee depreciation. Targeted measures by the government and RBI have improved the external economic situation significantly, even as India remains exposed to risk on or off sentiments of investors and to policy shifts in advanced economies. Regaining growth momentum requires restoration of domestic macroeconomic balance and to increase efficiency. To this end, the emphasis of policy would have to remain on fiscal consolidation and removal of structural constraints.

Sectoral Developments

Agriculture and Food Management: Substantial strides in agricultural production have been made in the last few years. There was an increase of around 40 lakh ha in overall area coverage under foodgrains in 2013-14 as compared to 2012-13. A record foodgrains production of 264.4 million tonnes is estimated in 2013-14, according to the third Advance Estimates, indicating an increase of more than 20 million tonnes over the average production during the previous five years. Horticulture production is estimated at 265 million tonnes in 2012-13 and for the first time has exceeded the production of foodgrains and oilseeds.

The robustness of the agriculture and allied sector can be attributed to the steady increase in gross capital formation (GCF) in this sector (both public and private) as a percentage of its GDP, from 14.9 percent in 2006-07 to 21.2 percent in 2012-13 (2004-05 prices). However, the share of public expenditure (comprising public investments and input subsidies) in total GCF of the agriculture and allied sector declined from 25 percent in 2006-07 to 14.7 percent in 2012-13. Private investment as a proportion of agri-allied GDP increased from 12.6 percent in 2007-08 to 18.1 percent in 2012-13.

In the monsoons for 2014-15, there are concerns about the likely occurrence of the El Nino, when surface temperatures in the Pacific Ocean continuously rise above average for several months which adversely affects weather in many regions. This is likely to have an impact on India’s agriculture and consequently on food prices. With 60 percent of the total foodgrains and oilseeds produced being grown in the kharif season, and with just about 35 percent of arable area being irrigated, Indian agriculture is still largely dependent on rainfall. The south-west monsoon from June to September accounts for almost 75 percent of total annual rainfall in India. Comparison of the rainfall distribution across 36 meteorological subdivisions and districts upto 11 June in the last five years shows that rainfall distribution is the worst this year. However, storage position of water reservoirs is better than the last year and the average of the last ten years.

Expansion in area and increase in MSPs of select agricultural crops, *inter alia*, have resulted in higher foodgrains production. Owing to higher procurement, there are huge stocks of foodgrains in the central pool, which as on 1 June 2014, was 77.7 million tonnes.

NOTES

The per capita net availability of foodgrains increased to 186.5 kg per year in 2013 from 162.1 kg per year in 2009 and the net availability of edible oils from 12.7 kg per year to 15.8 kg per year. While the production estimates highlight the continued robustness of Indian agriculture, some concerns remain.

Productivity levels in Indian agriculture are still much lower than global standards. Productivity levels of rice and wheat have not risen significantly after the 1980s. Without new technology and quality inputs, desired productivity levels would be difficult to achieve. Soil degradation owing to declining efficiency of fertilizer use and alarming reduction in the water level, particularly in Punjab and Haryana due to their cropping pattern are other major concerns. There is a need to review the nutrient based subsidy (NBS) policy, which does not have urea under its purview.

Further, pricing of subsidized fertilizers has resulted in their higher usage. Recommendation of the Task Force for Direct Transfer of Subsidy to shift to a system of direct transfer of fertilizer subsidy to farmers in a phased manner requires to be considered. The Crop Diversification Scheme has been introduced in the Punjab and Haryana region and is expected to promote technological innovations and encourage farmers to choose crop alternatives. Predominance of small and marginal farms in India's agriculture, with limited capital availability, hampers progress of farm mechanization. Domestic and international marketing of agricultural commodities needs immediate attention. A plethora of government interventions for building marketing set up has in fact created barriers to trade. There is need to facilitate a National Common Market for agricultural commodities with uniform taxes in the domestic market and to foster a long-term stable trade policy for agricultural products.

Industry and Infrastructure: According to the latest GDP data, the industry sector registered a growth of 1.0 percent in 2012-13 that slowed further to 0.4 percent in 2013-14. Major reason for poor performance was contraction in mining and deceleration in manufacturing. Manufacturing and mining sector GDP declined by 0.7 percent and 1.4 percent respectively in 2013-14. The underlying cause for this has been the deceleration in investment by the private corporate sector during 2011-12 and 2012-13. Based upon IIP data, mining output contracted for the third successive year in 2013-14, declining by 0.6 percent. Natural gas production plummeted mainly owing to declining production from the KG-6 basin. Electricity generation increased by 6.1 percent in 2013-14 as compared to 4.0 percent in the previous year, mainly due to significant capacity addition in recent years. Slowdown in construction resulted in capacity under- utilization in the steel as well as cement sectors. Steel and cement consumption increased by 0.6 percent and 3.0 percent respectively in 2013-14. The capital goods segment has been among the weakest performers in the manufacturing sector. Its index declined by 6.0 percent in 2012-13 and further by 3.6 percent in 2013-14.

Of the total 239 central infrastructure projects costing ₹ 1000 crore and above, 99 are delayed with respect to the latest schedule and 11 have reported additional delays and the date of completion reported in the previous month. Additional delays are in the range of 1 to 26 months in projects relating to the petroleum, power,steel and coal sectors. Among infrastructure services, growth in freight traffic by railways, cargo handled by major ports, and the civil aviation sector (except import cargo) has been comparatively higher during 2013-14. In the road sector, construction of national highways by the National Highways Authority of India (NHAI) posted negative growth of 33 percent during 2013-14 *vis-à-vis* a growth of 26.5 percent during 2012-13. Total foreign direct investment (FDI) inflows into major infrastructure sectors registered a growth of 22.8 percent in 2013-14 as compared to the contraction of 60.9 percent during 2012-13. In recent years, services, construction,

NOTES

telecommunications, computer software and hardware, drugs and pharmaceuticals, automobile industry, power, metallurgical industries and hotels and tourism sectors have attracted maximum FDI inflows.

Services Sector: Services sector has emerged as the fastest growing sector of the economy and the second fastest growing in the world, with a CAGR of 9 percent, behind China with a CAGR of 10.9 percent during the period from 2001 to 2012. Services have also contributed substantially to foreign investment flows, exports and employment. Share of the services sector in employment increased from 19.7 percent in 1993-94 to 26.9 percent in 2011-12.

Deceleration in growth was particularly sharp in the combined category of trade, hotels and restaurants and transport, storage and communications. However, robust growth continued in financing, insurance, real estate, and business services.

Financial Intermediation: Financial reforms are critical to the emergence of India as a strong market economy. A well-functioning financial system will support growth, financial inclusion and stability. The passage of the Pension Fund Regulatory and Development Authority (PFRDA) Act, shift of regulatory supervision of commodity futures trading to the Ministry of Finance, and the presentation of the Financial Sector Legislative Reforms Commission (FSLRC) report, are some of the major developments in 2013-14. Indian banking sector that exhibited considerable resilience in the immediate aftermath of the global financial crisis, has been impacted by the global and domestic economic slowdown over the last two years. During 2012-13, deteriorating asset quality of the banking sector emerged as a major concern, with gross non- performing assets (NPAs) of banks registering a sharp increase. Overall NPAs of the banking sector increased from 2.36 percent of total credit advanced in March 2011 to 3.90 percent of total credit advanced in March 2014. As a consequence of this slowdown and high levels of leverage, few industry and infrastructure sectors, viz., textiles, chemicals, iron and steel, food processing, construction, and telecommunications, are experiencing a rise in NPAs. The RBI in the Financial Stability Report identified five sectors—infrastructure, iron and steel, textiles, aviation and mining—as stressed sectors. Public sector banks (PSBs) have high exposures to the ‘industry’ sector in general and to such ‘stressed’ sectors in particular The New Pension System (NPS), now National Pension System, was introduced for the new recruits joining government service on or after January 2004. It represents a major reform of Indian pension arrangements and lays the foundation for a sustainable solution to aging in India by shifting to an individual account, defined contribution system. Till 7 May 2014, a total of 67.41 lakh members have been enrolled under the NPS with a corpus of ₹ 51,147 crore. From 1st May 2009, the NPS was opened up for all citizens in India to join on a voluntary basis. The Swavalamban Scheme for workers in the unorganized sector launched in 2010, initially for three years for the beneficiaries who enrolled themselves in 2010-11, has now been extended to five years for the beneficiaries enrolled in 2010-11, 2011-12, and 2012-13 and thus the benefits of co-contribution under the Scheme would be available till 2016-17.

Human Development: India with a large and young population has a great demographic advantage. The proportion of working-age population is likely to increase from approximately 58 percent in 2001 to more than 64 percent by 2021. While this provides opportunities, it also poses challenges. Policy makers have to design and execute development strategies that target this large young population. Demographic advantage is unlikely to last indefinitely. Therefore, timely action to make people healthy, educated, and adequately skilled is of paramount importance.

NOTES

According to the United Nations Human Development Report (HDR) 2013, India with a human development index (HDI) of 0.554 in 2012 slipped down the global ranking to 136 from 134 as per HDR 2012. India is in the medium human development category with countries including China, Egypt, Indonesia, South Africa, and Vietnam having better overall HDI ranking within the same category. The existing gap in health and education indicators in India as compared to developed countries and many developing countries calls for much faster spread of basic health and education.Life expectancy at birth in India was 65.8 years in 2012, compared to 75.1 years in Sri Lanka and 73.7 years in China. The expenditure on social services by the government as a percentage of GDP has increased from 6.8 percent in 2008-09 to 7.2 percent in 2013-14 with expenditure on education increasing from 2.9 percent to 3.3 percent and on health from 1.3 percent to 1.4 percent.

The poverty ratio declined from 37.2 percent in 2004-05 to 21.9 percent in 2011-12. In absolute terms, the number of poor declined from 407.1 million in 2004-05 to 269.3 million in 2011-12. During 2004-05 to 2011-12, employment growth (CAGR) was only 0.5 percent, compared to 2.8 percent during 1999-2000 to 2004-05 as per usual status. However, the unemployment rate continued to hover around 2 percent under usual status, i.e., principal and subsidiary.

Sustainable Development and Climate Change: Sustainable development is an imperative for achieving inter-generational equity. The business-as-usual approach to development has entailed unsustainable consumption patterns, which is essentially attributable to the developed countries. Anthropogenic activities are the dominant cause for climate change. GHG emissions grew on an average by 2.2 percent per year between 2000 and 2010, as compared to 1.3 percent per year between 1970 and 2000. India's per capita carbon emissions were 1.7 metric tonnes in 2010, well below the world average of 4.9 metric tonnes.

Governments are currently working on two new agreements on climate change and sustainable development, both of which will be new global frameworks for action to be finalized next year. Following the Rio +20 mandate, the global community is working to develop a set of Sustainable Development Goals (SDGs), possibly to be integrated with Millennium Development Goals (MDGs) when they end in 2015. Work is already under way and a number of thematic focus areas for the SDGs have been identified.

6.3 IMPORTANT TESTURE, MAJOR COMPONENTS OF REVENUE AND EXPENDITURE

Government revenue is the income a government receives, while government expenditure is the money it spends. In order to achieve consistency between on the one hand the national accounts logic (expressed in the sequence of accounts for production, generation, distribution, redistribution and use of income, accumulation and financing) and on the other hand a government budget perspective (government spending and receipts), two additional concepts about national accounts categories were defined in the European system of national accounts. Government revenue as a sum of — sales comprising market output,output for own final use, payments for the other non-market output; taxes on production and imports; other subsidies on production; property income;current taxes on income and wealth etc.; social contributions;other current transfers; capital transfers. On the other hand, government expenditure as a sum of – intermediate consumption; gross capital formation; compensation of employees;other taxes on production; subsidies payable; property income (including interest) payable; current taxes on income, wealth etc., social benefits other than social

NOTES

transfers in kind; social transfers in kind related to expenditure on products supplied to households via market producers; other current transfers payable;adjustment for the change in net equity of households in pension funds reserves;capital transfers payable; acquisitions less disposals of non-financial non-produced assets. By convention, the internal transactions inside the general government sector are left out of government revenue and expenditure: for instance, those transactions between different sub-sectors or between different general government units belonging to the same sub-sector, as well as those related to property income, other current transfers and capital transfers.

Classification of Government Revenue and Expenditures: This section provides an in-depth review of the classification used to prepare revenue and expenditures statistics for the government component of the public sector Basically, there are two main types of revenue, i.e., own source revenue and transfers from other government sub-sectors.

Own source revenue is defined as revenue raised by a government from its own imposition of a tax, a licence, a fee or any other charge. Personal income tax, consumption taxes and contributions to social insurance plans are all part of that group. On the other hand, a transfer from another government sub-sector is an amount of money received directly from another party without a direct impost by the receiving party. Transfer payments fall into two categories – general purpose, where no restriction is placed on their use, and specific purpose, where certain conditions must be fulfilled in order to qualify for the transfer which governs the use of the transfer. Equalization payments are classified in the general transfer category while provincial government transfers to assist municipalities in the operation and upgrade of the local road and bridge systems are classified in the specific transfer category.

Revenue: Revenue from fiscal monopolies are now considered taxes. They were previously classified under investment income. The category like privileges, licences and permits was deleted. Items like business licences, motor vehicle licences and all local government licences and permits are treated as taxes while most personal paid licences are classified as sales of goods and services. Grants in lieu of taxes, which were treated as transfers are now classified under property and related taxes.

The category 'Natural resource revenue' was deleted. Natural resource royalties are now considered investment income while mining and logging taxes are now allocated to the income taxes category. The tax category Health and social insurance levies has been split into two new non-tax categories, viz., Health insurance premiums and Contributions to social insurance plans.

Expenditures: The function 'Transfers to own enterprises' was deleted. Services previously classified under that heading are now assigned to other functions, as appropriate. Evolution in the field of social services has necessitated new sub-groupings of services assigned to the function 'Social services.Employer contributions to employee benefit plans (the Supplementary Labour Income (SLI)), the operation and maintenance of government buildings and provision of computer services to various ministries and crown corporations are now assigned to the function to which they relate rather than being totally assigned to the function "General services". Grants in lieu of taxes are now functionalized. They were previously considered general purpose transfers.

Revenue

Own Source Revenue:

Income Taxes

(a) Personal Income Tax: Encompasses general levies on income of individuals and unincorporated businesses as well as special levies on income that governments charge from

NOTES

time to time. The proceeds from the income tax on capital gains of individuals and unincorporated businesses are included here.

(b) Corporation Income Tax: Includes most federal, provincial and territorial taxes on taxable profits of corporations. It also includes special taxes which are occasionally levied on profits of corporations. Corporate Income Tax (CIT) revenues are shown on a gross basis by including the full amount of the CIT refundable tax credits as revenue. An equivalent amount of the refundable tax credit is also shown as an expenditure.

(c) Mining and Logging Taxes: Accounts for specific taxes which are sometimes levied on profits of natural resource based industries. Also included are refundable tax credits that are grossed up as revenue and expenditures. These taxes were previously classified to natural resource revenue.

(d) Taxes on Payments to Non-residents: Includes the federal tax withheld at source on payments to non-residents (both individuals and corporations) of dividends, interest, rents, royalties, alimony, managerial fees and amounts arising from trusts and estates as well as withholdings on foreign insurance companies.

(e) Other Income Taxes: Includes income taxes which cannot be allocated to any of the other categories.

Consumption Taxes

(a) **General sales tax:** The proceeds of the federal Goods and Services Tax (GST) and of provincial retail sales taxes are recorded in this category.

(b) **Alcoholic beverages taxes:** Two sub-groups have been devised:

Liquor gallonage taxes: Encompasses a levy on volume of alcoholic beverages produced.

Other liquor taxes: Includes all forms of special levies, excise tax, excise duty or other, imposed on the production and sale of alcoholic beverages. When a general sales tax applies to alcoholic beverages, the related proceeds are classified under the "General sales tax" group. Likewise, customs duties on imported alcoholic beverages are classified under the "Custom duties" heading.

(c) **Tobacco tax:** Encompasses special levies such as excise tax, excise duty and provincial specific taxes on the production and sale of tobacco products. General sales taxes and customs duties applicable to tobacco products are included under their respective headings.

(d) **Amusement tax:** Includes tax receipts from admissions to theaters, cinemas, recreational, cultural or other entertainment activities. Taxes levied by provincial and territorial governments on pari-mutuel betting at horse race tracks and on casinos' gaming activities are also included here.

(e) **Gasoline and motive fuel taxes:** Includes the proceeds of specific taxes on gasoline, on aviation and diesel fuel and on propane or other substances when used as motive fuel.

(f) **Customs duties:** Applies only to the proceeds from levies on commodities imported to the country like manufactured goods and food, beverages and tobacco.

(g) **Remitted liquor profits:** Accounts for total remitted profits of government owned liquor boards. Because government owned liquor boards operate as fiscal monopolies their profits are treated as taxes on products (indirect taxes). They were previously classified as investment income.

NOTES

(h) Remitted gaming profits: Accounts for total remitted profits of government owned lottery and other gaming corporations. Because government owned lottery and other gaming corporations operate as fiscal monopolies, their profits are considered as taxes on products (indirect taxes). Those amounts were previously classified as investment income.

(i) Other consumption taxes: Three sub-groups have been devised:

(a) Taxes on meals and hotels

(b) Property and Related Taxes

(c) Miscellaneous general property taxes

(a) Taxes on meals and hotels: Includes the proceeds from special taxes on meals and hotel accommodations.

(b) Property and Related Taxes:

General Property Taxes: Real property taxes – Taxation of real property (land and improvements) is shared by provincial and local governments. To compensate a government for the loss of revenue due to the exemption, grants in lieu of taxes are paid by the federal and provincial governments to provincial and local governments levying property taxes.

Lot Levies: Includes imposts or additional lump sum development charges levied on properties benefiting from local improvements or additional capital facilities. Imposition of these imposts or levies involves an agreement between the developer and the municipality, whereby, the developer is required to pay a levy to the municipality to finance specific services.

Grants in Lieu of Taxes: Includes provincial, territorial and local government revenue from higher levels of government as grants in lieu of property taxes, which are isolated for each level of government concerned.

(c) Miscellaneous general property taxes : Includes any other general property taxes.

(i) Capital taxes: Includes the taxes levied by federal, provincial and territorial governments on the paid-up capital of corporations.

(ii) Other Property-related Taxes: Land transfer tax – Includes the proceeds of levies on the value of property transferred.

Business Taxes: Includes taxes levied on businesses in lieu of or in addition to, property taxes. Taxes on income or profits of such businesses are classified under income taxes.

Wealth Transfer Taxes: Includes succession duties and gift taxes.

Miscellaneous Property-related Taxes: Any other property related taxes.

Other Taxes: This category now includes different kinds of licences and permits as follows:

1. Payments by a household for specific licences such as licences to own or use a vehicle, boat or aircraft, and licences to hunt, shoot or fish are to be treated as taxes. Payments for all type of other licences are to be treated as sales of goods and services.

2. Licences purchased by businesses are to be considered taxes. This "Other taxes" category is divided into four sub-categories:

(a) Payroll Taxes: This revenue sub-category encompasses tax revenues that are collected from employers as a percentage of their payroll. Payroll taxes collected from employees as a percentage of their salaries and wages are classified as personal income taxes.

NOTES

(b) Motor Vehicle Licences: Accounts for the proceeds of registration fees, drivers licences, permits and other fees relating to the ownership and operation of motor vehicles.

(c) Natural Resource Taxes and Licences: Accounts for the proceeds of taxes levied on private properties and production of natural resources. Freehold mineral right tax is classified under this category. This category also includes licence fees paid to be able to conduct activities related to natural resources but excludes activities related to exploration of natural resources.

(d) Miscellaneous Taxes:

Agricultural insurance premiums: Includes agricultural insurance premiums levied by most provinces. The proceeds are used specifically to finance crop insurance and farm income stabilization insurance schemes.

Insurance premium taxes: Encompasses the proceeds of special taxes levied on gross insurance premium income earned by insurance companies, on life, sickness, accident, fire and other insurance. Hunting and fishing licences, liquor licences and other licences and permits – includes licences paid by persons to hunt, shoot or fish; liquor licences to retailers of alcoholic beverages; all business licences other than motor vehicle licences and liquor licences mentioned above. At the local government level, it includes all licences because data limitations prevent any allocation to other revenue categories.

Other Miscellaneous Taxes: This category brings together the field of taxes not elsewhere specified such as premiums paid by financial corporations to federal and provincial deposit insurance corporations.

Health and Drug Insurance Premiums: Includes premiums levied by some provinces and used specifically to finance their hospitalization, medical care and drug insurance programmes. This category and the category "Contributions to Social Insurance Plans" to harmonize with the System of National Accounts (SNA), health insurance premiums and contributions to social insurance plans are no longer shown as taxes. In the SNA they are presented in separate series.

Contributions to Social Insurance Plans: These contributions are broken down into five types of plans. Contributions to social insurance plans are still reported on a gross basis.

(a) Employment Insurance (EI) Contributions: Covers employer and employee contributions toward income maintenance payments under the federal EI programme.

(b) Contributions to Workers' Compensation Boards (WCBs): Comprises government and non-government employer contributions to provincially-operated workers' compensation schemes. It is worth noting that most general governments act as their own insurers against risks of employee injury in the course of duty and do not contribute to their workers' compensation regular programme. However, certain classes of their employees are covered under separate agreement with the boards.

(c) Other social insurance plan contributions: Comprises contributions to social insurance plans not included elsewhere, such as employee contributions to pension plans that are embedded in the budgetary transactions of governments.

NOTES

Sales of Goods and Services

As providers of public goods and services, institutions within the government component of the public sector engage in transactions of commercial nature with organizations or individuals in the private sector and with other institutions within the government component. The revenues generated from such transactions are called 'Sales of goods and services,' are defined as receipts of fees and charges paid in proportion to the cost or distribution of the government goods and services provided to the payer. These revenue sales are broken down into three components.

(a) **Sales of Goods and Services to other Government Sub-sectors:** Includes all sales of goods and services by a government sub-sector to another government sub-sector.

(b) **Sales of Goods and Services to own Business Enterprises:** Includes all sales of goods and services by a government sub-sector to own business enterprises. For instance, fees charges to a provincial hydro-electric corporation by its provincial government for guaranteeing its debt.

(c) **Other Sales of Goods and Services:** Includes all sales of goods and services to persons, businesses, etc. For instance, tuition fees charged to students or sale of government statutes to businesses and individuals.

Investment income: This category is divided into four sub-categories: natural resource royalties, remitted trading profits, interest income and other investment income.

(a) **Natural resource royalties:** Includes all royalties on natural resources. Royalties cover leases of land ("Rentals" including rentals and fees, and bonus bids) and royalties paid on extraction. It also includes revenue from the auction of licences for the electro-magnetic spectrum. Royalties on books, recordings, films, etc. Revenue from the auction of the licences of the electro-magnetic spectrum prior to 2008/2009 are amortized over the period of the licence. Commencing in 2008/2009 the auction of licences of the electro-magnetic spectrum is considered a sale of assets and the revenue from the auction is included in the year (period), it is received. Prior to the 1997 historical revision the natural resource royalties were included in the "Natural resource revenue" category.

(b) **Remitted trading profits:** Returns from own enterprises comprise two categories: remitted profits and dividends. Prior to the 1997 historical revision, remittances of profits of provincial liquor boards and lottery and gaming corporations were classified under this category. They are now included in the consumption taxes category. When a government business enterprise is privatized or when sale of selected facilities of a government business enterprise takes place, the revenue created may be classified in a variety of ways, depending on the nature of the transaction and the entities involved in the transaction.

(c) **Interest income:** Includes interest received on loans and investments as well as interest on overdue taxes. Interest received by non-autonomous pension plans on the amount of debt the government is obligated to pay them, are also included here.

(d) **Other investment income:** Consists of other return on investment not classified elsewhere. Prior to the 1997 historical revision, other investment income included gains or losses on foreign exchange transactions and gains or losses on sale of securities. Those gains or losses are no longer included in any revenue category. They are now part of the financing accounts.

Other Revenue from Own Sources

(a) Other fines and penalties: Comprises personal paid fines and penalties arising from infractions of laws, bye-laws and ordinances, whether civil or criminal.

(b) Capital transfers from own sources: Includes cancellation of a liability by a creditor or similar transactions that reduce net debt of the recipient.

(c) Other donations: Includes revenue from fund-raising campaigns and other donations in cash or securities from individuals, businesses, etc.

(d) Miscellaneous revenue from own sources: Provides for revenue not elsewhere classified such as indemnities and recoveries under insurance policies, gifts, contributions from private sources, escheat and forfeitures of election deposits, as well as adjustments resulting from consolidation of two or more components of the public sector

Expenditures

An expenditure function is defined as a classification that identifies the principal purpose for which an expenditure is made rather than the activity involved. The following examples illustrate this definition:

(a) Expenditures on the transport of students to and from school are classified as "Education" and not "Transportation"; because the main purpose of the expenditures are to permit pupils to receive educational services.

(b) In general, government transfers to universities are of two kinds: transfers for operating and capital expenditures and transfers for research. In the first case, transfers for operations and capital formation are classified to "Education" because the principal purpose of the transfers is to enable universities to provide educational services. In the second case, transfers for research are classified according to the purpose for which research and investigation are made. If the research grants are used by university researchers to improve existing or develop new hospital equipment, the transfer payments are classified to "Health" and not "Education". On the other hand, if the research is devoted to improve methods of instruction, the transfer payments are classified to "Education".

(c) An expenditure resulting from a court award is classified to the function which best fits the main purpose of the award. For instance, an expenditure to compensate eligible class members for damages, for loss of income, and uninsured medication and treatment costs is classified to the function Social Services, not Health.

6.4 BUDGET AS AN INSTRUMENT OF SOCIAL AND ECONOMIC POLICY

The Budget – an Instrument for Forecasting Multiyear Budgeting: The budget represents one of the most important aspects of public finances. Placed at the confluence between economy and policy, the budget has always controversies in what concerns the resources it makes up, but especially the destinations those resources follows to cover. The public budget is not an abstract notion of theoretical nature, but represents the most important instrument of social and economic policy at the entire country's level, that contributes to the achievement of economic policy and macro stability in concordance with

NOTES

established directions of political power for every year.We may say that the budget appears and increases from the necessity of public expenses correlated with available resources mobilized at the national level. In the public finances evolution, the budget developed at the beginning of the contemporary period, as the main instrument of expenses projections. In concordance with the public finances law, by budget, we understand the document in which expenses and incomes are foreseen every year or sometimes only expenses in concordance with the system of public institutions.

Definition offered by Romanian law in the budgetary matter is compatible with the definition given to budget by the Financial Regalement of the European Community. The budget is the act that foresees and authorizes every year preliminary expenses and incomes of the Community. As regards the financial specialty legislation is concerned, we have adopted the model imposed by the French law on public bookkeeping, according to which the budget is the fundamentals of identification, establishment and incomes authorization and public yearly expenses of the state. This approval of the budget is valuable both from the theoretical as well as practical points of view. Theoretically, because it shows the technical necessity of the budget, but also because of the importance of the authorization act that the budget shows; the practical one developed from the need of knowing the level of public resources and expenses.

The Main Role of the Budget in Covering Governmental Policy: To speak about the budget includes a whole area of various elements from technical principles and bookkeeping, moving to the quasi philosophical principles about human actions' responsibility and ending with the offered solutions to the conciliation of political and social purposes through this budget.

By means of the public budget we can establish a ratio between public expenses, which are mainly taxes and duties and social needs aimed at avoiding the fiscal tasks of a society's members. Through a good and rigorous budget, the Parliament and Government can have a clear image of the relation between the value of material and immaterial goods made in an economy and the value of the efforts made for their accomplishment on the other. In the similar way, the power of local organs and state administration can have this kind of image at the mezo-economic level.

The yearly budget reflects the accomplishment of governmental activities, being the result of a rich negotiation. It must succeed in giving a complete image of the exterior environment of all economic and political factors. Alternatively, it should not only ensure the continuity of governmental actions projected on the years to come and show control conditions. The budget must offer establishment and continuity to the state policy, showing rules and precise procedures to be followed.

Foreseeing and budgetary planning are dealt with by the so-called budgetary offices. The budgetary offices have a rich culture resulted from the several tasks they must accomplish, e.g., guiding and watching the budgetary process to ensure working of financial markets and guarantee the financial reputation of the state. The budgetary office is the guardian of the financial resources, being to ensure a stable climate of policy for different governmental clients. Governmental policy shows the measures taken by pressure groups to change the policy adopted. The ministers and the others agencies are encouraged to come up with suggestions to help the centre foresee the financial matter. In this manner, the budget is a picture of all acts of foreseeing in financial matter, being the place of reconciliation of the resources with the social needs. Public budgets are elaborated in most of the state in the world for a period of one year. However, their elaboration must also take into account the events that are outside the yearly budgetary cycle in general aspects concerning budgeters' incomes to the general costs in the long term, as well as the impact of those on internal environment. A medium term vision of the budget is obligatory, because a period of one year is much too short to meet the requirements concerning public expenses. If taken into account, most of the expenses foreseen in the budget's elaboration are already involved. Elaboration of a yearly budget ensures the countenance of projected government policy that necessitates elaboration of a macroeconomic frame in the long and medium term. Macroeconomic forecasting made does not represent only a simple estimate affecting the macroeconomic variable. Forecasting is based on a clear definition of the targets and instruments specific to an area such as fiscal policy, monetary policy, trade and duty administration, particularly the external one. Macroeconomic general background must include the government's forecasts of the financial and fiscal background in the medium term. Forecasts must cover a period of 5 years. Setting up a clear policy represents the main task of budgetary offices in order to anticipate future evolution of the national macroeconomic background. For instance, achievement of reducing policy inflation is complementary to the measures taken to maintain budgetary deficit and duty report at an acceptable level. Elaboration of the yearly budget necessitates a distinct and accurate action plan and is defined by a series of objectives and priorities as well as by the establishment of fiscal and political objectives. Transposing these governmental political priorities into the budget depends on macroeconomic estimates as well as on fiscal and non-fiscal incomes estimates in the medium and long term. Therefore, elaboration of a macroeconomic background in the medium and long term constitutes a sine qua non condition for a solid budget. Elaboration of a coherent budget depends upon a series of factors with multiyear influence, such as:

1. The evolution's impact on fiscal deficit;
2. The paying of pledges regarding public duty;
3. The public institution's administrative capacity;
4. The costs of investment projects in the long term;
5. The future necessity to cover unexpected expenses.

At the same time, the budget is a powerful instrument of economic and financial administration,as well as a declaration of public policy and an area of expenses for several programmes. Budget elaboration implies difficult selections for all the agents involved. These must make sure that the budget fully corresponds to the policy promoted by the government.

Budgetary Forecasting: Expenses foreseen and the financial resources allotted make budget a really coherent instrument. An optimistic estimate of the budget will lead to confusions while complying with the rules. A political budget is an oxymoron because always there is a scale of political compromise and negotiation to avoid trifles in financing programmes. Elaboration of some yearly budget started in the 70s and the beginning of the 80's and later spread in the majority of the European states. In few states, the multiyear estimates are shown in governmental problems. Perceived at the beginning as an instrument to identify and also creating new financing programmes, budget planning is the most effective method of blending the short-term objectives with medium and long-term ones.

At the beginning, it was very difficult to do multiyear budget planning. In Great Britain, for instance, multiyear budgets were expressed mostly in real rather than nominal terms, while the expenses estimates were automatically adjusted, sometimes putting big pressure on public finances. At the opposite pole, at the beginning of the 80s, the Administration

NOTES

System of Political Expenses, which includes a fiscal programme running on a period of 5 years.

In 1995, an OECD report revealed the fact that the government reoriented the multiyear budget from planning to foreseeing. The estimates of the public financial resources focus upon public political pledges that lie at the basis of a coherent budget. Even if these represent only documents with informative title, they succeed in transcribing a limit for new expenses schemes.

The multiyear budgetary methodology varies from one state to another, from a period to another. However, what we should keep in mind is that it must be based on the accurate estimate of incomes, which is very hard to do in instable economic area. In Germany, the elaboration of the budget is realized on the basis of a financial plan drawn up and presented by the council of financial planning, that includes all govern pieces, structured on 40 major stages. These stages result from simultaneously making estimates over several years and calculating the yearly budget for every such expense article. It is worth mentioning that every estimated feature year includes a foreseeing resource designated to cover new financial programmes. In general, budgetary forecasting includes:

1. The current level of expenses;
2. Probability of supplementary expenses;
3. Accumulations achieved.

Control of expenses, and also the income estimate lead to must be based on a series of requests like —

1. Elaborating and outlining a coherent medium-term fiscal budget;
2. Defining and reanalyzing the promoted budgetary policy;
3. Establishing the limits of expenses;
4. Establishing the limits of reserves and contingents for predicted years;
5. Budget programming.

In many countries, the multiyear estimate is used for long-term engagement administration. The budgetary estimates and their drawing up in coherent programmes make a disciplined budgetary space. In practice, they are used expenses estimates depending on the policy promoted by the government, by economic and financial priorities. Multiyear estimates are usually elaborated in nominal terms or in constant price. If the estimate is elaborated in nominal terms, the Ministry of Finance must elaborate a set of rules that should be applied to current realities. Instead, the estimates made in current prices show that they are consistent with financial forecasting from governmental bookkeeping accounts. Often, budgetary background with multiyear development can develop opposite tendencies of certain expenses categories, concomitantly contributing to competent estimates of countenance of the current policy.

Thus, to conclude, budget is the principal instrument of materialization of a promoted policy developed at the governmental level. A general strategic background must ensure sectorial policy, together with the involvement of the main political administration vectors. The strategic budget planning is not a static or casual event but it has continuity giving the working base for the agents who administrate or derive programmes. Any estimate must be based on a formal economic model, that implies an analytical description of the situation, a description based on national accounts and social country life. Degree of intricacy or the rank of forecasting models differs from area to area. Complex models of budgetary forecasting can give birth to the so-called phenomenon of estimated illusion.

Elaboration of a coherent budget basis, either yearly or multiyear, is realized in most European nations by teams of experts. For instance, in the United Kingdom forecasts are certified and validated by the Central Censor. As we know, the budget focuses on three important rules, i.e., multilateralism, a multiyear perspective in budget elaboration as well as implementation monitoring.

Multilateralism supposes the fact that the budget series ensemble must give a complete image of the way in which the public area affects an economy. Accordingly, required rule can be reformulated. Therefore, every reallocation which is made via political process and not via market should be recorded and presented in budget for estimate. Though the budget execution is yearly, it must contribute to ensuring the government's policy and fiscal proposal. Multiyear budgetary solutions depend on our defining budget as an instrument for identifying the new programmes costs. The budget offers itself to the economic and political space, proving to be an potent instrument of economic forecasting and thereby succeeding in controlling present problems.

6.5 SUMMARY

1. Growth of gross domestic product (GDP) at factor cost at constant 2004-05 prices declined from 8.9 percent in 2010-11 to 6.7 percent in 2011-12 and further to 4.5 percent in 2012-13.
2. As per the provisional estimates released by the Central Statistics Office (CSO) Indian economy grew at 4.7 percent in 2013-14 in terms of GDP at factor cost at 2004-05 prices.
3. During the southwest monsoon season of 2013, our country received 6 percent higher rainfall than the long period average (LPA).
4. Based upon the index of industrial production (IIP), industrial output declined by 0.1 percent during 2013-14 relatively as compared to a growth of 1.1 percent in the previous year.
5. Odisha's economy has grown at a modest rate of 5.60 percent at 2004-05 prices in 2013-14, slightly better than that of all India expected growth rate of 4.9 percent.

6.6 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1. Macroeconomic stabilization in 2013-14 had to balance the concerns of containing __________ and promoting __________ as well.
2. __________ of the Centre as a proportion of GDP also declined for the second year in a row according to the announced medium term policy stance.

II. True and False

1. Higher growth in agriculture on the back of a steady monsoon and robust growth in financial as well as business services helped the modest uptick in growth in 2013-14.
2. Inflation too declined during this period, but continued to be above the comfort zone, owing primarily to the elevated level of food inflation.

NOTES

III. Multiple Choice Questions

1. Only intermediate and non-durable consumer goods registered higher growth rate in __________.
   (a) 2013-14 and 2012-13
   (b) 2013-14
   (c) 2012-13
   (d) None of the above
2. Share of the food items, beverages and tobacco group in total final consumption in real terms declined by 9.5 percentage points of the GDP in the nine years from __________.
   (a) 2004-05 to 2012-13
   (b) 2001-02 to 2011-12
   (c) 2002-03 to 2010-11
   (d) None of the above

Short Answer Questions

1. Define the term Gross Domestic Product.
2. Write short notes on 'Prices and Monetary Management'.

Long Answer Questions

1. Critically explain about the 'Broad trends of Indian budget and Orissa budgets during the plan period'.
2. Justify 'Budget as an instrument of social and economic policy'.

6.7 KEY TERMS

- Fiscal Consolidation
- Gross Domestic Product
- Index of Industrial Production
- Liquidity Adjustment Facility
- Monetary Policy
- Wholesale Price Index

6.8 KEY TO CHECK YOUR ANSWER

I. 1. Elevated inflation, growth, 2. Fiscal deficit.
II. 1. True, 2. True.
III. 1. (a), 2. (a).

Unit V: Budget and its Accountability

7 Chapter

BUDGET CYCLES

Objectives

- Budget Cycles (with Reference to India and Orissa)
- Budget Formation
- Legislative Encashment Implementation of Public Accounts Committee, Estimates
- Committee Efficiency and Accountability of the Present System of Budgeting Suggestions for Improvement

Structure:

7.1 BUDGET CYCLES: (WITH REFERENCE TO INDIA AND ORISSA)

Budget cycle describes the activities and processes behind developing budget for a single fiscal period. Length of the fiscal period differs depending upon the organization and the stated goals of a particular budget. Function of a budget cycle is to define the steps from the beginning to the end of the process. However, a budget is actually a continuous process, hence the term is used as budget cycle. Stages in the budget cycle often overlap and actions taken at one stage of the budget cycle often have an impact on later stages.

India

A step by step guide on how Union Budget is formulated: The budget process (Budget Advocacy) in India, like in most of the other nations, comprises four distinct phases. These are as follows:

1. Budget Formulation: It refers the technique of preparation of estimates of expenditure and receipts for the ensuing financial year. Budget Formulation is the first phase of the budget cycle and evolves over several months involving individual departments, their

NOTES

changing requirements over key parameters like economic growth, inflation, demographic changes, etc. and revenues as well. The executive branch of the government generally completes this process behind closed doors and the civil society has limited access in the formulation of the budget. The non-governmental groups and the civil society groups can analyze the issues that require greater emphasis in the budget and seek to include their recommendations in the budget.

2. Budget Enactment: It involves the approval of the proposed Budget by the Legislature through the enactment of Finance Bill and Appropriation Bill. Budget Enactment is the second phase of the budget cycle that takes place while the budget is discussed in the legislature and enacted into law. This is the phase that opens the budget for formal legislature discussions, public hearings, open discussions, etc. This phase gives extensive opportunity to the general public, non-governmental budget groups, legislators, special committees and media to discuss, debate, analyze and provide meaningful inputs to the budget.

3. Budget Execution: It refers to the enforcement of the provisions in the Finance Act and Appropriation Act by the government through collection of receipts and making disbursements for various services as approved by the Legislature. Budget Execution phase begins once the budget is enacted. This is a very crucial phase of the budget cycle owing to the fact that in practice, budgets are not implemented in the exact form as they were approved. Stringent measures are to be in place to ensure that the allocations do not deviate from their intended purpose. The civil society organizations can engage in some monitoring activities and advocate for the development of public expenditure tracking tools to assess the quality of spending for attaining the desired policy goals.

4. Legislative Review of Budget Implementation (Evaluation and Auditing): It implies audits of government's financial operations on behalf of the Legislature. Evaluation and Auditing forming the last stage of the budget cycle aim at measuring the effective use of the public resources. Normally, the assessments are done not for just identifying the leakages in the spending but also to map the inputs against the expected outcomes. The civil society has ample opportunity to contribute in this stage as it can engage it conducting independent surveys, studies and audits to assess issues like whether the objectives of the budget have been achieved, whether the intended beneficiaries have been actually received the benefits or whether the executive as well as the legislature responded timely and appropriately to the needs of the common man, etc.

Process Starts August-September: In the Union government, there is a budget division in the department of economic affairs under the Ministry of Finance. This division starts the process of formulation of the next financial year's Union budget in the months of August-September every year. To start the process, the budget division issues an annual budget circular around the last week of August or the first fortnight of September every year. This annual budget circular contains detailed instructions for the Union government ministries or departments relates to the form and content of the statement of budget estimates to be prepared by them.

Estimates, Revised Estimates and Actual: It must be noted that the ministries are required to provide three different kinds of figures relating to their expenditures and receipts during this process of budget preparation. These are budget estimates, revised estimates and actuals. Let us consider, for instance, the case of budget preparation in the second half of the calendar year 2011. The Union government would prepare the budget for 2012-13 during the time period of September 2011 to February 2012. Here, approval of Parliament would be sought for the estimated receipts/expenditures for 2012-13, which would be called budget estimates.

At the same time, the Union government, in its budget for 2012-13, would also present revised estimates for the ongoing financial year 2011-12. We may note here that the government would not seek approval from Parliament of revised estimates of 2011-12; but, these revised estimates would allow the government to reallocate its funds among different ministries based on the implementation of the budget for 2011-12 during the first six months of financial year 2011-12. Finally, ministries would also be reporting their actual receipts and expenditures for the previous financial year 2010-11. Hence, the Union budget for 2012-13 would consist of budget estimates for 2012-13, revised estimates for 2011-12, and actual expenditures and receipts of 2010-11.

Planning Commission's Role: The ministries would provide budget estimates for plan expenditure for the next financial year, only after they have discussed their respective plan schemes with the Central Planning Commission. The Planning Commission depends on the finance ministry to first arrive at the size of the gross budgetary support, which would be provided in the budget for the next annual plan of the Union government. In fact, the size of every annual plan should be derived from the approved size of the overall Five Year Plan (12th Five Year Plan, 2012-13 to 2016-17, in the present instance). However, the size of the gross budgetary support for an annual plan also depends on the expected availability of funds with the finance ministry for the next financial year.

Call to Reduce Deficit: In the past few years, the finance ministry has been vociferously arguing to reduce fiscal deficit and revenue deficit of the Union government, citing the targets set by the Fiscal Responsibility and Budget Management Act and its rules. At present, the aspirations of the Planning Commission and Union government ministries with regard to spending face the legal hurdle of this Act, that has made it mandatory for the Union government to show the revenue deficit as nil (total revenue expenditure not exceeding total revenue receipts by even a single rupee) and the fiscal deficit as less than 3 percent of GDP. It implies new borrowing of the government in a financial year cannot exceed 3 percent of the country's GDP for that particular year.

Final Stages: Also, during the final stage of budget preparation, the revenue earning ministries of the Union government provide the estimates for their revenue receipts in the current fiscal year (revised estimates) and next fiscal year (budget estimates) to the finance ministry. Subsequently, during the month of January, more attention is paid to finalization of the estimated receipts. With an idea about the total requirement of resources to meet expenditures in the next fiscal year, the finance ministry focuses on the revenue receipts for the next fiscal. In the final stage of budget preparation, the finance minister examines the budget proposals prepared by the ministry and makes necessary changes in them, if required. The finance minister consults the prime minister and also briefs the Union Cabinet, about the budget at this stage. In case there is any conflict between any ministry and the finance ministry about the budget, the matter is supposed to be resolved by the Cabinet. In the final stage, the budget division in the finance ministry consolidates all figures to be presented in the budget and prepares the final budget documents. The National Informatics Centre (NIC) helps the budget division in the process of consolidation of the budget data, which has been fully computerized. At the end of this process, the finance minister takes the permission of the president of India to present the Union budget to Parliament.

According to the Constitution, the Union budget is to be presented in the Lok Sabha on such a day as the president may direct. By convention, Union budget has been presented in Lok Sabha by the finance minister on the last working day of the month of February every year.

The finance minister, by convention, makes a speech while introducing the budget. The annual financial statement is laid on the table of Rajya Sabha only after the finance

NOTES

minister concludes his budget speech in Lok Sabha. The budget documents are made available to the members of Parliament after the finance bill has been introduced in Lok Sabha and the House has been adjourned for the day.

It may be noted that the budget process in India lacks transparency in one aspect, while enactment of the Budget by the legislature and as regards review of its implementation are reasonably transparent, the entire process of budget preparation by the government is carried out behind closed doors.

Budget Preparation (Odisha)

Instructions for the Preparation of Departmental Estimates – Receipts and Expenditure Responsibility of Estimating Officers: The Budget of the State is based on the departmental estimates submitted by the Controlling Officers and these departmental estimates are themselves mostly based on the estimates submitted by the district officers of the departments. Both the departmental estimates and the district estimates should always receive the careful personal attention of the officers who submit them, so that they may be neither inflated nor underpitched but as accurate as possible.

Once of the most important duties of every Controlling Officer, as an Estimating Officer, is to keep himself thoroughly acquainted with the progress of the revenue and expenditure under his control. He is charged with the administration of those various matters in respect of which Government is debtor or creditor, so far as his department is concerned and it is his duty to see that whether proper estimates are made of all these transactions.

Though the Finance Department is responsible, under the Subsidiary Rules of Business, for obtaining materials and also for the correctness of the estimates based on such materials, it is not, and cannot be, responsible for the correctness of these materials. If the material is defective, the estimate will be defective and the responsibility then reverts to the officer supplying such material.

As the Government accounts are maintained in general on a cash basis, the estimates should take into account only such receipts and payments (including those in respect of the arrears of past years) as the Estimating Officer expects to be actually realized or made during the budget year. Its aim must be to make the estimates as accurate as possible, not to overestimate and show large savings at the end of the year. The tendency to underestimate revenue and overestimate expenditure so as to be always on the safe side must be avoided.

Budget – First and Second Editions: The Budget of the State is prepared in two stages which are conveniently styled as the first edition and the second edition. The first edition of the Budget is a consolidation of the ordinary annual estimates of the departments, those are based upon estimates of the revenue expected under the existing laws, rules and orders and also of the expenditure required for the normal working of the departments on the existing scale and with reference to the existing sanctions. Rules 48 to 84 contain instructions in connection with the preparation of the first edition.

New scheme of expenditure including developmental schemes are not included in the "first edition" of the Budget. Where estimates of revenue are likely to rise for inclusion of new schemes, such increase in revenue should in no circumstances be taken into account to frame the first edition estimates. Possibility of embarking on new schemes naturally depends on the surplus available according to the first edition, supplemented by any loan that Government may propose to raise for the purpose and any grant or loan that the Government may receive from other sources. Proposals for new schemes that should compete for funds should be submitted separately according to the instructions contained in Rules 96 to 107. Such proposals as may be approved by Government with due regard to their relative importance and urgency and subject to the availability of funds, are then incorporated in the first edition and the result is what is called the "second edition" of the Budget".

"Voted" and "Charged" Expenditure: Estimates of expenditure embodied in the annual financial statement show separately two main classes of expenditure, one class which is subject to the vote of the Legislature and the other which does not require the vote of the Legislature. The latter class of expenditure is described as expenditure "charged" upon the Consolidated Fund of the state. Article 202(3) of the Constitution specifies the kinds of expenditure to be so charged on the 'Consolidated Fund.' Under Article 203(1) of the Constitution, the estimated of 'charged' expenditure should not be submitted to the vote of the Legislative Assembly but it will not prevent the discussion in the Legislature of any of these estimates.

Form of the Departmental Estimates: Printed forms for the preparation of estimates by Controlling Officers are supplied under arrangements made by the Finance Department and these forms only should be used, as uniformity in details is inevitable. The form used by the Controlling Officers is more comprehensive than that used by Estimating Officers. The Controlling Officers consolidate their estimates from those furnished by their subordinate estimating authorities and must be careful to subject them to the necessary scrutiny as well as correction. Forms under 'Public Works', and 'Hirakud', 'Irrigation', 'Electricity' are supplied under arrangements made by the Works Department and Irrigation and Power Department respectively. Where printed Controlling Officers' budget forms are not used, estimates in respect of each Major Head should be furnished in separate sheets of paper. Controlling Offices will make arrangements for the printing and supply of the Estimating Officers' budget forms. The form of the Controlling Officers' estimates contains columns both for receipts and expenditure as shown below:

(i) The headings under which the items should be classified;

(ii) The actuals of the past financial year or years;

(iii) The sanctioned Budget Estimate of the current year;

(iv) In some cases, the actuals of the first months of the last and current year;

(v) The Revised Estimate of the current year;

(vi) The Budget Estimate of the next year; and

(vii) Explanatory remarks.

But following facts should be remembered here in this context. These are as hereunder:

1. The column "Sanctioned Budget Estimate for the current year" should show the amounts in the Annual Budget and should not include additions made by supplementary grants or modifications sanctioned by reappropriations.
2. The Revised Estimate for the current year should take into account additions made by supplementary grants and also modifications which have already been sanctioned or are likely to be necessary.

The Finance Department, Works Department and Irrigation and Power Department will arrange for the supply of Controlling Officers' forms to the Controlling Officers and the Accountant-General between the 15th June and the 15th July every year.

The Accountant-General will by the 10th August forward to each Controlling Officer a copy of the form pertaining to the latter with the actuals of the previous year filled in. Every Controlling Officer will then take steps to prepare the estimate in respect of the heads

NOTES

pertains to him. While framing such estimates, the instructions in the following rules should be followed.

Numerical Strength: On the expenditure side of the form of estimate, a sub-column 'Numbers' is provided in Column 1 for showing the number of employees on the strength of the establishment in the year for which the estimate is being framed as well as that in the current year. Any difference between the two figures should be explained in the column marked for explanatory remarks. Sanctioned strength should be shown in all cases. Where, however, actual strength differs from it (for instance, when some posts are kept in abeyance or when the cadre strength of a service is reduced and there are supernumerary officers who will be absorbed as vacancies arise), the number actually on duty and for whom provision is made in the budget estimates should be shown in this column and also the sanctioned strength should be entered below it in square brackets.

Account Heads (Column I): Detailed heads printed in the form are those prescribed by the Finance Department and Budget provision should be made against the heads concerned. If any provision is to be made against any head not printed in the form, the required head should be opened in manuscript.

Revised Estimate: The Revised Estimate for a year is an estimate of the probable receipts or disbursements under each head for that particular year, framed in the course of the year with reference to the actual transactions recorded for the month of that year for which complete accounts have become available. The Revised.Estimates of the current year are *prima facie* the best indication as to what the Budget Estimates for the coming year should be. They should, therefore, be prepared with great care. Each estimate should be rounded to the nearest hundred rupees. Assuming that, at the time of the preparation of the estimates, the actuals of the first three months of the current year are available, then the Revised Estimate should be arrived at by adding to those actuals the requirements of the next nine months, which should be made on an appropriate calculating, such as the actuals of the corresponding nine months of the previous year, with due allowance for the special features that prevailed during that period and those that are also expected in the current year. The Revised Estimate should allow for any such additional appropriations that have been sanctioned after the Budget was passed or advances obtained from the Contingency Fund and references to the orders regarding them should be given in the remarks column.

7.2 BUDGET FORMATION (THE BUDGETARY PROCESS)

What is Budget?

The Annual Financial Statement or the Statement of the Estimated Receipts and Expenditure of the Government of India in respect of every financial year is popularly known as the Budget.

Presentation of Budget: The Budget is presented to Lok Sabha in two parts, viz., the Railway Budget pertaining to Railway Finance and the General Budget which gives an overall picture of the financial position of the Government of India, excluding the Railways.The Budget is presented to Lok Sabha on such day* as the President may direct. Immediately after

* By convention, the Railway Budget is presented sometime in the third week of February at 1200 hours after the Question Hour. The General Budget was presented by convention, till 1998, on the last working day of February at 5 p.m. This convention was, however, changed in 1999 when the General Budget was presented at 11 a.m. Since then the General Budget is presented at 11 a.m. on the last working day of February (except in 2000 when it was presented at 2 p.m.).

the presentation of the Budget, following three statements under the Fiscal Responsibility and Budget Management Act, 2003 are also laid on the Table of Lok Sabha: (i) The Medium Term Fiscal Policy Statement, (ii) The Fiscal Policy Strategy Statement, and (iii) The Macroeconomic Framework Statement. Simultaneously, a copy of the respective Budgets is laid on the Table of Rajya Sabha. In an election year, the Budgets may be presented twice — first to secure a Vote on Account for a few months and later in full.

Distribution of Budget Papers: In the case of the Railway Budget, the sets are distributed to members from the Publications Counter after the Railway Minister has concluded his speech. The sets of General Budget are distributed to members from several booths in the Inner and Outer Lobbies arranged according to the Division Numbers of members. In case Division Numbers have not been allotted, these booths are arranged State-wise. The budget introduced and the House has adjourned for the day.

Discussion on the Budget: No discussion on Budget takes place on the day it is presented to the House. Budgets are discussed in two stages — the General Discussion followed by detailed discussion and voting on the demands for grants.

Allotment of Time for Discussion: The whole process of discussion and voting on the demands for grants and the passage of the Appropriation and Finance Bills is to be completed within a specified time. As a result, often the demands for grants relating to all the Ministries or Departments cannot be discussed and demands of some Ministries get guillotined, i.e., voted without discussion. The Minister of Parliamentary Affairs, after the presentation of the Budget, holds a meeting of leaders of Parties or Groups in Lok Sabha for the selection of Ministries or Departments whose demands for grants might be discussed in the House. On the basis of decisions arrived at this meeting, the Government forwards the proposals for the consideration of the Business Advisory Committee. The Business Advisory Committee after considering the proposals allots time and also recommends the order in which the demands might be discussed. Usually, it is left to the Government to make any change in the order of discussion.

After the allotment of time by the Business Advisory Committee, a timetable showing the dates on and order in which the demands for grants of different Ministries would be taken up in the House is published in Bulletin – Part II for the information of members.

General Discussion on the Budget: During the General Discussion, the House is at liberty to discuss the Budget as a whole or any question of principles involved therein but no motion can be moved. A general survey of administration is in order. Scope of discussion is confined to an examination of the general scheme and structure of the Budget, whether the items of expenditure ought to be increased or decreased, the policy of taxation as expressed in the Budget and in the speech of the Finance Minister. Finance Minister or the Railway Minister has the general right of reply at the end of the discussion.

Consideration of the Demands for Grants by Departmentally Related Standing Committees of Parliament: With the creation of Departmentally Related Standing Committees of Parliament in 1993, Demands for Grants of all the Ministries or Departments are required to be considered by these Committees. After the General Discussion on the Budget is over, the House is adjourned for a fixed period. During this period, the Demands for Grants of the Ministries or Departments are considered by the Committees. These Committees are required to make their reports to the House within specified period without asking for more time and make separate report on the Demands for Grants of each Ministry.

NOTES

Discussion on Demands for Grants: Demands for grants are presented to Lok Sabha along with the Annual Financial Statement. These are not generally moved in the House by the Minister concerned. Demands are assumed to have been moved and are proposed from the Chair to save the time of the House. After the reports of the Standing Committees are presented to the House, the House proceeds to the discussion and voting on Demands for Grants, Ministry-wise. Scope of discussion at this stage is confined to a matter which is under the administrative control of the Ministry and to every head of the demand as is put to the vote of the House. It is open to members to disapprove a policy pursued by a particular Ministry or also to suggest measure for economy in the administration of that Ministry or to focus attention of the Ministry to specific local grievances. At this stage, cut motions can be moved to reduce any demand for grant but no amendments to a motion seeking to reduce any demand is permissible.

Cut Motions: The motions to reduce the amounts of demands for grants are called 'Cut Motions'. Object of a cut motion is to draw the attention of the House to the matter specified therein. Cut Motions can be classified into following three categories:

(i) Disapproval of Policy Cut;
(ii) Economy Cut; and
(iii) Token Cut.

Disapproval of Policy Cut: Cut motion which says, that amount of the demand be reduced to ₹ 1 implies that the mover disapproves of the policy underlying the demand. Member giving notice of such Cut Motion has to indicate briefly the particulars of the policy what he proposes to clarify. Discussion is confined to the specific point or points mentioned in the notice and it is open to the member to advocate an alternative policy.

Economy Cut: Where the object of the motion is to effect economy in the expenditure, form of the motion is that amount of the demand be reduced by any specified amount in ₹. Amount suggested for reduction may be either a lump-sum reduction in the demand or omission or reduction of an item in the demand.

Token Cut: Where the object of the motion is to ventilate a specific grievance within the sphere of responsibility of the Government of India, its form is that amount of the demand to be reduced by ₹ 100. Discussion on such a cut motion is confined to the particular grievance specified in the said motion which is within the sphere of responsibility of the Government of India. Here, for the facility of members, printed forms for giving notices of cut motions are kept in the Parliamentary Notice Office.

Notice period for Tabling Cut Motions: The notices of cut motions can be tabled after the presentation of Railway and General Budget. The notices of cut motions tabled up to 15.15 hours on a day are printed and circulated before the day the relevant demands for grants to which they relate are to be taken up in the House. The notices tabled after 15.15 hours are deemed to have been tabled on the next working day. These notices are printed and circulated on the next working day if the demands for grants to which they relate have not already been disposed of in the House. As cut motions are circulated to members both in English and Hindi simultaneously, the Rules Committee (Fourth Lok Sabha) at its sitting held on 9 March, 1970 decided that members might be requested to table such notices at least two days before the day they are to be taken up in the House. Accordingly, members should table the notice of cut motions at least two days before the day the demands for grants to which they relate, are to be taken up in the House, but in any case not later than 15.15 hours on the previous day.

Admissibility of Cut Motions — Conditions of

NOTES

A cut motion to be admissible should satisfy the following conditions:

1. It should relate to one demand only.
2. It should be clearly expressed and should not contain arguments, inferences, ironical expressions, imputations, epithets and defamatory statements.
3. It should be confined to one specific matter which should be stated in precise terms.
4. It should not reflect on the character or conduct of any person whose conduct can only be challenged on a substantive motion.
5. It should not make suggestions for the amendment or repeal of existing laws.
6. It should not relate to a State subject or to matters which are not primarily the concern of the Government of India.
7. It should not relate to expenditure 'Charged' on the Consolidated Fund of India.
8. It should not relate to a matter which is under adjudication by a court of law having jurisdiction in any part of India.
9. It should not raise a question of privilege.
10. It should not revive discussion on a matter which has been discussed in the same session and on which decision has been taken.
11. It should not anticipate a matter which has been previously appointed for consideration in the same session.
12. It should not ordinarily seek to raise discussion on a matter pending before any statutory tribunal or statutory authority performing any such judicial or quasi-judicial functions or any commission or court of enquiry appointed to enquire into or investigate any matter. However, the Speaker may in his discretion allow such matter being raised in the House as is concerned with the procedure or stage of enquiry, if the Speaker is satisfied that it is not likely to prejudice the consideration of such matter by the statutory tribunal, statutory authority, commission or court of enquiry.
13. It should not relate to a trifling matter. The Speaker decides whether a cut motion is or is not admissible and may disallow any cut motion when in his opinion it is an abuse of the right of moving cut motions or is calculated to obstruct or prejudicially affect the procedure of the House or contravention of the Rules of Procedure of the House. It is a Parliamentary convention that cut motion seeking to discuss the action of the Speaker or relates to Speaker's Department or matters under the control of Speaker are not allowed. Similarly, cut motions relating to the office of the Vice-President (who is also ex-officio Chairman of Rajya Sabha) are not admissible. Cut motion relates to matters under consideration of a Parliamentary Committee are not admissible. Cut motions are not admissible if they ventilate personal grievances or if they cast aspersions on individual Government officials. Cut motions seeks to discuss a matter affecting relations with a friendly foreign nation or details of internal administration of an autonomous body are out of order as also those that seeks omission of a whole grant. Token cuts seeking to clarify inadequacy of provision in respect of a particular demand are, however, in order. Normally, members of ruling party do not table cut motions.

Circulation of Lists of Cut Motions: Lists of cut motions to the several demands for grants as admitted by the Speaker are circulated to members generally two days in advance

NOTES

of the date on which the demands for grants in respect of the Ministry are to be taken up in the House for discussion.

Moving of Cut Motions: At the commencement of the discussion on the demands for grants in respect of a particular Ministry, members are asked by the Honourable Speaker to hand over at the Table, within fifteen minutes, slips indicating the serial numbers of their cut motions that they would like to move. The cut motions, thus, indicated are only treated as moved. Cut motions cannot be moved at a later stage. Cut motions cannot be moved by proxy. A member should be present in the House to move his cut motions when the relevant demands for grants are taken up.

Guillotine: On the last of the allotted days for discussion and voting on demands for grants, at the appointed time, the Speaker puts every such question necessary to dispose of all outstanding matters in connection with the demands for grants. This is known as guillotine. The guillotine concludes the discussion on demands for grants.

Annual Reports, Outcome Budgets and Detailed Demands for Grants of the Ministries: In connection with discussion on demands for grants, copies of the Annual Reports and Outcome Budget of the various Ministries and Departments are made available to members through the Publications Counter. Detailed demands for grants in respect of different Ministries or Departments are laid on the Table of Lok Sabha some time before the demands for grants are considered by the Departmentally Related Standing Committees.

Vote on Account: As the whole process of Budget beginning with its presentation and ending with discussion and voting of demands for grants and passing of Appropriation Bill and Finance Bill generally goes beyond the current financial year, a provision has been made in the Constitution empowering the Lok Sabha to make any grant in advance through a vote on account so as to enable Government to carry on until the voting of demands for grants and also the passing of the Appropriation Bill and Finance Bill.

Generally, vote on account is taken for two months for a sum equivalent to one sixth of the estimated expenditure for the entire year under several demands for grants. During an election year, the vote on account may be taken for a longer period say, 3 to 4 months if it is expected that the the main demands and the Appropriation Bill will take longer than two months to be passed by the House. As a convention, vote on account is treated as a formal matter and passed by Lok Sabha without discussion. Vote on account is passed by Lok Sabha after the general discussion on the Budget (General and Railway) is over and before the discussion on demands for grants is taken up.

Supplementary and Excess Demands for Grants: If the amount authorized to be expended for a particular service for the current financial year is found to be insufficient for the purpose of that year or while need has arisen during the current financial year for supplementary or additional expenditure upon some ‘new service’ not contemplated in the Budget for that year, the President causes to be laid before both the Houses of Parliament another statement showing the estimated amount of that expenditure. If any money has been spent on any service during a financial year in excess of the amount granted or the service for that year, the President causes to be presented to Lok Sabha a demand for such excess. All cases involving such excesses are brought to the notice of Parliament by the Comptroller and Auditor General through his report on the Appropriation Accounts. Thus, excesses are then examined by the Public Accounts Committee that makes recommendations about their regularization in its report to the House. The Supplementary Demands for Grants are presented to and passed by the House before the end of the financial year while the demands for excess grants are made after the expenditure has actually been incurred and

NOTES

after the financial year to which it relates, has expired. Copies of the Books of Demands for Supplementary or Excess Grants, received from the Ministry of Finance are made available to members from the Publications Counter after the presentation of such demands.

Procedure for Discussion: Supplementary and Excess Grants are regulated by the same procedure as is applicable in the case of demands for grants of the main Budget subject to such adaptations, whether by way of modification, addition or omission, as the Speaker deems necessary or expedient.

Scope of Discussion on Supplementary or Excess Grants: Discussion on the Supplementary Demands for Grants is confined to the items constituting the same and no discussion can be raised on the original grants nor on the policy underlying them. In respect of schemes already sanctioned in the main Budget, no discussion on any question of principle or policy is allowed. As regards demands for which no sanction has been obtained, the question of policy has to be confined to the items of expenditure on which the vote of the House is sought. General grievances cannot be ventilated during discussion on a Supplementary Grant. Member can only point out whether the Supplementary Demand is necessary or not. During discussion on Excess Demands for Grants, members can point out how money has been spent unnecessarily or that it ought not to have been spent; beyond this there is no scope for general discussion or for ventilation of grievances.

Cut Motions to Supplementary/Excess Demands for Grants: The cut motions to Supplementary or Excess Demands for Grants must relate to the subject matter of the Supplementary or Excess Demands. Cut motions that are extraneous to the subject matter of such demands are out of order.

Appropriation Bill: After the demands for grants have been passed by the House, a Bill to provide for the appropriation out of the Consolidated Fund of India of all moneys required to meet the grants and the expenditure charged on the Consolidated Fund of India is introduced, considered and passed. Introduction of such Bill cannot be opposed. Scope of discussion is limited to matters of public importance or administrative policy implied in the grants covered by the Bill and which have not already been raised during the discussion on demands for grants. However, Speaker may require members desiring to take part in the discussion to give advance intimation of the specific points they intend to raise and may withhold permission for raising the points as in his opinion appear to be repetition of the matters discussed on a demand for grant. Such advance intimation must be given before 10.00 hours on the day the Appropriation Bill is to be taken into consideration. No action is taken on intimations received after 10.00 hours. No amendment can be proposed to an Appropriation Bill which will have the effect of varying the amount or altering the destination of any grant so made or of varying the amount of any expenditure charged on the Consolidated Fund of India and the decision of the Speaker as to whether such amendment is admissible is final. An amendment to an Appropriation Bill for omission of a demand voted by the House is out of order. In other respects, the procedure in respect of an Appropriation Bill is the same as in respect of other Money Bills.

Finance Bill: 'Finance Bill' implies a Bill ordinarily introduced every year to give effect to the financial proposals of the Government of India for the next following financial year and includes a Bill to give effect to supplementary financial proposals for any period. The Finance Bill is introduced immediately after the presentation of the Budget. Introduction of the Bill cannot be opposed. Appropriation Bills and Finance Bills may be introduced without prior circulation of copies to members. The Finance Bill usually contains declaration under the Provisional Collection of Taxes Act, 1931, by which the declared provisions of the Bill relates to imposition or increase in duties of customs or excise come

NOTES

into force immediately on the expiry of the day on which the Bill is introduced. In view of such provisions and the provision of Act of 1931, the Finance Bill has to be passed by Parliament and assented to by the President before the expiry of the seventy-fifth day after the day on which it was introduced. As the Finance Bill contains taxation proposals, it is considered and passed by the Lok Sabha only after the Demands for Grants have been voted and the total expenditure is known. Scope of discussion on the Finance Bill is vast and members can discuss any action of the Government of India. Entire administration comes under review. The procedure in respect of Finance Bill is the same as in the case of other Money Bills.

Budgets of Union Territories and States under President's Rule: Budgets of Union territories and States under President's Rule are also presented to Lok Sabha. Procedure as regards the Budget of the Union Government is followed in such cases with such variations or modifications, as the Speaker may make.

7.3 LEGISLATIVE ENCASHMENT IMPLEMENTATION OF PUBLIC ACCOUNTS COMMITTEE, ESTIMATES

Public Accounts Committee in India: The Committee on Public Accounts is constituted by Parliament every year for examination of accounts showing the appropriation of sums granted by Parliament for expenditure of Government of India, the annual Finance Accounts of Government of India and such other Accounts laid before Parliament as the Committee may deem fit like that of accounts of autonomous and semi-autonomous bodies (except those of Public Undertakings and Government Companies which come under the purview of the Committee on Public Undertakings.

Constitution of Public Accounts Committee in India: The Public Accounts Committee (PAC) examines the report of Accounts of the union government submitted by the Comptroller and Auditor General of India, to the President. The Public Accounts Committee in India ensures Parliamentary control over government expenditure.

In India either House is entitled to have a Public Accounts Committee (PAC) of its own, for the President lays the report on accounts of union government submitted by the Comptroller and Auditor General before each House of the Parliament.

However, only the Lok Sabha has constituted a PAC. The present PAC consists of 15 members from the Lok Sabha. From 1954, 7 members from the Rajya Sabha are elected to the PAC as associate members. Thus, the present PAC is a joint committee of the two Houses. Ministers are not eligible for election. By convention, a member of the opposition is named chairman of this committee by the Speaker of the Lok Sabha.

The honourable Speaker, for the first time, appointed a member of the opposition as the Chairman of the Committee for 1967-68. This practice has been continued since then. A Minister is not eligible to be elected as a member of the Committee. If a member after his election to the Committee is appointed a Minister, he ceases to be a member of the Committee from the date of such appointment.

Change in Set-up: From its inception in the year 1921 till early 1950, the Finance member was appointed as the Chairman of the Committee and its secretarial functions were looked after by the Finance Department (later Ministry of Finance). With the coming into force of the Constitution of India on 26th January, 1950, the Committee became a Parliamentary Committee under the control of Speaker. Its secretarial functions were transferred to the Parliament Secretariat (now Lok Sabha Secretariat).

Functions of the Committee: The Examination of the Appropriation Accounts relating to the Railways, Defence Services, P&T Department and other Civil Ministries of the Government of India and Reports of the Comptroller and Auditor General of India thereon as also the Reports of the Comptroller and Auditor General on Revenue Receipts mainly form the basis of the deliberation of the Committee. While scrutinizing the Appropriation Accounts and the Reports of the Comptroller and Auditor General thereon, it is the duty of the Committee to satisfy itself:

(a) That the money shown in the accounts as having been disbursed were legally available for and, applicable to the service or purpose to which they have been applied or charged;

(b) That the expenditure conforms to the authority which governs it; and

(c) That every reappropriation has been made in accordance with the provisions made in this behalf under rules framed by competent authority.

Thus, the function of this committee are as hereunder:

Firstly to examine the report of Accounts of the union government submitted by the Comptroller and Auditor General of India, to the President. Article 151 of the Indian Constitution require the President to lay this report before each House of the Parliament.

Secondly, in examining the report of the Comptroller and Auditor General, the committee has to satisfy itself that: (a) the expenditures made by the government, were authorized by the Parliament, and (b) that the expenditures under any head has not crossed the limits of parliamentary authorization. Every expenditure made by the government must be sanctioned by the Parliament. Thus, the committee brings to the notice of the Parliament instances of unauthorized expenditures or expenditures beyond sanctioned limits.

Thirdly, the committee not only ensures that ministries spend money in accordance with parliamentary grants. It also brings to the notice of the Parliament instances of extravagance, loss, in fructuous expenditure and lack of financial integrity in public services. The committee cannot question polices of the government. It only concerns itself with the execution of policy on its financial aspects.

Fourthly, a new dimension is added to the function of the PAC, as it is entrusted with scrutinizing the Audit report of public corporations. This aspect of the PAC was unknown when Gladstone instituted the PAC in the sixties of the last century. But today, both in England and in India, huge sums of money are invested in public corporations. In India, more than 30,000 crores of rupees are invested in public corporations. Naturally, examining the accounts of these corporations constitutes a very important aspect of the work of the PAC.

Finally, in examining the audits and accounts of the ministries and public corporations, the PAC gets the opportunity to scrutinize the process of their working. It points out the weakness and shortcomings of the administration of ministries and public corporations Criticisms of the PAC draw national attention. This keeps the ministries and public corporations sensitive to the criticisms of the PAC. Thus, it is wrong to consider that the PAC is only an instrument of financial control, it is as well an instrument of administrative control.

Therefore, because of the overwhelming importance of the Public Accounts Committee (PAC) both the government and the opposition try to gain control over the PAC. The government has an in-built advantage in that, inevitably the majority of members of the PAC belong to the ruling party. But the opposition also has an advantage. It has now become a convention that the chairman of the PAC is a member of the opposition. But since

NOTES

the chairman is nominated by the Speaker, whether an effective and assertive member of the opposition will be the chairman depends on the strict neutrality of the Speaker.

Hence, one of the duties of the Committee is to ascertain that money granted by Parliament has been spent by Government within the scope of the demand. It considers the justification for spending more or less than the amount originally sanctioned. If any money has been spent on a service in excess of the amount granted by the House for the purpose, the Committee examines with reference to the facts of each case, the circumstances leading to such an excess and makes such recommendations as it may deem fit.

The functions of the Committee extend, however, "beyond, the formality of expenditure to its wisdom, faithfulness and economy". The Committee thus examines cases involving losses, nugatory expenditure and financial irregularities. While scrutinizing the Reports of the Comptroller and Auditor General on Revenue Receipts, the Committee examines various aspects of Government's tax administration. The Committee, thus examines cases involving under-assessments, tax-evasion, non-levy of duties, misclassifications, etc. identifies the loopholes in the taxation laws and procedures and makes recommendations in order to check leakage of revenue.

Working of the Committee

Representatives of the Ministries appear before the Committee when examining the Accounts and Audit Reports relating to their Ministries. The Committee proceeds by way of interrogation of witnesses. The Comptroller and Auditor General is the friend, philosopher and guide of the Committee. He attends the sittings of the Committee and assists it in its deliberations The Committee may appoint one or more Sub-committees or Sub-groups to examine any particular matter. At the beginning of its term, the Committee appoints a few Working Groups or Sub-committees to facilitate the examination of the various Accounts and Audit Reports and Sub-committee to consider the action taken by the Government on the recommendations made by the Committee in its earlier Reports. If it appears to the Committee that is necessary for the purpose of its examination that an on-the-spot study should be made, the Committee may, either in its entirety or by dividing itself into Study Groups decide to undertake tours to make an on-the-spot study of any project or establishment. All discussions held during tour by the Committee/Study Groups, with the representatives of the establishment, Ministries or Departments, non-official organizations, Labour Unions etc. are treated as confidential and no one having access to the discussion, directly or indirectly is to communicate to the Press or any unauthorized person, any information about matters taken up during the discussions.

Reports Presented by the Committee: Since the Committee became a Parliamentary Committee under the control of the Speaker from 26th January, 1950, it has presented 1310 Reports till 5 February, 2004 (i.e., till the dissolution of the 13th Lok Sabha). Government take action on the recommendations of the Committee and submit action taken notes to the Committee. The Committee then present an Action Taken Report after considering the views of the Government. The Government further submit an 'Action Taken Statement' on the action taken by the Government on the 'Action Taken Report' of the Committee. The Action Taken Statement is generally laid before the House without any further examination by the Committee. Normally, almost all the recommendations of the Committee are implemented by the Government.

Can Ministers be Summoned by Public Accounts Committee?: The Public Accounts Committee examines how the Government spends public money. It examines the amount granted by the Parliament and the amount actually spent. A Speaker in the past, has passed a direction which specifies clearly that a Minister cannot be summoned by the Financial Committees. This has been incorporated in a document titled "Directions by the Speaker" available here. The Committee on Estimates or the Committee on Public Accounts or the Committee on Public Undertakings may call officials to give evidence in connection with the examination of the estimates and accounts, respectively, relating to a particular Ministry or Undertaking. But a Minister shall not be called before the Committee either to give evidence or for consultation in connection with the examination of estimates or accounts by the Committee.

Public Accounts Committee – Odisha: As regards the Public Accounts Committee – Odisha is concerned, (i) Section 4(1)(b) states that the expenditure confirms to the authority which governs it; and (ii) Section 4(1)(c) states that every reappropriation has been made in accordance with provisions made in this behalf under rules framed by competent authority. Further, it shall be also the duty of the Public Accounts Committee:

(a) To examine the statement of accounts showing the income and expenditure of State Corporations, Trading and Manufacturing Schemes and Projects together with the balance sheets and statements of profit and loss accounts which the Governor may have required to be prepared or are prepared under the provisions of the statutory rules regulating the financing of a particular Corporation, trading concern or project and the report of the Comptroller and Auditor General thereon.

(b) To consider the report of the Comptroller and Auditor General in cases where the Governor may have required him to conduct an audit of any receipts or to examine the account of stores and stock.

Again, if any money has been spent on any service during a financial year in excess of the amount granted by the Assembly for that purpose the Committee shall examine with reference to the facts of each case the circumstances leading to such an excess and make such recommendation as it may deem fit. It is also provided that the Committee shall not exercise its functions in relation to such Public Undertaking as are allotted to the Committee on Public Undertakings by these rules or by the Speaker.

Committee on Public Accounts:

According to Section 135:

1. The Committee on Public Accounts shall consist of twelve members who shall be elected by the Assembly every year from amongst its members according to the principle of proportional representation by means of single transferable vote.

   Provided that a Minister shall not be elected a member of the Committee or if a member, after election to the Committee, is appointed a Minister, he shall cease to be a member of the Committee from the date of such appointment.
2. The term of office of members of the Committee shall be one year.
3. In order to constitute a meeting of the Committee, the quorum shall be four.
4. The Committee shall have power to pass resolution on matters of procedure for the consideration of the Speaker who may make such variations in procedure as he may consider necessary.

Provisions Applicable in other Respects: Section 136 provides that, in other respect, the rules applicable to Committee in general provided in Chapter XXV of these rules shall *mutatis mutandis* apply.

Committee on Estimates: According to Section 137:

NOTES

1. There shall be a Committee on Estimates for the examination of such of the estimates as may be deem fit to the Committee or are specifically referred to it by the Assembly. The functions of the Committee shall be:
   (a) To report what economics improvements in organization, efficiency or administrative reform consistent with the policy underlying the estimates, may be effected;
   (b) To suggest alternative policies in order to bring about efficiency and economy in administration;
   (c) To examine whether the money is well laid out within the limits of the policy implied in the estimates;
   (d) To suggest the form in which the estimates shall be presented to the Assembly:

   Further it is also provided that the Committee shall not exercise its functions in relation to such Public Undertakings as are allotted to the Committee on Public Undertakings by these rules or by the Speaker.
2. The Committee shall consist of twelve members who shall be elected by the Assembly every year from amongst its members according to the principle of proportional representation by means of single transferable vote. It is also provided that a Minister shall not be elected a member of the Committee, or if a member, after election to the Committee, is appointed a Minister, he shall cease to be a member of the Committee from the date of such appointment.

7.4 COMMITTEE EFFICIENCY AND ACCOUNTABILITY OF THE PRESENT SYSTEM OF BUDGETING SUGGESTIONS FOR IMPROVEMENT

Budget in Parliament (Accountability)

Accountability: Obligation of an individual or organization to account for its activities, accept responsibility for them and to disclose the results in a transparent manner. It also includes the responsibility for money or other entrusted property.

With the emergence of Welfare State, Governments have come to look after virtually every sphere of human life. They have to perform manifold functions from maintaining law and order, protecting their territories to implement plans for economic and social betterment. Besides, they provide a variety of social services like education, health, employment and housing to the people. Needless to say, Government require adequate resources to discharge these functions effectively. Where is this money to come from and who is to sanction the funds? The necessary funds are mobilized from the country's resources by way of taxes both direct and indirect, loans both long-term and short-term, to meet the Governmental expenditure. In India, the principal sources of revenue are customs and excise duties and income tax on individuals and companies.

Need for Budget: It is not as if the Government can tax, borrow and spend money the way it likes. Since there is a limit to the resources, the need for proper budgeting arises to allocate scarce resources to several governmental activities. Each item of expenditure has to be well thought-out and total outlay worked out for a specific period. Prudent spending is inevitable for stability of a Government and proper earnings are a pre-requisite to wise

NOTES

spending. Thus, planned expenditure and accurate foresight of earnings are *sine qua non* of sound Governmental finance.

Parliamentary Control over Finance: Ours is a Parliamentary system of Government based on Westminster model. The Constitution has, thus, vested the power over the purse in the hands of chosen representatives of the people sanctifying the principle 'no taxation without representation'. Preparation of Budget for the approval of the Legislature is a Constitutional obligation of the Government both at the Centre as well as the State levels. Legislative prerogative over taxation, legislative control over expenditure and executive initiative in financial matters are some of the fundamental principles of the system of Parliamentary financial control. There are specific provisions in the Constitution of India for incorporating these tenets. For instance, article 265 provides that no tax shall be levied or collected except by the authority of law, no expenditure can be incurred except with the authorization of the Legislature (Article 266) and President shall, in respect of every financial year, cause to be laid before the Parliament, Annual Financial Statement (Article 112). All these provisions of our Constitution make the Government accountable to Parliament.

The Budget: The 'Annual Financial Statement', laid before both the Houses of Parliament constitutes the Budget of the Union Government. This statement takes into account a period of one financial year. The financial year commences in India on 1st April each year. The statement embodies the estimated receipts and expenditure of the Government of India for the financial year.

Demands for Grants: The estimates of expenditure included in the Budget and required to be voted by Lok Sabha are in the form of Demands for Grants. These Demands are arranged Ministry-wise and a separate Demand for each of the major services is presented. Each Demand contains first a statement of the total grant and then a statement of the detailed estimate divided into items.

Railway Budget: The Budget of the Indian Railways is presented separately to Parliament and dealt with separately, although the receipts and expenditure of the Railways form part of the Consolidated Fund of India and the figures relating to them are included in the 'Annual Financial Statement'.

Presentation: In India, the Budget is presented to Parliament on such date as is fixed by the President. The Budget speech of the Finance Minister is usually in two parts. Part A deals with general economic survey of the country while Part B relates to taxation proposals. General Budget was earlier being presented at 5 p.m. on the last working day of February, but since 1999 the General Budget is being presented at 11 a.m. on the last working day of February, i.e., about a month before the commencement of the Financial year except in the year when General Elections to Lok Sabha are held. In an election year, Budget may be presented twice — first to secure Vote on Account for a few months and later in full.

The General Budget is presented in Lok Sabha by the Minister of Finance. He makes a speech introducing the Budget and it is only in the concluding part of his speech that the proposals for fresh taxation or for variations in the existing taxes are disclosed by him. The 'Annual Financial Statement' is laid on the Table of Rajya Sabha at the conclusion of the speech of the Finance Minister in Lok Sabha.

Budget Documents: Along with the 'Annual Financial Statement', Government presents the following documents an Explanatory Memorandum briefly explaining the nature of receipts and expenditure during the current year and the next year and the reasons for variations in the estimates for the two years, the Books of Demands showing the provisions Ministry-wise and a separate Demand for every Department and service of the Ministry. The Finance Bill which

NOTES

deals with the taxation measures proposed by Government is introduced immediately after the presentation of Budget. It is accompanied by a memorandum explaining the provisions of the Bill and their effect on the finances of the country.

Vote on Account: Discussion on the Budget begins a few days after its presentation. In a democratic set-up, Government is anxious to give Parliament full opportunity to discuss the budgetary provisions and the various proposals for taxation. Since Parliament is not able to vote the entire budget before the commencement of the new financial year, necessity to keep adequate finance at the disposal of Government to allow it to run the administration of the country remains top priority. Hence, a special provision is, made for "Vote on Account" by which Government obtains the Vote of Parliament for a sum sufficient to incur expenditure on various items for a part of the year. Generally, the Vote on Account is taken for two months only. But during election year or when it is expected that the main Demands and Appropriation Bill will take longer time than two months, the Vote on Account may be for a period exceeding two months.

Discussion: The Budget is discussed in two stages in Lok Sabha. First, there is the General Discussion on the Budget as a whole and it lasts for about 4 to 5 days. Only the broad outlines of the Budget and the principles and policies underlying it are discussed at this stage.

Consideration of the Demands by Standing Committees of Parliament: After the first stage of General Discussion on both Railway as well as General Budget is over, the House is adjourned for a fixed period. During this period, the Demands for Grants of various Ministries or Departments including Railways are considered by concerned Standing Committees (Rule 331G). These Committees are required to make their reports to the House within specified period without asking for more time. The system of consideration of Demands for Grants by the Standing Committees was introduced from the Budget for the year 1993-94. The Standing Committee consists of 45 Members, 30 from Lok Sabha and 15 from Rajya Sabha. Reports of the Standing Committees are of persuasive nature (Rule 331N) and it will not suggest anything of the nature of cut motions.

Now, just after the reports of the Standing Committees are presented to the House, the House proceeds to the discussion and Voting on Demands for Grants, Ministry-wise. The time for discussion and Voting of Demands for Grants is allocated by the Speaker in consultation with the Leader of the House. On the last day of the allotted days, Speaker puts all the outstanding Demands to the Vote of the House. This device is popularly known as 'guillotine'. Lok Sabha has the power to assent to or refuse to give assent to any Demand or even to reduce the amount of Grant sought by Government. In Rajya Sabha, there is only a General Discussion on the Budget. It does not vote on the Demands for Grants. Only so much of the amount is subject to the vote of Lok Sabha as is not a "charged" expenditure on the Consolidated Fund of India. The "charged" expenditure includes the emoluments of the President and the salaries and allowances of the Chairman and Deputy Chairman of Rajya Sabha and the Speaker and Deputy Speaker of Lok Sabha, Judges of Supreme Court, Comptroller and Auditor General of India and certain other items specified in the Constitution of India. Discussion in Lok Sabha on 'charged' expenditure is permissible but such expenditure is not voted by the House. Members have absolute opportunity to criticize the budgetary provisions during the entire course of discussion and also to make suggestions to improve financial position of the country.

Cut Motions: Motions for reduction to various Demands for Grants are made in the form of Cut Motions seeking to reduce the sums sought by Government on grounds of economy or difference of opinion on matters of policy or just in order to voice a grievance.

Appropriation Bill: After the General Discussion on the Budget proposals and Voting on Demands for Grants have been completed, Government introduces the Appropriation Bill. The Appropriation Bill is intended to give authority to Government to incur expenditure from and out of the Consolidated Fund of India. Procedure for passing this Bill is the same as in the case of other money Bills.

Finance Bill: The Finance Bill seeking to give effect to the Government's taxation proposals which is introduced in Lok Sabha immediately after the presentation of the General Budget, is taken up for consideration and passing after the Appropriation Bill is passed. However, certain provisions in the Bill relates to levy and collection of fresh duties or variations in the existing duties come into effect immediately on the expiry of the day on which the Bill is introduced by virtue of a declaration under the Provisional Collection of Taxes Act. Parliament has to pass the Finance Bill within 75 days of its introduction.

Supplementary or Excess Grants: No expenditure in excess of the sums authorized by Parliament can be incurred without the sanction of Parliament. Whenever a need arises to incur extra expenditure, a Supplementary estimate is laid before Parliament. If any money has been spent on any service during a financial year in excess of the amounts granted for that service and for that year, the Minister of Finance or Railways presents a Demand for Excess Grant. The necessary procedure followed in Parliament in regard to Supplementary or Excess Grants is more or less the same as is adopted in the case of estimates included in the General Budget.

Budget of a State or Union Territory under President's Rule: Budget of a State under President's rule is presented to Lok Sabha. Procedure followed in regard to the Budget of the Union Government is followed in the case of State Budget also with such variations or modifications, as the Speaker may make.

7.5 SUMMARY

1. Budget cycle describes the activities and processes behind developing budget for a single fiscal period.
2. Budget enactment involves the approval of the proposed Budget by the Legislature through the enactment of Finance Bill and Appropriation Bill.
3. In the Union government, there is a budget division in the department of economic affairs under the Ministry of Finance.
4. The Annual Financial Statement or the Statement of the Estimated Receipts and Expenditure of the Government of India in respect of every financial year is popularly known as the Budget.

7.6 SELF ASSESSMENT QUESTIONS

I. Fill in the Blanks

1. __________ of a budget cycle is to define the steps from the beginning to the end of the process.
2. __________ phase begins once the budget is enacted.

NOTES

II. True and False

1. Length of the fiscal period differs depending upon the organization and the stated goals of a particular budget.
2. Budget execution refers enforcement of the provisions in the Finance Act and appropriation Act by the government through collection of receipts and making disbursements for various services as approved by the Legislature.

III. Multiple Choice Questions

1. Budget Formulation is the __________.
   (a) First phase of the budget cycle
   (b) Second phase of the budget cycle
   (c) Third phase of the budget cycle
   (d) Fourth phase of the budget cycle
2. Cut Motions can be classified into three categories __________.
   (a) Three categories
   (b) Four categories
   (c) Five categories
   (d) None of the above

Short Answer Questions

1. Define the term budget and Budget cycle.
2. Write a short note on Budget execution.

Long Answer Questions

1. Explain in detail about the Budgetary process in India.
2. Critically explain about the 'Committee efficiency and accountability of the present system of budgeting suggestions for improvement.'

7.7 KEY TERMS

- Budget Advocacy
- Budget Cycle
- Budget Implementation

7.8 KEY TO CHECK YOUR ANSWER

I. 1. Function, 2. Budget Execution.
II. 1. True, 2. True.
III. 1. (a), 2. (a).