ECONOMICS OF PUBLIC FINANCE

Principles • Policies • Perspectives

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Preface

Economics of Public Finance has been written to provide students, teachers, and researchers with a clear, well-organised, and up-to-date account of how governments raise revenue, incur expenditure, manage debt, and design fiscal policy to meet economic and social objectives. Public finance sits at the heart of every modern economy, and a sound understanding of its principles is indispensable for anyone seeking to make sense of budgets, taxation, federal financial relations, and the broader machinery of the state.

The book is organised into five units. Unit One introduces the meaning, nature, and scope of public finance, along with the theory of public goods, market failure, and the fiscal functions of government. Unit Two deals with budgeting — its meaning, types, modern classification, budgetary deficits, and the pattern and problems of public expenditure in India. Unit Three takes up the theory of taxation, covering the ability-to-pay and benefit principles, taxable capacity, incidence of taxation, classification of taxes, and the special considerations that apply to taxation in a developing economy. Unit Four examines Indian fiscal federalism in depth, including vertical and horizontal imbalances, the shift from competitive to cooperative federalism, constitutional provisions, Centre–State financial relations, local body finance, and the role of the Finance Commission of India. Unit Five looks ahead to an emerging and increasingly important theme — the implications of artificial intelligence for the economics of public finance, including its effects on tax revenue systems, public expenditure and welfare delivery, and fiscal governance.

Throughout the book, concepts are explained in simple language and illustrated with contemporary Indian examples — from GST and the Union Budget to MGNREGA, the National Infrastructure Pipeline, and the recommendations of successive Finance Commissions — so that theory is always anchored in practice. Each chapter is supported by definitions, summaries, and review questions designed to reinforce learning and encourage critical thinking.

It is my hope that this book will serve as a dependable companion for students preparing for university examinations and competitive examinations alike, and that it will also be of value to general readers who wish to understand the economic logic behind government policy. Suggestions and feedback from readers and fellow teachers are always welcome, as they will help improve future editions of this work.

Author

Acknowledgement

This book is the outcome of the encouragement, support, and guidance of many people, and it is a pleasure to record my gratitude to them.

I am deeply thankful to my teachers and mentors in the field of economics, whose lectures and writings first kindled my interest in public finance and continue to shape the way I think about the subject. Their insistence on clarity, rigour, and relevance to the Indian context has left a lasting mark on this work.

I would like to express my sincere appreciation to my colleagues and fellow faculty members for their valuable suggestions, discussions, and constructive criticism at various stages of writing, which greatly helped in improving the content and presentation of this book.

I am equally grateful to my students, whose questions in the classroom over the years helped me understand which concepts needed simpler explanation and more examples — much of this book has been shaped by those conversations.

I owe a special debt of gratitude to my family for their patience, understanding, and constant encouragement throughout the writing of this book. Their support made it possible for me to devote the time and attention this work required.

Finally, I thank the publisher and everyone associated with the production of this book for their professionalism and care in bringing this manuscript to its present form. Any errors or shortcomings that remain are, of course, entirely my own.

Author

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Unit 1:

Meaning, nature and importance of public finance, the concept of public goods, Pure public goods, private goods, mixed goods, merit goods and club goods. Market failure and government intervention. Fiscal functions.

Chapter 1:
Introduction to Public Finance

- Meaning of Public Finance
- Nature of Public Finance
- Scope of Public Finance
- Importance of Public Finance in an Economy
- Difference between Public Finance and Private Finance

Definition

Public Finance is the branch of economics that studies the financial activities of the government — how it raises revenue, incurs expenditure, and manages public debt to achieve economic and social goals.
The term was coined by Hugh Dalton, who defined it as "the income and expenditure of public authorities and their mutual relationship."

2. Nature of Public Finance

1) Science or art

Public Finance is both a positive science (what is) and a normative science (what ought to be). It analyses facts and also prescribes policies.

2) Compulsory Nature

Unlike private finance, public finance is backed by the sovereign power of the state. Taxes are compulsory; no individual can refuse to pay.

3) Social Objective

The primary goal is social welfare, not profit. The government may run schemes at a loss if they serve the public good.

4) Macroeconomic Focus

It operates at a macro level, influencing the entire economy through fiscal policy, taxation, and public spending.

3. Scope of Public Finance

1) Public Revenue

Tax & non-tax income of the govt. E.g. GST, income tax, customs

2) Public Expenditure

Govt spending on defence, education, health, subsidies

3) Public Debt

Borrowings by govt. E.g. Treasury Bills, Market Loans

4) Financial Administration

Budgeting, fiscal policy, audit — e.g. CAG of India

5) Fiscal Federalism

Revenue sharing between Centre & States via Finance Commission

4. Importance of Public Finance in the Indian Economy

1) Resource Allocation

Directs resources to priority areas. E.g. PM Gram Sadak Yojana funds rural road infrastructure.

2) Redistribution of Income

Progressive taxation + welfare schemes reduce inequality. E.g. MGNREGA provides employment to rural poor.

3) Economic Stability

Fiscal policy controls inflation & recession. RBI & Finance Ministry coordinate to maintain macro stability.

4) Economic Development

Capital expenditure on infrastructure drives growth. E.g. National Infrastructure Pipeline (NIP) of ₹111 lakh crore.

5) Merit Goods & Externalities

Govt. funds public goods like Ayushman Bharat (health) and Sarva Shiksha Abhiyan (education).

6) Employment Generation

Public expenditure creates jobs. E.g. Central & State PSUs, defence recruitment, teacher hiring.

5. Public Finance vs Private Finance — with Indian Examples

Basis	Public Finance (Govt. of India)	Private Finance (Individual/Firm)
Objective	Social welfare & public good. E.g. PM Kisan gives ₹6,000/yr to farmers regardless of profit.	Profit maximisation or personal utility. E.g. Reliance Industries plans capital based on ROI.
Revenue Sources	Compulsory taxes (GST, income tax, customs), fees, public borrowing.	Salary, business income, investments — all voluntary and earned.
Budget Approach	Expenditure-first: Govt. decides spending needs, then arranges revenue (deficit budgeting is common).	Income-first: A household spends only what it earns or can borrow prudently.
Deficit Financing	Permissible & used as a policy tool. India's fiscal deficit target: ~5.1% of GDP (2024–25).	Persistent deficit is unsustainable and leads to bankruptcy.
Secrecy	Made public. Union Budget is presented in Parliament and published for all citizens.	Kept private. A company's internal finances are confidential (except listed companies).
Scale	Massive scale. Union Budget 2024–25 total expenditure: ₹47.65 lakh crore.	Limited to the individual, household, or firm's own resources.
Borrowing Power	Can borrow from RBI, foreign institutions, issue bonds. Backed by sovereign guarantee.	Borrowing depends on creditworthiness; no sovereign backing.
Accountability	Accountable to Parliament & citizens. CAG audits government accounts.	Accountable only to self, partners, or shareholders.

On the nature of Public Finance — the most important distinction is that it is both positive (it describes how governments actually behave) and normative (it prescribes how they should behave). This dual nature makes it different from pure natural sciences.

On scope — examiners often ask you to list the five components. A handy mnemonic for India: *"Revenue, Expenditure, Debt, Administration, Federalism"* — think of the Finance Commission as the institution that ties all five together.

Multiple CHOICE QUESTION

1) Who defined Public Finance as 'the income and expenditure of public authorities and their mutual relationship'?

a) Adam Smith
b) Hugh Dalton
c) John Maynard
d) KeynesPigou

2) Public Finance is best described as which type of science?

a) Only positive science
b) Only normative science
c) both
d) None of the above

3) Which of the following is NOT part of the scope of Public Finance?

a) Public revenue
b) Public debt
c) Monetary policy
d) Financial administration

4) Which Indian institution audits the government's public accounts?

a) RBI
b) SEBI
c) CAG (Comptroller & Auditor General)
d) Finance Commission

5) In which of the following ways does Public Finance differ from Private Finance?

a) Private finance uses compulsory taxation
b) Public finance is expenditure-first; private is income-first
c) Public finance aims at profit maximisation
d) Private finance can borrow from the RBI

6) GST (Goods and Services Tax) in India is an example of:

a) Public expenditure
b) Public debt
c) Public revenue
d) Financial administration

7) MGNREGA in India is an example of Public Finance achieving which objective?

a) Controlling inflation
b) Redistribution of income and employment generation
c) Reducing public debt
d) Monetary stability

8) Which statement about public debt is CORRECT?

a) Only individuals can borrow from private banks
b) The government cannot run a deficit
c) India's fiscal deficit target is around 5.1% of GDP (2024-25)
d) Deficit financing always causes hyperinflation

9) The National Infrastructure Pipeline (NIP) worth ₹111 lakh crore represents which importance of Public Finance?

a) Redistribution of income
b)Price stabilisation
c) Economic development through capital expenditure
d) Controlling black money

10) Taxes levied by the government are 'compulsory' in nature. This reflects which characteristic of Public Finance?

a) Normative nature
b) Sovereign power of the state
c) Profit motive
d) Macro secrecy

Chapter 2:
Public Goods and Their Types

- Concept of Public Goods
- Characteristics of Public Goods
    - Non-rivalry
    - Non-excludability

Types of Goods

- Pure Public Goods
- Private Goods
- Mixed Goods
- Merit Goods
- Club Goods

· Concept of public goods

What are public goods?

· Public goods are goods and services that are available to all members of society simultaneously and from which no one can be excluded — regardless of whether they contribute to the cost. They are typically provided by the government because private markets fail to supply them in adequate quantities due to the free-rider problem (people consume without paying).

· Indian example

· National defence provided by the Indian Army protects every citizen of India — whether they pay taxes or not, whether they live in Mumbai or a remote village. No one can be excluded from this protection, and one person's safety does not reduce another's.

· The free-rider problem

· Because no one can be excluded from consuming a public good, individuals have an incentive to not pay and still benefit — they "free-ride." This means private firms cannot recover costs and will not supply these goods, making government provision necessary.

· Indian example

· Street lighting in Indian cities — a person who has not paid any local municipal tax still benefits from the streetlight. The municipality (government) must fund it because no private firm can charge for it.

· 2. Characteristics of public goods

Non-rivalry

· One person's consumption does not reduce the amount available for others. The good is not "used up." Many people can enjoy it simultaneously without diminishing it.

· Indian example
· Doordarshan (DD National) broadcast — millions of viewers watch simultaneously. One household's viewing does not reduce signal availability for others.

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Non-excludability

· Once the good is provided, it is impossible (or impractical) to prevent anyone from using it — even those who have not paid for it.
· Indian example
· Flood control embankments along the Ganga river protect all residents in the flood-prone area — authorities cannot selectively protect only taxpayers.
· 3. Classification matrix — all types at a glance

Type of good	Non-rival	Non-excludable	Govt. provided?	Indian example
Pure public good	Yes	Yes	Always	National defence, street lights
Private good	No	No	Rarely	Bread, mobile phone, car
Mixed / quasi-public good	Partial	Partial	Often	Public hospitals, government schools
Merit good	Varies	Varies	Yes	Primary education, vaccines
Club good	Yes (within club)	No (excludable)	Sometimes	Toll highways, OTT platforms

4. Types of goods — detailed notes

· Pure public goods Non-rivalNon-excludable

· These are goods that are both perfectly non-rival and perfectly non-excludable. No one can be excluded from their benefits, and one person's consumption does not reduce availability for others. Because of the free-rider problem, only the government can efficiently provide them. They represent the "purest" form of market failure.
· Indian examples
· National defence: Indian Army, Navy, Air Force — protects all 140 crore citizens equally. Street lighting: Municipal streetlights on public roads. Lighthouse signals:

Warning signals for ships in Indian ports. Air quality: Clean air resulting from pollution-control policies benefits everyone.

Private goods & Rival Excludable

- Private goods are both rival (consumed by one person, unavailable to another) and excludable (sellers can prevent non-payers from accessing them). These are efficiently provided by private markets through the price mechanism. The government generally does not need to supply them, though it may regulate them.

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Indian examples

- Food items: A samosa bought from a Delhi street vendor — once eaten, it cannot be eaten by another. Medicines: A strip of paracetamol from a pharmacy is purchased and consumed individually. Smartphone: A Jio phone used by one person. Petrol: Fuel purchased at an IOCL pump — rival and excludable.
- Mixed goods (quasi-public goods)

Partially rival & Partially excludable

- Mixed goods have characteristics of both public and private goods. They may be non-excludable but become rival when congested (common pool resources), or they may be excludable but non-rival up to a point. Also called quasi-public goods, they are often jointly provided by the government and private sector.

Indian examples

- Government hospitals (AIIMS): Open to all citizens (non-excludable) but beds become rival when overcrowded. Public parks: Delhi's Lodhi Garden is free and open, but becomes crowded on weekends. Public roads: NH-48 (Delhi–Mumbai) — free to use but congested during peak hours. Common fisheries: Fish in a river — anyone can fish but stock depletes (tragedy of the commons).

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Merit goods (Under consumed privately & Positive externality)

- Merit goods are goods that society deems beneficial and that individuals tend to under consume when left to the market (due to lack of information or short-sighted preferences). The government intervenes by subsidising, mandating, or directly providing them to ensure adequate consumption. They generate positive externalities — benefits beyond the individual consumer.
- Indian examples
- Primary education: Right to Education Act (RTE) makes schooling free and compulsory — left to the market, poor families may not send children to school. Vaccines: Government's Universal Immunisation Programme provides free polio, BCG, and measles vaccines. Ayushman Bharat: Free health insurance for 10 crore poor families — individuals would otherwise underinsure. Mid-Day Meal Scheme: Free school lunches to improve nutrition and attendance.
- Club goods Non-rival (within club) Excludable
- Club goods (also called artificially scarce goods) are non-rival up to a certain capacity but are excludable — only paying members or those with access can consume them. Named after James Buchanan's "theory of clubs," they can be provided privately

because exclusion is possible. They become rival (congested) only when the club is overcrowded.

- Indian examples
- Toll highways (NHAI): Mumbai–Pune Expressway — non-rival until congested, but you pay a toll to enter (excludable). OTT platforms: Netflix/JioCinema subscription — only subscribers can access (excludable), but one person watching does not reduce availability for other subscribers (non-rival). Delhi Metro: Non-rival within seating capacity, but excludable via smart card/tokens. Golf clubs / gymkhana clubs: Delhi Gymkhana — membership-only access, non-rival within member limit.

Chapter 3:
Market Failure

Learning Objectives

After studying this chapter, you will be able to:

- Define market failure and explain its significance in economic theory
- Identify and analyse the four major causes of market failure
- Apply the concept of externalities to real-world Indian scenarios
- Understand how monopoly power leads to market inefficiency
- Explain information asymmetry with Indian examples such as healthcare and insurance
- Discuss the public goods problem and the role of government in India
- Evaluate the social and economic effects of market failure on Indian society

3.1 Meaning of Market Failure

In a perfectly competitive market, prices act as signals, resources flow to their most efficient uses, and society's welfare is maximised. This ideal scenario, described by economists as allocative efficiency, is central to the case for free markets. However, real-world markets frequently deviate from this ideal — and when they do, economists say that market failure has occurred.

Key Term	**Market Failure:** A situation in which the free-market mechanism fails to allocate resources efficiently, leading to a divergence between private and social costs and benefits, and resulting in a loss of economic welfare.

Market failure does not mean that markets collapse or stop functioning. Rather, it refers to a systematic tendency for markets to produce outcomes that are either allocatively inefficient — too much or too little of a good is produced — or distributionally unjust. In either case, government intervention is often justified to correct the failure and restore welfare.

Market failure is not a peripheral concern. In India — a vast, diverse, and rapidly developing economy — market failures pervade nearly every sector, from agriculture and healthcare to energy and urban infrastructure. The consequences are felt most acutely by the poor, who lack the resources to compensate for market shortfalls and who depend heavily on public goods and services.

Condition	Indian Example
Overproduction of harmful goods	*Coal power generation causing air pollution beyond socially optimal levels*
Underproduction of beneficial goods	*Rural healthcare services underprovided by private markets*
Monopoly pricing and output restriction	*Telecom sector before TRAI regulation and the Jio disruption*
Uninformed consumers	*Patients accepting unnecessary surgeries due to information asymmetry*
Non-provision of public goods	*Flood management infrastructure in Bihar and Assam*

3.2 Causes of Market Failure

Economists have identified four principal causes of market failure: externalities, monopoly power, information failure, and the public goods problem. Each arises from a different structural deficiency in the market mechanism, and each has distinctive policy implications. We examine each in detail below, with particular reference to the Indian context.

3.2.1 Externalities

An externality arises when the production or consumption of a good imposes costs or confers benefits on third parties who are not part of the transaction — and who receive no compensation for the costs or pay no price for the benefits they receive. Because these third-party effects are not reflected in the market price, the price mechanism fails to guide producers and consumers toward the socially optimal level of output.

Key Term	**Externality:** A cost or benefit experienced by a party not directly involved in an economic transaction. Externalities cause a divergence between private and social costs or benefits.

Negative Externalities

A negative externality (or external cost) occurs when the social cost of production or consumption exceeds the private cost. Classic examples include industrial pollution, passive

smoking, and traffic congestion. In each case, producers and consumers impose uncompensated costs on others, leading to overproduction relative to the social optimum.

Indian Case Study: Industrial Pollution in the Ganga River Basin

The Ganga — India's holiest river and primary water source for over 500 million people — has been severely degraded by industrial effluents from tanneries, textile mills, paper factories, and chemical plants, particularly in the states of Uttar Pradesh, Bihar, and West Bengal.

The tanneries of Kanpur, which produce leather goods worth billions of rupees annually, discharge chromium-laden wastewater directly into the river. The private cost of production — labour, raw materials, machinery — does not include the cost of water treatment or ecological restoration. The social cost, however, is enormous: contaminated drinking water, loss of fish stocks, rising incidence of waterborne diseases, and damage to religious and cultural heritage.

The divergence between private and social cost constitutes a classic negative externality. The Namami Gange Programme, launched by the Government of India in 2015 with an outlay of ₹20,000 crore, is an attempt to internalise these external costs through regulation and public investment in sewage treatment infrastructure.

Positive Externalities

A positive externality (or external benefit) occurs when the social benefit of production or consumption exceeds the private benefit. In such cases, goods tend to be underproduced or underconsumed relative to the social optimum, because private actors cannot capture the full value they generate for society.

Indian Case Study: Education and Skill Development

When an individual receives education, they obtain private benefits — higher wages, better career prospects, greater social mobility. However, society also benefits substantially: an educated population drives innovation, raises productivity, reduces crime, improves public health outcomes, and strengthens democratic institutions. These social benefits are not fully captured by the individual, making private investment in education fall below the socially desirable level.

In India, the positive externalities of education are particularly significant given the scale of the demographic dividend. The Sarva Shiksha Abhiyan (SSA) and its successor the

Samagra Shiksha scheme are government responses to this market failure — using public funding to bridge the gap between private and social returns to education.

Similarly, vaccination programmes generate massive positive externalities through herd immunity. India's Universal Immunisation Programme (UIP) — covering vaccines for diphtheria, tetanus, polio, measles, and other diseases — is justified precisely by the external benefits of immunisation, which private markets would severely underprovide.

3.2.2 Monopoly

A monopoly exists when a single firm dominates an entire market and faces no effective competition. In the absence of competitive pressure, monopolists have the power to restrict output below the competitive level and raise prices above competitive levels. The result is allocative inefficiency: consumers are charged more than the marginal cost of production, and some mutually beneficial transactions that would occur in a competitive market do not take place.

Key Term	**Monopoly:** A market structure in which a single seller dominates supply, faces no close substitutes or significant competitors, and thereby possesses the power to determine price and output independently of competitive forces.

Monopolies arise from several sources: natural monopoly (where average costs fall continuously with output, as in railways or water supply); legal monopoly (patents, licences); ownership of key resources; and anti-competitive practices such as predatory pricing and mergers.

India's post-independence economic history is replete with state-created monopolies — in steel, telecommunications, aviation, banking, insurance, and heavy industry — justified under the socialist framework of the Nehruvian era. While some of these monopolies served developmental objectives, many became bywords for inefficiency, corruption, and consumer exploitation.

Indian Case Study: The Telecommunications Sector and the Jio Disruption

Until the early 2000s, the Department of Telecommunications (DoT) held a monopoly over basic telephony in India. Even after liberalisation, the sector remained oligopolistic, with Airtel, Vodafone, and Idea charging high tariffs for voice and data services that were inaccessible to the majority of Indians.

The entry of Reliance Jio in September 2016 transformed the market. By offering free voice calls and steeply subsidised data services — as low as ₹1 per GB compared to the industry average of ₹250 per GB — Jio triggered a price war that drove tariffs down by over 95 per cent within two years. Data consumption in India grew from 200 million GB per month in 2016 to over 10,000 million GB per month by 2019.

This case illustrates both the deadweight loss of monopoly power — reflected in the vast number of Indians who were priced out of digital access — and the transformative potential of competition. It also raises concerns about the dangers of a new monopoly: Jio's aggressive pricing eventually drove several competitors into bankruptcy or merger, potentially reconcentrating market power.

3.2.3 Information Failure

The price mechanism functions efficiently only when buyers and sellers are well informed about the qualities, risks, and true costs of the goods and services they trade. When information is incomplete, inaccurate, or asymmetrically distributed between parties, markets produce outcomes that diverge from the social optimum. This phenomenon is known as information failure.

Key Term	**Information Failure:** A situation in which market participants lack the information necessary to make optimal decisions, or in which one party to a transaction has more information than the other (information asymmetry), leading to market inefficiency.

The seminal analysis of information failure was provided by economist George Akerlof in his 1970 paper 'The Market for Lemons', which showed how information asymmetry in the used car market could cause high-quality goods to be driven out by low-quality ones — a phenomenon known as adverse selection. Subsequent work by Michael Spence (on signalling) and Joseph Stiglitz (on screening) elaborated the mechanisms through which information failures distort market behaviour. All three were awarded the Nobel Prize in Economics in 2001.

Adverse Selection

Adverse selection occurs when asymmetric information before a transaction leads to the selection of undesirable counterparties. In insurance markets, for example, those who know they are high-risk are more likely to purchase insurance, while those who are low-risk opt out — leading to a pool of insured individuals that is riskier than the population average, driving up premiums and potentially causing market collapse.

Indian Case Study: Health Insurance and Adverse Selection

India's health insurance market, despite rapid expansion under the Pradhan Mantri Jan Arogya Yojana (PM-JAY) and Ayushman Bharat, continues to be distorted by information asymmetry. Private health insurers face significant adverse selection: individuals with pre-existing conditions — who are more likely to make claims — are disproportionately inclined to purchase insurance, while healthy individuals, who perceive less need, are less likely to enrol.

As a result, private insurers respond by charging high premiums, excluding pre-existing conditions, and engaging in stringent underwriting — practices that price out lower-income and higher-risk individuals, who arguably have the greatest need for coverage. This is a textbook case of market failure: the free market produces too little health insurance at prices that are too high, relative to the social optimum.

PM-JAY attempts to correct this failure through compulsory enrolment of below-poverty-line families, government premium subsidies, and risk pooling across a large population — effectively mandating participation to prevent adverse selection.

Moral Hazard

Moral hazard occurs when information asymmetry after a transaction — once a contract is entered into — leads one party to behave in a riskier manner because they do not bear the full consequences of their actions. In insurance, for example, insured individuals may take fewer precautions against the insured risk, knowing that losses will be covered.

Indian Case Study: Agricultural Credit and Moral Hazard

India's priority sector lending norms require banks to allocate a prescribed share of their credit to agriculture. A persistent problem in agricultural lending has been moral hazard arising from loan waiver programmes: when state governments announce blanket agricultural debt relief — as occurred in Maharashtra in 2017, Uttar Pradesh in 2017, and Karnataka in 2018 — the expectation of future waivers reduces the incentive for farmers to repay existing loans.

This creates a cycle of wilful default, deteriorating credit culture, and bank NPAs (Non-Performing Assets). While loan waivers may be justified on grounds of rural distress and equity, their unintended consequence is a market failure stemming from the moral hazard they generate. The Reserve Bank of India has repeatedly cautioned against loan waivers for precisely this reason.

3.2.4 The Public Goods Problem

Not all goods and services can be efficiently supplied by private markets. Public goods — goods characterised by non-rivalry and non-excludability — cannot be profitably provided by the market, because firms cannot prevent non-paying consumers from benefiting (the free-rider problem). As a result, private markets either underprovide or entirely fail to provide such goods, necessitating government intervention.

Key Term	**Public Good:** A good that is both non-rival (consumption by one person does not reduce availability for others) and non-excludable (it is impossible or impractical to prevent non-payers from consuming it). Classic examples include national defence, lighthouses, and public broadcast weather forecasts.

Type of Good	Rival?	Excludable?
Pure Public Good	No	No — National defence, street lighting
Private Good	Yes	Yes — Food, clothing, smartphones
Club Good	No	Yes — Toll roads, streaming services
Common Resource	Yes	No — Fish in the ocean, groundwater

Table 3.2: Classification of Goods by Rivalry and Excludability

The Free-Rider Problem

The defining challenge of public goods provision is the free-rider problem. Because non-payers cannot be excluded from consuming the good once it is provided, rational consumers have an incentive to conceal their true preferences and allow others to pay — 'free-riding' on their contributions. If everyone reasons this way, the good is severely underprovided or not provided at all, even though everyone would benefit from its provision.

Indian Case Study: Flood Control and Disaster Management Infrastructure

Flood control — through embankments, reservoirs, early warning systems, and drainage networks — is a classic public good. Once a flood barrier is built, all residents in the protected area benefit, regardless of whether they contributed to its construction. No private firm can profitably exclude non-payers from the protection it confers.

Consequently, flood management infrastructure is severely underprovided by the market. In India, this has catastrophic consequences. The Brahmaputra valley in Assam and the Kosi basin in Bihar experience devastating floods almost annually, partly because decades of underinvestment in protective infrastructure have left millions of rural poor exposed to climatic risk.

The National Disaster Management Authority (NDMA) and the National Flood Control Programme represent government attempts to correct this market failure — providing flood management infrastructure as a public good, funded through general taxation.

Indian Case Study: Street Lighting in Urban and Rural India

Street lighting is a textbook example of a public good: it is non-rival (one person's use of the illumination does not diminish its availability to others) and non-excludable (it is impractical to prevent anyone walking down a lit street from benefiting from the light).

Private markets would underprovide street lighting because providers cannot charge users. The government therefore funds street lighting through local taxes and municipal budgets. Under the UJALA scheme and Street Light National Programme (SLNP), India has replaced over 1.3 crore conventional street lights with energy-efficient LEDs, reducing energy consumption by over 9 billion units per year — demonstrating that effective public provision can also be economically and environmentally efficient.

3.3 Effects of Market Failure on Society

Market failure is not merely an abstract theoretical concept — its consequences are profoundly material, shaping the life chances of hundreds of millions of Indians. The effects of market failure permeate income distribution, health, education, the environment, and social cohesion. Below, we examine the principal social consequences of market failure in the Indian context.

3.3.1 Allocative Inefficiency and Welfare Loss

At its most fundamental, market failure produces allocative inefficiency: resources are misallocated, and the economy produces too much of some goods and too little of others relative to the social optimum. This generates a deadweight welfare loss — a reduction in the total surplus available to society — that represents the direct cost of the market failure.

In India, allocative inefficiency stemming from market failure is particularly apparent in the energy sector. The underpricing of fossil fuels — historically subsidised through the administered pricing mechanism — led to overconsumption of coal and petroleum, excessive carbon emissions, and underinvestment in renewable energy. The gradual deregulation of petroleum prices since 2010, and the extension of production-linked incentives for solar and wind energy, represent efforts to correct this misallocation.

3.3.2 Environmental Degradation

Negative externalities are the primary mechanism through which market failure drives environmental degradation. When firms and consumers do not bear the full social cost of pollution, they produce and consume beyond the socially optimal level, depleting natural resources and degrading the environment. India's environmental challenges — ranked as one of the world's most polluted countries by the *Environmental Performance Index* — are substantially attributable to market failure.

Delhi's air quality crisis exemplifies the social cost of unaddressed externalities. Vehicle emissions, construction dust, stubble burning by farmers in Haryana and Punjab, and industrial pollution combine to produce dangerous levels of particulate matter (PM2.5 and PM10) during winter months. The health costs — measured in premature deaths, hospital admissions, and lost productivity — are borne disproportionately by the urban poor, who cannot afford air purifiers, better housing, or private healthcare.

The National Clean Air Programme (NCAP), targeting a 40 per cent reduction in particulate matter by 2026, and the Bharat Stage VI emissions norms (introduced in 2020) represent regulatory responses to these externalities — attempting to force polluters to internalise the social costs they impose.

3.3.3 Inequality and Social Exclusion

Market failure frequently exacerbates inequality. Public goods, once underprovided, affect the poor more severely — the wealthy can purchase substitutes (private security, bottled water, generators, private schools), while the poor cannot. Information failures disadvantage the less educated and the less connected, who are more vulnerable to fraud, predatory lending, and exploitation.

The underproduction of healthcare — a good with strong positive externalities and significant information asymmetry — exemplifies this mechanism. India's public health expenditure, at approximately 2.1 per cent of GDP, is among the lowest in the world. Private healthcare, while growing rapidly, is largely unaffordable for the bottom 60 per cent of the income distribution. The result is that millions of poor Indians forego necessary treatment, accumulate catastrophic medical debt, or rely on quacks and informal practitioners — perpetuating cycles of illness, impoverishment, and social exclusion.

3.3.4 Underinvestment in Human Capital

Because education and healthcare generate positive externalities, private markets tend to invest less in these areas than is socially desirable. The consequences for long-run economic development are severe: a less healthy, less educated workforce is less productive, less innovative, and less adaptable to technological change.

India's demographic dividend — the potential economic benefit from a large, young working-age population — can only be realised if this cohort is adequately educated and healthy. Market failure in education (private underprovision in rural and tribal areas, low quality of primary schooling) and healthcare (high out-of-pocket expenditure, low immunisation coverage in remote areas) threatens to squander this dividend. Correcting these market failures through public investment is therefore not merely a matter of equity but of macroeconomic imperative.

3.3.5 Monopoly and Consumer Exploitation

Where markets are dominated by monopolies or cartels, consumers face higher prices, lower quality, and reduced choice. The welfare transfer from consumers to producers represents not only an equity concern but, to the extent that it generates deadweight loss, a net reduction in social welfare.

India's pharmaceutical sector provides a poignant illustration. Essential medicines — for tuberculosis, diabetes, hypertension, cancer — are frequently patented by multinational corporations, who charge prices far beyond the means of the average Indian patient. The government's use of compulsory licensing under Section 84 of the Patents Act — most famously for the cancer drug Sorafenib (Nexavar) in 2012 — and the maintenance of the National List of Essential Medicines (NLEM) with price controls represent policy responses to monopoly-driven market failure in a sector where access to affordable medicine is a matter of life and death.

3.3.6 Macroeconomic Instability

At the aggregate level, pervasive market failures can contribute to macroeconomic instability. Information failures in financial markets — of the kind that precipitated the global financial crisis of 2008 — can amplify business cycle fluctuations and trigger financial crises. The accumulation of non-performing assets (NPAs) in India's banking sector, partly attributable to moral hazard in corporate lending and regulatory failure, represents a market failure with significant macroeconomic consequences: credit contraction, reduced investment, slower growth, and diminished public finances.

CHAPTER SUMMARY

- Market failure occurs when the free-market mechanism fails to allocate resources efficiently, diverging from the social optimum.
- The four principal causes of market failure are: (i) externalities, (ii) monopoly, (iii) information failure, and (iv) the public goods problem.
- Negative externalities (e.g. industrial pollution of the Ganga) lead to overproduction; positive externalities (e.g. education, vaccination) lead to underproduction.
- Monopoly power restricts output and raises prices, causing deadweight welfare loss — as seen in India's pre-liberalisation telecom and pharmaceutical sectors.
- Information failure — including adverse selection (health insurance) and moral hazard (agricultural lending) — distorts market outcomes.
- Public goods, characterised by non-rivalry and non-excludability, are underprovided by markets due to the free-rider problem; government provision is necessary.
- The social effects of market failure in India include environmental degradation, inequality, underinvestment in human capital, consumer exploitation, and macroeconomic instability.

Review Questions

Section A: Short Answer Questions

- Define market failure. How does it differ from a market that fails to exist?
- Distinguish between a negative externality and a positive externality. Give one Indian example of each.
- Explain the concept of deadweight loss with reference to monopoly pricing.
- What is meant by information asymmetry? Briefly explain adverse selection and moral hazard.
- Why does the free-rider problem prevent the private provision of public goods?

Section B: Application and Analysis

- Using the concept of externalities, analyse the economic justification for India's National Clean Air Programme.
- Discuss how information failure affects India's agricultural credit markets. What policy measures could be used to reduce moral hazard in this context?
- With reference to the Jio case study, evaluate the argument that market competition is more effective than government regulation in correcting monopoly market failure.
- To what extent is the free-rider problem the most serious consequence of public goods being non-excludable? Use Indian examples to support your answer.
- Assess the social consequences of market failure in healthcare for income inequality in India.

Chapter 4:
Government Intervention in the Economy

- Need for Government Intervention
- Methods of Government Intervention
  - Taxation
  - Subsidies
  - Price Control
  - Public Expenditure
  - Regulations
- Role of Government in Correcting Market Failure

Learning Objectives

After studying this chapter, you will be able to:

- Explain why government intervention in a market economy is necessary
- Identify and evaluate the principal instruments of government intervention
- Analyse the use of taxation — including Pigouvian taxes and the GST — to correct market failure
- Examine how subsidies are deployed in India's agricultural and social sectors
- Evaluate price control policies including the Minimum Support Price and drug price caps
- Discuss the role of public expenditure in providing merit goods and public goods
- Assess regulatory frameworks in India's telecom, banking, and environmental sectors

Critically evaluate the effectiveness of government intervention in correcting market failures

4.1 The Need for Government Intervention

The classical liberal tradition, from Adam Smith to Friedrich Hayek, holds that free markets — guided by the price mechanism — allocate resources efficiently without the need for central direction. Smith's metaphor of the 'invisible hand' suggests that individuals pursuing their own self-interest inadvertently promote the welfare of society as a whole. On this view, government intervention is not merely unnecessary but positively harmful, creating distortions that reduce welfare below the free-market level.

Yet modern economics — and the lived experience of rapidly developing economies like India — has demonstrated that the conditions required for the invisible hand to operate efficiently are frequently absent. Market failures, as discussed in Chapter 4, are endemic to real economies. When markets fail, the case for government intervention becomes compelling — not to replace the market, but to correct its failures and supplement its limitations.

Key Term	**Government Intervention:** The actions taken by the state to influence the allocation of resources, correct market failures, redistribute income, stabilise the macroeconomy, and promote long-run economic development.

4.1.1 Economic Justifications for Intervention

Economists identify several distinct grounds on which government intervention in a market economy is justified:

- Correcting externalities: Where private costs and benefits diverge from social costs and benefits, the price mechanism misallocates resources. Government can use taxes, subsidies, and regulations to align private incentives with social welfare.
- Providing public goods: Goods that are non-rival and non-excludable will be underprovided by private markets due to the free-rider problem. The state must step in as provider or funder.
- Addressing information failures: Where information is asymmetric or incomplete, markets produce inefficient outcomes. Regulation, disclosure requirements, and consumer protection legislation can mitigate information failures.
- Regulating monopoly power: Where natural or artificial monopolies restrict output and raise prices above competitive levels, government regulation or public ownership can restore efficiency.
- Redistributing income: Even efficient markets may produce distributions of income that are widely regarded as inequitable. Progressive taxation and social transfers can redistribute toward greater fairness.
- Providing merit goods: Some goods — education, healthcare, housing — are held to be so beneficial that society should ensure their provision regardless of ability to pay. Government provides or subsidises such goods.
- Macroeconomic stabilisation: Fiscal and monetary policy are deployed to manage aggregate demand, control inflation, and reduce unemployment — objectives that free markets cannot achieve on their own.

The Indian Context: Why Government Intervention Has Special Salience

In India, the case for government intervention is reinforced by structural features of the economy that amplify the extent and consequences of market failure. These include:

- A large informal sector (employing over 80 per cent of the workforce) where market information is poor and contracts are weakly enforced
- Extreme income inequality — India's Gini coefficient of approximately 0.35 masks sharp regional and caste-based disparities
- Widespread poverty, which limits effective demand and prevents poor households from signalling their preferences through the market
- Underdeveloped financial markets, particularly in rural areas, limiting private investment in agriculture and small enterprise
- Significant environmental externalities stemming from rapid industrialisation and urbanisation
- A constitutional commitment, expressed in the Directive Principles of State Policy (Articles 36–51), to use state power to achieve economic justice

4.2 Methods of Government Intervention

Governments have at their disposal a range of instruments for intervening in the economy. Each instrument operates through a different mechanism, carries different costs and benefits, and is suited to addressing different types of market failure. In this section, we examine five principal methods: taxation, subsidies, price control, public expenditure, and regulation.

4.2.1 Taxation

Taxation is the compulsory levy imposed by the state on individuals, households, and firms. It is the most versatile instrument of government intervention, serving simultaneously as a revenue-raising mechanism, a tool for correcting externalities, a means of redistribution, and an instrument of macroeconomic management.

Key Term	**Pigouvian Tax:** A tax levied on a good or activity that generates negative externalities, set equal to the marginal external cost at the socially optimal level of output, so as to make the producer internalise the social cost of their activity. Named after the British economist Arthur Pigou.

The Theory of Corrective Taxation

When a firm or consumer generates a negative externality, the private cost of their activity is lower than the social cost. This causes overproduction relative to the social optimum. A Pigouvian tax — set equal to the marginal external cost — raises the private cost to equal the social cost, shifting the supply curve upward and reducing output to the socially efficient level. The tax does not merely raise revenue; it changes behaviour by making the generator of the externality internalise the cost they impose on society.

Indian Case Study: The Goods and Services Tax (GST) and Sin Taxes

India's landmark Goods and Services Tax, introduced in July 2017, unified a fragmented indirect tax system of central and state levies into a single, destination-based value-added tax. Beyond its revenue and simplification objectives, the GST incorporates a corrective taxation logic through its tiered rate structure:

- Essential goods (cereals, fresh vegetables, medicines): 0% — reflecting positive externalities and merit good characteristics
- Standard goods and services: 12% and 18%
- Luxury and demerit goods (tobacco, aerated drinks, luxury cars, casinos): 28% + cess — reflecting the logic of Pigouvian taxation

Tobacco products attract a total effective rate of over 50 per cent under the GST, justified by the enormous negative externalities of smoking: premature death, passive smoking, healthcare costs, and lost productivity. The cess on tobacco generates approximately ₹35,000 crore annually, part of which funds the National Health Mission.

Similarly, the National Calamity Contingent Duty (NCCD) on coal — a fossil fuel generating massive carbon and particulate externalities — applies an additional levy designed to discourage consumption and fund clean energy alternatives.

Direct Taxation and Redistribution

India's income tax system is progressive: individuals with higher incomes pay a higher marginal rate, ranging from nil for incomes below ₹3 lakh to 30 per cent for incomes above ₹15 lakh. The surcharge for ultra-high earners (incomes above ₹5 crore) effectively raises the marginal rate to 42.74 per cent — among the highest in the world. This progressive structure is justified on equity grounds and as a mechanism for redistribution from high-income to low-income households through public expenditure.

Corporate taxation — at a standard rate of 22 per cent for domestic companies — is a further tool. The reduced rate of 15 per cent for new manufacturing companies, introduced in 2019 to stimulate the Production-Linked Incentive (PLI) schemes, illustrates how tax policy can be

used not merely to raise revenue but to direct private investment toward sectors deemed strategically important.

Type of Tax	Indian Example	Market Failure Addressed	Mechanism
Pigouvian (sin) tax	GST cess on tobacco and liquor	Negative externality (health)	Raises private cost to social cost
Carbon / energy tax	NCCD on coal	Environmental externality	Discourages fossil fuel consumption
Progressive income tax	30% on incomes above ₹15 lakh	Income inequality	Redistribution via public spending
Import tariff	Customs duty on solar panels	Infant industry / strategic	Protects domestic industry
Capital gains tax	Securities Transaction Tax (STT)	Financial speculation	Reduces excess trading

Table 4.1: Types of Taxation and Their Role in Correcting Market Failure in India

Limitations of Taxation as an Intervention Tool

Despite its theoretical elegance, corrective taxation faces significant practical challenges in the Indian context:

- Difficulty of measurement: Estimating the precise marginal external cost of an activity — necessary to set the optimal Pigouvian tax rate — is technically demanding and politically contested.
- Tax evasion and informality: With over 80 per cent of India's workforce in the informal sector, large segments of economic activity lie outside the tax net. Evasion through cash transactions, under-reporting, and hawala channels reduces the efficacy of tax-based interventions.
- Regressive incidence: Indirect taxes on demerit goods, while correcting externalities, may impose a proportionately heavier burden on lower-income households who spend a larger share of their income on such goods — raising equity concerns.
- Political resistance: Tax increases on politically sensitive commodities (petrol, diesel, agricultural inputs) face resistance from affected interest groups, limiting the government's ability to set taxes at the theoretically optimal level.

4.2.2 Subsidies

A subsidy is a payment made by the government to producers or consumers to encourage the production or consumption of a good or service. Subsidies are the mirror image of corrective taxes: where taxes are used to internalise negative externalities and reduce overproduction, subsidies are used to internalise positive externalities and correct underproduction.

Key Term	**Subsidy:** A financial grant or tax concession provided by the government to reduce the cost of production for firms or the price paid by consumers, with the objective of increasing the output or consumption of a good whose social benefit exceeds its private benefit.

Economic Rationale for Subsidies

When a good generates positive externalities, the social benefit of its production exceeds the private benefit received by the producer. Consequently, the market produces less than the socially optimal quantity. A production subsidy lowers the producer's cost, shifting the supply curve rightward and increasing output toward the social optimum. A consumption subsidy reduces the price paid by consumers, increasing demand and consumption.

Indian Case Study: Agricultural Subsidies and the PDS

India operates one of the world's largest agricultural subsidy systems, encompassing:

1. Fertiliser subsidies: The government subsidises urea, phosphatic, and potassic (P&K) fertilisers to reduce input costs for farmers. The fertiliser subsidy bill for 2023-24 exceeded ₹1.75 lakh crore — approximately 0.6 per cent of GDP. The economic rationale combines positive externalities (food security is a public good), equity (small farmers cannot afford unsubsidised fertiliser), and the strategic importance of agricultural self-sufficiency.

2. Minimum Support Price (MSP): While technically a price floor (discussed in Section 5.2.3), the MSP functions as an implicit subsidy to farmers by guaranteeing a price above the market-clearing level for designated crops.

3. The Public Distribution System (PDS): Under the National Food Security Act 2013, approximately 81 crore beneficiaries receive heavily subsidised foodgrains — rice at ₹3/kg and wheat at ₹2/kg — through a network of 5.5 lakh Fair Price Shops. The food subsidy in 2023-24 stood at approximately ₹2.12 lakh crore. The economic justification rests on the positive externalities of nutrition (better health, higher productivity, lower crime) and the merit good character of food.

Critics argue that India's agricultural subsidies are poorly targeted, distort cropping patterns toward water-intensive crops (paddy in Punjab and Haryana), and have contributed to soil degradation, groundwater depletion, and fiscal stress. The PM-KISAN scheme — a direct income transfer of ₹6,000 per year to eligible farmers — represents a shift toward better-targeted support.

Indian Case Study: Renewable Energy Subsidies and the Jawaharlal Nehru National Solar Mission

The shift from fossil fuels to renewable energy requires government subsidy because renewable energy generates large positive externalities (reduced air pollution, lower carbon emissions, energy security) that private investors cannot capture. India's solar energy sector has been transformed by a combination of:

- Production-Linked Incentives (PLI) for solar photovoltaic module manufacturing
- Viability Gap Funding (VGF) for solar and wind projects
- Concessional loans from the Indian Renewable Energy Development Agency (IREDA)
- Accelerated depreciation benefits for renewable energy assets

As a result of these subsidy-driven interventions, India's solar power capacity grew from a negligible 2.6 GW in 2014 to over 85 GW by 2024, and the cost of solar electricity fell from ₹12/unit to below ₹2/unit in competitive auctions. This illustrates how well-designed subsidies can correct positive externality failures and drive structural transformation.

Limitations of Subsidies

- Fiscal cost: Subsidies impose a direct burden on the government budget. India's combined subsidy bill (food, fertiliser, fuel, and others) has at times exceeded 3 per cent of GDP, contributing to fiscal deficits.
- Leakage and targeting failures: A disproportionate share of subsidies in India has historically benefited the non-poor. The Planning Commission estimated that for every rupee of food subsidy, only 27 paise reached the intended beneficiary — the rest was absorbed by administrative costs, pilferage, and diversions.
- Market distortions: Input subsidies can distort production decisions, encouraging farmers to use excessive fertiliser or water. Fuel subsidies discourage energy efficiency and renewable adoption.
- Subsidy dependency: Prolonged subsidisation can reduce the incentive for firms and farmers to innovate or improve productivity, creating dependency rather than development.

4.2.3 Price Control

Price controls are government-imposed legal limits on the prices that can be charged for goods and services. They take two forms: price ceilings (maximum prices, set below the equilibrium) and price floors (minimum prices, set above the equilibrium). Both represent direct interventions in the price mechanism and can cause significant allocative distortions if not carefully designed.

Key Term	**Price Ceiling:** A legal maximum price set below the free-market equilibrium, intended to keep a good affordable. Results in excess demand (shortage) if binding. Examples: rent control, essential drug price caps.

Key Term	**Price Floor:** A legal minimum price set above the free-market equilibrium, intended to protect producers' incomes. Results in excess supply (surplus) if binding. Examples: minimum wage, agricultural support prices.

Price Ceilings in India: Drug Price Regulation

Indian Case Study: The Drug Price Control Order (DPCO) and NPPA

Pharmaceuticals are characterised by monopoly power (patent protection), information failure (patients cannot evaluate drug quality), and positive externalities (public health benefits of treatment). These market failures justify price regulation.

India's National Pharmaceutical Pricing Authority (NPPA), established in 1997, regulates drug prices under the Drug Price Control Order (DPCO). The DPCO 2013 extended price control to all medicines on the National List of Essential Medicines (NLEM) — covering over 800 formulations. The ceiling price for each drug is calculated as the simple average of prices of all brands with at least 1 per cent market share, plus a margin.

The policy has had tangible outcomes: the average price of anti-tuberculosis drugs fell by 50–60 per cent following price caps, and the ceiling on coronary stents (introduced in 2017) reduced stent prices from ₹45,000–₹1,00,000 to ₹7,260 for bare metal stents and ₹29,600 for drug-eluting stents.

However, the DPCO has also generated unintended consequences. Manufacturers have responded by withdrawing price-controlled formulations from the market, reformulating drugs to create new combinations outside the NLEM, or compromising on quality. This

illustrates the classic tension between access and availability in pharmaceutical price regulation.

Price Floors in India: The Minimum Support Price (MSP)

Indian Case Study: The Minimum Support Price System

The Minimum Support Price (MSP) — announced annually by the government on the recommendation of the Commission for Agricultural Costs and Prices (CACP) — is a price floor for 23 major agricultural commodities including rice, wheat, pulses, and oilseeds.

The economic rationale for the MSP rests on several grounds: farm income support, food security (incentivising production of strategic crops), reducing agricultural price volatility, and correcting the monopsony power of large traders and middlemen who would otherwise depress farm-gate prices below competitive levels.

The MSP creates a price floor effect: when market prices fall below the MSP, the government (through agencies such as the Food Corporation of India and NAFED) procures the crop at the support price, preventing farm income from collapsing. However, because not all crops are procured at all locations, the effective coverage of the MSP remains limited — an estimated 6–8 per cent of farmers benefit substantially from MSP operations.

The three contentious farm laws proposed in 2020 — subsequently repealed following sustained farmer protests — illustrate the political sensitivity of MSP policy. The fear that private market entry would undermine MSP protections mobilised millions of farmers in what became one of India's largest sustained protests.

Price Control Type	Indian Example	Objective	Key Risk
Price ceiling	Drug price caps (DPCO)	Affordability of essential medicines	Product withdrawal, quality reduction
Price ceiling	Rent control in Mumbai	Housing affordability	Reduced rental supply, housing deterioration

Price floor	MSP for wheat and rice	Farm income support, food security	Excess procurement, fiscal cost, distorted cropping
Price floor	Minimum wage (floor wage)	Worker welfare, reduce exploitation	Possible unemployment in covered sectors

Table 4.2: Price Control Instruments in India — Types, Examples, and Risks

4.2.4 Public Expenditure

Public expenditure — the spending of government funds on goods, services, and transfers — is the most direct form of market intervention. By funding the provision of public goods, merit goods, and infrastructure, the state can overcome the market failures that lead to underprovision of these socially critical outputs.

Key Term	**Merit Good:** A good or service whose social benefit is deemed to exceed the private benefit perceived by consumers, leading to underconsumption in the free market. Governments provide or subsidise merit goods — such as education, healthcare, and public housing — to ensure socially adequate consumption.

Capital Expenditure and Infrastructure

Infrastructure — roads, railways, ports, irrigation systems, electricity grids — generates large positive externalities by reducing transaction costs, improving market integration, and enabling private investment. Because infrastructure is often non-excludable and has high upfront costs relative to the willingness of private investors to pay, public capital expenditure is essential.

Indian Case Study: PM Gati Shakti and National Infrastructure Pipeline

India's National Infrastructure Pipeline (NIP), launched in 2019, envisions public and private investment of ₹111 lakh crore in infrastructure over 2019–2025. The PM Gati Shakti National Master Plan, introduced in 2021, provides a unified digital platform for multi-modal infrastructure planning — integrating road, rail, aviation, waterways, and logistics to eliminate bottlenecks and reduce logistics costs.

The economic rationale is compelling: India's logistics costs are estimated at 13–14 per cent of GDP, compared to 8 per cent in developed economies. This gap — largely

attributable to inadequate infrastructure — imposes a hidden tax on every producer and consumer in the economy, reducing competitiveness and suppressing growth.

Capital expenditure by the Union Government rose from ₹4.4 lakh crore in 2021–22 to ₹11.1 lakh crore in 2024–25 — a threefold increase in three years — reflecting a deliberate shift toward growth-enabling public investment as a cornerstone of economic policy. The multiplier effect of capital expenditure — estimated at 2.45 in the Indian context — suggests that each rupee of infrastructure spending generates ₹2.45 of additional economic output.

Social Expenditure and Merit Goods

Public expenditure on education, healthcare, and social protection corrects the underprovision of merit goods and reduces the inequality generated by market failure.

Indian Case Study: Ayushman Bharat — Pradhan Mantri Jan Arogya Yojana (PM-JAY)

PM-JAY, launched in September 2018, is the world's largest government-funded health assurance scheme. It provides health coverage of ₹5 lakh per family per year to approximately 50 crore beneficiaries — the bottom 40 per cent of India's population — for secondary and tertiary care hospitalisation.

The scheme addresses three interlocking market failures:

- Positive externality: Healthcare generates public health benefits (reduced disease transmission, herd immunity) beyond those captured by the individual patient
- Information failure: Patients cannot assess the quality or necessity of medical interventions, making them vulnerable to provider-induced demand
- Distributional failure: Catastrophic health expenditure is the leading cause of poverty impoverishment in India, affecting approximately 5.5 crore people annually

By 2024, PM-JAY had facilitated over 7 crore hospitalisations, protecting millions of poor households from financial ruin. The scheme exemplifies how targeted public expenditure on merit goods can simultaneously correct market failure and reduce inequality.

4.2.5 Regulation

Regulation refers to rules, standards, and requirements imposed by the government on the behaviour of firms and individuals, enforced through legal penalties. Unlike taxation and subsidies, which operate by altering price incentives, regulation mandates or prohibits specific behaviours directly. Regulation is particularly suited to addressing market failures where the costs of adjustment are hard to calculate in monetary terms, where minimum standards must be assured, or where rapid behavioural change is required.

Key Term	**Regulation:** Government-imposed rules that constrain or mandate the behaviour of economic actors, enforced through legal sanctions. Regulations may set minimum standards (safety, quality), prohibit harmful activities (pollution, anti-competitive behaviour), or require disclosure (financial reporting, product labelling).

Economic Regulation: Competition and Natural Monopoly

Indian Case Study: TRAI and the Regulation of Telecom

The Telecom Regulatory Authority of India (TRAI), established in 1997, was created to regulate a sector characterised by natural monopoly tendencies (high fixed infrastructure costs create barriers to entry), network effects (the value of a network increases with the number of users), and the potential for dominant firms to abuse market power.

TRAI's regulatory functions include setting interconnection charges, monitoring service quality, issuing licences, and adjudicating disputes between operators and consumers. Its interventions have progressively opened the sector to competition — from the duopoly of the 1990s to the current (post-Jio) three-player market.

The sector illustrates both the achievements and limitations of economic regulation. TRAI's role in facilitating competition drove down call and data tariffs dramatically, extending connectivity to over 100 crore subscribers. However, the collapse of several operators following the Jio price war raises concerns about the long-run sustainability of hyper-competition and the risk of market reconcentration.

Social Regulation: Environmental and Safety Standards

Indian Case Study: The Environment Protection Act and Bharat Stage Emission Norms

Environmental regulation addresses the most pervasive negative externality in the Indian economy — industrial and vehicular pollution. The Environment Protection Act 1986, administered by the Central Pollution Control Board (CPCB) and State Pollution Control Boards (SPCBs), sets standards for air and water quality, mandates environmental impact assessments, and empowers the government to prohibit or restrict polluting activities.

India's Bharat Stage (BS) emission norms — analogous to European Euro norms — regulate the permissible level of pollutants from motor vehicles. India made the leap from

BS-IV to BS-VI norms in a single step in April 2020 (skipping BS-V), reducing sulphur content in fuels by 80 per cent and mandating particle filters on diesel vehicles. The transition was made possible by requiring oil companies to supply BS-VI fuel across the country simultaneously.

The regulation imposes compliance costs on vehicle manufacturers and consumers (BS-VI vehicles are more expensive) but internalises the enormous social costs of vehicular pollution — estimated at ₹600,000 crore annually in health and productivity losses by the National Clean Air Programme.

Indian Case Study: SEBI and Financial Market Regulation

Financial markets are characterised by severe information asymmetry (insider trading, accounting fraud), systemic risk (the failure of one institution threatening others), and the potential for speculative bubbles. The Securities and Exchange Board of India (SEBI), established in 1992, regulates India's capital markets — setting disclosure standards, prohibiting insider trading, overseeing mutual funds and brokers, and taking enforcement action against market manipulation.

SEBI's reforms have transformed India's capital markets from an opaque, manipulation-prone system into one of the most technologically advanced and (by emerging market standards) well-regulated exchanges in the world. The introduction of T+1 settlement in 2023 — completing equity trades within one business day — exemplifies SEBI's use of regulation to reduce counterparty risk and improve market efficiency.

The failure to prevent the Harshad Mehta securities scam (1992) and the Satyam accounting fraud (2009) illustrates the limits of regulation and the importance of adaptive regulatory capacity.

4.3 The Role of Government in Correcting Market Failure

Having examined the individual instruments of intervention, we now consider how these instruments are combined to address specific types of market failure — and how the effectiveness of intervention should be evaluated.

4.3.1 Correcting Externalities

The optimal policy response to externalities depends on their nature, severity, and the costs of different interventions. The Pigouvian framework recommends corrective taxes for negative externalities and corrective subsidies for positive externalities. However, regulation may be preferred where the externality is severe and the optimal level of harmful activity is zero (as

with some toxic pollutants), or where monitoring and enforcement make price-based approaches impractical.

Market Failure	Primary Instrument	Secondary Instrument	Indian Example
Negative externality (pollution)	Pigouvian tax / cess	Environmental regulation (standards)	Coal cess + BS-VI norms
Positive externality (education)	Subsidy / public provision	Regulation (compulsory schooling)	RTE Act + Samagra Shiksha
Positive externality (healthcare)	Public expenditure	Regulation (licensing, standards)	PM-JAY + MCI norms
Monopoly power	Economic regulation	Competition law (CCI)	TRAI telecom regulation
Information failure	Disclosure regulation	Consumer protection law	SEBI + Consumer Protection Act
Public goods	Direct public provision	Public expenditure	NDMA flood management

Table 4.3: Matching Government Instruments to Types of Market Failure in India

4.3.2 Government Failure: The Limits of Intervention

Intervention is not automatically welfare-enhancing. Government failure — the tendency for state intervention to reduce rather than increase welfare — is a real and important phenomenon. Just as markets can fail, so can governments.

Key Term	**Government Failure:** A situation in which government intervention in the economy produces outcomes that are worse than the free-market equilibrium, reducing rather than improving allocative efficiency and social welfare.

The principal sources of government failure include:

- Information problems: Governments, like markets, face information constraints. Setting the optimal Pigouvian tax rate requires accurate measurement of marginal external

costs; designing effective regulations requires detailed knowledge of industry costs and technologies. In practice, regulators often lack this information.

- Regulatory capture: Regulated industries invest heavily in lobbying and cultivating relationships with regulators, leading regulators to advance industry interests at the expense of consumers and the public. The SEBI's slow response to early warning signs in the Harshad Mehta and Satyam scandals illustrates regulatory capture's dangers.
- Political distortions: Democratic pressures may lead governments to favour interventions that are politically popular but economically inefficient — blanket fertiliser subsidies that benefit large landowners more than small farmers, or fuel subsidies that disproportionately benefit the urban middle class.
- Crowding out: Large public expenditures, financed by borrowing, can raise interest rates and displace private investment. India's high fiscal deficit in the period 2011–2014 contributed to elevated borrowing costs and suppressed private sector growth.
- Unintended consequences: Interventions routinely produce effects beyond those intended. The DPCO's price ceilings have led to drug withdrawals; rent controls have reduced rental supply; MSP has distorted cropping patterns toward water-intensive staples.

Critical Evaluation: Does Government Intervention Always Improve Welfare?

The answer depends on the relative magnitudes of market failure and government failure. The appropriate policy question is not 'should the market or the state allocate resources?' but rather 'what combination of market forces, regulation, public provision, and incentive design best serves social welfare in this specific context?'

India's economic reform trajectory since 1991 reflects a growing appreciation of this nuance. The dismantling of the License Raj, the deregulation of prices, and the opening of the economy to competition have corrected many government-created distortions. At the same time, the expansion of social protection (PM-JAY, PM-KISAN, PMGKAY) and the strengthening of regulatory institutions (SEBI, TRAI, CCI, RERA) reflect a recognition that markets require active support, correction, and oversight to serve the interests of all citizens.

The most effective approach is one that combines the efficiency of competitive markets with targeted, evidence-based government intervention to correct genuine market failures — while continuously evaluating whether interventions are achieving their stated objectives.

CHAPTER SUMMARY

- Government intervention is justified when markets fail to allocate resources efficiently — due to externalities, monopoly, information failure, or the public goods problem — and when the social benefits of intervention exceed its costs.
- Taxation — including Pigouvian taxes, the GST cess structure, and progressive direct taxes — corrects negative externalities, raises revenue for public goods, and redistributes income.
- Subsidies — including fertiliser subsidies, the PDS, and renewable energy incentives — correct positive externalities and ensure access to merit goods, but carry risks of fiscal cost, leakage, and market distortion.
- Price controls — such as the DPCO drug price caps and the agricultural MSP — protect consumers and producers from market power, but can create shortages, surpluses, and unintended consequences.
- Public expenditure — on infrastructure (PM Gati Shakti), healthcare (PM-JAY), and education (Samagra Shiksha) — directly provides public and merit goods, correcting the free-rider problem and addressing distributional failures.
- Regulation — through TRAI, SEBI, CPCB, and the BS-VI emission norms — mandates behaviour standards and corrects information failures, monopoly abuse, and environmental externalities.
- Government failure — stemming from information constraints, regulatory capture, political distortions, and unintended consequences — means that intervention is not automatically welfare-enhancing; policy design must be evidence-based and adaptive.

Review Questions

Section A: Short-Answer Questions

- Define government intervention and state two economic justifications for it in the Indian context.
- Explain the concept of a Pigouvian tax. How does the GST cess on tobacco reflect Pigouvian logic?
- Distinguish between a price ceiling and a price floor. Give one Indian example of each.
- What is meant by 'leakage' in the context of subsidy programmes? Why is it a problem for the PDS?
- Define government failure. Give two reasons why government intervention may reduce rather than increase welfare.

Section B: Application and Analysis

- Evaluate the claim that the Minimum Support Price system is the most effective way to protect Indian farmers' incomes. Consider both economic arguments and the evidence from India.
- Using the concept of positive externalities, justify India's public expenditure on the Pradhan Mantri Jan Arogya Yojana (PM-JAY). To what extent does the scheme successfully correct the relevant market failure?
- Assess the view that regulation is always preferable to Pigouvian taxation as a method of controlling industrial pollution in India.
- Discuss the proposition that India's economic reforms since 1991 represent a shift from government failure to market failure — and that both extremes are damaging.
- To what extent can it be argued that government intervention in India's pharmaceutical sector through the DPCO has improved social welfare? Consider both benefits and costs.

Chapter 5:
Fiscal Functions of Government

Learning Objectives

After studying this chapter, you will be able to:

- Define fiscal policy and explain its three classical functions as articulated by Richard Musgrave
- Analyse the Allocation Function and evaluate India's public expenditure decisions in infrastructure, education, and healthcare
- Explain the Distribution Function and examine India's tax-transfer system as a tool for reducing inequality
- Understand the Stabilisation Function and assess India's counter-cyclical fiscal interventions
- Evaluate the importance of fiscal policy in promoting long-run economic development in India

Critically assess the limitations and trade-offs of fiscal policy in a developing economy context.

5.1 Meaning of Fiscal Functions

Fiscal policy refers to the use of government revenue — principally taxation — and government expenditure to influence economic activity. Unlike monetary policy, which operates through interest rates and money supply, fiscal policy acts directly on aggregate demand, resource allocation, income distribution, and economic stability. Fiscal policy is therefore one of the most powerful instruments available to the state for shaping economic outcomes.

The systematic analysis of the functions of fiscal policy was most comprehensively articulated by the American economist Richard A. Musgrave in his landmark 1959 work, The Theory of Public Finance. Musgrave identified three distinct but interrelated functions that a fiscal system must perform:

Function	Core Question Addressed	Indian Example
Allocation	How should society's resources be divided between public and private uses?	*Capital expenditure on roads, railways, and social infrastructure; PM-JAY health coverage*
Distribution	How should the benefits of economic activity be distributed across society?	*Progressive income tax, GST exemptions on essentials, MGNREGS, PM-KISAN*
Stabilisation	How should fiscal policy be used to maintain full employment, price stability, and growth?	*COVID-19 fiscal stimulus (Atmanirbhar Bharat), FRBM Act deficit targets*

Table 5.1: Musgrave's Three Fiscal Functions and Indian Applications

Key Term	**Fiscal Policy:** The deliberate use of government expenditure and taxation to influence macroeconomic conditions — including aggregate demand, resource allocation, income distribution, and economic stability — in pursuit of defined social and economic objectives.

These three functions are analytically distinct, but in practice they interact continuously. A decision to increase public health expenditure simultaneously serves the Allocation Function (providing a merit good), the Distribution Function (benefiting poor households most), and potentially the Stabilisation Function (sustaining aggregate demand during a downturn). Indian fiscal policy must negotiate all three simultaneously — within a federal structure that divides fiscal powers between the Union and State governments, and subject to constitutional and statutory constraints.

> *The budget is not merely a financial statement but an instrument of social and economic change.*
>
> **— Dr. B.R. Ambedkar, Constituent Assembly Debates, 1948**

5.2 The Allocation Function

The Allocation Function of fiscal policy concerns the use of public resources to correct the misallocation that arises from market failure. As established in Chapter 4, free markets underprovide public goods (due to the free-rider problem), underprovide merit goods (due to positive externalities), and may overprovide demerit goods (due to negative externalities). The state uses its fiscal powers to redirect resources toward socially optimal uses.

Key Term	**Allocation Function:** The function of fiscal policy concerned with ensuring that resources are allocated efficiently across the economy — providing public goods, supporting merit goods, and correcting externalities — to maximise social welfare.

5.2.1 Provision of Public Goods

Public goods — non-rival and non-excludable — cannot be profitably provided by private markets. The state must step in as provider or financier. In India, the constitutional assignment of public good provision is divided between the Union (defence, national highways, major ports, atomic energy) and the States (law and order, irrigation, state roads), with Concurrent List items (education, health, forests) shared between the two.

Indian Case Study: National Defence and Internal Security

National defence is the paradigmatic public good — its benefits are simultaneously available to all citizens regardless of their contribution to its cost, and no citizen can be excluded from its protection. India's defence expenditure in 2024-25 stands at ₹6.22 lakh crore, or approximately 1.9 per cent of GDP — the largest single head of Union Government expenditure.

The allocation of this expenditure reflects collective decisions about India's security requirements — border management (particularly with China and Pakistan), maritime security, counter-terrorism, and nuclear deterrence. Because no private market mechanism could provide national defence — no firm can exclude non-payers from the protection conferred — the Allocation Function must be performed entirely through the public budget.

Internal security — police, paramilitary forces, disaster response — is a shared public good provided primarily by State governments. The Pradhan Mantri Suraksha Bima Yojana and the NDRF represent the Union's role in supplementing state capacity in public safety provision.

5.2.2 Provision of Merit Goods and Infrastructure

Merit goods — whose social benefits exceed their private benefits — are underproduced by markets. The Allocation Function of fiscal policy calls for public provision or subsidisation of such goods to bring consumption up to the socially optimal level. In India, the principal merit goods addressed through public allocation are education, healthcare, and physical infrastructure.

Indian Case Study: Union Budget 2024-25 — Allocation Priorities

The Union Budget 2024-25 reflects the Allocation Function across several dimensions:

- Education: ₹1.48 lakh crore allocated to the education sector, covering Samagra Shiksha (school education), PM POSHAN (mid-day meal scheme), and the National Education Policy implementation. The Skill India Mission receives ₹60,000 crore to address the positive externalities of vocational training.

- Healthcare: ₹89,287 crore to the health sector, anchored by PM-JAY (covering 50 crore beneficiaries) and the National Health Mission. The Ayushman Arogya Mandir scheme aims to establish 1.5 lakh Health and Wellness Centres providing preventive and primary care.

- Infrastructure: ₹11.11 lakh crore in capital expenditure (3.4% of GDP) — the highest in India's history — directed at roads (NHAI), railways (Indian Railways), urban infrastructure (AMRUT, Smart Cities), and rural connectivity (PM Gram Sadak Yojana).

- Rural development: ₹2.66 lakh crore for rural infrastructure including irrigation (Jal Jeevan Mission), rural housing (PM Awas Yojana-Gramin), and sanitation (Swachh Bharat Mission). Each of these generates significant positive externalities: clean water reduces child mortality, housing improves health and productivity, sanitation reduces disease burden.

5.2.3 Correcting Externalities through Allocative Expenditure

Beyond direct provision, the Allocation Function encompasses fiscal choices that correct externality-driven misallocations in the private economy. Production-Linked Incentive (PLI) schemes — providing financial incentives to manufacturers in strategic sectors — are a striking example of allocative expenditure used to correct positive externalities and overcome coordination failures.

Indian Case Study: PLI Schemes and Allocative Correction

India's Production-Linked Incentive (PLI) schemes, introduced from 2020 onwards, commit ₹1.97 lakh crore of budgetary allocation across 14 strategic sectors — including mobile phones, pharmaceuticals, semiconductors, solar PV modules, speciality steel, and advanced chemistry cells for batteries.

The economic rationale is rooted in the Allocation Function: private markets underinvest in these sectors because the social returns (technological spillovers, employment generation, import substitution, strategic self-sufficiency) exceed the private returns captured by individual firms. The PLI subsidy bridges this gap, shifting the marginal cost curve downward and inducing private investment that would not otherwise occur.

By 2023-24, PLI-linked production had exceeded ₹10.8 lakh crore, with exports of ₹3.8 lakh crore — a substantial multiplier effect on the initial fiscal allocation. The mobile phone sector saw India emerge as the world's second-largest mobile phone manufacturer, with Apple and Samsung establishing major production bases — a transformation directly attributable to the allocative correction provided by PLI incentives.

Allocation Category	2024-25 Budgetary Provision	% of Total Expenditure	Primary Market Failure Corrected
Capital expenditure (infrastructure)	₹11.11 lakh crore	17.2%	Public goods; positive externalities
Education (Samagra Shiksha + HE)	₹1.48 lakh crore	2.3%	Positive externality; merit good
Health (NHM + PM-JAY)	₹89,287 crore	1.4%	Information failure; merit good
Rural development (JJM + PMAY-G)	₹2.66 lakh crore	4.1%	Public goods; positive externalities
Defence and internal security	₹6.22 lakh crore	9.6%	Pure public good provision

PLI and industrial incentives	₹35,000 crore (annual)	~0.5%	Positive externality; coordination failure

Table 5.2: Allocation Function in India's Union Budget 2024-25 (Approximate Figures)

5.3 The Distribution Function

Even a fully efficient market economy — one with no market failures — may produce a distribution of income and wealth that is widely regarded as unjust. Market outcomes reward factors of production in accordance with their marginal productivity, not in accordance with social need or ethical desert. Individuals who inherit wealth, who are born with exceptional abilities, or who happen to possess skills in high demand at a given moment will earn far more than others through no virtue of their own. The Distribution Function of fiscal policy addresses this by using the tax-transfer system to redistribute income and wealth toward a more equitable outcome.

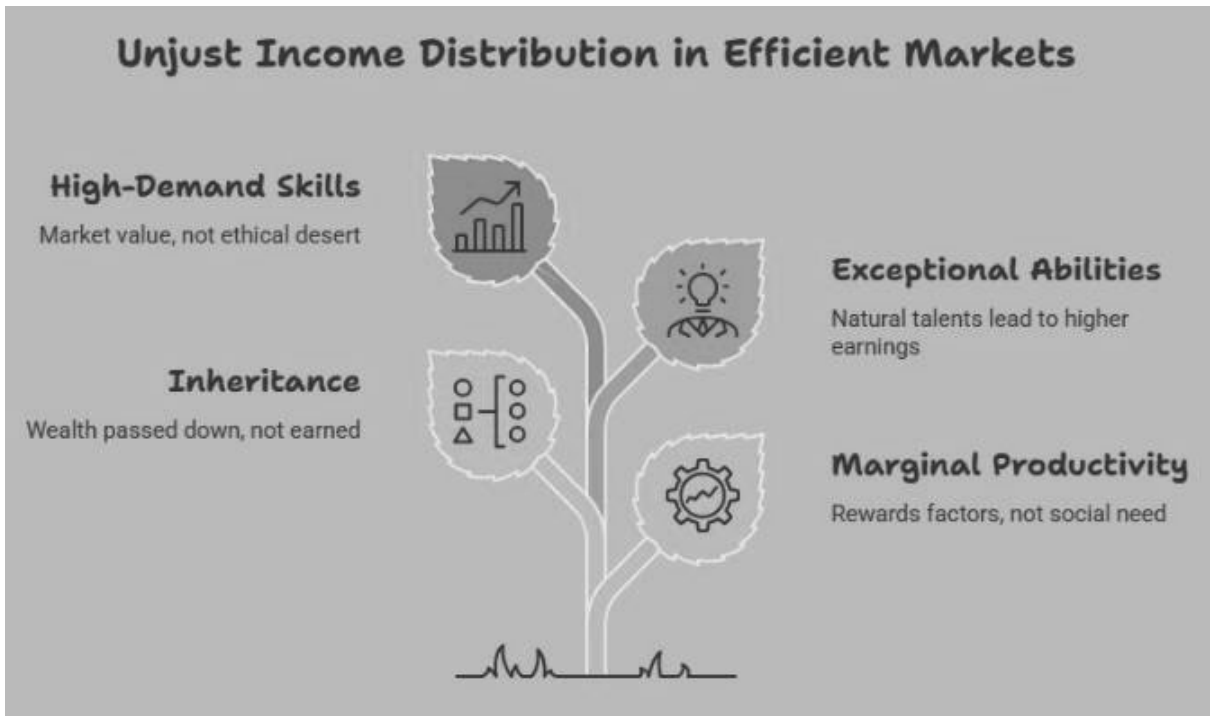

Figure 5.1 Income Distribution in markets

Key Term	**Distribution Function:** The function of fiscal policy concerned with adjusting the distribution of income and wealth across society — through progressive taxation, social transfers, and targeted public expenditure — to reduce inequality and ensure that all citizens can meet their basic needs.

India's Gini coefficient of approximately 0.35 masks far greater disparities when measured by wealth rather than income — the richest 1 per cent of Indians own over 40 per cent of national wealth.

— World Inequality Report, 2022

5.3.1 Progressive Taxation as a Redistributive Instrument

A progressive tax system — in which the average tax rate rises with income — is the primary fiscal mechanism for redistribution on the revenue side. By extracting a larger proportion of income from high earners and using the proceeds to fund transfers and public services for lower-income groups, the state can compress the post-tax, post-transfer distribution relative to the pre-tax distribution.

Indian Case Study: India's Progressive Direct Tax Structure

India's personal income tax system operates through a slab structure. Under the new tax regime (introduced in 2020 and made default in 2023), income tax rates rise from nil on incomes up to ₹3 lakh to 30 per cent on incomes above ₹15 lakh. A surcharge of 25 per cent applies to incomes above ₹5 crore, creating an effective marginal rate of 39 per cent.

The redistributive impact of this structure is augmented by the wealth tax-adjacent measures — Securities Transaction Tax (STT) on equity trades, dividend taxes, and capital gains taxes — that bear more heavily on asset-rich households.

However, India's direct tax base remains narrow. Only approximately 7.5 crore individuals filed income tax returns in 2022-23, out of a working-age population of over 80 crore — reflecting the dominance of informal employment and agriculture (which enjoys an income tax exemption under Article 10(1) of the Income Tax Act). The redistributive power of direct taxation in India is therefore substantially weaker than in developed economies where near-universal formal employment makes broad income taxation feasible.

Corporate tax revenues — at approximately ₹9.1 lakh crore in 2023-24 — contribute significantly to the redistributive budget, funding social expenditures that benefit lower-income households disproportionately.

5.3.2 Social Transfers and Direct Benefit Transfers

On the expenditure side, the Distribution Function is performed through social transfers — cash payments, in-kind benefits, and subsidised services that improve the welfare of lower-income households. India's social protection architecture encompasses both contributory schemes (Employees' Provident Fund, ESIC) and non-contributory schemes (MGNREGS, PM-KISAN, PDS, PM Awas Yojana).

Indian Case Study: MGNREGS — Fiscal Redistribution through Employment Guarantee

The Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), enacted in 2005, is the world's largest public works programme. It guarantees 100 days of wage employment per year to every rural household whose adult members volunteer for unskilled manual work, at a statutory minimum wage (currently ₹267/day for most states).

The Distribution Function of MGNREGS operates through several channels:

- Direct income transfer: In 2022-23, MGNREGS generated 289 crore person-days of employment and transferred approximately ₹89,000 crore to the rural poor — a direct fiscal redistribution from the broader tax base to the bottom quartile
- Wage floor effect: By establishing a guaranteed wage, MGNREGS raises the reservation wage of agricultural labourers, improving their bargaining position vis-à-vis landlords and reducing the monopsony power of rural employers
- Asset creation: MGNREGS works create rural infrastructure (ponds, canals, roads, afforestation) that generates further economic benefits, giving the scheme both Allocation and Distribution dimensions
- Gender impact: Women constitute approximately 57 per cent of MGNREGS workers, making it a significant instrument of gender-equalising redistribution

A 2021 study by the Centre for Sustainable Employment (Azim Premji University) found that MGNREGS participation reduced rural poverty incidence by 15–20 per cent in districts with high coverage, illustrating the distributional power of well-designed employment-linked fiscal transfers.

Indian Case Study: Direct Benefit Transfer (DBT) and JAM Trinity

India's Direct Benefit Transfer (DBT) system, launched in 2013 and dramatically expanded from 2014 onwards, uses the JAM Trinity — Jan Dhan bank accounts, Aadhaar biometric identification, and Mobile connectivity — to transfer government benefits directly to beneficiaries' bank accounts, eliminating intermediaries.

By 2024, DBT covers over 300 schemes across 50 ministries, having transferred over ₹34 lakh crore cumulatively since inception. The distributional significance is twofold:

- Targeting efficiency: By eliminating ghost beneficiaries (duplicate or non-existent claims), DBT has saved an estimated ₹3.5 lakh crore in the decade since implementation — resources that can be redirected to genuine beneficiaries
- Financial inclusion: DBT has drawn over 50 crore previously unbanked households into the formal financial system, expanding their access to credit, insurance, and savings instruments — addressing a structural source of inequality

PM-KISAN (annual income support of ₹6,000 to eligible farmers), LPG subsidy transfers (PM Ujjwala Yojana), and scholarship transfers to SC/ST students are among the flagship DBT programmes performing the Distribution Function of fiscal policy.

5.3.3 Horizontal Equity and Fiscal Federalism

The Distribution Function in India has an important spatial dimension. Regional disparities in income, infrastructure, and human development are substantial: per capita GSDP in Goa (₹5.5 lakh) is over ten times that of Bihar (₹52,000). India's fiscal federal system addresses this horizontal inequality through the Finance Commission — a constitutional body that determines the formula for sharing Union tax revenues among States.

Indian Case Study: The 15th Finance Commission and Horizontal Equity

The 15th Finance Commission (2020–2026), chaired by N.K. Singh, recommended that States receive 41 per cent of the divisible pool of central taxes (down from 42 per cent in the 14th FC, to account for the bifurcation of Jammu and Kashmir). The devolution formula gives significant weight to:

- Income distance (45% weight): States with lower per capita income receive a larger share, redistributing from richer to poorer states
- Population (15%) and area (15%): Accounting for service delivery needs and geographic challenges
- Forest and ecology (10%): Rewarding environmental stewardship
- Tax effort (2.5%) and demographic performance (12.5%): Incentivising fiscal responsibility and human development

In 2024-25, Bihar, Uttar Pradesh, Madhya Pradesh, and Rajasthan together receive approximately 40 per cent of total State devolution despite accounting for a smaller share of national GDP — a substantial horizontal redistribution that performs the spatial dimension of the Distribution Function.

5.4 The Stabilisation Function

The Stabilisation Function of fiscal policy concerns the use of government expenditure and taxation to maintain macroeconomic stability — supporting full employment, controlling inflation, sustaining economic growth, and managing the balance of payments. The theoretical foundation for fiscal stabilisation policy was provided by John Maynard Keynes in The General Theory of Employment, Interest and Money (1936), which demonstrated that private economies could get stuck in low-equilibrium, high-unemployment states and that government expenditure could provide the demand stimulus needed to restore full employment.

Key Term	**Stabilisation Function:** The function of fiscal policy concerned with using government expenditure and taxation to moderate the business cycle — stimulating demand during recessions, restraining it during inflationary booms — and maintaining macroeconomic stability around the path of potential output.

5.4.1 The Keynesian Fiscal Multiplier

The theoretical basis for the Stabilisation Function is the fiscal multiplier — the ratio of the change in national income to the change in government expenditure or taxation that causes it. When the government increases expenditure by ₹100 crore, the initial recipients spend a portion of this income (determined by the marginal propensity to consume, MPC), generating further rounds of income and spending. The total increase in national income exceeds the initial stimulus — the multiplier amplifies the fiscal impulse.

The Fiscal Multiplier in India

The size of the fiscal multiplier varies with economic conditions and the type of expenditure. Key findings for India include:

- Capital expenditure multiplier: Studies by the RBI and NIPFP estimate India's capital expenditure multiplier at 2.0–2.5 — meaning each rupee of public infrastructure investment generates ₹2–2.50 of GDP, reflecting high backward linkages in construction and manufacturing
- Revenue expenditure multiplier: Transfers and social spending have a multiplier of approximately 1.0–1.5, because a larger share is saved or spent on imports
- Cyclical sensitivity: Multipliers are larger during recessions (when private demand is depressed and monetary policy may be constrained by the zero lower bound) and smaller during expansions
- Leakage through imports: India's import intensity means a portion of fiscal stimulus leaks abroad, reducing the domestic multiplier effect

These estimates explain the Union Government's emphasis on capital expenditure as the preferred vehicle for fiscal stabilisation since 2021–22 — maximising the GDP impact per rupee of fiscal deficit.

5.4.2 Automatic Stabilisers

Automatic stabilisers are fiscal mechanisms that automatically moderate economic fluctuations without requiring new legislative action. In advanced economies, progressive income taxes and unemployment insurance are the primary automatic stabilisers: during a recession, tax revenues fall automatically (as incomes decline and profit tax yields drop) and transfer payments rise (as more individuals qualify for unemployment benefits), providing an automatic expansionary impulse. During a boom, the reverse occurs — tax revenues rise and transfers fall, applying an automatic contractionary brake.

India's automatic stabilisers are weaker than those in developed economies, primarily because of the large informal sector (where income fluctuations are not captured by the tax system or unemployment insurance) and the absence of a universal unemployment benefit scheme. The MGNREGS functions as a partial substitute — its demand-driven design means employment and expenditure automatically expand when rural economic distress increases — but its reach does not extend to urban informal workers.

5.4.3 Discretionary Fiscal Policy: Counter-Cyclical Stimulus

Indian Case Study: The Atmanirbhar Bharat Fiscal Package — COVID-19 Stabilisation

The COVID-19 pandemic of 2020 produced India's most severe economic contraction in post-independence history: GDP fell by 6.6 per cent in 2020-21, with manufacturing and services contracting sharply and unemployment reaching a 45-year high. The Stabilisation Function demanded an unprecedented fiscal response.

The Government of India announced the Atmanirbhar Bharat Abhiyan (Self-Reliant India Mission) in five tranches between May and November 2020, with a headline figure of ₹29.87 lakh crore (approximately 15 per cent of GDP). The package combined:

- Direct fiscal measures (budgetary expenditure): Additional food grain distribution (PMGKAY), MGNREGS wage enhancement, PM-KISAN advance payment, and healthcare spending totalling approximately ₹2.76 lakh crore (1.3% of GDP)
- Liquidity measures (RBI actions): Emergency credit lines, moratoriums, and monetary easing worth ₹8.01 lakh crore
- Structural reforms: IBC amendments, agricultural market reforms, PLI schemes, and privatisation commitments aimed at raising long-run potential output

The fiscal deficit widened from a budgeted 3.5 per cent of GDP to 9.2 per cent in 2020-21 — a deliberate departure from the FRBM target to perform the Stabilisation Function.

India's GDP recovered strongly in 2021-22, growing by 8.7 per cent, partly vindicating the stimulus approach.

The episode illustrates a central dilemma of the Stabilisation Function: aggressive counter-cyclical stimulus supports recovery but builds public debt, potentially constraining future fiscal space. India's general government debt reached approximately 89 per cent of GDP in 2020-21 — higher than the IMF's recommended threshold for emerging markets.

5.4.4 The FRBM Framework: Institutionalising Fiscal Discipline

A tension inherent in the Stabilisation Function is the risk that discretionary fiscal expansion during recessions is not offset by consolidation during expansions — generating a ratchet effect in public debt. The Fiscal Responsibility and Budget Management Act (FRBM Act, 2003) was introduced to institutionalise fiscal discipline by setting statutory targets for the fiscal deficit and debt-to-GDP ratio.

Indian Case Study: The FRBM Act and the NK Singh Committee Reforms

The original FRBM Act (2003) set a target of reducing the Union fiscal deficit to 3 per cent of GDP by 2007-08. While the target was broadly met by 2007-08 (fiscal deficit of 2.5 per cent), it was suspended during the global financial crisis of 2008-09 and has been repeatedly revised since.

The NK Singh Committee (2017) recommended a shift from a single deficit target to a fiscal council model, with:

- A fiscal deficit target of 3 per cent of GDP by 2020-21 (later revised to 2022-23)
- A medium-term debt target of 60 per cent of GDP (Union + States combined)
- An 'escape clause' permitting deviation from targets in the event of a national calamity or structural reform

The FRBM framework attempts to reconcile the Stabilisation Function (which calls for counter-cyclical flexibility) with long-run fiscal sustainability (which requires debt discipline). The escape clause was invoked during the COVID-19 crisis, allowing the fiscal deficit to reach 9.2 per cent in 2020-21 without violating the legal framework.

By 2024-25, the Union fiscal deficit has been reduced to a targeted 5.1 per cent of GDP, reflecting a medium-term consolidation path that seeks to restore fiscal space while sustaining growth-enabling capital expenditure — a delicate balancing act between the Stabilisation and Allocation Functions.

5.5 Importance of Fiscal Policy in Economic Development

Economic development — the sustained improvement in living standards, human capabilities, and structural transformation of an economy — requires much more than macroeconomic stability. It demands the accumulation of physical capital, the development of human capital, structural transformation from agriculture to industry and services, the reduction of poverty and inequality, and the building of institutional capacity. In all of these dimensions, fiscal policy plays a central and often irreplaceable role — particularly in developing economies like India, where private markets are underdeveloped, institutions are weak, and the legacy of colonial underdevelopment persists.

Figure 5.2: Economic development

Key Term	**Economic Development:** A process of sustained improvement in a nation's productive capacity, human welfare, and institutional quality — encompassing economic growth, poverty reduction, human capital formation, structural transformation, and improvement in the quality of life across all segments of society.

5.5.1 Mobilising Resources for Capital Formation

Capital formation — the accumulation of physical infrastructure, machinery, and productive capacity — is the engine of long-run economic growth. In a developing economy, private savings may be insufficient to finance the required level of investment, and capital markets may be too shallow to channel available savings efficiently. Fiscal policy can supplement private capital formation through public investment, and improve its efficiency through the tax system.

Indian Case Study: From Plan Expenditure to Capital Expenditure — India's Investment Story

India's fiscal approach to capital formation has evolved significantly over the post-independence era:

• The Nehru-Mahalanobis model (1950s–1980s): The Five-Year Plans directed public investment into heavy industry, dams, steel plants, and power generation — building India's industrial base but at the cost of consumer welfare and fiscal sustainability. Public sector enterprises were the primary vehicle of capital formation.

• Post-liberalisation transition (1990s–2010s): The share of public investment fell as the private sector assumed a larger role. The fiscal consolidation of the Vajpayee and early Manmohan Singh years reduced the fiscal deficit but also compressed public capital expenditure, contributing to infrastructure bottlenecks.

• The capex-led growth strategy (2020s): Recognising that private investment requires public infrastructure as a complement, the Modi government dramatically expanded capital expenditure: from ₹4.4 lakh crore in 2021-22 to ₹11.11 lakh crore in 2024-25 — a 152 per cent increase in three years. National Highways construction accelerated from 10,000 km per year in 2014 to 16,000+ km in 2023-24. Railway investment reached ₹2.62 lakh crore in 2024-25, transforming freight logistics and passenger connectivity.

The crowding-in effect of public capital expenditure — whereby infrastructure investment attracts private investment by improving connectivity, reducing logistics costs, and demonstrating state commitment — is a crucial channel through which the Allocation and Stabilisation Functions serve the broader goal of economic development.

5.5.2 Human Capital Development

Investment in education and health — human capital — is as essential to long-run development as physical capital. Fiscal policy is the primary mechanism through which a society invests in human capital, because the positive externalities of education and health cause private markets to invest less than is socially optimal.

Indian Case Study: The Right to Education Act and Samagra Shiksha

The Right of Children to Free and Compulsory Education Act (RTE Act, 2009) is one of independent India's most significant fiscal-development linkages. It enshrines the right to free and compulsory education for all children aged 6–14 as a fundamental right (Article 21-A of the Constitution), and mandates that the Union and State governments together finance universal elementary education.

The Samagra Shiksha scheme — which consolidates the SSA, RMSA, and Teacher Education programmes — allocated ₹37,500 crore in 2024-25. Its outcomes illustrate the fiscal-development nexus: gross enrolment ratios at primary level have reached near-universality (over 99%), and the gender gap in school enrolment has been virtually eliminated at the primary stage.

The National Education Policy 2020 envisions increasing public education expenditure to 6 per cent of GDP (from the current 4.6 per cent) — a fiscal commitment that, if realised, would add approximately ₹1.5 lakh crore per year to human capital investment and dramatically accelerate India's development trajectory.

5.5.3 Structural Transformation and Industrialisation

Economic development requires structural transformation — the shift of labour and resources from low-productivity agriculture to higher-productivity industry and services. Fiscal policy can accelerate this transformation through targeted tax incentives, infrastructure investment, and sectoral expenditure that reduce the cost of industrial activity and enhance the productivity of manufacturing.

Indian Case Study: Make in India, PLI, and Fiscal-Driven Industrialisation

India's manufacturing sector contributes approximately 17 per cent of GDP — well below the 25–30 per cent typical of successful Asian industrialisers at comparable stages of development. Closing this gap requires fiscal interventions that address the market failures impeding industrial expansion:

1. Infrastructure deficit: Manufacturing competitiveness requires reliable power, efficient logistics, and deep-water ports. The ₹11.11 lakh crore capital expenditure in 2024-25 is partly justified as an industrialisation-enabling fiscal intervention.

2. Skill development: Manufacturing requires a skilled workforce. The PM Kaushal Vikas Yojana (PMKVY) has trained over 1.4 crore individuals in industry-relevant skills, using fiscal transfers to correct the positive externality of vocational training.

3. PLI schemes: As discussed in Section 6.2.3, PLI incentives have catalysed private investment in mobile phones, pharmaceuticals, solar modules, and defence equipment — using fiscal allocation to correct positive externalities and coordinate private investment in strategically important sectors.

4. Special Economic Zones (SEZs) and industrial corridors: The Delhi-Mumbai Industrial Corridor (DMIC), Chennai-Bengaluru Industrial Corridor (CBIC), and other projects use public land acquisition and infrastructure investment to create industrial ecosystems that private developers cannot co-ordinate on their own.

5.5.4 Poverty Reduction and Social Protection

Economic development is not merely growth in aggregate income but improvement in the living standards of all citizens — particularly the poorest. Fiscal policy performs this development function through social protection programmes that provide a basic income floor, healthcare access, housing, and nutrition for those left behind by market processes.

India's Multidimensional Poverty Reduction: The Fiscal Contribution

NITI Aayog's Multidimensional Poverty Index (MPI) report (2023) found that approximately 24.8 crore Indians escaped multidimensional poverty between 2013-14 and 2022-23 — the largest poverty reduction in any comparable period in Indian history. The fiscal contributions to this achievement include:

- PM Awas Yojana (Gramin and Urban): Over 4 crore houses built for the homeless poor, addressing shelter deprivation
- Jal Jeevan Mission: 14.9 crore tap water connections provided to rural households — the largest clean water expansion programme in the world
- Swachh Bharat Mission: Over 11.5 crore toilets built, reducing open defecation and improving health outcomes
- PM Ujjwala Yojana: 10 crore LPG connections to below-poverty-line households, replacing indoor air pollution from biomass cooking
- Ayushman Bharat PM-JAY: 7+ crore hospitalisations facilitated, preventing catastrophic health expenditure-induced poverty

Each of these programmes performs the Distribution Function while simultaneously contributing to human capital (health, nutrition) and the Allocation Function (providing merit goods). Their combined fiscal cost represents a major commitment of national resources to development — and a demonstration that well-designed fiscal policy can achieve rapid, broad-based improvement in human welfare.

5.5.5 Managing the Balance of Payments and External Sustainability

Fiscal policy affects a developing economy's external position through several channels. Fiscal deficits financed by domestic borrowing raise interest rates, attracting capital inflows and appreciating the exchange rate — potentially harming export competitiveness (the 'twin deficits' hypothesis). Conversely, fiscal surpluses and disciplined debt management build

international credibility and reduce sovereign risk premia, lowering the cost of external borrowing.

India's export promotion strategy illustrates the development-oriented use of fiscal instruments for external balance. The Remission of Duties and Taxes on Exported Products (RoDTEP) scheme provides fiscal transfers to exporters to neutralise indirect tax burdens that would otherwise impair competitiveness. Merchandise exports under the scheme exceeded US$450 billion in 2023-24, with fiscal support helping sustain India's export diversification into electronics, chemicals, and engineering goods.

Development Objective	Fiscal Instrument	Key Scheme/Example	Fiscal Function
Physical capital formation	Capital expenditure	PM Gati Shakti, NIP, NHAI	Allocation + Stabilisation
Human capital: education	Public provision + subsidy	Samagra Shiksha, NEP 2020	Allocation + Distribution
Human capital: health	Public provision + insurance	PM-JAY, NHM, Ayushman Arogya Mandir	Allocation + Distribution
Industrialisation	Tax incentives + PLI	PLI schemes, SEZs, DMIC	Allocation
Poverty reduction	Social transfers	MGNREGS, PM-KISAN, PDS, DBT	Distribution
External competitiveness	Export fiscal support	RoDTEP, SEZ benefits	Allocation
Macroeconomic stability	Counter-cyclical policy	Atmanirbhar Bharat stimulus	Stabilisation
Horizontal equity	Fiscal federalism	15th Finance Commission devolution	Distribution

Table 5.3: Fiscal Policy Instruments and Their Role in India's Economic Development

5.5.6 Limitations of Fiscal Policy in Promoting Development

Despite its importance, fiscal policy faces significant limitations as an instrument of economic development in the Indian context:

- Fiscal capacity constraints: India's tax-to-GDP ratio of approximately 17 per cent (Union + States) is low relative to comparator economies, limiting the resources available for development expenditure. Expanding the tax base — through formalisation of the economy, improved compliance, and rationalisation of exemptions — is a precondition for strengthening the fiscal-development nexus.
- Implementation and absorption capacity: The ability of government agencies to efficiently execute large capital projects is constrained by regulatory bottlenecks, land acquisition challenges, bureaucratic delays, and shortages of skilled project management personnel. A significant share of capital expenditure sanctioned in any given year is not actually spent — undermining the intended fiscal impulse.
- Crowding out: High fiscal deficits and government borrowing can raise interest rates and crowd out private investment — particularly when the banking system is dominated by government securities requirements (Statutory Liquidity Ratio). The net development impact of fiscal expansion depends critically on whether the crowding-out effect outweighs the direct public investment benefit.
- Leakage and corruption: Despite the improvements enabled by DBT and Aadhaar-linked beneficiary identification, significant leakages persist in social spending. Subsidies reach unintended beneficiaries; public works expenditures generate ghost employment; procurement is distorted by corruption. These leakages reduce the development efficiency of fiscal outlays.
- Federalism and coordination failures: India's federal structure divides fiscal responsibility across Union, State, and local governments. Coordination failures between these levels — particularly in implementation of Centrally Sponsored Schemes (CSS) — reduce the effectiveness of fiscal interventions. States often lack the administrative capacity and fiscal space to match Union funding, creating bottlenecks in critical development programmes.
- Debt sustainability: Sustained fiscal deficits accumulate public debt, raising debt service costs and potentially squeezing out productive expenditure. India's general government debt of approximately 85 per cent of GDP in 2024 — while manageable given the predominantly domestic denomination of debt — constrains the fiscal space available for development spending and stabilisation responses to future shocks.

CHAPTER SUMMARY

- Musgrave's framework identifies three fiscal functions: Allocation (efficient resource use), Distribution (equitable sharing of income), and Stabilisation (macroeconomic management). Indian fiscal policy must perform all three simultaneously within a federal structure.
- The Allocation Function addresses market failure by funding public goods (defence, internal security), merit goods (education, healthcare), infrastructure (PM Gati Shakti), and production incentives (PLI schemes) that private markets underprovide.
- The Distribution Function uses progressive taxation, the Finance Commission's equalisation transfers, MGNREGS, PM-KISAN, PDS, and the DBT system to redistribute income from richer to poorer households and from richer to poorer States.
- The Stabilisation Function manages the business cycle through automatic stabilisers and discretionary intervention. The Atmanirbhar Bharat package (2020–21) widened the fiscal deficit to 9.2 per cent of GDP to sustain demand during COVID-19, while the FRBM Act provides the institutional framework for fiscal discipline.
- Fiscal policy is central to India's economic development through capital formation, human capital investment (RTE Act, Samagra Shiksha, PM-JAY), industrialisation (PLI, SEZs), poverty reduction (NITI Aayog MPI data), and horizontal equity (Finance Commission devolution).
- Key limitations include India's low tax-to-GDP ratio, implementation bottlenecks, crowding out risks, leakage in social spending, federal coordination failures, and debt sustainability concerns.

Review Questions

Section A: Short-Answer Questions

- Define fiscal policy and state the three functions identified by Richard Musgrave.
- Explain the Allocation Function of fiscal policy with reference to India's capital expenditure strategy.
- What is the Distribution Function? How does MGNREGS perform this function in the Indian context?
- Distinguish between automatic stabilisers and discretionary fiscal policy. Why are India's automatic stabilisers weaker than those of developed economies?
- Define the fiscal multiplier. Why does capital expenditure typically have a larger multiplier than revenue expenditure in India?
- What is the FRBM Act? How does it balance the Stabilisation Function with fiscal sustainability?

Section B: Application and Analysis

- Using India's Union Budget 2024-25, evaluate how effectively the Allocation Function has been performed. Which sectors receive the greatest allocations, and are these priorities economically justified?
- Critically assess the view that the Distribution Function of fiscal policy has been more effectively performed through expenditure transfers (MGNREGS, PM-KISAN) than through progressive taxation in India.
- Analyse India's fiscal response to the COVID-19 pandemic of 2020-21 with reference to the Stabilisation Function. To what extent was the Atmanirbhar Bharat package successful?
- Evaluate the argument that fiscal policy is the most important instrument for promoting economic development in India. In your answer, consider both the Allocation and Distribution Functions, and address at least two key limitations.
- Discuss the proposition that India's fiscal federal system — particularly the Finance Commission's devolution formula — is an effective instrument for performing the Distribution Function at the national level.

To what extent do the three Musgrave functions conflict with one another in the Indian context? Illustrate your answer with reference to specific policy examples.

Chapter 6:
Public Finance and Economic Welfare

- Public Finance and Social Welfare
- Role of Public Finance in Reducing Inequality
- Public Finance and Economic Growth
- Challenges in Public Finance

Learning Objectives

After studying this chapter, you will be able to:

- Define public finance and explain its relationship with social welfare
- Analyse how public expenditure and taxation influence the overall welfare of society
- Examine the role of public finance in reducing income and wealth inequality in India
- Evaluate the instruments through which public finance promotes economic growth
- Identify and critically assess the principal challenges confronting India's public finance system

  Integrate the concepts of allocation, distribution, and stabilisation to form a holistic assessment of India's fiscal performance

6.1 Public Finance and Social Welfare

Public finance is the branch of economics that studies the role of the government in the economy — encompassing the generation of public revenues, the management of public expenditure, and the effects of these activities on the allocation of resources, the distribution of income, and the overall welfare of society. At its heart, public finance is not merely a technical discipline concerned with budget arithmetic; it is a normative enterprise — an inquiry into how the fiscal power of the state should be exercised to advance human welfare.

Key Term	**Public Finance:** The field of economics concerned with the revenues, expenditures, and debt of government, and with the effects of fiscal activities on the allocation of resources, the distribution of income, macroeconomic stability, and the welfare of individuals and society.

> *The purpose of a budget is not to balance the accounts of the treasury but to improve the conditions of human life.*
>
> **— Jawaharlal Nehru, First Prime Minister of India**

The concept of social welfare, in economic terms, refers to the aggregate wellbeing of all members of a society. It encompasses not only material living standards — income, consumption, and wealth — but also access to healthcare, education, clean environments, personal security, and the freedom to live a life one has reason to value (in Amartya Sen's capabilities framework). Public finance affects social welfare through three principal channels:

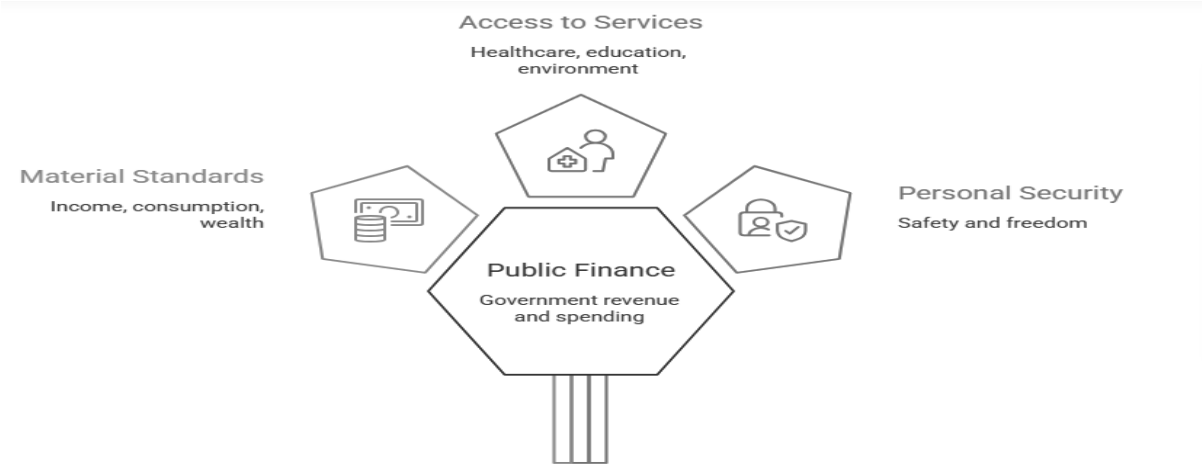

Figure 6.1: Public Finance in Social welfare

- Resource allocation: By providing public goods, correcting externalities, and supplying merit goods, fiscal policy ensures that society receives goods and services that the market undersupplies, improving allocative efficiency and welfare.
- Income redistribution: Through progressive taxation and social transfers, fiscal policy can compress income inequality, reducing the welfare loss associated with extreme poverty and deprivation.
- Macroeconomic stabilisation: By moderating business cycle fluctuations, fiscal policy reduces the welfare costs of unemployment, inflation, and economic uncertainty — particularly for the most vulnerable households.

Key Term	**Social Welfare:** The aggregate wellbeing of all members of a society, encompassing material living standards, access to public services, freedom from deprivation, and the capability of each person to live a life they have reason to value.

6.1.1 The Welfare Economics Foundation

The link between public finance and social welfare is grounded in welfare economics — the branch of economic theory concerned with evaluating the desirability of economic outcomes from a social perspective. The Pareto criterion holds that an economic change improves social welfare if it makes at least one person better off without making anyone worse off. The Kaldor-Hicks criterion extends this: a change improves welfare if those who gain could, in principle, compensate those who lose and still be better off.

In practice, most fiscal interventions involve trade-offs: taxes impose costs on some to fund benefits for others. The utilitarian tradition — following Bentham and Marshall — argues that welfare is improved whenever the gains to recipients exceed the losses to contributors, adjusted for the diminishing marginal utility of income (an additional rupee generates more utility for a poor person than for a rich one). This utilitarian logic is a powerful justification for redistributive fiscal policy: transferring income from rich to poor increases aggregate utility even if total income is unchanged.

Indian Case Study: The Welfare Economics of PM-POSHAN (Mid-Day Meal Scheme)

The PM-POSHAN scheme — formerly the Mid-Day Meal Scheme and one of the largest school feeding programmes in the world — provides hot cooked meals to approximately 11.8 crore children in 11.8 lakh government and government-aided schools across India. Its budgetary allocation in 2024-25 is ₹12,467 crore.

The scheme's welfare impact operates through multiple channels simultaneously:

- Nutritional welfare: Addresses chronic undernutrition, which affects approximately 35 per cent of children under five. Improved nutrition raises cognitive development, school performance, and lifetime productivity.
- Enrolment and retention: By providing a nutritious meal, the scheme creates a material incentive for attendance, raising gross enrolment ratios and reducing dropout rates — particularly for girls and children from SC/ST families.
- Redistributive welfare: The programme is means-tested de facto (only government school children benefit), targeting resources toward the lower-income strata whose children attend government schools.
- Local economic welfare: The scheme sources food locally through self-help groups (SHGs) and women's cooperatives, generating rural employment and supporting local agricultural demand.

A cost-benefit analysis by the International Food Policy Research Institute (IFPRI) estimated that every rupee invested in school feeding in India generates ₹7–8 in long-run welfare benefits through improved educational attainment and earnings. This multiplier effect illustrates how public expenditure on merit goods generates social welfare gains far exceeding the direct cost to the public exchequer.

6.1.2 Public Goods and Aggregate Welfare

The provision of public goods — national defence, public health, scientific research, meteorological services, street lighting — directly augments social welfare in ways that no market mechanism can replicate. Because these goods are non-rival and non-excludable, their provision generates universal benefits, and the welfare gains are not limited to any subgroup of the population.

Indian Case Study: India Meteorological Department and Disaster Early Warning

India's meteorological and disaster early warning infrastructure — operated by the India Meteorological Department (IMD) and the Indian National Centre for Ocean Information Services (INCOIS) — is a public good that generates enormous social welfare benefits.

The Integrated Cyclone Warning System, developed through sustained public investment over decades, has transformed India's disaster mortality profile. Deaths from cyclones along India's coastline declined from over 10,000 per cyclone in the 1990s to below 100 in most recent events — a reduction attributable primarily to accurate early warnings and government-coordinated evacuation. Cyclone Fani (2019), which struck Odisha with winds exceeding 250 km/h, resulted in only 89 deaths because of a mass evacuation of 1.2 million people facilitated by IMD warnings issued five days in advance.

This welfare gain — tens of thousands of lives preserved annually — is a direct return on public fiscal investment in scientific infrastructure. No private firm could profitably provide cyclone warnings at a price that excluded non-payers from the forecast; only public finance can supply this life-saving public good.

6.1.3 Amartya Sen's Capabilities Approach and Indian Fiscal Policy

Amartya Sen's capabilities approach offers a richer conceptualisation of welfare than the utilitarian income-based framework. Sen argues that what matters is not merely income but the capability to achieve valuable functionings — to be well-nourished, to be healthy, to be educated, to participate in community life, to exercise political freedoms. Public finance contributes to welfare by expanding these capabilities, particularly for those whose command over private resources is insufficient.

India's Human Development Index and the Fiscal-Welfare Nexus

India's Human Development Index (HDI) score of 0.644 (2022) ranks it 134th out of 193 countries — a moderate ranking that masks significant internal variation. States with higher per capita public expenditure on health and education — Kerala, Himachal Pradesh, Goa — consistently outperform states with similar per capita income but lower social spending.

Kerala's 'high human development at low income' model is a canonical illustration of the fiscal-welfare nexus: decades of sustained public investment in education (literacy rate: 94%), health (infant mortality: 6 per 1,000 live births, vs national average of 28), and social protection have produced welfare outcomes comparable to middle-income countries, at a per capita income far below them.

Conversely, Bihar and Jharkhand — among India's poorest states — exhibit not only low incomes but low HDI scores, reflecting the compounding deprivation of inadequate private income and inadequate public services. This pattern confirms that public finance is not merely a luxury of rich societies but a fundamental determinant of human welfare even at low income levels.

The implication for fiscal policy is powerful: public expenditure decisions are welfare decisions. Choices about how much to spend on healthcare versus debt service, on primary education versus higher education, on rural infrastructure versus urban amenities, are simultaneously choices about whose capabilities are expanded and whose are neglected.

6.2 Role of Public Finance in Reducing Inequality

India's economic growth since liberalisation has been remarkable — real GDP has grown at an average of approximately 7 per cent per year between 1991 and 2024, lifting hundreds of millions out of absolute poverty. Yet this growth has not been uniformly distributed. Income inequality, as measured by the Gini coefficient, has risen modestly but persistently. Wealth inequality is far more extreme: the richest 1 per cent of Indians hold approximately 40 per cent of national wealth, while the bottom 50 per cent hold barely 3 per cent. Regional disparities — between states, between rural and urban areas, between caste groups — remain deep and persistent.

Key Term	**Inequality:** Unequal distribution of income, wealth, opportunities, or access to public services across individuals, households, regions, or social groups. Economic inequality has both vertical dimensions (rich vs. poor) and horizontal dimensions (urban vs. rural; upper vs. lower caste; men vs. women).

Public finance is the primary instrument through which the state acts to reduce inequality — both vertical (between income groups) and horizontal (between regions, genders, and social groups). The mechanisms operate through both the revenue side (progressive taxation) and the expenditure side (targeted transfers and public services).

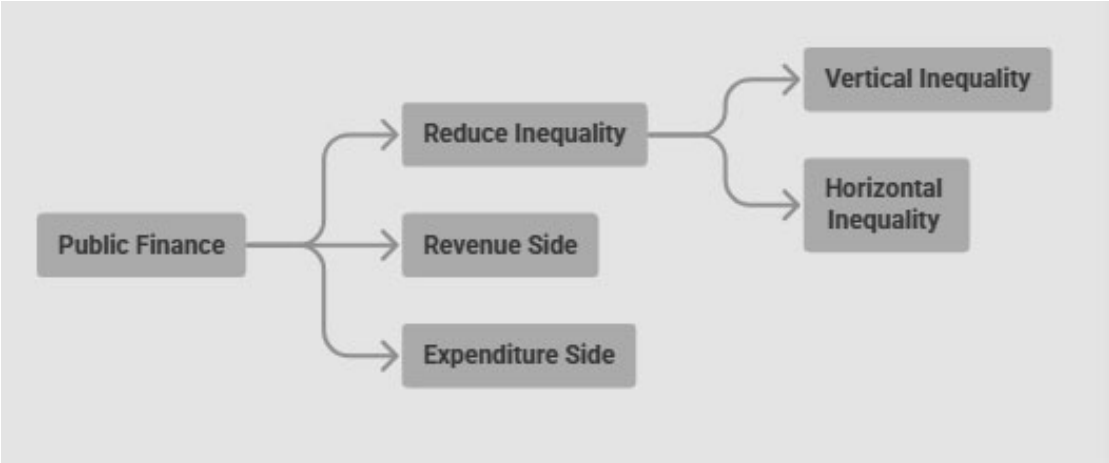

Figure 5: Public Finance and Inequality Reduction

6.2.1 Vertical Redistribution: The Tax-Transfer System

The vertical redistributive impact of fiscal policy is measured by comparing the pre-fiscal and post-fiscal distribution of income. A progressive tax system extracts proportionately more from high-income households; social transfers augment the incomes of low-income households. Together, they compress the income distribution — reducing the Gini coefficient from its pre-fiscal to its post-fiscal value.

Indian Case Study: India's Redistribution Gap — Fiscal Capacity and Ambition

India's fiscal redistribution is less extensive than in comparable emerging economies, for several structural reasons:

• Narrow direct tax base: Only approximately 3–4 per cent of India's population pays income tax (compared to 50–60 per cent in OECD countries), limiting the progressivity of the tax system. The dominance of indirect taxes (GST, customs, excise) in India's revenue mix — which account for approximately 50 per cent of Union tax revenues — is broadly regressive, since lower-income households spend a larger share of income on taxed consumption.

• Agricultural income exemption: Agricultural income — which constitutes a significant share of rural incomes, including for wealthy landowners — is exempt from income tax under Article 10(1) of the Income Tax Act, creating a vertical inequity that limits redistributive capacity.

• Fiscal transfers: Despite these limitations, India's social expenditure programmes — MGNREGS, PDS, PM-KISAN, PM Awas Yojana, and Ayushman Bharat — provide significant in-kind and cash transfers to lower-income households, achieving meaningful redistribution on the expenditure side even where revenue-side progressivity is limited.

A 2023 CEQ (Commitment to Equity) analysis of India's fiscal system found that fiscal interventions reduced the poverty headcount ratio by approximately 7 percentage points and the Gini coefficient by approximately 0.03–0.04 points — a modest but meaningful redistributive effect given India's fiscal constraints.

6.2.2 Horizontal Redistribution: Addressing Structural Inequalities

India's inequalities are not only vertical (between income groups) but deeply horizontal — structured by geography, caste, gender, and ethnicity. Public finance is deployed to address these structural inequalities through targeted expenditure, reservations, and special category benefits.

Indian Case Study: Scheduled Caste and Scheduled Tribe Sub-Plans

Despite constitutional protections and decades of affirmative action, Scheduled Castes (SCs) and Scheduled Tribes (STs) remain significantly disadvantaged on virtually every welfare indicator: lower income, higher poverty, lower educational attainment, worse health outcomes, and limited access to formal financial services.

The Union Government addresses caste-based horizontal inequality through the Scheduled Caste Sub-Plan (SCSP) and Tribal Sub-Plan (TSP) — now rebranded as the Development Action Plans for Scheduled Castes (DAPSC) and Scheduled Tribes (DAPST). These frameworks require that the proportion of Plan expenditure allocated to SC and ST welfare be at least proportional to their share of the population (16.6% and 8.6% respectively).

Key schemes under these frameworks include:

- Post-Matric Scholarships for SC and OBC students: supporting higher education access for socially disadvantaged groups
- PM Janman Yojana (2023): ₹24,000 crore targeted at Particularly Vulnerable Tribal Groups (PVTGs) — the most marginalised tribal communities — for housing, drinking water, connectivity, and livelihood
- Pradhan Mantri Adarsh Gram Yojana (PMAGY): integrated development of villages with >50 per cent SC population

These targeted fiscal allocations represent an acknowledgement that general growth and universal programmes are insufficient to overcome the accumulated disadvantage of centuries of social discrimination: specific fiscal interventions are necessary to achieve horizontal equity.

Indian Case Study: Gender and Public Finance — Gendered Budgeting

India's Gender Budget, introduced in 2005-06, disaggregates Union Budget allocations into two parts: Part A (schemes with 100 per cent gender focus) and Part B (schemes with at least 30 per cent gender focus). In 2024-25, India's Gender Budget stands at approximately ₹3.3 lakh crore — approximately 6.5 per cent of total Union Budget expenditure.

Key gender-equalising fiscal interventions include:

- Beti Bachao Beti Padhao: Addressing the adverse sex ratio (929 girls per 1,000 boys in 2011) through fiscal incentives and awareness campaigns in 640 districts
- PM Matru Vandana Yojana (PMMVY): Maternity benefit of ₹5,000 for the first child of working women in the unorganised sector, performing the Distribution Function for a group excluded from formal maternity protection
- PM Ujjwala Yojana: LPG connections to women in BPL households, reducing the time burden of biomass fuel collection (estimated at 374 million hours per day nationally) and improving women's capability to pursue economic activity
- Mahila Samman Savings Certificate: A special savings scheme for women at 7.5% interest — using fiscal incentive to promote women's financial inclusion

Despite these initiatives, India's female labour force participation rate of approximately 37 per cent (2023–24) remains low by global standards, and the gender wage gap persists. This suggests that while gendered public finance is a necessary condition for gender equality, it is not sufficient without complementary changes in social norms, legal enforcement, and private sector practices.

6.2.3 Spatial Redistribution: Addressing Regional Disparities

India's regional economic disparities are among the widest of any large federal economy. The per capita GSDP of Maharashtra is more than six times that of Bihar. These disparities reflect historical patterns of industrial location, agricultural geography, and the uneven spread of infrastructure investment. Public finance — through fiscal federalism, Centrally Sponsored Schemes, and special category provisions — is the principal mechanism for spatial redistribution.

Indian Case Study: Aspirational Districts Programme — Targeted Spatial Redistribution

The Aspirational Districts Programme (ADP), launched in January 2018, identifies 112 districts across India that lag most severely on indicators of health, nutrition, education, financial inclusion, infrastructure, and agriculture. These districts — concentrated in the 'BIMARU' states (Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh) and tribal belt states — receive concentrated public investment and administrative attention to accelerate their convergence with national averages.

The programme uses a delta ranking system — measuring improvement from baseline rather than absolute level — to incentivise performance and create competitive pressure between districts. Fiscal transfers are enhanced for Aspirational Districts, and district collectors are given greater administrative authority over resource deployment.

By 2024, measurable improvements have been recorded in:

- Institutional delivery rates (up from 63% to 87% in Aspirational Districts between 2018 and 2023)
- Antenatal care coverage (significant improvement in 97 of 112 districts)
- Banking access (Jan Dhan accounts in Aspirational Districts grew faster than national average)

The programme illustrates how targeted spatial fiscal policy — directing resources to the most left-behind places rather than distributing them proportionally — can reduce regional disparities and bring the benefits of development to those furthest from them.

Dimension of Inequality	Public Finance Instrument	Key Indian Scheme/Policy	Mechanism of Reduction
Vertical (income)	Progressive taxation + transfers	MGNREGS, PM-KISAN, PDS, DBT	Raises post-tax income of poor; reduces rich's disposable income
Caste-based (horizontal)	Targeted sub-plan expenditure	SCSP/TSP, PM Janman Yojana	Directs resources to historically marginalised groups

Gender-based	Gendered budgeting	Beti Bachao, PMMVY, Ujjwala Yojana	Reduces gender gaps in health, education, economic participation
Regional (spatial)	Fiscal federalism + targeted schemes	Finance Commission devolution, ADP	Transfers resources from richer to poorer states and districts
Urban-rural	Rural development expenditure	PM Awas Yojana-G, PMGSY, JJM	Reduces infrastructure and income gaps between rural and urban areas
Intergenerational	Human capital investment	NEP 2020, PM-JAY, POSHAN 2.0	Breaks poverty traps; expands capabilities of the next generation

Table 6.1: Dimensions of Inequality and the Role of Public Finance in India

6.3 Public Finance and Economic Growth

Economic growth — the sustained increase in an economy's productive capacity, measured by real GDP per capita — is driven by factor accumulation (physical and human capital), technological progress, and the quality of institutions. Public finance contributes to each of these growth drivers — and can hinder them if poorly managed. The relationship between fiscal policy and growth is therefore nuanced: the right fiscal policies at the right fiscal scale can dramatically accelerate development, while poor fiscal choices or unsustainable deficits can suppress investment and lock economies in low-growth traps.

Key Term	**Economic Growth:** A sustained increase in an economy's real output per capita, driven by the accumulation of physical and human capital, technological innovation, improvements in productivity, and the quality of economic institutions.

6.3.1 Public Investment and the Crowding-In Effect

Public investment in infrastructure, research, and human capital directly adds to the economy's productive capacity — and, crucially, it often complements rather than substitutes for private investment. When the government builds a national highway, it reduces logistics costs and travel times for private firms across the economy. When it invests in grid electricity, it enables factories and small businesses to operate that could not otherwise do so. This complementarity

is called the crowding-in effect: public investment attracts private investment rather than displacing it.

Indian Case Study: National Highways and Private Investment Crowding-In

India's National Highway network expanded from 91,287 km in 2014 to over 1,46,000 km by March 2024 — a 60 per cent increase facilitated by the massive scaling-up of NHAI's capital programme and the Bharatmala Pariyojana, which aims to build 34,800 km of economic corridors and ring roads at a total investment of ₹5.35 lakh crore.

Economic research on the growth impact of India's highway programme finds substantial private investment crowding-in:

- Studies of the Golden Quadrilateral (GQ) highway network — which connected Delhi, Mumbai, Chennai, and Kolkata — found that districts along the GQ corridor experienced significantly faster growth in firm entry, employment, and manufacturing output than comparable districts off the corridor
- The GQ programme reduced transport costs by 30–40 per cent for goods moving along the corridor, improving market integration and enabling firms to access larger markets
- Fertiliser prices fell in agricultural areas near improved highways as distribution costs declined, illustrating the welfare-growth linkage

These findings establish a direct causal link between public fiscal investment in infrastructure and private-sector growth — validating the crowding-in hypothesis for the Indian context.

6.3.2 Human Capital Formation and Long-Run Growth

The endogenous growth theories of Paul Romer and Robert Lucas established that human capital — the stock of knowledge, skills, and health embodied in the workforce — is an engine of long-run growth. Unlike physical capital, human capital does not face diminishing returns: a more educated workforce generates technological spillovers and innovations that sustain growth indefinitely. Public finance, by investing in education and health, directly augments the human capital stock and raises the economy's long-run growth trajectory.

Indian Case Study: The Demographic Dividend and the Fiscal Imperative

India is in the middle of a demographic transition that offers a once-in-a-generation growth opportunity: approximately 65 per cent of the population is under 35, and the working-age population (15–64) will continue to expand until approximately 2040. If this large cohort is adequately educated, skilled, and healthy, India can reap a demographic dividend — an acceleration of growth driven by a high ratio of workers to dependents — similar to that experienced by East Asian economies in the 1970s–1990s.

The realisation of India's demographic dividend depends critically on fiscal policy:

- Education quality: Despite near-universal primary enrolment, learning outcomes remain poor — ASER surveys consistently show that a majority of children in Grade 5 cannot read a Grade 2 text. Improving educational quality requires not merely higher expenditure but better-directed expenditure: teacher training, accountability mechanisms, and digital infrastructure. The NEP 2020 and PM e-Vidya platform represent fiscal bets on quality improvement.
- Skill development: India's rapidly growing youth population requires not merely general education but industry-relevant skills. The PM Kaushal Vikas Yojana (PMKVY) and National Skill Development Corporation (NSDC) use fiscal transfers to bridge the gap between formal education and market-ready skills.
- Health: A workforce afflicted by malnutrition, tuberculosis (India has the world's highest TB burden), and preventable disease cannot reach its productive potential. The National Tuberculosis Elimination Programme (NTEP) and the National Nutrition Mission (POSHAN 2.0) are fiscal investments in workforce health with direct growth implications.

6.3.3 Taxation, Incentives, and Private Sector Growth

The design of the tax system profoundly affects private sector behaviour — investment decisions, location choices, employment practices, and innovation activity. A well-designed tax system minimises distortions, preserves investment incentives, and provides a stable revenue base; a poorly designed system introduces wedges between private and social returns that suppress growth.

Indian Case Study: Corporate Tax Reform and the Growth-Investment Nexus

In September 2019, the Government of India announced a dramatic reduction in the base corporate tax rate from 30 per cent to 22 per cent for existing domestic companies, and a special rate of 15 per cent for new manufacturing companies incorporated after October 2019 and commencing production by March 2024 (subsequently extended).

The reform was motivated by the need to maintain India's competitiveness as a manufacturing destination relative to Southeast Asian economies (Vietnam: 20%, Thailand: 20%, Singapore: 17%) and to stimulate private investment following a period of weak corporate capital expenditure. The revenue cost was approximately ₹1.45 lakh crore per year.

The growth impact has been mixed but directionally positive:

- Corporate capital expenditure (capex) began recovering in 2021-22 and reached multi-year highs by 2023-24, suggesting that improved post-tax returns improved investment incentives
- FDI inflows rose to a record USD 84.8 billion in 2021-22, partly reflecting India's improved tax competitiveness
- The fiscal cost — revenue foregone of ₹1.45 lakh crore annually — represents an opportunity cost: resources that could alternatively have been spent on infrastructure or social programmes

This episode illustrates the fundamental tension in growth-oriented fiscal policy: tax cuts that stimulate private investment reduce fiscal resources for public investment. The net growth effect depends on whether the private investment induced exceeds the public investment displaced.

6.3.4 Research, Innovation, and the Knowledge Economy

Modern growth theory emphasises that technological progress — driven by investment in research a6nd development, innovation, and the diffusion of knowledge — is the ultimate source of sustained long-run growth. Public finance supports innovation through direct research funding (universities, national laboratories), tax incentives (R&D deduction under Section 35 of the Income Tax Act), and the provision of scientific infrastructure.

Indian Case Study: India's Space Programme and Fiscal Returns to R&D

The Indian Space Research Organisation (ISRO), funded entirely through public finance, provides one of India's most striking examples of the long-run growth returns to public R&D investment. ISRO's annual budget of approximately ₹12,000–14,000 crore generates returns across multiple dimensions:

- Commercial revenues: Antrix Corporation and NewSpace India Limited (NSIL), ISRO's commercial arms, earned foreign exchange through satellite launch services. The Chandrayaan and Mangalyaan missions, conducted at a fraction of equivalent NASA or ESA costs (₹450 crore for Mangalyaan vs. USD 2.4 billion for the NASA MAVEN mission), established India's credentials as a cost-competitive space power.
- Technology spillovers: ISRO-developed technologies — in miniaturisation, telemetry, propulsion, and materials science — have diffused into India's defence, telecommunications, and manufacturing sectors
- GPS and navigation: ISRO's NavIC satellite navigation system, once fully operationalised, will reduce India's dependence on US GPS and enable precision agriculture, disaster management, and transport logistics
- Inspiration externality: ISRO's achievements have significantly raised enrolment in science and engineering programmes, contributing to India's human capital stock in technical fields

India's Space Policy 2023, which opens private sector participation in space activities while retaining public funding for foundational R&D, reflects an evolving model of fiscal-private partnership in the knowledge economy.

Growth Channel	Public Finance Mechanism	Indian Example	Growth Impact
Physical capital	Public infrastructure investment	Bharatmala, NHAI, Railways capex	Reduces logistics costs; crowds in private investment
Human capital (education)	Public education expenditure	Samagra Shiksha, NEP 2020, PMKVY	Raises productivity; generates spillovers; demographic dividend
Human capital (health)	Public health expenditure	NTEP, POSHAN 2.0, PM-JAY	Healthier, more productive workforce

Private investment incentives	Corporate tax reform	CIT reduction 2019 (30%→22%)	Higher post-tax returns; improved FDI competitiveness
Innovation and R&D	Public R&D funding + tax incentives	ISRO, DRDO, Sec 35 deduction	Technology spillovers; long-run productivity growth
Market integration	Infrastructure + trade facilitation	GST, freight corridors, digital infra	Reduces transaction costs; deepens domestic market

Table 6.2: Channels through which Public Finance Promotes Economic Growth in India

6.4 Challenges in Public Finance

India's public finance system has achieved remarkable results — sustaining one of the world's fastest-growing major economies, making substantial progress on poverty and human development, and building institutional frameworks for fiscal discipline. Yet it faces deep-seated challenges that constrain its capacity to deliver welfare, reduce inequality, and sustain growth. These challenges are structural, political, and institutional in character — and many of them are reinforcing, creating vicious cycles that are difficult to break without fundamental reform.

6.4.1 Low Tax-to-GDP Ratio and Revenue Adequacy

India's combined central and state government tax revenue amounts to approximately 17 per cent of GDP — significantly lower than the OECD average of 33 per cent, and below comparators such as Brazil (33%), South Africa (26%), and China (21%). This revenue constraint fundamentally limits the resources available for public investment, social protection, and fiscal stabilisation.

Challenge: Revenue Adequacy and the Tax Compliance Gap

India's revenue constraint has multiple structural roots:

1. Agricultural income exemption: Agriculture contributes approximately 15–18 per cent of GDP but is entirely exempt from income tax. Large landowners and commercially successful agribusinesses benefit from this exemption, which has no justification on equity or efficiency grounds at current agricultural income levels.

2. Informality: Over 80 per cent of India's workforce is employed in the informal sector, outside the formal payroll tax and income tax net. Self-employed workers, casual

labourers, and micro-enterprise owners generate incomes that are largely unobserved by the tax authority, creating a vast tax compliance gap.

3. Tax expenditures: The Revenue Foregone Statement appended to the Union Budget estimates that tax exemptions, deductions, and concessions cost approximately ₹10–12 lakh crore per year in foregone revenue — equivalent to nearly 4 per cent of GDP. Many of these concessions disproportionately benefit high-income households and large corporations, eroding the base of the most progressive taxes.

4. GST implementation gaps: Despite the GST's expansion of the indirect tax base, the compliance gap — estimated by the IMF at approximately 4–6 per cent of GDP — persists due to invoice mismatching, composition scheme abuse, and evasion in the real estate and informal sectors.

6.4.2 Fiscal Deficit and Public Debt Sustainability

India's general government fiscal deficit — combining Union and State deficits — has averaged approximately 6–8 per cent of GDP over the past decade, generating persistent public debt accumulation. The Union Government's fiscal deficit reached 9.2 per cent of GDP during COVID-19 (2020-21), and despite subsequent consolidation, remains above the FRBM target of 3 per cent at 5.1 per cent in 2024-25.

Challenge: Debt Dynamics and Fiscal Space

India's general government debt stands at approximately 85 per cent of GDP in 2024 — high relative to the IMF's recommended threshold of 60 per cent for emerging markets. The debt service burden — interest payments on Union Government debt — consumes approximately ₹11.9 lakh crore or 18–20 per cent of Union expenditure in 2024-25, crowding out resources for productive investment and social spending.

The debt dynamics are particularly concerning for three reasons:

- Interest rates above growth rates: If the real interest rate on government debt persistently exceeds the real GDP growth rate (the 'r > g' condition), debt-to-GDP ratios will rise unsustainably without primary surpluses — requiring either higher taxes or lower spending
- Off-budget liabilities: A significant share of quasi-fiscal activity — NSSF borrowings, oil bonds, food credit from FCI — does not appear in the headline fiscal deficit, understating the true fiscal burden
- State government stress: Several state governments — particularly those with large off-budget borrowings, power sector liabilities (UDAY), and DISCOM losses — face deteriorating fiscal positions that could trigger contingent liabilities for the Union Government

Sustainable fiscal consolidation — reducing the deficit through a combination of revenue enhancement and expenditure rationalisation, without compressing growth-enabling capital expenditure — is the central challenge of Indian public finance in the medium term.

6.4.3 Quality of Public Expenditure

The challenge of Indian public finance is not only quantitative (spending enough) but qualitative (spending well). Large nominal allocations frequently fail to translate into proportionate welfare outcomes because of implementation weaknesses, leakages, and misalignment between expenditure priorities and development needs.

Challenge: Expenditure Quality, Leakage, and Implementation Capacity

Key dimensions of expenditure quality failure in India include:

1. Revenue-capital composition: Until the mid-2010s, India's Union Budget was heavily weighted toward revenue expenditure (salaries, subsidies, interest payments) at the expense of capital expenditure. Revenue spending generates limited growth multipliers; capital spending has multipliers of 2–2.5. The deliberate rebalancing toward capex since 2021–22 has improved expenditure quality but the structural pressure of entrenched revenue commitments persists.

2. Subsidy rationalisation: India's combined food, fertiliser, and fuel subsidy bill exceeds ₹4 lakh crore annually. A substantial share is poorly targeted — benefiting non-poor households, encouraging inefficient resource use (water-intensive crops, polluting fuels), and crowding out productive investment. The shift from in-kind to cash transfers (through DBT) has improved targeting, but the political economy of subsidy reform makes further rationalisation difficult.

3. Project execution: India's capital expenditure programme has historically been marked by time and cost overruns. The compulsory acquisition of land, complex environmental clearances, contractor capacity constraints, and bureaucratic delays mean that a significant share of sanctioned capex remains unspent at year-end. Improving project execution capacity is as important as raising allocation levels.

4. Centrally Sponsored Schemes (CSS): India operates over 130 CSS, with complex matching grant requirements, multiplied reporting burdens, and limited flexibility for states to adapt programmes to local conditions. The Administrative Reforms Commission and successive Finance Commissions have recommended rationalisation of CSS; progress has been limited by the political economy of scheme proliferation.

6.4.4 Fiscal Federalism and Intergovernmental Imbalances

India's federal fiscal architecture faces structural tensions between the assignment of expenditure responsibilities and the distribution of revenue powers. States bear primary responsibility for education, health, agriculture, law and order, and local infrastructure — but the revenue-generating taxes (income tax, corporate tax, GST) are predominantly under Union control. This vertical imbalance — States spending more than they raise — is partially addressed by Finance Commission transfers and Plan grants, but creates chronic dependence and reduces States' fiscal autonomy.

Challenge: Vertical and Horizontal Fiscal Imbalances in Indian Federalism

Key federalism challenges in Indian public finance include:

1. Vertical imbalance: States finance approximately 60 per cent of social sector expenditure but generate only about 38–40 per cent of total government revenues. This dependence on central transfers creates vulnerability — when Union revenues underperform (as in COVID-19), state finances come under immediate stress.

2. GST compensation disputes: The GST reform (2017) promised States compensation for revenue shortfalls for five years (until 2022). As GST revenues underperformed initial projections, the Union Government borrowed on States' behalf rather than paying compensation directly — triggering disputes about fiscal autonomy and cooperative federalism.

3. Off-budget borrowings by States: Several states have accumulated significant off-budget liabilities through State-owned enterprises, power distribution companies (DISCOMs), and special purpose vehicles. These liabilities — not captured in headline deficit statistics — pose systemic fiscal risks and complicate macroeconomic management.

4. Third tier neglect: India's third tier of government — Panchayati Raj Institutions (PRIs) and urban local bodies (ULBs) — remains severely under-resourced. Most PRIs collect negligible own-source revenue and depend entirely on central and state grants. The resulting mismatch between local fiscal capacity and local service delivery responsibilities is a fundamental constraint on the quality of grassroots public services.

6.4.5 Corruption, Leakage, and Governance Deficits

The efficacy of public finance ultimately depends on the quality of governance — the capacity and integrity of public institutions to translate fiscal allocations into welfare outcomes. Corruption, patronage, and institutional weakness can effectively neutralise even the best-designed fiscal interventions.

Challenge: Corruption and Institutional Capacity in Public Expenditure

Despite significant improvements in transparency and accountability — RTI Act (2005), DBT, PFMS (Public Financial Management System), and GeM (Government e-Marketplace) — governance deficits continue to impair the welfare impact of public finance in India:

- Public procurement corruption: Government procurement of goods and services — amounting to approximately 20–25 per cent of GDP — is a major site of rent-seeking. Kickbacks, tender rigging, and quality compromises divert public resources from their intended purposes. GeM, which digitises government procurement, processed ₹2.35 lakh crore in 2023-24 and has improved price discovery and reduced corruption in covered categories.

- MGNREGS ghost employment: Despite Aadhaar seeding and bank-linked payments, MGNREGS continues to suffer from inflated muster rolls, ghost workers, and diversion of funds by local political networks. An estimated 10–15 per cent of MGNREGS expenditure does not reach genuine beneficiaries in the most affected states.

- Healthcare and education provider absenteeism: A persistent feature of India's public health and education systems is provider absenteeism — doctors and teachers who are on the payroll but absent from their posts. World Bank surveys have found teacher absence rates of 25 per cent and healthcare worker absence rates of 40 per cent in government facilities in some states — making public expenditure on salaries a partial subsidy for private practice rather than a provision of public services.

- State capacity variation: Public finance outcomes are extremely heterogeneous across states — reflecting vast differences in administrative capacity, political accountability, and institutional quality. Kerala's high-performing public health and education system and Tamil Nadu's efficient PDS implementation demonstrate that strong institutions can deliver excellent welfare outcomes at moderate expenditure levels; other states spend comparable amounts with far worse results.

6.4.6 Climate Change and Fiscal Risk

An emerging and increasingly urgent challenge for Indian public finance is the fiscal risk posed by climate change. India is among the world's most climate-vulnerable countries — exposed to intensifying droughts, floods, cyclones, heatwaves, and sea-level rise that impose growing costs on public budgets through disaster relief, agricultural support, infrastructure repair, and health system stress.

India's Climate Fiscal Challenge

The Economic Survey 2022-23 estimated that India will need to spend approximately USD 2.5 trillion (approximately ₹200 lakh crore at current exchange rates) on climate adaptation and mitigation between now and 2030 — requiring sustained public finance commitment on a scale that strains existing fiscal frameworks.

Key fiscal dimensions of India's climate challenge include:

- Green infrastructure: Renewable energy capacity (targeting 500 GW by 2030), EV charging infrastructure, coastal protection, and flood management require massive public and private capital mobilisation beyond existing budgetary frameworks
- Loss and damage: Climate-related agricultural losses, property destruction, and displacement impose growing demands on public disaster relief and social protection budgets
- Just transition: Coal mining regions (Jharkhand, Chhattisgarh, Odisha) face structural unemployment as India transitions away from coal; public finance must fund the social protection and economic diversification of these communities
- Green taxonomy and sovereign green bonds: India issued its inaugural Sovereign Green Bonds in January 2023, raising ₹16,000 crore for green infrastructure — a new fiscal instrument that aligns public finance with climate objectives

Climate fiscal risk is not a future problem: it is already present in India's annual disaster management expenditure, agricultural insurance costs, and the growing fiscal exposure of state governments to climate-linked food price volatility.

CHAPTER SUMMARY

- Public finance affects social welfare through three channels: allocative efficiency (public and merit goods provision), redistribution (tax-transfer system), and macroeconomic stabilisation. Sen's capabilities approach extends welfare beyond income to encompass education, health, and freedom from deprivation.
- The welfare impact of public finance in India is illustrated by PM-POSHAN (cost-benefit multiplier of ₹7–8), IMD cyclone warnings (lives saved as a return on public R&D), and the Kerala model (high HDI at modest income through sustained social spending).
- Public finance reduces inequality through vertical redistribution (progressive taxation, MGNREGS, PDS, DBT), horizontal redistribution (SC/ST sub-plans, gendered budgeting, Ujjwala Yojana), and spatial redistribution (Finance Commission devolution, Aspirational Districts Programme).
- Public finance promotes economic growth through infrastructure investment (Bharatmala, crowding-in effect), human capital formation (Samagra Shiksha, PMKVY, NTEP), corporate tax reform (CIT reduction 2019), and public R&D (ISRO, technology spillovers).
- The principal challenges confronting India's public finance are: low tax-to-GDP ratio (~17% of GDP), fiscal deficit and debt sustainability (general government debt ~85% of GDP), poor expenditure quality (subsidy leakage, capex execution), fiscal federal imbalances, governance deficits (corruption, provider absenteeism), and emerging climate fiscal risk.
- Addressing these challenges requires a comprehensive fiscal reform agenda: broadening the tax base, rationalising subsidies, strengthening state capacity, deepening fiscal federalism, and integrating climate risk into public finance frameworks.

Review Questions

Section A: Short-Answer Questions

- Define public finance and explain the three channels through which it affects social welfare.
- What is the capabilities approach? How does it provide a richer account of welfare than the income-based approach, and what are its implications for Indian fiscal policy?
- Distinguish between vertical and horizontal inequality. Give one Indian example of a fiscal policy instrument designed to address each.
- Explain the crowding-in effect of public investment. How does India's highway programme illustrate this concept?
- Define the fiscal deficit. Why does a persistent fiscal deficit pose a challenge to long-run welfare and growth in India?

- What is meant by the quality of public expenditure? Give two examples of poor expenditure quality in Indian public finance.

Section B: Application and Analysis

- Using the cases of Kerala and Bihar, evaluate the proposition that public finance is a more important determinant of human welfare than per capita income. What are the implications for fiscal policy priorities?
- Critically assess the role of public finance in reducing caste-based horizontal inequality in India. To what extent have SCSP/TSP expenditures and targeted schemes succeeded in closing gaps, and what structural limitations remain?
- Evaluate the claim that India's low tax-to-GDP ratio is the most fundamental challenge facing Indian public finance. Consider both the revenue and governance dimensions of the problem.
- Discuss the relationship between fiscal policy and economic growth with reference to India's capital expenditure strategy since 2021-22. Does the emphasis on infrastructure capex represent the most effective use of public resources for growth?
- To what extent does climate change represent an existential challenge to the fiscal sustainability of the Indian state? Consider both the expenditure demands and the potential for innovative fiscal instruments (green bonds, carbon pricing) to address them.

  Integrate the concepts of allocation, distribution, and stabilisation to provide a comprehensive assessment of whether India's public finance system is fit for purpose in delivering economic welfare in the 21st century.

Unit 2:

Budgeting: meaning of budget and its various types. Modern classification of budget. Concept of various budgetary deficits and its implications. Public expenditure in India, trends, and issues.

Chapter 1:
Introduction to Budgeting

- Meaning of Budget
- Objectives of Budget
- Importance of Budget in an Economy
- Features of a Good Budget
- Budget as a Fiscal Policy Tool

LEARNING OBJECTIVES

After studying this chapter, students should be able to:

1. Define the concept of a budget and explain its core components.
2. Identify and explain the primary objectives of budgeting.
3. Assess the importance of budgeting within an economy.
4. Enumerate the essential features of a sound and effective budget.
5. Analyse the role of a budget as an instrument of fiscal policy.

1.1 Meaning of Budget

The term 'budget' is derived from the Old French word bougette, meaning a small leather bag or wallet. Over the centuries the word evolved in English usage to denote the annual statement of government revenues and expenditures presented to a legislative assembly. Today, the concept of a budget has expanded far beyond government finance and is applied by households, corporations, non-profit organisations, and public institutions as a central tool of financial planning and control.

At its most fundamental level, a budget is a formal financial plan that estimates expected revenues and proposed expenditures over a defined period — typically one fiscal year. It serves as both a blueprint for resource allocation and a benchmark against which actual financial performance is subsequently measured. A budget is therefore simultaneously a statement of intent, a guide for action, and a standard for evaluation.

1.1.1 Definitions of Budget

Several authorities have offered precise definitions that capture the multi-dimensional nature of a budget:

Burkhead (1956)	A budget is a plan for the accomplishment of programmes related to objectives and goals within a definite time period, including an estimate of resources required, together with a systematic reporting of work accomplished compared with the plan.

National Finance Committee	A budget is a comprehensive plan, expressed in financial terms, by which an operating programme is made effective.

International Monetary Fund	The government budget is a comprehensive statement of the government's revenue and expenditure plans over the forthcoming financial year, designed to meet macroeconomic, social, and developmental goals.

From the foregoing definitions, it is clear that a budget possesses three essential characteristics: (i) it is expressed in quantitative — usually monetary — terms; (ii) it covers a specified future period; and (iii) it represents management's or government's plan or policy for the relevant period.

1.1.2 Types of Budget

Budgets may be classified on the basis of scope, time horizon, or the basis of preparation. The major types include:

- Government (Public) Budget: Prepared annually by the central or state government and presented to the legislature for approval. It details tax revenues, non-tax revenues, capital receipts, and expenditure on various public programmes.
- Corporate Budget: Prepared by business organisations to plan revenues from operations and costs of production, marketing, and administration.
- Household Budget: An informal or semi-formal plan by families to manage personal income and expenditure.
- Balanced Budget: A budget in which total revenues equal total expenditures, with no deficit or surplus.
- Surplus Budget: A budget in which revenues exceed expenditures; typically used as a contractionary fiscal measure.

- Deficit Budget: A budget in which expenditures exceed revenues; government finances the gap through borrowing or drawing from reserves; commonly used during downturns to stimulate growth.
- Zero-Based Budget (ZBB): Every expenditure item must be freshly justified each period, regardless of the previous year's allocation.
- Programme Budget: Expenditures are organised by programmes or objectives rather than by line-items or departments.
- Performance Budget: Links financial inputs to expected outputs and outcomes, facilitating accountability.

1.2 Objectives of Budget

Budgets — whether public or private — are not prepared as a mere accounting formality. They are purposeful instruments whose objectives determine their design, content, and the process by which they are enacted and administered. The principal objectives of budgeting are discussed below.

1.2.1 Resource Allocation

One of the paramount objectives of a budget is to allocate scarce financial resources among competing needs efficiently and equitably. In the public sector, a government must decide how much to spend on defence, education, health, infrastructure, agriculture, and social protection, among others. The budget provides the mechanism for making these difficult trade-off decisions explicit, transparent, and subject to democratic scrutiny. By directing resources to priority sectors, the budget operationalises the government's development vision and social contract with citizens.

1.2.2 Economic Stabilisation

Modern governments use the budget as a major instrument for maintaining macroeconomic stability. During periods of economic recession or high unemployment, a government may deliberately adopt an expansionary budget — increasing expenditure or reducing taxes — to inject demand into the economy (the so-called fiscal stimulus). Conversely, during periods of inflation or an overheating economy, a contractionary budget — curtailing expenditure or raising taxes — helps withdraw excess purchasing power from circulation. This counter-cyclical use of the budget is central to Keynesian demand-management theory.

1.2.3 Redistribution of Income and Wealth

Budgetary policy is a primary instrument for correcting the inequalities generated by market forces. Progressive taxation — where higher-income individuals pay proportionately more in taxes — combined with targeted social expenditures such as cash transfers, subsidised healthcare, free public education, and food support programmes, shifts resources from wealthier segments of society to those less privileged. The redistributive objective of the budget is central to achieving social justice and reducing poverty in an economy.

1.2.4 Mobilisation of Resources

The budget sets out the government's plan for raising revenue through taxes, fees, grants, and borrowing. A well-crafted budget broadens the tax base, improves tax compliance, eliminates wasteful tax exemptions, and explores non-tax revenues. This mobilisation function is particularly critical in developing economies that face large financing gaps in funding public infrastructure and social services.

1.2.5 Control and Accountability

The budget is the principal instrument through which the executive is held accountable by the legislature and, ultimately, by citizens. Once approved by Parliament or Congress, the budget authorises public spending and sets a ceiling on it. Any deviation — overspending, underspending, or misallocation — must be explained and justified. Internal audit, external audit, and legislative oversight committees use the approved budget as the reference document against which actual financial performance is evaluated, thereby deterring corruption and promoting transparency.

1.2.6 Promotion of Economic Growth and Development

Beyond short-term stabilisation, a budget can be designed to promote long-term structural transformation of the economy. Capital budgets that allocate funds to infrastructure — roads, electricity, ports, irrigation — improve factor productivity and reduce the cost of doing business, thereby catalysing private investment. Research and development expenditure, investments in education and skills training, and support for technology adoption collectively enhance an economy's productive capacity and its global competitiveness.

1.2.7 Financing Public Goods and Externalities

Markets tend to under-provide public goods (such as national defence, lighthouses, or public health campaigns) because of the free-rider problem, and they may over-produce negative externalities (such as pollution) because private producers do not bear the full social cost of their activities. The budget corrects these market failures by directly financing public goods from tax revenues and by using taxes (Pigouvian taxes), subsidies, and regulations to internalise externalities.

1.3 Importance of Budget in an Economy

The budget occupies a unique position at the intersection of politics, economics, and public administration. Its importance for the functioning of a modern economy can scarcely be overstated. The following dimensions illustrate the wide-ranging significance of the budget.

1.3.1 Instrument of Macroeconomic Management

As elaborated in the discussion of objectives, the budget is the government's most powerful lever for managing aggregate demand. Through the fiscal multiplier effect, a one-unit increase in government expenditure can generate a greater-than-one-unit increase in national income, depending on the marginal propensity to consume and the degree of import leakage. Similarly, tax cuts raise disposable income, stimulate consumption and investment, and expand output. Sound budgetary management is therefore inseparable from the pursuit of the key

macroeconomic goals of full employment, price stability, sustained growth, and balance-of-payments equilibrium.

1.3.2 Guide for National Planning

In developing economies, where governments play an activist role in directing economic transformation, the annual budget is the principal vehicle for translating medium-term development plans into funded programmes and projects. The budget disaggregates the targets of a Five-Year Plan or a Medium-Term Expenditure Framework (MTEF) into annual allocations across ministries, departments, and agencies, ensuring that strategic priorities are resourced and implemented incrementally.

1.3.3 Confidence and Investor Sentiment

A credible, predictable, and transparent budget process inspires confidence among domestic and foreign investors, lenders, and international organisations such as the IMF and World Bank. When investors observe that a government manages public finances prudently — maintaining fiscal discipline, controlling the debt-to-GDP ratio, and delivering on budget commitments — they are more willing to invest, extend credit at reasonable rates, and provide development assistance. Conversely, chronic fiscal deficits, opaque budget processes, or arbitrary changes in tax policy erode investor confidence and can trigger capital flight or sovereign credit-rating downgrades.

1.3.4 Social Development and Poverty Reduction

Public spending on education, health, water and sanitation, housing, and social protection — all financed through the budget — directly improves human welfare and reduces poverty. The budget determines whether adequate resources flow to primary schools in rural areas, community health centres, maternal health programmes, and social safety nets. By prioritising the poor and vulnerable in expenditure decisions, a budget can serve as a powerful instrument of human development and inclusive growth.

1.3.5 Financial Discipline and Fiscal Sustainability

Without a budget, there is no framework to prevent overspending, accumulation of unpaid bills (arrears), or uncontrolled borrowing. The budget imposes fiscal discipline by establishing hard expenditure ceilings, setting deficit targets, and limiting debt accumulation to sustainable levels. Fiscal sustainability — ensuring that today's borrowing does not create an intolerable burden for future generations — is fundamentally a budgetary concern. Fiscal rules embedded in law, such as deficit ceilings or debt brakes, give these discipline objectives legal force.

1.3.6 Transparency and Democratic Governance

The annual budget debate in the legislature is one of the foremost democratic rituals in a modern state. It provides an opportunity for elected representatives to scrutinise the government's revenue and spending plans, propose amendments, and hold the executive accountable. Budget transparency — through open budget documents, citizens' budgets, and public hearings — empowers civil society and ordinary citizens to engage with fiscal decisions that directly affect their lives. International indices such as the Open Budget Index (OBI)

measure the degree to which governments make budget information publicly available and promote citizen participation.

1.3.7 Coordination among Government Agencies

The budget process requires all ministries and departments to articulate their spending plans within a common framework and a central resource envelope. This inter-agency coordination prevents duplication of programmes, identifies complementarities, and ensures that the aggregate expenditure plan is coherent and internally consistent. The Ministry of Finance or Treasury plays a coordinating role, adjudicating competing claims on the budget and ensuring that sectoral plans align with overall macro-fiscal targets.

1.4 Features of a Good Budget

Not all budgets are equally effective. A budget can be technically correct yet practically useless if it is not grounded in realistic assumptions, transparently presented, or faithfully implemented. The following features are widely regarded as the hallmarks of a sound budget.

1.4.1 Comprehensiveness

A good budget should cover all government revenues and expenditures — nothing should be hidden off-budget in special accounts or extra-budgetary funds that escape legislative scrutiny. Comprehensiveness ensures that the legislature and the public have a complete picture of the government's fiscal position and can make meaningful comparisons across years and against benchmarks. The proliferation of extra-budgetary funds in some countries has been criticised precisely because it undermines the comprehensive nature of the budget.

1.4.2 Clarity and Transparency

Budget documents should be presented in a clear, accessible format that allows legislators, analysts, journalists, and citizens to understand what the government intends to do with public money. Transparency requires not only publishing the budget but also disclosing the assumptions behind revenue and expenditure projections, the methodology used for macroeconomic forecasting, and the risk factors that could cause actual outcomes to deviate from plans. Many governments now publish a 'Citizens' Budget' — a simplified, non-technical summary of the annual budget for a general audience.

1.4.3 Realism and Accuracy

Revenue and expenditure estimates must be grounded in rigorous analysis of current economic conditions, historical trends, and credible assumptions about future developments. Overestimating revenues or underestimating costs — sometimes done to make the budget appear balanced on paper — leads to mid-year shortfalls, spending cuts, or supplementary budgets that undermine fiscal credibility. Realistic budgeting requires independent macroeconomic forecasting capacity and, in many countries, the use of fiscal councils or independent budget offices to validate official projections.

1.4.4 Flexibility

While fiscal discipline requires adherence to the budget, a good budget also incorporates mechanisms for responding to unforeseen events — natural disasters, economic shocks, or security crises — without triggering a complete breakdown of fiscal planning. Contingency reserves, emergency funds, and virement provisions (which allow reallocation of funds within

a vote) provide the flexibility needed to address genuine emergencies while preserving the overall integrity of the budget framework.

1.4.5 Consistency with Policy Objectives

A good budget should be internally consistent and aligned with the government's stated policy objectives and medium-term development plans. If a government declares that education is its top priority, that priority must be reflected in the education sector's share of total expenditure. Disconnect between policy rhetoric and budget allocations signals either fiscal constraints or a lack of commitment, both of which erode public trust. Budget programmes and expenditure lines should be clearly linked to outcomes, so that resource allocation decisions can be defended on the basis of expected results.

1.4.6 Balance between Revenue and Expenditure

While it is recognised that deficit budgets may be economically justified in certain circumstances, a good budget should aim for fiscal balance — or at least a sustainable deficit — over the medium term. Chronically large deficits accumulate as debt, which future taxpayers must service. A good budget thus makes explicit the financing of any deficit, explains the sustainability of the debt path, and sets out a credible medium-term fiscal consolidation plan where deficits are projected to narrow over time.

1.4.7 Accountability and Enforceability

A budget that cannot be enforced is merely aspirational. A good budget is backed by a legal framework — an Appropriations Act, a Budget Law, or a Public Finance Management Act — that authorises spending, establishes spending limits, and imposes sanctions for non-compliance. Robust internal controls, timely financial reporting, independent external audit, and effective legislative oversight committees are the institutional pillars that give the budget its force and ensure that public funds are used for their intended purposes.

1.4.8 Annual Currency and Timeliness

A budget must be approved and in place before the start of the fiscal year to which it relates. Late budgets — a chronic problem in many legislatures — create uncertainty, force government agencies to operate on the basis of interim cash releases, and delay the implementation of public programmes. Good budget systems establish clear statutory deadlines for budget preparation, submission, and legislative approval, and enforce those deadlines consistently.

1.5 Budget as a Fiscal Policy Tool

Fiscal policy refers to the use of government revenue and expenditure decisions to influence the macroeconomic environment. The budget is the principal instrument through which fiscal policy is formulated, communicated, and implemented. Understanding this relationship requires familiarity with the mechanisms by which fiscal policy operates, the types of fiscal policy stances, and the conditions under which fiscal policy is most effective.

1.5.1 The Theoretical Foundation: Keynesian Economics

The intellectual basis for using the budget as a fiscal policy tool derives primarily from the work of John Maynard Keynes, whose landmark publication, The General Theory of Employment, Interest and Money (1936), demonstrated that market economies can get stuck

in equilibrium below full employment, and that deliberate government intervention — particularly through deficit spending — can restore aggregate demand and output. Keynes's insight was that during a deflationary depression, when consumers and businesses are unwilling to spend, government can step in as the 'spender of last resort,' injecting purchasing power into the economy through public expenditure. This foundational insight underpins modern fiscal policy and legitimises the use of budget deficits as a counter-cyclical tool.

1.5.2 Fiscal Policy Transmission Mechanisms

The budget influences the economy through several channels:

- Aggregate Demand Effect: Government expenditure on goods, services, and transfers directly increases aggregate demand (C + I + G + NX). An increase in G raises GDP through the multiplier effect.
- Disposable Income Effect: Tax cuts increase households' disposable income, stimulating consumption and saving.
- Investment Effect: Tax incentives (such as investment allowances or accelerated depreciation) and public infrastructure investment crowd in private investment by reducing costs and improving the business environment.
- Wealth Effect: Capital expenditure creates public assets — roads, bridges, ports — that generate long-run productivity gains and raise the economy's potential output.
- Distributional Effect: Targeted transfers and progressive taxation shift purchasing power to lower-income groups, who typically have a higher marginal propensity to consume, thus amplifying the demand stimulus.

1.5.3 Types of Fiscal Policy Stance

The overall fiscal stance of a budget — whether it is expansionary, contractionary, or neutral — depends on the relationship between government expenditure and revenue:

Expansionary Fiscal Policy	The budget is expansionary when government spending exceeds tax revenues (deficit budget). This stance is appropriate during recessions, high unemployment, or deflationary pressures. The deficit injects net demand into the economy, stimulating output and employment.

Contractionary Fiscal Policy	The budget is contractionary when tax revenues exceed government spending (surplus budget). This stance is used to cool an overheating economy, reduce inflationary pressures, or pay down public debt. It withdraws net demand from the economy.

Neutral Fiscal Policy	A balanced budget — revenues equal expenditures — implies a broadly neutral stance, though the composition of revenues and expenditures still matters for resource allocation and distributional outcomes.

1.5.4 Automatic Stabilisers

Not all fiscal policy responses are discretionary. Built into every modern budget are automatic stabilisers — fiscal mechanisms that automatically expand the deficit during downturns and reduce it during upturns, without requiring any deliberate policy action. The principal automatic stabilisers are:

- Progressive Income Tax: As incomes fall during a recession, taxpayers automatically move into lower tax brackets, reducing the tax burden and cushioning the fall in disposable income. Conversely, rising incomes during a boom push taxpayers into higher brackets, withdrawing purchasing power and dampening inflationary pressure.
- Unemployment Benefits: As job losses rise during a recession, unemployment benefit payments automatically increase, partially replacing lost wage income and sustaining consumption. As employment recovers, these payments automatically fall.
- Corporate Tax Revenue: Profits tend to fall sharply during recessions, automatically reducing corporate tax receipts and easing the tax burden on businesses precisely when they are under stress.

Automatic stabilisers are particularly valued because they operate quickly, do not require legislative action, and are broadly symmetrical — they expand the deficit in bad times and reduce it in good times, making them inherently counter-cyclical.

1.5.5 Discretionary Fiscal Policy

Beyond automatic stabilisers, governments also use discretionary fiscal policy — deliberate, policy-driven changes in taxation or expenditure — to achieve macroeconomic objectives. Examples include: stimulus packages during recessions (as seen globally during the 2008-09 Global Financial Crisis and the COVID-19 pandemic), infrastructure investment programmes, targeted tax cuts for businesses or households, and austerity measures to reduce fiscal deficits. Discretionary fiscal policy is generally slower to implement than monetary policy because it requires legislative approval, but it can be more powerful in situations where monetary policy is constrained — such as when the policy interest rate is at or near the zero lower bound.

1.5.6 Fiscal Multipliers

The fiscal multiplier measures the change in GDP resulting from a given change in government spending or taxes. If the multiplier is greater than one, a one-unit increase in government expenditure produces a more-than-one-unit increase in GDP — a powerful amplification effect. The size of the fiscal multiplier depends on:

- The Marginal Propensity to Consume (MPC): Higher MPC leads to larger multipliers, as additional income is quickly spent and re-spent through the economy.
- Trade Openness: In highly open economies, a significant portion of additional demand leaks out as imports, reducing the domestic multiplier.

- Exchange Rate Regime: Under a flexible exchange rate, fiscal expansion may appreciate the currency and crowd out net exports, reducing the multiplier.
- Monetary Policy Accommodation: If the central bank accommodates fiscal expansion by keeping interest rates low, the crowding-out effect on private investment is minimised and the multiplier is larger.
- Type of Fiscal Instrument: Research suggests that public investment multipliers are generally larger than tax-cut multipliers, because investment creates assets and raises productive capacity.

1.5.7 Challenges and Limitations of Fiscal Policy

While the budget is a powerful fiscal policy instrument, its effectiveness is subject to a number of practical and theoretical constraints:

- Implementation Lags: There are significant lags between the recognition of an economic problem, the decision to act, the enactment of a budget measure, and its actual impact on the economy. By the time a fiscal stimulus takes effect, the recession may have already ended.
- Crowding-Out Effect: Deficit financing through borrowing can raise interest rates (by competing with the private sector for funds), thereby crowding out private investment and partially offsetting the fiscal stimulus.
- Ricardian Equivalence: Some economists argue that rational households, anticipating future tax increases to repay government debt, will save rather than spend a tax cut, neutralising the demand stimulus.
- Debt Sustainability Concerns: Persistent deficits accumulate as public debt. If debt reaches levels that markets regard as unsustainable, the government may face a fiscal crisis, higher borrowing costs, and ultimately forced austerity — the very opposite of the intended stimulus.
- Political Economy Constraints: In practice, governments often find it easier to increase spending or cut taxes during downturns than to pursue fiscal consolidation during booms. This asymmetric political economy of fiscal policy tends to produce a structural bias toward deficits and debt accumulation.
- Capacity and Governance Constraints: In developing countries, the effectiveness of fiscal policy may be limited by weak administrative capacity, poor expenditure management systems, and governance challenges such as corruption and leakages.

1.5.8 The Budget and Fiscal Rules

To address the political economy biases in fiscal policy, many countries have adopted fiscal rules — legislated constraints on budget deficits, debt levels, or expenditure growth. Well-known examples include the Stability and Growth Pact (SGP) in the European Union, which requires member states to keep budget deficits below 3% of GDP and debt below 60% of GDP; Germany's constitutional debt brake (Schuldenbremse); and the Public Finance Management Acts of various African and Commonwealth countries. Fiscal rules can enhance the credibility of fiscal policy, anchor market expectations, and protect fiscal sustainability, but they must be

designed with escape clauses for genuine emergencies and must be enforced by credible institutions.

CHAPTER SUMMARY

This chapter has provided a foundational understanding of the concept, purposes, and importance of budgeting. The following key points were covered:

- A budget is a formal financial plan estimating revenues and expenditures over a specified period. Types include government, corporate, balanced, surplus, deficit, zero-based, programme, and performance budgets.
- The key objectives of a budget include resource allocation, economic stabilisation, income redistribution, resource mobilisation, control and accountability, promoting economic growth, and financing public goods and correcting externalities.
- The importance of a budget spans macroeconomic management, national planning, investor confidence, social development, fiscal discipline, democratic governance, and inter-agency coordination.
- Features of a good budget include comprehensiveness, clarity, realism, flexibility, policy consistency, fiscal balance, accountability, and timeliness.
- As a fiscal policy tool, the budget operates through demand, income, investment, wealth, and distributional channels. Fiscal policy stances include expansionary, contractionary, and neutral. Automatic stabilisers and discretionary measures are the two main categories of fiscal policy. Fiscal multipliers, crowding-out effects, implementation lags, and debt sustainability considerations all shape the effectiveness of budget-based fiscal policy.

Review Questions

1. Define a budget and distinguish between a deficit budget, surplus budget, and balanced budget. In what circumstances is each type appropriate?

2. Explain how a government budget can be used as an instrument of income redistribution. Provide specific examples of revenue and expenditure measures that serve this objective.

3. 'A budget is not merely a financial document but a statement of political priorities.' Discuss this assertion with reference to the objectives and features of a good budget.

4. What are automatic stabilisers? Explain, with the aid of examples, how they function to moderate the business cycle without discretionary government action.

5. Evaluate the effectiveness of fiscal policy as a tool for macroeconomic management, taking into account the concept of fiscal multipliers and the major challenges and limitations of discretionary fiscal policy.

6. Critically assess the role of fiscal rules in promoting fiscal discipline. Use any one country or regional framework as a case study.

Chapter 2:
Types of Budget

- Balanced Budget
- Surplus Budget
- Deficit Budget
- Revenue Budget
- Capital Budget
- Performance Budget
- Programme Budget
- Zero-Based Budget
- Gender Budget
- Outcome Budget

LEARNING OBJECTIVES

After studying this chapter, students should be able to:

- Define and distinguish between Balanced, Surplus, and Deficit Budgets.
- Explain the structure and significance of Revenue and Capital Budgets.
- Describe Performance, Programme, Zero-Based, Gender, and Outcome Budgets.
- Illustrate each budget type with concrete numerical and real-world examples.
- Evaluate the advantages and limitations of each budgetary approach.
- Apply knowledge of budget types to analyse fiscal policy decisions.

A budget is not a monolithic instrument — it takes many forms, each designed to serve specific fiscal, managerial, or social objectives. The choice of budget type reflects the priorities of the government or organisation, the level of administrative sophistication, and the economic environment. This chapter examines ten major types of budget used in public finance, each explained with its definition, key features, advantages, limitations, and a practical numerical example.

2.1 Balanced Budget

Definition

A Balanced Budget is one in which total government revenues are exactly equal to total government expenditures over a given fiscal period. There is neither a fiscal deficit nor a fiscal surplus. The government spends no more than it collects.

The concept of the balanced budget has deep historical roots, rooted in the classical economic tradition that treated government finance analogously to household finance — a responsible government, like a prudent household, should not spend beyond its means. While modern Keynesian economics has challenged this orthodoxy, the balanced budget remains an important benchmark and is enshrined in the fiscal rules of many countries.

Key Features

- Total Revenue = Total Expenditure (Budget Deficit = 0).
- No borrowing is required to finance expenditure.
- Implies fiscal prudence and self-sufficiency.
- Commonly associated with classical and conservative fiscal philosophy.
- Automatically avoids debt accumulation from current operations.

Merits

- Promotes fiscal discipline and prevents reckless spending.
- Maintains public confidence and investor trust.
- Avoids the burden of debt servicing on future taxpayers.
- Prevents inflationary financing of deficits.

Demerits

- May be contractionary during recessions — reducing expenditure or raising taxes during a downturn can worsen economic hardship.
- Limits the government's ability to respond to emergencies, wars, or natural disasters.
- Rigid adherence may sacrifice important public investments in infrastructure or human capital.
- May not accommodate the financing needs of developing economies with large structural gaps.

Practical Example

Consider a hypothetical national government for Fiscal Year 2024–25:

REVENUE RECEIPTS	EXPENDITURE
Income Tax: $120 billion	Education: $80 billion
Corporate Tax: $80 billion	Health: $60 billion
VAT/GST: $60 billion	Infrastructure: $70 billion
Customs & Excise: $30 billion	Defence: $50 billion
Non-Tax Revenue: $10 billion	Social Protection: $40 billion
	Administration: $30 billion
TOTAL REVENUE: $300 billion	TOTAL EXPENDITURE: $300 billion
BUDGET BALANCE:	ZERO (Balanced)

In this example, every dollar of expenditure is matched by a dollar of revenue. No borrowing is needed. This budget signals that the government is living within its means.

Real-World Reference: Switzerland consistently achieves near-balanced budgets under its constitutional 'debt brake' (Schuldenbremse), which requires the federal government to balance its structural budget over the economic cycle. This rule has helped Switzerland maintain one of the lowest debt-to-GDP ratios among advanced economies.

2.2 Surplus Budget

Definition
A Surplus Budget occurs when total government revenues exceed total government expenditures during a fiscal year. The excess of revenue over expenditure is called the fiscal surplus, which can be used to repay existing debt, build up reserves, or accumulate a sovereign wealth fund.

A surplus budget is generally adopted as a contractionary fiscal measure — to cool an overheating economy, reduce inflationary pressures, or pay down previously accumulated

public debt. It reflects a government that is collecting more in taxes and fees than it is currently spending on public services and programmes.

Key Features

- Total Revenue > Total Expenditure.
- Results in a fiscal surplus (positive budget balance).
- Contractionary in nature — reduces aggregate demand.
- Surplus may be saved in a stabilisation fund or used for debt redemption.
- Often used during boom periods when tax revenues naturally rise.

Merits

- Reduces inflationary pressure by withdrawing purchasing power from the economy.
- Allows repayment of public debt, reducing future interest burden.
- Builds fiscal buffers for future recessions or emergencies.
- Improves sovereign credit ratings and reduces borrowing costs.

Demerits

- May be pro-cyclical in recessions if maintained rigidly.
- Implies taxpayers are over-taxed relative to current services received.
- Can slow economic growth by reducing public expenditure below optimal levels.
- Politically difficult to sustain as there is pressure to spend the surplus.

Practical Example

REVENUE RECEIPTS	EXPENDITURE
Income Tax: $140 billion	Education: $75 billion
Corporate Tax: $90 billion	Health: $55 billion
VAT/GST: $70 billion	Infrastructure: $60 billion
Customs & Excise: $35 billion	Defence: $48 billion
Non-Tax Revenue: $15 billion	Social Protection: $37 billion
	Administration: $25 billion

TOTAL REVENUE: $350 billion	TOTAL EXPENDITURE: $300 billion
FISCAL SURPLUS:	$50 billion

The $50 billion surplus can be directed to: (i) redemption of outstanding government bonds, reducing the national debt; (ii) deposit in a Sovereign Wealth Fund for intergenerational savings; or (iii) accumulation as a stabilisation reserve against future downturns.

Real-World Reference: Norway consistently runs large fiscal surpluses, which are channelled into the Government Pension Fund Global (GPFG) — the world's largest sovereign wealth fund, exceeding $1.6 trillion in assets. This surplus-based model has allowed Norway to save oil revenues for future generations rather than spending them immediately.

2.3 Deficit Budget

Definition
A Deficit Budget arises when total government expenditures exceed total government revenues in a fiscal year. The shortfall — the fiscal deficit — must be financed through borrowing (domestic or external), drawing down accumulated reserves, or monetisation (central bank financing). Deficit budgeting is the most common form of public budgeting globally.

Rooted in Keynesian economics, the deficit budget is the primary instrument of expansionary fiscal policy. During periods of recession, unemployment, or inadequate aggregate demand, a government deliberately spends more than it collects in order to inject purchasing power into the economy and stimulate growth. The logic is that the fiscal multiplier — the amplification of spending through the economy — more than compensates for the cost of borrowing.

Key Features

- Total Expenditure > Total Revenue.
- Results in a fiscal deficit (negative budget balance).
- Expansionary in nature — increases aggregate demand.
- Financed through government borrowing (Treasury Bills, Government Bonds, external loans) or reserve drawdown.
- Increases national debt if sustained over multiple years.

Types of Deficit

- Revenue Deficit: When revenue expenditure exceeds revenue receipts. Indicates that the government is borrowing even for its day-to-day operations, which is fiscally concerning.
- Fiscal Deficit: Total expenditure minus total revenue receipts (excluding borrowings). The most widely used deficit measure. Fiscal Deficit = Total Expenditure - (Revenue Receipts + Non-debt Capital Receipts).
- Primary Deficit: Fiscal deficit minus interest payments. Measures the deficit excluding the cost of past borrowing, providing insight into the current fiscal effort.
- Monetised Deficit: The portion of the fiscal deficit financed by the central bank, which can be inflationary.

Merits

- Stimulates economic growth during recessions through demand injection.
- Finances critical public investment in infrastructure and human development.
- Reduces unemployment by creating government jobs and stimulating private sector demand.
- Can be self-liquidating if investment raises GDP and future tax revenues sufficiently.

Demerits

- Increases public debt and future interest payment obligations.
- Can crowd out private investment by pushing up interest rates.
- If monetised, can trigger inflation.
- Structural deficits — deficits that persist even at full employment — are fiscally unsustainable.

Practical Example

REVENUE RECEIPTS	EXPENDITURE
Income Tax: $100 billion	Education: $85 billion
Corporate Tax: $65 billion	Health: $70 billion
VAT/GST: $50 billion	Infrastructure: $90 billion
Customs & Excise: $25 billion	Defence: $55 billion
Non-Tax Revenue: $10 billion	Social Protection: $50 billion

	Debt Servicing: $45 billion
TOTAL REVENUE: $250 billion	TOTAL EXPENDITURE: $395 billion
FISCAL DEFICIT:	$145 billion (financed by borrowing)

Deficit as % of GDP: If GDP = $2,900 billion, Fiscal Deficit = 145/2900 x 100 = 5.0% of GDP. This exceeds the commonly referenced 3% benchmark set by many fiscal rules, signalling a need for eventual consolidation.

Real-World Reference: The United States ran a fiscal deficit of approximately $1.7 trillion (6.3% of GDP) in FY 2023, driven by mandatory entitlement spending, interest payments, and discretionary appropriations exceeding tax revenues. India's Union Budget 2023-24 targeted a fiscal deficit of 5.9% of GDP, with plans to consolidate to 4.5% by 2025-26.

2.4 Revenue Budget

Definition
The Revenue Budget covers the government's current (day-to-day) financial transactions — it records all revenue receipts (both tax and non-tax) and all revenue expenditures (current spending on salaries, subsidies, interest payments, and maintenance) for a fiscal year. It does not create assets or liabilities; it reflects the operational flow of government finance.

In most countries — including India, the United Kingdom, and many Commonwealth nations — the full government budget is divided into a Revenue Budget and a Capital Budget. The Revenue Budget is analogous to a company's Income Statement: it shows the ordinary income earned and the ordinary costs incurred in running government operations during the year.

Components of the Revenue Budget

A. Revenue Receipts

- Tax Revenue: Direct taxes (income tax, corporation tax, wealth tax) and indirect taxes (VAT/GST, customs duties, excise duties). These are the government's primary source of income.
- Non-Tax Revenue: Interest receipts from loans advanced to states and PSUs, dividends from public sector enterprises, fees and charges for government services, grants from external sources.

B. Revenue Expenditure

- Salaries and wages of government employees.
- Pensions and retirement benefits.
- Interest payments on existing debt.
- Subsidies on food, fertiliser, fuel, etc.
- Grants to state governments and local bodies.
- Current expenditure on education, health, and defence (wages, medicines, fuel, etc.).

Revenue Deficit = Revenue Expenditure - Revenue Receipts. A revenue deficit is particularly concerning because it means the government is borrowing to meet current consumption needs rather than productive investment.

Practical Example — Revenue Budget

REVENUE RECEIPTS ($bn)	REVENUE EXPENDITURE ($bn)
Income Tax: 110	Salaries & Wages: 95
Corporation Tax: 85	Pensions: 40
GST: 75	Interest Payments: 70
Customs Duties: 30	Subsidies: 55
Excise Duties: 20	Grants to States: 35
Non-Tax Revenue: 30	Current Defence Spending: 30
Dividends from PSUs: 10	Other Current Expenditure: 25
TOTAL: $360 billion	TOTAL: $350 billion
REVENUE SURPLUS:	$10 billion

A revenue surplus of $10 billion means the government is meeting all its current operating costs from current revenues and has $10 billion available to partially fund capital investments — a fiscally healthy position. If instead the Revenue Total were $340 billion, there would be

a Revenue Deficit of $10 billion, meaning the government must borrow even for day-to-day spending.

2.5 Capital Budget

Definition

The Capital Budget covers all transactions that affect the government's assets and liabilities. It includes capital receipts (such as borrowings, recoveries of loans, and disinvestment proceeds) and capital expenditure (investment in infrastructure, loans to states and PSUs, and repayment of debt). Unlike the Revenue Budget, Capital Budget transactions create or extinguish assets and liabilities.

If the Revenue Budget is analogous to a company's Income Statement, the Capital Budget is analogous to a Balance Sheet or Cash Flow from Investing/Financing Activities. Capital expenditure (capex) creates durable public assets — highways, airports, power plants, dams, schools, hospitals — that generate long-run economic returns and productive capacity. It is for this reason that economists distinguish between 'good' deficits (financing capex) and 'bad' deficits (financing revenue consumption).

Components of the Capital Budget

A. Capital Receipts

- Borrowings: Domestic (Treasury Bills, Government Securities) and external (loans from the World Bank, IMF, bilateral donors).
- Recoveries of Loans: Repayments by state governments and PSUs of loans previously advanced by the Centre.
- Disinvestment Proceeds: Revenue from selling government stakes in public sector enterprises (privatisation).
- Small Savings, Provident Funds: Mobilisation of long-term household savings through post office schemes and provident funds.

B. Capital Expenditure

- Investment in physical infrastructure: roads, railways, ports, airports, irrigation, power, urban housing.
- Acquisition of machinery, equipment, and durable goods for public services.
- Loans and advances to state governments, union territories, and public sector undertakings.
- Repayment of principal on previously borrowed debt.
- Investment in financial assets (equity in public sector banks and corporations).

Practical Example — Capital Budget

CAPITAL RECEIPTS ($bn)	CAPITAL EXPENDITURE ($bn)
Market Borrowings: 180	Roads & Highways: 60
Small Savings/PF: 40	Railways: 45
Disinvestment: 20	Urban Infrastructure: 35
External Loans: 25	Irrigation & Power: 30
Recovery of Loans: 15	Defence Capital: 40
	Health Infrastructure: 20
	Education (capital): 15
	Loans to States: 30
	Debt Repayment: 45
TOTAL: $280 billion	TOTAL: $320 billion
CAPITAL DEFICIT:	$40 billion (financed by higher borrowings)

The $40 billion capital deficit is financed by additional market borrowings. Since this deficit funds productive public assets — roads, railways, power plants — it is economically justifiable, as these investments raise the economy's productive capacity and generate future returns.

Golden Rule of Public Finance: A government should borrow only to invest, not to consume. This principle distinguishes productive capital deficit from fiscally imprudent revenue deficit borrowing.

2.6 Performance Budget

Definition
A Performance Budget links financial inputs (money spent) to outputs (goods or services produced) and outcomes (impact on beneficiaries), enabling policymakers and citizens to assess whether public money achieves the intended results. It shifts the focus of budgeting from 'how much was spent' to 'what was achieved with the money spent.'

Introduced in the United States through the Hoover Commission Report (1949) and subsequently adopted by many countries, performance budgeting emerged as a reaction to line-item budgeting, which focused only on controlling expenditure inputs without measuring results. The core idea is results-based management: resources should be allocated to programmes and activities that demonstrably deliver on stated objectives.

Key Features

- Defines clear objectives and performance targets for each programme.
- Measures outputs (deliverables) and outcomes (results) against targets.
- Links budget allocation to demonstrated performance.
- Enhances accountability through output-based reporting.
- Requires a monitoring and evaluation (M&E) framework.

Distinction: Output vs. Outcome

DIMENSION	OUTPUT	OUTCOME
Definition	Immediate product of an activity	Broader change resulting from outputs
Health Example	Number of vaccines administered	Reduction in disease incidence
Education Example	No. of schools built	Improvement in literacy rate
Roads Example	Kilometres of road constructed	Reduction in transport cost & travel time

Practical Example — Ministry of Health Performance Budget

Programme	Budget ($mn)	Output Target	Output Achieved	Key Outcome Indicator
Immunisation	120	5 mn children vaccinated	4.8 mn (96%)	Measles incidence ↓ 18%
Primary Healthcare	200	800 clinics upgraded	820 clinics (103%)	OPD visits per 1,000 ↑ 22%
Maternal Health	80	500,000 births attended	490,000 (98%)	Maternal mortality ↓ 12%
Nutrition	60	2 mn children enrolled	1.75 mn (88%)	Stunting rate ↓ 5%

This performance budget allows the Finance Ministry to assess whether the $460 million allocated to health programmes is generating measurable improvements in health outcomes, enabling evidence-based decisions about future allocations.

2.7 Programme Budget

Definition
A Programme Budget organises government expenditure around broad programmes or functional objectives rather than around administrative departments, line-items, or objects of expenditure. Resources are grouped by what they are intended to achieve — e.g., 'Rural Poverty Reduction' or 'Universal Primary Education' — regardless of which ministry or agency is responsible for delivery.

Traditional line-item budgets group expenditures by object (salaries, supplies, travel) or by department, making it difficult to assess the total cost of achieving a specific policy goal that may involve multiple agencies. Programme budgeting, also called functional budgeting, reorganises this information so that policymakers can see the total investment in any given policy objective and compare the cost-effectiveness of alternative programmes.

Programme budgeting is closely related to PPBS — Planning, Programming, and Budgeting System — introduced in the United States Department of Defense by Secretary Robert

McNamara in 1961 and subsequently extended to all federal agencies by President Lyndon Johnson in 1965.

Key Features

- Expenditures grouped by programme or policy objective, not by department.
- Facilitates multi-year planning aligned with medium-term plans.
- Encourages inter-agency coordination for cross-cutting programmes.
- Makes trade-offs between programmes explicit and transparent.
- Each programme has defined objectives, activities, and expected results.

Practical Example — Rural Development Programme Budget

PROGRAMME	ALLOCATION ($mn)	KEY OBJECTIVES
Rural Roads & Connectivity	450	Connect 5,000 villages to all-weather roads; reduce transport cost by 30%
Rural Electrification	380	Achieve 100% household electrification in rural districts
Drinking Water & Sanitation	320	Provide safe piped water to 10 mn rural households; build 2 mn toilets
Rural Livelihoods & MSME	270	Create 500,000 rural jobs; support 200,000 micro-enterprises
Digital Connectivity	180	Extend broadband to 8,000 gram panchayats
TOTAL PROGRAMME	$1,600 million	Integrated rural transformation agenda

Notice that each programme may draw on the resources of multiple ministries (Public Works, Energy, Water Resources, Labour, IT), yet the programme budget presents the total investment in each objective cohesively. This allows policymakers to ask: 'Is $1,600 million the right amount to invest in rural development relative to, say, urban infrastructure or industrial promotion?'

2.8 Zero-Based Budget (ZBB)

Definition

Zero-Based Budgeting (ZBB) is a budgeting method in which every expenditure item must be freshly justified from a zero base for each new budget period, regardless of whether it was included in the previous budget. Unlike incremental budgeting — where last year's budget is the starting point and only changes (increments) are scrutinised — ZBB requires every manager to justify the entire budget, as if the organisation were starting from scratch.

ZBB was developed by Peter A. Pyhrr at Texas Instruments in the early 1970s and gained widespread attention when Jimmy Carter, as Governor of Georgia, adopted it for state government budgeting (1973) and later as U.S. President (1977). In the public sector, ZBB has been used as a tool for eliminating redundant programmes, cutting wasteful expenditure, and reallocating resources to higher-priority activities.

Key Features

- Every budget cycle starts from zero — no expenditure is automatically approved.
- Each activity or 'decision unit' must justify its existence, objectives, cost, and benefits.
- Activities are ranked by priority; lower-priority activities are cut if resources are constrained.
- Encourages a culture of cost consciousness and efficiency.
- Eliminates the 'spend it or lose it' mentality of incremental budgeting.

The ZBB Process

1. Identify Decision Units: Each distinct organisational unit, programme, or activity that can be independently evaluated and potentially discontinued.
2. Prepare Decision Packages: Each decision unit prepares 'packages' describing what it does, what it will achieve, and what it will cost at different funding levels (minimum, current, enhanced).
3. Rank Decision Packages: Senior management ranks all packages from highest to lowest priority across the entire organisation.
4. Allocate Resources: The budget is allocated by funding packages in priority order until the resource envelope is exhausted. Packages below the cut-off line are not funded.

Merits

- Eliminates outdated, obsolete, or low-priority expenditures.
- Encourages innovative thinking about cost-effective service delivery.
- Improves allocation efficiency by directing funds to highest-value activities.

- Increases managerial accountability and cost awareness.

Demerits

- Extremely time-consuming and resource-intensive — impractical if applied annually to every government department.
- Requires detailed costing and analytical capacity that many public sector organisations lack.
- Can be politically contentious as it threatens established programmes and vested interests.
- May produce short-termism by cutting long-gestation programmes with deferred benefits.

Practical Example — Ministry of Agriculture ZBB

Decision Unit / Activity	Min. Level ($mn)	Current ($mn)	Enhanced ($mn)	Priority Rank & Decision
Crop Insurance Scheme	80	120	160	#1 — FUND at $120mn (core priority)
Irrigation Modernisation	60	90	130	#2 — FUND at $90mn (essential)
Agri-Extension Services	40	65	90	#3 — FUND at $65mn (important)
Soil Health Cards	25	40	55	#4 — FUND at $40mn (useful)
Agricultural Research	30	50	70	#5 — FUND at Min $30mn (constrained)
Legacy Demonstration Farm	10	18	25	#6 — NOT FUNDED (low value-for-money; activities merged into extension)
Organic Farming Portal	5	12	20	#7 — NOT FUNDED (digital platform to be outsourced at no cost)
TOTAL FUNDED		**$345mn**		**Saving vs prior year: $50mn**

The ZBB exercise results in a $50 million saving compared to the previous year's budget, by eliminating two low-priority activities and right-sizing others. These savings can be reallocated to higher-priority crop insurance and irrigation.

2.9 Gender Budget

Definition

A Gender Budget (also called a Gender-Responsive Budget) is not a separate budget for women; it is a disaggregated analysis of the mainstream government budget through a gender lens. It examines the differential impact of budget revenues, expenditures, and policies on women and men, girls and boys, and uses this analysis to promote gender equity in resource allocation and policy outcomes.

Gender budgeting originated in Australia in 1984 (the Women's Budget Statement) and has since spread to over 80 countries. It recognises that public expenditure and taxation are not gender-neutral — they affect women and men differently because of different roles, access to resources, and socioeconomic conditions. A gender budget audit makes these differential impacts visible so that corrective resource allocation decisions can be made.

Conceptual Framework: Three Categories of Expenditure

- Category 1 — Specifically targeted expenditures: Programmes exclusively or primarily for women, e.g., women's helplines, maternity benefit schemes, shelters for survivors of domestic violence, women's empowerment centres.
- Category 2 — Equal opportunity expenditures: Programmes to promote equal pay, non-discrimination in employment, and gender-sensitive service delivery within mainstream government operations, e.g., creches in government offices, gender training for police.
- Category 3 — General mainstream expenditure: All other government spending (roads, defence, agriculture, taxes) analysed to assess its differential impact on women vs. men — e.g., what % of agricultural credit actually reaches women farmers?

Key Features

- Involves gender disaggregation of budget data and impact analysis.
- Sets gender-specific targets and tracks progress through sex-disaggregated indicators.
- Requires capacity building in gender analysis within finance and line ministries.
- Complements gender equality legislation and national action plans.
- Promotes Sustainable Development Goal 5 (Gender Equality).

Practical Example — Gender Budget Statement (Ministry of Finance)

Scheme / Programme	Total Budget ($mn)	Women-Specific Allocation ($mn)	Gender Objective & Outcome Target
Maternity Benefit Scheme	350	350 (100%)	Cover 4 mn women; reduce maternal mortality by 10%
Women's Self-Help Groups (SHGs)	280	280 (100%)	Empower 2 mn women entrepreneurs; ↑ female labour participation by 5%
Girl Child Education	450	225 (50%)	Achieve gender parity in secondary enrolment; reduce dropout rate for girls by 15%
Agricultural Credit	1,200	240 (20%)	Ensure 20% of Kisan Credit Cards issued to women farmers
Skill Development	600	180 (30%)	Train 1.5 mn women in market-relevant vocational skills
Safe City Programme	120	120 (100%)	Install 10,000 CCTV cameras; 24/7 helpline; ↓ reported crimes against women by 20%
TOTAL GENDER BUDGET	**$3,000mn**	**$1,395mn (46.5%)**	**Proportion of total budget explicitly tracked for gender impact**

Real-World Reference: India publishes an annual Gender Budget Statement as Part B of the Union Budget. In Union Budget 2023-24, allocations under the Gender Budget amounted to approximately Rs. 2.23 lakh crore — around 4.9% of the total Union Budget — covering schemes across 49 ministries.

2.10 Outcome Budget

Definition

An Outcome Budget is a reform of the traditional expenditure budget that explicitly links financial allocations with expected policy outcomes. For each scheme or programme, it specifies: (i) the financial outlay; (ii) the physical output targets (deliverables); and (iii) the expected outcomes (development results) that the programme is intended to produce. It enables the legislature and citizens to hold the executive accountable not merely for spending money, but for achieving results.

India introduced the Outcome Budget in 2005-06 under the initiative of Finance Minister P. Chidambaram, making it one of the pioneering developing-country experiments in results-based budgeting. The United Kingdom's Spending Reviews similarly employ outcome-based budgeting through Public Service Agreements (PSAs), and the OECD has advocated outcomes-based budgeting as best practice for member countries.

The Outcome Budget is a step further than the Performance Budget. While both link money to results, the Outcome Budget is specifically focused on development outcomes — changes in living standards, welfare, and capabilities — rather than merely operational outputs. It asks the question: 'What difference did government spending make to the lives of citizens?'

Key Columns in an Outcome Budget Statement

- Name of Scheme/Programme
- Objective / Mandate of the Scheme
- Outlay (Budget Allocation) — Current Year
- Physical Output Target — Current Year (deliverables)
- Outcome / Impact Indicator — What change in the development situation is expected
- Medium-Term Projection (2-3 year outlook for outputs and outcomes)
- Risk Factors — What may prevent achievement of targets

Practical Example — Outcome Budget: Ministry of Education

Scheme	Outlay ($mn)	Output Target (FY 2024-25)	Outcome Indicator & Target
Samagra Shiksha (Universal Elementary Education)	2,800	Open 12,000 new classrooms; recruit 80,000 teachers; distribute 40mn free textbooks	Gross Enrolment Ratio (GER) at primary level to reach 98%; dropout rate below 2%; learning outcomes score ↑ 8 points
Mid-Day Meal Scheme	950	Serve hot meals to 120 mn children on 220 school days	Reduction in child malnutrition rate among school-going children by 5%; school attendance ↑ 6%
PM Poshan (Anganwadi Nutrition)	680	Cover 8 mn children under 6 yrs; 1.4 mn pregnant & lactating mothers	Stunting prevalence among under-5 children ↓ from 35% to 30%; anaemia in pregnant women ↓ 8%
National Digital Education (DIKSHA)	420	Develop 1 mn digital content modules; 50 mn active learners on platform	Digital learning adoption in rural schools ↑ to 60%; gender gap in digital access ↓ by 50%
Higher Education (PM USHA)	1,100	Establish 5 new universities; upgrade 120 existing colleges	GER in higher education ↑ from 27.3% to 30%; employability rate of graduates ↑ 12%
TOTAL EDUCATION OUTLAY	**$5,950mn**	**Multiple physical targets across levels**	**Comprehensive improvement in access, quality, and equity in education**

The Outcome Budget makes it possible to ask, at year-end: Did the 2,800 million invested in Samagra Shiksha actually raise the Gross Enrolment Ratio? Did dropout rates fall? If not, why? This accountability mechanism is far more powerful than simply verifying that the ministry spent its allocation.

Comparative Summary of Budget Types

The table below provides a concise comparison of all ten budget types covered in this chapter, enabling easy revision and cross-referencing.

Budget Type	Core Principle	Primary Purpose	Key Metric
Balanced Budget	Revenue = Expenditure	Fiscal discipline; zero deficit	Budget Balance = 0
Surplus Budget	Revenue > Expenditure	Debt repayment; cooling economy	Fiscal Surplus = R - E > 0
Deficit Budget	Expenditure > Revenue	Stimulate growth; finance capex	Fiscal Deficit = E - R > 0
Revenue Budget	Current transactions only	Manage day-to-day government operations	Revenue Deficit / Surplus
Capital Budget	Asset & liability transactions	Finance long-term investment	Capital Outlay; Debt levels
Performance Budget	Inputs linked to outputs & outcomes	Improve accountability & efficiency	Output achievement vs. target
Programme Budget	Expenditure by programme / objective	Align resources with policy priorities	Cost per programme; trade-offs
Zero-Based Budget	Every item justified from zero	Eliminate waste; reallocate to priorities	Savings vs. prior year
Gender Budget	Gender-disaggregated analysis	Promote gender equity in resource use	% budget for women; gender indicators
Outcome Budget	Allocations linked to development outcomes	Results-based accountability	Outcome indicators vs. targets

CHAPTER SUMMARY

This chapter examined ten major types of government budget, revealing that the choice of budget type is not merely technical but reflects fiscal philosophy, governance values, and development priorities:

- Balanced, Surplus, and Deficit Budgets describe the relationship between revenues and expenditures, and signal the government's fiscal stance (neutral, contractionary, or expansionary).
- Revenue and Capital Budgets disaggregate the budget by the nature of transactions — current flows vs. asset/liability transactions — reinforcing the Golden Rule that borrowing should finance investment, not consumption.
- Performance, Programme, Zero-Based, Gender, and Outcome Budgets are modernising reforms designed to improve the efficiency, transparency, equity, and accountability of public spending by linking money to results and embedding social values into fiscal decisions.

Each type has its strengths and limitations, and many governments use hybrid approaches — combining, for example, a Revenue/Capital structure with Outcome Budget reporting and Gender Budget analysis.

Review Questions

1. A country has revenues of $500 billion and expenditures of $620 billion. Identify the type of budget, compute the fiscal deficit, and suggest two fiscal measures to reduce the deficit.
2. Distinguish between Revenue Deficit and Fiscal Deficit. Why is a persistent Revenue Deficit considered more harmful than a Capital Deficit?
3. Explain the concept of Zero-Based Budgeting with the aid of a decision package example. What are its principal advantages over incremental budgeting?
4. 'A Gender Budget is not a budget for women; it is a budget that is gender-sensitive.' Explain this statement with examples of Category 1, 2, and 3 expenditures.
5. Compare and contrast Performance Budgeting and Outcome Budgeting. Illustrate with examples from the education or health sector.

Using the comparative summary table in Section 2.11, discuss which two budget types you would recommend for a developing country seeking to improve public expenditure efficiency and gender equity. Justify your recommendation.

Chapter 3:
Modern Classification of Budget

- Revenue Receipts and Capital Receipts
- Revenue Expenditure and Capital Expenditure
- Plan and Non-Plan Expenditure (Traditional Concept)
- Developmental and Non-Developmental Expenditure
- Classification According to Functions and Programs

Learning Objectives

After studying this chapter, you will be able to:

- Distinguish between Revenue Receipts and Capital Receipts with Indian examples
- Classify Revenue Expenditure and Capital Expenditure and evaluate their economic significance
- Explain the traditional Plan/Non-Plan distinction and understand why India abolished it in 2017
- Define Developmental and Non-Developmental Expenditure and apply the classification to India's budget
- Understand the functional and programme-based classification of the budget and its advantages

  Critically evaluate how budget classification systems affect fiscal transparency, policy analysis, and accountability

3. Introduction: Why Budget Classification Matters

A government budget involving tens of lakh crore rupees and hundreds of schemes cannot be meaningfully understood as a single lump sum. Budget classification — the systematic arrangement of revenues and expenditures into categories based on their nature, purpose, and economic effect — is essential for analysis, accountability, and effective fiscal management. How the budget is classified determines what questions analysts can answer: Is the government saving or dissaving? Is it building assets or consuming resources? Is it investing in development or maintaining legacy structures? Are resources reaching their intended functional purposes?

India's budget classification has evolved substantially over the decades, reflecting both international best practices and the country's own development experience. This chapter examines five major dimensions of budget classification: the receipts side (Revenue vs. Capital), the expenditure side (Revenue vs. Capital), the traditional Plan/Non-Plan distinction

and its abolition, the Developmental/Non-Developmental framework, and the modern Functional and Programme-based classification.

> *How we classify public expenditure is not a bureaucratic technicality — it is a statement about what we believe government is for.*
>
> **— Vijay Kelkar, Chairman, 13th Finance Commission**

3.1 Revenue Receipts and Capital Receipts

Government receipts — the inflows of funds to the government's Consolidated Fund of India — are classified into two broad categories: Revenue Receipts and Capital Receipts. This distinction, rooted in the economic nature of the receipt, has critical implications for fiscal analysis: it determines whether the government's revenue side is sustainable (relying on recurring income) or structurally stressed (relying on asset sales and borrowings to meet current obligations).

Key Term	**Revenue Receipts:** Receipts of the government that do not create a liability or lead to a reduction in the government's assets. They are recurring in nature, flowing regularly from the government's normal operations, and are used to finance current (revenue) expenditure.

Key Term	**Capital Receipts:** Receipts of the government that either create a liability (such as borrowings that must be repaid) or lead to a reduction in the government's assets (such as the sale of public enterprises). They are typically non-recurring and are used, in principle, to finance capital (asset-creating) expenditure.

3.1.1 Revenue Receipts

Revenue receipts are the government's regular, recurring income streams. They arise from the government's exercise of its sovereign power to tax (tax revenues) and from the services it renders and assets it manages (non-tax revenues). Because they are recurring and do not reduce the government's net worth, revenue receipts are the preferred financing source for routine government operations.

Tax Revenues

Tax revenues are compulsory levies collected from individuals, households, and corporations under the authority of law. They are the dominant component of government revenue in all modern economies. In India, tax revenues are further classified into Direct Taxes (where the

incidence falls on the payer) and Indirect Taxes (where the incidence can be shifted to others through price adjustments).

Indian Case Study: India's Tax Revenue Architecture — Union Budget 2024-25

India's gross tax revenue in 2024-25 (BE) is estimated at ₹38.40 lakh crore, comprising:

DIRECT TAXES (estimated ₹21.99 lakh crore):

- Personal Income Tax: ₹10.44 lakh crore — levied on individual and HUF incomes above the basic exemption limit; progressive rate structure from nil to 30% (plus surcharge and cess)
- Corporation Tax: ₹10.20 lakh crore — levied on net profits of companies; standard domestic rate reduced to 22% in 2019; 15% for new manufacturing companies
- Other direct taxes: Securities Transaction Tax (STT), Capital Gains Tax, Dividend Distribution Tax

INDIRECT TAXES (estimated ₹16.41 lakh crore):

- Goods and Services Tax (Central share): ₹10.68 lakh crore — destination-based, multi-tier VAT on supply of goods and services; rates from 0% (essentials) to 28% (luxury/demerit goods)
- Customs Duty: ₹2.47 lakh crore — levied on imports; serves both revenue and protective (infant industry) objectives
- Union Excise Duty: ₹3.26 lakh crore — on petroleum products and a few other items remaining outside GST

The share of direct taxes in gross tax revenue has risen from approximately 35% in 2000-01 to over 57% in 2024-25 — reflecting the broadening of the formal economy and improved compliance, and making India's tax structure progressively less regressive over time.

Non-Tax Revenues

Non-tax revenues are income earned by the government from sources other than taxation. They include interest received on loans given to states, railways, and PSUs; dividends and profits from government-owned enterprises; fees and service charges; grants-in-aid received from international bodies; and miscellaneous receipts.

Indian Case Study: Non-Tax Revenue Sources of the Union Government

India's non-tax revenue in 2024-25 (BE) is estimated at ₹3.99 lakh crore, comprising:

- Interest receipts: ₹1.07 lakh crore — interest earned on loans given to state governments, central autonomous bodies, and PSUs; a major and stable component of non-tax revenue

- Dividends and profits from PSUs: ₹56,000 crore — includes dividends from Navratna and Maharatna PSUs (ONGC, Coal India, BHEL, HAL) and surplus transfer from the Reserve Bank of India. The RBI's surplus transfer of ₹2.11 lakh crore in 2023-24 — an exceptionally large transfer reflecting high interest income on foreign exchange reserves and valuation gains — was a major source of non-tax revenue in that year, illustrating the variability of this income stream.

- Economic services fees: Spectrum auction proceeds, mining royalties, port fees, civil aviation levies

- Receipts under social and general services: Court fees, licence fees, registration charges

Non-tax revenue is inherently less predictable than tax revenue, making it a less reliable financing base for recurring expenditure. The RBI surplus transfer, for example, varies substantially year to year depending on monetary policy operations and exchange rate movements.

3.1.2 Capital Receipts

Capital receipts are fundamentally different from revenue receipts in their economic character: they either create a repayment obligation (borrowings and liabilities) or reduce the government's asset base (disinvestment, recovery of loans). Because they are generally non-recurring and affect the government's balance sheet, capital receipts require separate classification and, in principle, should be used to finance capital (asset-creating) expenditure rather than current operations.

Borrowings and Other Liabilities

Borrowings are the largest component of capital receipts in India, reflecting the persistent fiscal deficit. They include: market borrowings (dated securities and treasury bills sold to banks, insurance companies, and other investors); external borrowings (loans from World Bank, ADB, bilateral creditors); and securities against small savings (funds from Post Office Savings Schemes invested in government securities).

Indian Case Study: India's Borrowing Programme — Composition and Management

India's gross market borrowings in 2024-25 (BE) stand at ₹14.01 lakh crore, making it one of the world's largest government borrowing programmes. Key features:

- Dated securities: The Reserve Bank of India manages the government's dated securities issuance through weekly auctions. The weighted average maturity of outstanding central government securities has been deliberately lengthened from approximately 10 years in 2014 to over 12 years by 2024 — reducing refinancing risk and interest rate sensitivity.

- Treasury Bills (T-Bills): Short-term (91, 182, 364 days) instruments for cash management; not long-term financing

- Sovereign Green Bonds: India issued its inaugural Sovereign Green Bonds in January 2023 (₹16,000 crore), earmarking proceeds for renewable energy, energy efficiency, clean transport, and climate adaptation — a new capital receipt category reflecting the integration of climate objectives into fiscal management

- External commercial borrowings: ₹24,935 crore (BE 2024-25); subject to RBI approval and hedging requirements; primarily for infrastructure and social sector projects with limited rupee financing capacity

- Net market borrowings: After repayments of maturing securities, net borrowings in 2024-25 are estimated at ₹11.13 lakh crore — broadly equal to the fiscal deficit, consistent with the FRBM framework's requirement that the deficit be financed primarily by market borrowings rather than monetisation.

Disinvestment Proceeds

Disinvestment — the sale by the government of its equity stake in public sector undertakings (PSUs) — is a capital receipt because it reduces the government's asset base. Disinvestment can take several forms: initial public offerings (IPOs) of government-owned companies; follow-on public offers (FPOs); strategic sales (selling a majority stake and management control to a private buyer); and buybacks of shares by the PSU itself.

Indian Case Study: India's Disinvestment Programme — Achievements and Challenges

India's disinvestment programme, initiated in 1991 as part of the structural adjustment reforms, has raised over ₹5 lakh crore cumulatively since inception. Key milestones:

- Air India privatisation (2022): The strategic sale of Air India to the Tata Group for ₹18,000 crore (enterprise value) was the landmark disinvestment of the Modi era — transferring management control to the private sector and ending decades of government ownership of a loss-making airline
- LIC IPO (2022): The IPO of Life Insurance Corporation of India raised ₹20,557 crore, making it India's largest IPO ever and reducing the government's stake from 100% to approximately 96.5%. The listing was significant not only as a capital receipt but as a corporate governance milestone, requiring LIC to adopt public company disclosure standards
- BPCL, IDBI Bank: These strategic sales have been in the pipeline for several years, with completion delayed by market conditions and regulatory complexities
- Persistent underperformance against targets: The disinvestment target has been met or exceeded in only a handful of years (2017-18: ₹1.00 lakh crore actual vs ₹72,500 crore target). The average gap between target and achievement has been approximately 30-40%, reflecting market volatility, political economy constraints, and the complexity of strategic sales

Critically, disinvestment proceeds are a capital receipt — they represent asset sales, not income. Using disinvestment proceeds to fund revenue expenditure (as has sometimes occurred) is analogous to a household selling its property to pay its grocery bills — fiscally unsustainable in the long run.

Category	Sub-Category	Indian Example (2024-25 BE)	Recurring?	Creates Liability?
REVENUE RECEIPTS	Direct Taxes	Corporation Tax: ₹10.20 lakh crore; Personal IT: ₹10.44 lakh crore	Yes	No
	Indirect Taxes	GST (Central share): ₹10.68 lakh crore;	Yes	No

		Customs: ₹2.47 lakh crore		
	Non-Tax Revenue	Interest receipts: ₹1.07 lakh crore; RBI surplus transfer: variable	Mostly	No
	External Grants	Grants from foreign governments and international bodies	Variable	No
CAPITAL RECEIPTS	Market Borrowings	Dated securities: ₹14.01 lakh crore (gross)	No	Yes
	Small Savings (NSSF)	Post Office deposits channelled to government	No	Yes
	Disinvestment	LIC IPO (₹20,557 crore, 2022); Air India sale	No	No (reduces assets)
	Recovery of Loans	Repayments of loans given to states, PSUs	Partial	No (reduces assets)

Table 9.1: Classification of Government Receipts with Indian Examples

3.2 Revenue Expenditure and Capital Expenditure

On the expenditure side, the Revenue-Capital distinction is equally fundamental. The classification determines whether government spending is investing in the future (creating assets) or consuming resources in the present (meeting current obligations). This distinction is critical for assessing fiscal sustainability, growth impact, and intergenerational equity.

Key Term	**Revenue Expenditure:** Government spending that neither creates assets nor reduces liabilities. It is recurring in nature, used to maintain the government's day-to-day operations, and includes salaries, pensions, interest payments, subsidies, and grants for current use. Revenue expenditure does not improve the government's net worth.

Key Term	**Capital Expenditure:** Government spending that either creates physical or financial assets (roads, buildings, equipment, equity investments in PSUs) or reduces liabilities (repayment of loans). It is generally non-recurring and improves the government's net worth or productive capacity. Capital expenditure has a higher fiscal multiplier than revenue spending.

3.2.1 Revenue Expenditure: Components and Analysis

Revenue expenditure constitutes the bulk of total government spending in India — approximately 76 per cent of total Union expenditure in 2024-25. While much of it (salaries, health services, education provision) is essential for maintaining government functions and public welfare, some components — particularly subsidies and interest payments — represent ongoing financial obligations that have grown to constrain the space for productive investment.

Indian Case Study: Anatomy of India's Revenue Expenditure 2024-25

India's revenue expenditure in 2024-25 (BE) is ₹37.09 lakh crore. Its major components:

1. Interest Payments (₹11.90 lakh crore | 32% of revenue expenditure):

The largest single head of revenue expenditure, reflecting the accumulated public debt of decades of fiscal deficits. Interest payments are entirely non-discretionary — they must be paid regardless of other priorities. The interest-to-revenue receipts ratio of approximately 34% is a measure of fiscal stress: over one-third of every rupee collected in revenue is pre-committed to debt service before any developmental expenditure can be made.

2. Subsidies (₹3.81 lakh crore | 10.3% of revenue expenditure):

Includes food subsidy (PMGKAY/PDS: ₹2.05 lakh crore), fertiliser subsidy (₹1.64 lakh crore), and petroleum subsidy (₹12,000 crore for cooking gas). All are classified as revenue expenditure because they fund current consumption rather than creating assets.

3. Salary and Pension (₹5.82 lakh crore | 15.7% of revenue expenditure):

Remuneration of approximately 48 lakh Central Government employees and pensions for retired civil servants and defence personnel. The Seventh Pay Commission (2016) and its successors have significantly expanded this obligation.

4. Defence Revenue Expenditure (₹3.11 lakh crore | 8.4% of revenue expenditure):

Salaries, maintenance, and operating costs of the armed forces (distinct from defence capital expenditure on weapons systems and equipment).

5. Grants-in-Aid (₹5.26 lakh crore | ~14% of revenue expenditure):

Transfers to state governments, autonomous bodies, and central universities for current operations. Some grants finance capital formation at the recipient level (e.g. grants to states for Jal Jeevan Mission infrastructure) — leading to the concept of Effective Revenue Deficit.

The Revenue Deficit Problem

When revenue expenditure exceeds revenue receipts, a revenue deficit arises. The revenue deficit indicates that the government is dissaving — using its income not to invest in the future but to meet current obligations. Prolonged revenue deficits are a sign of fiscal stress and crowd out capital formation. India's revenue deficit in 2024-25 is targeted at 2.0 per cent of GDP (₹6.56 lakh crore), down from a peak of 7.4 per cent in 2020-21.

Effective Revenue Deficit: A Refinement for India

India introduced the concept of Effective Revenue Deficit (ERD) in the budget, recognising that some revenue expenditure in the form of grants to states actually finances capital assets at the state level (schools, roads, health centres). The ERD = Revenue Deficit − Grants for Capital Formation.

In 2024-25:

- Revenue Deficit: ₹6.56 lakh crore (2.0% of GDP)
- Grants for Capital Formation to States: ₹1.77 lakh crore
- Effective Revenue Deficit: ₹4.79 lakh crore (1.5% of GDP)

The ERD provides a more accurate picture of the government's true dissaving — acknowledging that some transfers classified as revenue expenditure do generate productive assets, even if at the sub-national rather than central level. The FRBM Act targets eliminating the ERD over the medium term, rather than merely the revenue deficit, as a more meaningful measure of fiscal health.

3.2.2 Capital Expenditure: The Engine of Growth

Capital expenditure — spending that creates assets or reduces liabilities — is the growth-generating component of the budget. Infrastructure capital expenditure has a multiplier of 2.0–2.5 in the Indian context, meaning each rupee invested generates ₹2–2.50 of GDP. Building schools, hospitals, roads, dams, and railway lines creates productive capacity that benefits the economy for decades.

Indian Case Study: India's Capital Expenditure Transformation 2014–2025

One of the most significant fiscal policy shifts in recent Indian history has been the dramatic scaling-up of capital expenditure by the Union Government:

Year	Capital Expenditure	% of GDP
2014-15	₹3.09 lakh crore	1.7%
2017-18	₹4.11 lakh crore	2.1%
2020-21	₹4.44 lakh crore	2.2%
2021-22	₹5.54 lakh crore	2.5%
2022-23	₹7.50 lakh crore	2.9%
2023-24	₹9.48 lakh crore	3.2%
2024-25 (BE)	₹11.11 lakh crore	3.4%

Key components of capital expenditure in 2024-25:

- Railways: ₹2.62 lakh crore — the largest single capex item; Vande Bharat trains, Kavach collision avoidance, new lines, electrification
- NHAI/Roads: ₹1.68 lakh crore — National Highway construction, Bharatmala Phase 1
- Defence capital: ₹6.21 lakh crore total defence allocation, with ₹2.35 lakh crore for capital acquisitions (weapons, aircraft, naval vessels)
- Loans to States for Capital Expenditure: ₹1.30 lakh crore — interest-free 50-year loans to state governments earmarked for capital projects, incentivising states to invest rather than consume

The 258% increase in capital expenditure between 2014-15 and 2024-25 represents a fundamental reorientation of India's fiscal stance from consumption to investment — the most consequential budget classification shift of the era.

REVENUE EXPENDITURE	CAPITAL EXPENDITURE
Does NOT create assets or reduce liabilities	Creates assets OR reduces liabilities
Recurring — arises every year	Non-recurring or lumpy — large individual items
Financed by revenue receipts	Financed ideally by capital receipts
Fiscal multiplier: ~1.0–1.5	Fiscal multiplier: ~2.0–2.5
Excess over revenue receipts = Revenue Deficit (sign of dissaving)	Contributes to growth, productivity, and future revenue capacity

Examples: salaries (₹5.82 lakh cr), interest (₹11.90 lakh cr), subsidies (₹3.81 lakh cr)	Examples: Railways (₹2.62 lakh cr), Roads (₹1.68 lakh cr), Defence capital (₹2.35 lakh cr)

Table 9.2: Revenue Expenditure vs. Capital Expenditure — Key Differences

3.3 Plan and Non-Plan Expenditure (Traditional Concept)

For over six decades following India's independence, the budget was organised around a distinction that was unique to India's planned economy framework: the division of expenditure into Plan Expenditure and Non-Plan Expenditure. This classification reflected the dominant role of Five-Year Plans in shaping India's development strategy from the 1950s onward, and the institutional prominence of the Planning Commission in determining resource allocation.

Key Term	**Plan Expenditure:** Under the traditional classification, expenditure specifically provided for in the current Five-Year Plan or Annual Plan, intended to build productive capacity and achieve planned development targets. Plan expenditure was approved by the Planning Commission and was considered 'new' development spending.

Key Term	**Non-Plan Expenditure:** Under the traditional classification, all expenditure outside the Five-Year Plan — including ongoing maintenance, salaries, interest payments, subsidies, and defence. It was considered 'committed' expenditure arising from past decisions, as opposed to new development investment.

3.3.1 The Logic of Plan/Non-Plan Classification

The Plan/Non-Plan distinction was rooted in India's post-independence development philosophy. Inspired by Soviet planning models, the Nehru government established the Planning Commission in 1950 to prepare successive Five-Year Plans that would direct public investment toward key sectors — heavy industry, irrigation, power, and social infrastructure. Plan expenditure represented the new investments proposed in each Plan; Non-Plan expenditure represented the costs of running what had already been built.

Over time, however, the distinction created a perverse incentive structure: ministries lobbied vigorously for Plan allocations (which brought prestige, resources, and influence) while neglecting Non-Plan maintenance (which was seen as unglamorous). As a result, newly built infrastructure often deteriorated rapidly for want of maintenance funds classified under Non-Plan.

Indian Case Study: The Perverse Consequences of Plan vs. Non-Plan

The Plan/Non-Plan classification created several well-documented distortions in Indian public expenditure:

1. The maintenance neglect problem: Government schools, hospitals, roads, and irrigation canals built under Plan expenditure were inadequately maintained because maintenance budgets fell under Non-Plan, which was consistently squeezed relative to the more prestigious Plan expenditure. The 12th Finance Commission (2004-09) estimated that India's maintenance backlog for roads alone amounted to over ₹60,000 crore — with newly-built roads deteriorating within 2-3 years for want of basic upkeep funds.

2. The completion bottleneck: Ongoing Plan schemes required fresh Plan approval each year. New schemes competed with ongoing ones for Plan allocation, incentivising the proliferation of new schemes rather than the completion of existing ones. By 2016, over 1,500 centrally sponsored schemes were in various stages of implementation — many receiving inadequate funding to achieve their objectives.

3. The salaries anomaly: Teachers, doctors, and engineers employed in Plan-funded schools, hospitals, and infrastructure projects had their salaries classified as Plan expenditure in the early years. Once the project was 'completed' and handed over, their salaries migrated to Non-Plan — creating accounting complexity without any economic rationale.

4. Confusion about the role of states: States' share in Plan expenditure was determined through Gadgil-Mukherjee formula negotiations with the Planning Commission, creating an adversarial bargaining dynamic rather than needs-based resource allocation.

3.3.2 Abolition of Plan/Non-Plan Classification (2017)

Following the dissolution of the Planning Commission in August 2014 and its replacement by NITI Aayog — a policy think-tank without resource allocation powers — the rationale for the Plan/Non-Plan distinction disappeared. On the recommendation of the C. Rangarajan Committee and the expenditure management reforms, the government formally abolished the Plan/Non-Plan classification with effect from the Union Budget 2017-18.

The 2017 Budget Reform: From Plan/Non-Plan to Revenue/Capital

The Union Budget 2017-18, presented by Finance Minister Arun Jaitley, made three landmark structural changes that transformed the budget's classification framework:

1. Abolition of Plan/Non-Plan distinction: All expenditure is now classified under a single head, with the Revenue/Capital distinction as the primary analytical division. This eliminated the arbitrary separation of 'development' from 'maintenance' and allowed ministries to plan integrated budgets for each programme.

2. Merger of Railway Budget with Union Budget: The separate Railway Budget — presented by the Railway Minister on a different date since 1924 — was merged with the Union Budget, ending an anachronistic separation that obscured the integrated nature of the government's fiscal position.

3. Advancement of Budget presentation date: The budget is now presented on 1 February instead of the last day of February, allowing new schemes and expenditure approvals to take effect from the start of the financial year (1 April) rather than after the monsoon.

These reforms represent a significant modernisation of India's budget process, aligning it with international best practices and improving the coherence and transparency of fiscal management.

3.4 Developmental and Non-Developmental Expenditure

Another important classification of government expenditure is the distinction between Developmental Expenditure — spending that directly promotes economic growth, human development, and social welfare — and Non-Developmental Expenditure — spending that is necessary to maintain the government's administrative and security functions but does not directly add to productive capacity.

Key Term	**Developmental Expenditure:** Government spending that directly contributes to economic growth, human capital formation, and social welfare. It encompasses investment in education, health, agriculture, irrigation, power, transport, communications, science and technology, and social protection. Developmental expenditure builds the economy's productive capacity.

Key Term	**Non-Developmental Expenditure:** Government spending on administrative overhead, defence, police, judiciary, and debt service that is necessary to maintain state functions but does not directly create productive capacity. While essential, non-developmental expenditure crowds out developmental spending when it grows disproportionately.

This distinction is particularly relevant for assessing the development orientation of a budget. A budget that allocates a high and growing share of expenditure to developmental categories — education, health, agriculture, infrastructure — is more growth-promoting and welfare-enhancing than one in which non-developmental commitments (interest payments, security expenditure) dominate.

3.4.1 Developmental Expenditure in India

Developmental expenditure in India spans several major functional areas, each with its own economic justification and social impact. In aggregate, developmental expenditure has expanded significantly in absolute terms, though its share of GDP remains lower than in comparable economies.

Indian Case Study: Developmental Expenditure Categories — Union Budget 2024-25

India's developmental expenditure is organised across the following broad categories:

ECONOMIC SERVICES (₹21.83 lakh crore):

- Agriculture & allied: ₹1.52 lakh crore (PM-KISAN, PMFBY, RKVY, Digital Agriculture Mission)
- Rural development: ₹2.66 lakh crore (MGNREGS, PM Awas Yojana-G, PMGSY, JJM)
- Energy: ₹6,500 crore (PM Surya Ghar, National Green Hydrogen Mission, RE subsidies)
- Transport (Roads + Railways): ₹4.30 lakh crore (NHAI, Railways capital programme, Bharatmala)
- Communications: ₹1,230 crore (BharatNet, PM WANI)
- Science, Technology & Environment: ₹1.10 lakh crore (DST, DBT, ISRO, Anusandhan NRF)

SOCIAL SERVICES (₹8.37 lakh crore):

- Education: ₹1.48 lakh crore (Samagra Shiksha, Higher Education, NEP implementation)
- Health: ₹89,287 crore (NHM, PM-JAY, NTEP, POSHAN 2.0)

- Housing: ₹82,577 crore (PM Awas Yojana-Urban, AMRUT 2.0)
- Water supply and sanitation: ₹77,903 crore (JJM, SBM)
- Labour and employment: ₹69,000 crore (MGNREGS wages, ESIC, EPFO contributions)
- Social welfare (SC/ST/minorities/women): ₹48,000 crore

Together, economic and social services constitute approximately 58% of total Union expenditure — the developmental core of the budget.

9.4.2 Non-Developmental Expenditure: Trends and Concerns

Non-developmental expenditure, while essential, can crowd out developmental spending when it grows disproportionately. India's two largest non-developmental expenditure heads — interest payments (₹11.90 lakh crore) and defence revenue expenditure (₹3.11 lakh crore) — together consume approximately 45 per cent of Union revenue expenditure, limiting the space for developmental priorities.

Indian Case Study: The Interest Payment Burden — Crowding Out Development

India's interest payment bill is the single largest revenue expenditure item at ₹11.90 lakh crore in 2024-25 — larger than the combined education and health budgets, and larger than the total capital expenditure of most state governments.

Key dimensions of the interest burden:

- Interest-to-revenue receipts ratio: ~34% — over one-third of every rupee collected goes to servicing past debt before any fresh developmental commitment can be made
- Growth trajectory: Interest payments have grown from ₹5.75 lakh crore (2018-19) to ₹11.90 lakh crore (2024-25) — a 107% increase in six years — driven by the debt accumulation of the COVID-19 fiscal response
- Opportunity cost: If India's interest-to-GDP ratio (approximately 3.6% of GDP) could be reduced to the level of comparable economies (approximately 2.5% of GDP), the freed resources (₹3.6 lakh crore) could double the education budget or triple the health budget

The high and growing interest burden is the most direct expression of how non-developmental expenditure crowds out developmental investment — making fiscal consolidation and debt reduction not merely an accounting objective but a developmental imperative.

Expenditure Category	Sub-Category	2024-25 (BE)	Developmental?	Growth Impact
Education	Samagra Shiksha, HE, skilling	₹1.48 lakh crore	Yes — Human capital	High (long-run)
Health	NHM, PM-JAY, NTEP	₹89,287 crore	Yes — Human capital	High (long-run)
Agriculture	PM-KISAN, PMFBY, RKVY	₹1.52 lakh crore	Yes — Rural economy	Moderate
Transport infra	Roads, Railways capital	₹4.30 lakh crore	Yes — Physical capital	Very high (2.0-2.5x)
Rural development	MGNREGS, JJM, PMAY-G	₹2.66 lakh crore	Yes — Welfare + assets	Moderate-High
Defence revenue	Salaries, maintenance	₹3.11 lakh crore	Non-developmental	Security, not output
Interest payments	Debt service	₹11.90 lakh crore	Non-developmental	Negative (crowds out)
General administration	Salaries, overheads	~₹3.5 lakh crore	Non-developmental	Indirect

Table 9.3: Developmental vs. Non-Developmental Expenditure in India's Budget 2024-25

3.5 Classification According to Functions and Programmes

The most analytically sophisticated approach to budget classification — and the one increasingly adopted by modern governments, including India — is the Functional and Programme classification. Rather than organising the budget by administrative ministry or accounting category, functional classification organises expenditure by the purpose it serves from society's perspective. Programme classification drills down further, linking budgetary resources to specific policy programmes and their measurable outcomes.

Key Term	**Functional Classification:** A system of organising government expenditure according to the purpose or function it serves in the economy — such as education, health, defence, transportation, housing, and environmental protection. Adopted from the United Nations Classification of Functions of Government (COFOG), functional classification enables cross-country comparison and assessment of national priorities.

Key Term	**Programme Classification:** A system linking budgetary allocations to specific government programmes, with each programme defined by its objectives, target beneficiaries, activities, and measurable outputs and outcomes. Programme classification is the foundation of performance-based budgeting.

3.5.1 The UN Classification of Functions of Government (COFOG)

The international standard for functional classification is the United Nations Classification of Functions of Government (COFOG), which organises government expenditure into ten major functional categories. These categories enable cross-country comparison of how governments allocate resources across different societal needs and objectives.

COFOG Function	Description	Indian Budget Equivalent	2024-25 Approximate Share
01 General Public Services	Executive, legislative, financial management, external affairs	General Administration + MEA + Finance Ministry	~5%
02 Defence	Military, civil defence, foreign military aid	Ministry of Defence (₹6.22 lakh crore)	~9.6%
03 Public Order & Safety	Police, fire, courts, prisons	Home Ministry, Law + Justice	~3%
04 Economic Affairs	Agriculture, energy, transport, communications, R&D	Agriculture + MoRTH + Railways + MoPNG + DST	~33%
05 Environmental Protection	Waste, pollution, biodiversity	MoEFCC, CPCB, NMC	~0.5%

06 Housing & Community	Housing, urban development, water	MoHUA, PMAY, JJM, SBM	~4%
07 Health	Hospitals, primary care, public health	Ministry of Health, NHM, PM-JAY	~4.5%
08 Recreation, Culture, Religion	Sports, culture, broadcasting	Sports + Culture + I&B	~0.5%
09 Education	Primary to tertiary, skill training	Ministry of Education, Skill Dev.	~5%
10 Social Protection	Pensions, unemployment, family, disability	MGNREGS, PMAY, PM-KISAN, PDS	~18%

Table 9.4: COFOG Classification Applied to India's Union Budget 2024-25

3.5.2 India's Functional Classification System

India's budget uses a four-level hierarchical classification system to organise its expenditure: Major Heads (broad functions), Sub-Major Heads (sub-functions), Minor Heads (programmes), and Sub-Heads (schemes). This system, known as the List of Major and Minor Heads of Account, is maintained by the Controller General of Accounts (CGA) and is standardised across all Union Ministries.

Indian Case Study: India's Major Head Classification — How the Budget is Organised

India's budget expenditure is classified under over 100 Major Heads, each identified by a four-digit code. Examples:

- Major Head 2202 — General Education: Encompasses primary, secondary, and adult education expenditure; sub-major heads distinguish between elementary education (22020101), secondary education (22020201), and adult education
- Major Head 2210 — Medical and Public Health: Encompasses hospital services, public health administration, and disease control programmes including NHM sub-schemes
- Major Head 3054 — Roads and Bridges: Capital expenditure on National Highway construction, NHAI loans, and bridge projects
- Major Head 2401 — Crop Husbandry: Expenditure on seed development, crop insurance (PMFBY), and agricultural extension

- Major Head 2076 — Defence Services: Revenue expenditure on the three services (Army, Navy, Air Force)

This four-level classification enables detailed tracking of expenditure by function, sub-function, programme, and scheme — essential for financial management, audit, and performance assessment. The Public Financial Management System (PFMS) uses this classification to track expenditure in real-time from the point of sanction to final payment.

3.5.3 Programme-Based and Performance Budgeting

Beyond functional classification, modern public finance has moved toward programme-based budgeting (PBB) — a system in which budgetary allocations are organised around clearly defined programmes with stated objectives, expected outputs, and measurable outcomes. PBB represents a shift from asking 'how much did we spend?' to asking 'what did we achieve with what we spent?'

Indian Case Study: Outcome Budget and the Results Framework

India introduced the Outcome Budget framework in 2005-06, requiring each Ministry to present a document translating financial outlays (inputs) into physical outputs and developmental outcomes. The framework has evolved considerably:

PHASE 1 (2005-06 to 2016-17): Outcome Budget published as a companion document to the Union Budget. Each Ministry was required to specify:

- Financial outlay (input): Budgetary allocation for each scheme
- Physical output: Number of beneficiaries, units constructed, route-km built
- Projected outcome: Development impact (immunisation coverage, literacy rate, connectivity)

PHASE 2 (2017-18 onwards): Integration of output-outcome monitoring into the budget process:

- Output-Outcome Monitoring Framework: Published annually alongside the budget, specifying measurable targets for each major scheme against which progress is tracked quarterly
- PRAGATI platform: Monthly video-conferencing reviews of major projects, tracking physical and financial progress against output targets
- Scheme evaluation: Third-party evaluations of major CSS schemes feed back into budget allocation decisions

EXAMPLES OF OUTCOME LINKAGES:

- Jal Jeevan Mission: Input (₹69,926 crore); Output (tap connections provided); Outcome (% rural households with safe drinking water — target: 100% by Dec 2024)
- PM-JAY: Input (₹7,500 crore); Output (hospital empanelments, e-cards issued); Outcome (hospitalisations facilitated, catastrophic health expenditure prevented)
- MGNREGS: Input (₹86,000 crore); Output (person-days of employment); Outcome (rural wages, poverty reduction in covered districts)

3.5.4 Gender Budget and Thematic Budget Statements

A significant development in India's functional and programme classification has been the introduction of thematic budget statements — supplementary documents that cut across the standard classification to highlight spending directed at specific cross-cutting objectives: gender equality, climate, child welfare, and SC/ST welfare.

Indian Case Study: India's Thematic Budget Statements — Gender, Climate, and Beyond

India presents several thematic statement alongside the Union Budget:

1. Gender Budget Statement (since 2005-06):

   Part A: Schemes with 100% gender-focused allocation (e.g. Beti Bachao Beti Padhao, PM Matru Vandana Yojana)

   Part B: Schemes with at least 30% gender-focused allocation (e.g. MGNREGS, PMAY-G)

   2024-25 total: ₹3.3 lakh crore — approximately 6.5% of Union Budget

2. Statement of Allocations for Welfare of Scheduled Castes:

   Tracks all expenditure benefiting SC households across all ministries

   Helps hold government accountable for SCSP commitments

3. Statement of Allocations for Welfare of Scheduled Tribes:

   Corresponding tracking for ST households and TSP commitments

4. Climate Budget (introduced incrementally from 2023-24):

   Tracks expenditure contributing to India's Nationally Determined Contributions (NDCs) under the Paris Agreement; green-tagged expenditure includes renewable energy subsidies, green infrastructure, CAMPA (forest conservation), and climate adaptation schemes

These thematic classifications address a fundamental limitation of functional classification: cross-cutting objectives like gender equality or climate action are dispersed across dozens of ministries and programmes and are invisible in standard functional accounts. Thematic budget statements make these dispersed allocations visible, enabling advocacy, accountability, and course correction.

3.5.5 Advantages and Limitations of Functional and Programme Classification

Functional and programme-based classification represents a significant advance over simple line-item or revenue/capital classification. Its advantages are substantial, but important limitations and challenges remain in the Indian context.

ADVANTAGES	LIMITATIONS
Enables cross-ministry, cross-government analysis of spending on health, education, defence, etc. Facilitates cross-country comparison using COFOG standards Links budgetary inputs to policy outputs and outcomes, improving accountability Enables citizens and parliamentarians to assess whether the budget reflects stated priorities Reduces the risk of resources being trapped in administrative silos Supports evidence-based reallocation: if Programme A achieves outcomes and Programme B does not, resources can be shifted Thematic classifications make cross-cutting commitments (gender, climate, SC/ST) visible and measurable	Requires sophisticated data systems and capacity that may be absent in state/local governments Outcomes take years to materialise; annual budgeting cycles may be too short for meaningful outcome assessment Attribution problem: multiple programmes contribute to a single outcome; it is hard to credit any one programme Political incentives favour input/output reporting (tangible, short-run) over outcome reporting (diffuse, long-run) Classification boundaries are arbitrary: is a rural road 'transportation' or 'rural development'? Outcome targets can be gamed (reporting 'connections provided' rather than 'water flowing') Implementation capacity varies enormously across states, undermining national outcome benchmarks

CHAPTER SUMMARY

- Revenue Receipts (tax revenues: ₹38.40 lakh crore; non-tax revenues: ₹3.99 lakh crore) are recurring and do not create liabilities. Capital Receipts (borrowings: ₹14.01 lakh crore gross; disinvestment proceeds) are non-recurring and either create liabilities or reduce assets. Sustainable public finance requires revenue receipts to cover revenue expenditure.
- Revenue Expenditure (₹37.09 lakh crore; 76% of total) is non-asset-creating and recurring; key items are interest payments (₹11.90 lakh crore), subsidies (₹3.81 lakh crore), and salaries (₹5.82 lakh crore). Capital Expenditure (₹11.11 lakh crore; 3.4% of GDP) creates assets and has a multiplier of 2.0–2.5; India has tripled its capex in three years.
- The Plan/Non-Plan classification, rooted in India's Five-Year Planning framework, created perverse incentives (maintenance neglect, scheme proliferation) and was formally abolished in Union Budget 2017-18, replaced by a simpler Revenue/Capital distinction. The Railway Budget was simultaneously merged with the Union Budget.
- Developmental Expenditure (education, health, infrastructure, agriculture, rural development) builds productive capacity; Non-Developmental Expenditure (interest payments, defence revenue, administration) is necessary but crowds out development when it grows disproportionately. India's interest payment burden (₹11.90 lakh crore; 34% of revenue receipts) is the principal non-developmental constraint on the budget.
- Functional Classification (using COFOG) organises expenditure by social purpose; India's four-level Major Head system implements this. Programme Classification links allocations to outputs and outcomes through the Output-Outcome Monitoring Framework. Thematic budget statements (Gender Budget: ₹3.3 lakh crore; SC/ST welfare; Climate Budget) make cross-cutting commitments visible and accountable.

Review Questions

Section A: Short-Answer Questions

- Distinguish between Revenue Receipts and Capital Receipts. Give two examples of each in the Indian context.
- What is meant by a Revenue Deficit? How does the Effective Revenue Deficit differ from the Revenue Deficit? Why is the distinction important?
- Explain the Plan/Non-Plan classification. Why was it criticised, and why was it abolished in 2017?
- Define Developmental and Non-Developmental Expenditure. Give three examples of each from India's Union Budget.
- What is Functional Classification of the budget? Explain the COFOG framework with Indian examples.
- What is Programme-based budgeting? How does India's Output-Outcome Monitoring Framework attempt to implement it?

Section B: Application and Analysis

- Using India's Union Budget 2024-25, critically evaluate the Revenue-Capital composition of both receipts and expenditure. Does the current structure represent fiscal health or stress? Justify your answer.
- Assess the implications of India's heavy reliance on borrowings as a capital receipt for long-term fiscal sustainability. In your answer, consider the debt dynamics and the FRBM framework.
- With reference to India's disinvestment programme, discuss the proposition that disinvestment proceeds should never be used to finance revenue expenditure. Do you agree? What are the limits of this argument?
- Evaluate the claim that the abolition of Plan/Non-Plan classification in 2017 was the most important reform of India's budget process in the past two decades. What specific problems did it solve, and what challenges remain?
- Discuss whether the Developmental/Non-Developmental expenditure classification or the Revenue/Capital classification is more useful for assessing the growth-promoting quality of India's budget. Which classification would you recommend as the primary analytical framework, and why?
- To what extent has India's Outcome Budget and Output-Outcome Monitoring Framework successfully shifted budget management from input orientation to outcome orientation? Consider both achievements and remaining limitations.

Chapter 4:
Budgetary Deficits

- Meaning of Budget Deficit
- Revenue Deficit
- Fiscal Deficit
- Primary Deficit
- Effective Revenue Deficit
- Difference among Various Deficits

Learning Objectives

1. Understand the concept and meaning of government budget deficit
2. Distinguish between revenue deficit, fiscal deficit, and primary deficit
3. Comprehend the concept of effective revenue deficit introduced in India
4. Analyse the policy significance and macroeconomic implications of each deficit
5. Compare different deficit measures and interpret their relationship
6. Evaluate India's fiscal consolidation framework under the FRBM Act

Introduction

The government budget is a comprehensive financial statement that presents the estimated receipts and expenditures of the government for a given fiscal year. When a government's expenditure exceeds its revenue, the difference is referred to as a budget deficit. Budget deficits are a central concept in public finance and fiscal economics, as they directly influence the government's borrowing requirements, debt accumulation, monetary policy, and the broader macroeconomic environment.

In modern economies, governments rarely achieve a perfectly balanced budget. The nature of public expenditure — which includes defence, social services, subsidies, infrastructure development, and debt service — is often expansive, while revenue mobilisation through taxes and non-tax sources may be insufficient to meet these demands. Understanding the different types of budget deficits, their measurement, and their policy implications is therefore essential for students of economics, policymakers, and citizens alike.

In India, budget deficits gained particular significance after the economic reforms of 1991 and the subsequent adoption of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. The government formally tracks and targets Revenue Deficit, Fiscal Deficit, Primary Deficit, and Effective Revenue Deficit as key indicators of fiscal health.

4.2 Meaning of Budget Deficit

A budget deficit occurs when a government's total expenditure surpasses its total receipts during a fiscal year. In simple terms:

> *Basic Definition*
>
> **Budget Deficit = Total Government Expenditure − Total Government Receipts**

A positive value indicates a deficit (expenditure exceeds receipts), while a negative value indicates a surplus (receipts exceed expenditure). When receipts and expenditure are equal, the budget is said to be balanced.

4.2.1 Government Budget: A Framework

To understand budget deficits comprehensively, it is essential to appreciate the structure of the government budget, which is divided into two main accounts:

Revenue Account	Capital Account
Receipts: Tax revenue (Direct & Indirect), Non-tax revenue (Dividends, Fees, Interest)	**Receipts:** Borrowings, Recovery of loans, Disinvestment, Small savings
Expenditure: Salaries, subsidies, interest payments, pensions, defence revenue	**Expenditure:** Loans to states, capital investments, infrastructure creation, loan repayments

The revenue account records receipts and expenditures that do not create or reduce financial assets of the government. The capital account, on the other hand, deals with transactions that either create assets or reduce liabilities. This distinction is fundamental to understanding different types of deficits.

4.3 Revenue Deficit

4.3.1 Concept and Definition

Revenue Deficit is the excess of government's revenue expenditure over its revenue receipts. It arises when the government is unable to meet its routine operational and consumption expenditures through its regular revenue sources alone.

Formula: Revenue Deficit

Revenue Deficit = Revenue Expenditure − Revenue Receipts

Revenue receipts include tax revenues (income tax, GST, customs duty, excise duty) and non-tax revenues (interest receipts, dividends from PSUs, fees, fines, and grants from external sources). Revenue expenditure includes spending on salaries, pensions, subsidies, maintenance, interest payments on past borrowings, and defence operational costs.

4.3.2 Significance and Implications

Revenue deficit is a critical indicator of fiscal health because revenue expenditure is largely of a non-productive or consumption nature. When the government incurs a revenue deficit, it implies:

Key Implications of Revenue Deficit

- The government is borrowing to meet day-to-day consumption needs, not for investment — an unsustainable fiscal practice.
- It crowds out productive capital expenditure, as borrowing is consumed rather than invested.
- Over time, it increases the interest burden, creating a vicious cycle of debt.
- It signals structural weakness in public finance — government revenues are inadequate for operational needs.
- It may necessitate monetisation of deficit (printing money), leading to inflationary pressures.

4.3.3 Policy Concern

From a fiscal management perspective, the ideal target for revenue deficit is zero or nil. India's FRBM Act originally aimed to eliminate revenue deficit entirely. A persistent revenue deficit means the government is dissaving — consuming more than it earns — and must rely on borrowed funds or capital receipts to finance consumption, which is fiscally imprudent.

4.4 Fiscal Deficit

4.4.1 Concept and Definition

Fiscal Deficit is the most widely discussed and monitored budget deficit indicator. It represents the total borrowing requirements of the government during a fiscal year. Formally, it is defined as the excess of total government expenditure over total receipts excluding borrowings.

Formula: Fiscal Deficit

Fiscal Deficit = Total Expenditure − (Revenue Receipts + Non-debt Capital Receipts)

It can also be expressed as:

Alternative Expression

Fiscal Deficit = Net Borrowings from RBI + Net Borrowings from Market + Other Capital Receipts (debt-creating)

Non-debt capital receipts include recovery of loans and disinvestment proceeds, as these do not create new liabilities. Debt-creating capital receipts such as market borrowings, small savings, and provident fund collections are excluded from receipts when computing fiscal deficit, since the deficit itself represents the extent of such borrowing needs.

4.4.2 Fiscal Deficit as a Policy Indicator

The fiscal deficit is the single most important measure of a government's overall financial position for several reasons:

Why Fiscal Deficit Matters

- It captures the government's total borrowing requirement from all sources — a comprehensive measure of fiscal imbalance.
- It is directly related to the national debt: a persistent high fiscal deficit leads to rapid debt accumulation.
- Monetisation of fiscal deficit (borrowing from the central bank) can cause inflation.

• High fiscal deficits raise interest rates in the economy by crowding out private investment.

• Rating agencies and international bodies (IMF, World Bank) monitor fiscal deficit as a key indicator of creditworthiness.

• Under FRBM Act, 2003, India targets a fiscal deficit of 3% of GDP — considered the prudential threshold for a developing economy.

4.4.3 Causes of Fiscal Deficit

Fiscal deficits may arise due to structural or cyclical factors. Common causes in the Indian context include:

- Large subsidy burden (food, fertiliser, petroleum)
- Rising interest payments on accumulated public debt
- Inadequate tax revenue due to narrow tax base and evasion
- Off-budget expenditures and contingent liabilities
- Economic downturns reducing tax buoyancy (cyclical deficit)
- Expansion in social sector spending without commensurate revenue measures

4.5 Primary Deficit

4.5.1 Concept and Definition

The Primary Deficit is derived from the fiscal deficit by excluding the net interest payments made by the government on its past borrowings. It measures the fiscal deficit exclusive of the interest burden — in other words, it tells us how much of the deficit is due to current government operations rather than the legacy of past borrowings.

Formula: Primary Deficit

Primary Deficit = Fiscal Deficit − Net Interest Payments

Where Net Interest Payments = Interest Paid on Government's Borrowings − Interest Received on Loans Extended by Government.

Equivalently: Primary Deficit = Primary Revenue Expenditure (all revenue expenditure except interest payments) − Revenue Receipts − Non-debt Capital Receipts

4.5.2 Why Primary Deficit?

The primary deficit is a particularly useful indicator because interest payments represent a legacy cost — they are the result of past deficits and borrowing decisions, not current policy choices. By stripping out interest payments, the primary deficit reveals the government's current fiscal stance: whether today's government is adding to or reducing the debt burden through its own operational decisions.

Interpretation of Primary Deficit

- A zero primary deficit means the government's current revenues are sufficient to meet all expenditures except interest — it is borrowing only to pay interest on past debt.
- A negative primary deficit (primary surplus) indicates the government is generating enough revenue surplus to start repaying debt.
- A high primary deficit shows the government is adding substantially to national debt through its own current-year choices.
- Primary deficit is used in debt sustainability analysis: if the primary surplus exceeds the growth-adjusted interest rate, the debt-to-GDP ratio stabilises.

4.5.3 Illustrative Example

Suppose in a fiscal year:

Indicator	Amount (₹ Lakh Crore)
Total Expenditure	44.90
Revenue Receipts + Non-debt Capital Receipts	27.57
Fiscal Deficit (A − B)	17.33
Interest Payments (net)	10.50
Primary Deficit (Fiscal Deficit − Interest)	6.83

4.6 Effective Revenue Deficit

4.6.1 Background and Introduction

The concept of Effective Revenue Deficit (ERD) was introduced in India's Union Budget for 2011-12. It was a significant conceptual refinement in fiscal accounting, proposed to present a more accurate picture of the revenue deficit by accounting for an important category of expenditure: grants given to states and other bodies specifically for the creation of capital assets.

4.6.2 The Problem: Grants for Capital Asset Creation

Within the revenue expenditure of the central government, a significant portion comprises grants given to state governments, local bodies, and other entities for capital expenditure purposes — such as construction of roads, schools, hospitals, and irrigation projects. Under traditional classification, these grants appear as revenue expenditure of the central government (since grants are revenue outlays), even though they ultimately lead to capital asset creation in the recipient entity's books.

This creates a distortion: the conventional revenue deficit overstates the consumption nature of government expenditure by including grants that actually finance productive investment.

4.6.3 Definition and Formula

Effective Revenue Deficit corrects this distortion by deducting grants for capital asset creation from the revenue deficit. It thus captures only that part of the revenue deficit which truly reflects the government's consumption expenditure — expenditure that does not result in any asset creation, even indirectly.

Formula: Effective Revenue Deficit

Effective Revenue Deficit = Revenue Deficit − Grants for Creation of Capital Assets

Grants for capital asset creation are transfers made by the central government (classified as revenue expenditure) but which fund tangible capital formation in recipient states or bodies. Examples include Centrally Sponsored Scheme grants for construction of school buildings, hospital infrastructure, rural roads under PMGSY, and irrigation projects.

4.6.4 Significance of Effective Revenue Deficit

Why Effective Revenue Deficit is Important

- It provides a more precise picture of the government's purely consumptive borrowing needs.

- It acknowledges that some revenue expenditure (grants) does contribute to national capital formation.
- It prevents overestimation of fiscal profligacy — the revenue deficit figure alone may be misleading.
- It enables better tracking of fiscal consolidation: the FRBM framework targets elimination of ERD.
- It aligns fiscal accounting with economic substance rather than mere accounting classification.

4.7 Difference Among Various Deficits

Having examined each deficit concept individually, it is instructive to compare and contrast them systematically. The following analysis and table encapsulate the key distinctions.

4.7.1 Comprehensive Comparison Table

Deficit Type	Definition	Formula	Significance	Ideal Value
Revenue Deficit	Revenue Expenditure > Revenue Receipts	Revenue Receipts - Revenue Expenditure	Government unable to meet day-to-day expenses	None
Fiscal Deficit	Total Expenditure > Revenue Receipts + Non-debt Capital Receipts	Total Expenditure - (Revenue Receipts + Non-debt Capital Receipts)	Total borrowing requirement of the government	Nil (no borrowing)
Primary Deficit	Fiscal Deficit minus Interest Payments	Fiscal Deficit - Net Interest Payments	Current fiscal burden excluding legacy debt	Zero
Effective Revenue Deficit	Revenue Deficit minus Grants for Capital Assets	Revenue Deficit - Grants for Capital Asset Creation	True consumption gap in revenue account	Zero

4.7.2 Hierarchical Relationship Among Deficits

The various deficit concepts are not independent — they are interrelated and can be derived from each other. The following hierarchy illustrates their relationship:

Budget Deficit

Broadest concept: Total Expenditure > Total Receipts (including borrowings)

↓

Fiscal Deficit

Borrowing requirement: Total Expenditure − (Revenue Receipts + Non-debt Capital Receipts)

↓

Primary Deficit

Fiscal Deficit − Net Interest Payments [current-year fiscal burden only]

↓

Revenue Deficit

Revenue Expenditure − Revenue Receipts [consumption gap only]

↓

Effective Revenue Deficit

Revenue Deficit − Grants for Capital Assets [true consumption gap]

4.7.3 Conceptual Distinctions: Revenue vs. Fiscal Deficit

Scope: Revenue deficit has a narrower scope than fiscal deficit. Revenue deficit pertains only to the revenue account (operational transactions), while fiscal deficit encompasses both revenue and capital accounts.

Borrowing purpose: Revenue deficit implies borrowing for consumption — the more dangerous form. Fiscal deficit may include borrowing for capital formation (e.g., building infrastructure), which is economically justified.

Arithmetic relationship: Fiscal Deficit = Revenue Deficit + Capital Expenditure (net of non-debt capital receipts). A government can have a fiscal deficit even with zero revenue deficit if it is borrowing only for capital creation.

4.7.4 Conceptual Distinctions: Fiscal vs. Primary Deficit

Interest burden: The key difference is the treatment of interest payments. Fiscal deficit includes interest payments as part of total expenditure; primary deficit excludes them. This distinction separates current fiscal decisions from past debt obligations.

Debt sustainability: Primary deficit is a better indicator of the current government's fiscal stance. If primary deficit is zero, the government is not adding to debt in real terms (borrowing only to service existing debt). A rising primary deficit signals deteriorating fiscal management in the present.

Policy relevance: Primary deficit is used in Domar's debt sustainability condition. If the primary surplus (negative primary deficit) is at least equal to the product of (interest rate minus growth rate) and (debt-to-GDP ratio), national debt stabilises.

4.7.5 Revenue Deficit vs. Effective Revenue Deficit

The effective revenue deficit is always lower than or equal to the conventional revenue deficit. The difference between the two equals the grants given for capital asset creation. The ERD is a more refined and realistic measure of the government's consumptive borrowing needs, recognising that some revenue transfers ultimately serve a capital function.

Revenue Deficit	Effective Revenue Deficit
Includes all grants given to states	Excludes grants given for capital asset creation
Overstates consumptive borrowing	Shows true consumption borrowing requirement
Traditional FRBM target: eliminate	FRBM 2012 amendment: eliminate ERD
Higher in absolute value	Lower than or equal to Revenue Deficit
Used globally in fiscal reporting	Specific to India's fiscal framework

4.8 India's FRBM Framework and Deficit Targets

The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 provided a statutory framework for fiscal consolidation in India, with specific targets for different deficit indicators. This was amended significantly in 2012 (to introduce ERD targets), and the NK Singh Committee (2017) recommended further revisions.

4.8.1 Key Deficit Targets Under FRBM

Indicator	2022-23	2023-24	2024-25 (BE)	Target
Fiscal Deficit (% of GDP)	3.5%	3.0%	3.0%	3.0%
Revenue Deficit (% of GDP)	2.0%	1.8%	1.5%	0.0%
Primary Deficit (% of GDP)	0.5%	0.4%	0.0%	0.0%

The FRBM framework recognises that fiscal consolidation must be gradual and credible. A fiscal deficit of 3% of GDP is considered the prudential limit for India, balancing the need for public investment with debt sustainability. However, escape clauses permit temporary relaxation during emergencies, structural reforms, or severe downturns — as witnessed during the COVID-19 pandemic when the deficit rose to 9.2% of GDP in 2020-21.

4.9 Chapter Summary

This chapter has examined the various concepts of government budget deficits in depth. The following table provides a concise summary:

Concept	Core Meaning	FRBM Target
Budget Deficit	Excess of total expenditure over total receipts including borrowings	Not separately targeted
Revenue Deficit	Govt. borrows to meet day-to-day operational/consumption expenses	Eliminate (0%)
Fiscal Deficit	Total borrowing requirement; most important macro indicator	3.0% of GDP
Primary Deficit	Fiscal deficit minus interest payments; current fiscal burden	0% (fiscal balance excl. interest)
Effective Revenue Deficit	Revenue deficit minus grants for capital asset creation; true consumption gap	Eliminate (0%)

Understanding these deficit concepts is essential for analysing fiscal policy, evaluating government budgets, and assessing the long-term sustainability of public finances. Each

indicator illuminates a different dimension of fiscal imbalance — together, they provide a comprehensive picture of the government's financial health and fiscal discipline.

Key Terms

Budget Deficit	Excess of total government expenditure over total receipts.
Revenue Deficit	Excess of revenue expenditure over revenue receipts.
Fiscal Deficit	Excess of total expenditure over revenue receipts and non-debt capital receipts; equals net borrowing requirement.
Primary Deficit	Fiscal deficit minus net interest payments on government debt.
Effective Revenue Deficit	Revenue deficit minus grants given for creation of capital assets in recipient entities.
FRBM Act	Fiscal Responsibility and Budget Management Act, 2003 — provides statutory fiscal consolidation targets for India.
Debt Sustainability	The ability of a government to service its debt obligations without resort to exceptional financing measures.
Monetisation of Deficit	Financing the fiscal deficit by borrowing from the central bank (Reserve Bank of India), leading to money creation and inflation risk.
Crowding Out	Reduction in private investment resulting from increased government borrowing, which raises interest rates.
Primary Surplus	Negative value of primary deficit; situation where revenues exceed non-interest expenditure.

Review Questions

Short Answer Questions

1. Define revenue deficit. Why is it considered more problematic than fiscal deficit?
2. Explain the concept of primary deficit and its significance in debt sustainability analysis.
3. What is effective revenue deficit? How does it differ from conventional revenue deficit?
4. State the formulae for (a) fiscal deficit, (b) primary deficit, and (c) effective revenue deficit.
5. What are the fiscal deficit targets under India's FRBM Act?

Long Answer Questions

1. Explain the various types of budget deficits with their formulae, significance, and policy implications.
2. Distinguish between revenue deficit and fiscal deficit. Can a government have a fiscal deficit with zero revenue deficit? Explain with an example.
3. Why was the concept of Effective Revenue Deficit introduced in India? How does it improve upon the conventional revenue deficit measure?
4. Critically analyse the role of the FRBM Act in India's fiscal consolidation. What are the merits and limitations of statutory deficit targets?
5. Using the concept of primary deficit, explain how a government can assess whether its current fiscal stance is adding to or stabilising the national debt.

Chapter 5:
Public Expenditure in India

- Meaning of Public Expenditure
- Objectives of Public Expenditure
- Importance of Public Expenditure in India
- Classification of Public Expenditure
- Central and State Government Expenditure

Learning Objectives

1. Understand the meaning and definition of public expenditure in a modern economy
2. Identify and explain the key objectives of government spending
3. Appreciate the significance and growing importance of public expenditure in India
4. Classify public expenditure using multiple criteria (revenue/capital, plan/non-plan, productive/transfer, etc.)
5. Analyse the structure and trends of Central Government expenditure in India
6. Examine the pattern and responsibilities of State Government expenditure
7. Compare Central and State expenditure responsibilities under India's federal framework

5.1 Introduction

Public expenditure is one of the most powerful instruments of fiscal policy available to any modern government. As economies grow in complexity and social expectations from the state expand, the scale and composition of government spending become increasingly important determinants of economic performance, social equity, and political legitimacy.

In India, the role of public expenditure has been shaped by a unique blend of historical inheritance — the colonial administrative state, Nehruvian planning philosophy, and post-liberalisation market reforms. From the First Five-Year Plan (1951) onwards, the Indian state used public expenditure as the primary lever for accelerating capital formation, reducing

poverty, and achieving balanced regional development. Today, despite significant structural reforms and the rise of the private sector, public expenditure remains central to India's development agenda.

> *"The expenditure of a state should be commensurate with its revenue, but it should not be a mere mechanical function of it. The state must spend to fulfil its responsibilities to society."*
>
> **— R.K. Shanmukham Chetty, India's First Finance Minister, Budget Speech, 1947**

5.2 Meaning of Public Expenditure

5.2.1 Definition

Public expenditure refers to the expenditure incurred by public authorities — Central Government, State Governments, and local bodies — for the satisfaction of collective needs and for the promotion of social and economic welfare of the community.

In the words of **Prof. Hugh Dalton**, public expenditure is "the expenditure of public authorities — central, state and local — and covers all types of government spending." Unlike private expenditure, which is guided by the profit motive, public expenditure is motivated by social welfare, economic development, and the fulfilment of government obligations.

Components of Public Expenditure

Public Expenditure = Government Consumption + Government Investment + Transfer Payments + Debt Servicing

5.2.2 Characteristics of Public Expenditure

🏛 Key Characteristics of Public Expenditure

- Non-quid-pro-quo in nature for transfer payments: the government provides benefits without a direct exchange (e.g., subsidies, pensions).
- Governed by legal authority: every rupee of public expenditure must be sanctioned by the legislature through the Appropriation Act.
- Motivated by social welfare and public interest, not profit maximisation.
- Financed from tax revenues, non-tax revenues, borrowings, or grants — not from sale of private goods.

• Subject to public accountability: government is answerable to Parliament/Legislature for every expenditure.

• Includes both consumption (salaries, maintenance) and investment (infrastructure, capital equipment).

• Can be used as a deliberate counter-cyclical policy tool to stabilise the economy.

5.2.3 Historical Context: Classical vs. Modern View

🏛 Classical View (19th Century)	🏦 Modern View (Post-Keynes)
• Laissez-faire: state should minimise intervention • Public expenditure seen as a burden on the economy • Advocated balanced budgets and minimal government • Adam Smith: only defence, justice, and public works • Canons of public expenditure emphasised economy and frugality	• Public expenditure is a positive instrument of economic policy • Justified to correct market failures and externalities • Keynesian: government spending stimulates aggregate demand • Musgrave: Allocation, Distribution, Stabilisation functions • Welfare State: government obligated to provide social services

5.3 Objectives of Public Expenditure

Modern governments pursue multiple, sometimes conflicting, objectives through public expenditure. Richard Musgrave's classic taxonomy identifies three core fiscal functions, to which a fourth — economic development — is added in the context of developing economies like India.

5.3.1 Allocation Function

The allocation function refers to the government's role in providing public goods and services that the private market either cannot provide or would provide sub-optimally.

⚖ Allocation Function — Key Aspects

• Public goods (non-rival, non-excludable): defence, lighthouses, street lighting — private market fails due to the free-rider problem.

• Merit goods: goods/services whose consumption benefits society beyond what individuals would choose — education, healthcare, sanitation.

• Correction of externalities: subsidising positive externalities (vaccination, tree planting) and taxing negative ones (pollution).

• Natural monopolies: government provides or regulates services like electricity, water supply, rail transport where single-firm provision is efficient.

• Examples in India: National Defence, All India Radio, Doordarshan, National Highways, lighthouses, and flood control.

5.3.2 Distribution Function

The distribution function aims to correct the inequalities of income and wealth generated by the market mechanism. The market distributes rewards based on factor endowments and productivity, often resulting in extreme disparities. Public expenditure redistributes resources from the affluent to the less privileged.

Distribution Function — Key Aspects

• Transfer payments: old age pensions, unemployment allowances, disability benefits, scholarships for disadvantaged groups.

• Subsidies on essential commodities: food grains through PDS, LPG subsidies for the poor, fertiliser subsidies for farmers.

• Progressive public services: free or subsidised education and healthcare reduce effective inequality even if income disparities persist.

• Regional equity: higher public investment in backward states/districts — special category status, Finance Commission grants.

• India-specific: PM Kisan, MGNREGA wage income, PM Awas Yojana housing subsidy, Ayushman Bharat health insurance.

6.3.3 Stabilisation Function

The stabilisation function refers to the use of public expenditure to moderate economic fluctuations — inflation during booms and unemployment during recessions. This is the Keynesian rationale for active fiscal policy.

Stabilisation Function — Key Aspects

• Counter-cyclical policy: increase spending during recessions to boost demand; reduce spending during inflationary booms.

• Automatic stabilisers: welfare payments and progressive taxes automatically rise/fall with the business cycle, dampening volatility.

• Employment generation: direct employment in government services and indirect through public investment in construction.

• Managing aggregate demand: public expenditure is a component of GDP (G in Y = C + I + G + NX); government spending directly stimulates economic activity.

• India's COVID-19 response (2020-21): fiscal deficit rose to 9.2% of GDP as government massively increased spending on food, health, and relief.

5.3.4 Economic Development Function

In developing economies, the state plays an additional developmental role that goes beyond Musgrave's three branches. This is particularly relevant for India, which requires massive public investment to overcome structural constraints on growth.

Development Function — Key Aspects

• Capital formation: government investment in infrastructure (roads, power, ports, irrigation) that crowd-in private investment.

• Human capital development: expenditure on education and healthcare builds the productive capacity of the workforce.

• Reducing regional disparities: directing investment to economically laggard regions to achieve balanced spatial development.

• Technology and innovation: funding for research (ISRO, DRDO, CSIR) that private sector would underprovide due to public goods nature.

• Institutional development: building regulatory agencies, judicial infrastructure, and governance capacity for a functioning market economy.

5.3.5 Other Objectives

Beyond the four primary functions, public expenditure serves several additional goals:

- **Provision of social security:** insurance against risk of illness, old age, disability, and unemployment.
- **Defence and national security:** the primary obligation of the state — maintaining territorial integrity and internal order.
- **Debt servicing:** meeting interest and principal repayment obligations on past borrowings.

- **Environmental protection:** expenditure on pollution control, afforestation, and climate adaptation.
- **Scientific and technological advancement:** funding basic research and space/atomic energy programmes.

5.4 Importance of Public Expenditure in India

Public expenditure occupies a position of exceptional importance in the Indian economy, owing to the country's developmental stage, federal structure, historical role of the planning process, and constitutional mandate for social justice. The following aspects underscore its centrality.

5.4.1 Engine of Capital Formation

In the early decades after Independence, private investment was inadequate to meet India's developmental needs. Public investment in heavy industry (steel plants, machine tools), power, irrigation, and transport laid the foundational infrastructure upon which private enterprise subsequently built. Even today, the government's capital expenditure — which crossed ₹10 lakh crore in the Union Budget 2023-24 — is essential for infrastructure creation in areas such as national highways, railways, and digital connectivity.

Public Investment and Growth

ICOR (Incremental Capital-Output Ratio): Higher public investment → Higher GDP growth through Multiplier Effect

5.4.2 Poverty Alleviation and Social Protection

India's multi-dimensional poverty continues to demand significant public expenditure on social protection. Programmes such as the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), the Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY), and PM-KISAN direct benefit transfers represent direct redistributive mechanisms funded through the budget. These schemes collectively cover hundreds of millions of beneficiaries and represent a significant portion of total government expenditure.

5.4.3 Human Development: Education and Health

India's National Education Policy (2020) envisions raising public expenditure on education to 6% of GDP from the current ~4.5%. Similarly, health expenditure targets of 2.5% of GDP under the National Health Policy (2017) underscore the government's commitment to improving human capital. Public schools, government hospitals, AIIMS institutions, IITs, and IIMs — all financed through public expenditure — form the backbone of India's human development infrastructure.

5.4.4 Correcting Market Failures

The Indian market economy suffers from significant market failures: information asymmetries in rural credit markets, externalities in industrial pollution, monopolistic tendencies in key sectors, and the inability of private markets to provide public goods efficiently. Public expenditure addresses these through subsidies, regulation, public enterprises, and direct provision of services.

5.4.5 Regional Balance and Federalism

India's federal structure creates sharp inter-state fiscal disparities. Richer states with larger tax bases can spend more on public services, creating a divergence in development levels. The Central Government uses public expenditure — through Finance Commission devolution, grants-in-aid, and Centrally Sponsored Schemes — to ensure minimum standards of public services across states and correct regional imbalances.

Note: The 15th Finance Commission (2021-26) devolved 41% of divisible pool taxes to states, reflecting the principle that public expenditure allocation should correct fiscal disparities in India's federal system.

5.4.6 Economic Stabilisation in Downturns

During the 2008 global financial crisis and the 2020 COVID-19 pandemic, the Indian government deployed public expenditure as a counter-cyclical instrument. Fiscal stimulus packages — including direct transfers, employment schemes, and infrastructure spending — helped sustain aggregate demand, prevent catastrophic unemployment, and maintain economic activity. India's fiscal deficit rose to 9.2% of GDP in 2020-21, reflecting the scale of emergency public expenditure.

5.4.7 Validation of Wagner's Law in India

Wagner's Law of Increasing State Activity

Adolph Wagner (1883) postulated that as economies develop and national income rises, the share of public expenditure in national income increases secularly. This arises from three forces:

(i) Expansion of administrative and protective functions of the state

(ii) Growing need for social and cultural expenditures as urbanisation increases

(iii) Rising capital intensity of industry requiring large-scale public investment

India's public expenditure trend strongly validates Wagner's Law: Central Government expenditure grew from ₹1.5 lakh crore in 2000-01 to over ₹45 lakh crore in 2023-24.

5.5 Classification of Public Expenditure

Public expenditure can be classified using multiple criteria, each serving a different analytical purpose. The following classifications are most commonly used in public finance theory and Indian budgetary practice.

5.5.1 Overview of Classifications

Classification Basis	Definition / Criterion	Examples	Significance
Revenue vs Capital	Based on the nature of expenditure in the budget	Revenue: Salaries, interest Capital: Dams, roads	Budget Accounting
Plan vs Non-Plan (pre-2017)	Based on Five-Year Plan linkage	Plan: MGNREGA, PMAY Non-Plan: Defence, Admin	Planning Commission era
Capital vs Revenue (Economic)	Based on asset creation vs. consumption	Capital: Infrastructure Revenue: Subsidies, pensions	National Accounting
Transfer vs Non-Transfer	Based on quid pro quo (service rendered)	Transfer: Subsidies, grants Non-Transfer: Salaries	Musgrave's Classification
Development vs Non-Dev.	Based on contribution to economic development	Dev: Education, health Non-Dev: Interest, police	Pigou's Classification
Productive vs Unproductive	Based on whether expenditure yields a return	Productive: Irrigation Unproductive: Defence	Classical Economics
Obligatory vs Voluntary	Based on legal mandate	Obligatory: Debt servicing Voluntary: Social welfare	Legal Framework

5.5.2 Revenue Expenditure vs. Capital Expenditure

Revenue Expenditure

Revenue expenditure refers to the expenditure that neither creates assets nor reduces liabilities for the government. It is recurring in nature and relates to the normal functioning of government departments and provision of services. Examples include:

- Salaries and wages of government employees
- Interest payments on government's borrowings
- Subsidies — food, fertiliser, and fuel
- Pensions and gratuities to retired employees

- Grants-in-aid to states and institutions
- Defence operational (non-capital) expenditure

Capital Expenditure

Capital expenditure refers to expenditure that creates assets or reduces liabilities. It results in the creation of tangible and intangible capital assets that yield benefits over multiple years. Examples include:

- Construction of roads, bridges, dams, ports, and airports
- Procurement of defence equipment — aircraft, warships, artillery
- Investment in public sector undertakings (equity participation)
- Loans extended by the Central Government to state governments and PSUs
- Repayment of principal on government's past borrowings

> **Note:** Capital expenditure is considered more growth-oriented than revenue expenditure. India has progressively emphasised capital expenditure — rising from ₹4.26 lakh crore (2020-21) to ₹10 lakh crore (2023-24) — as part of its fiscal strategy to drive infrastructure-led growth.

5.5.3 Plan and Non-Plan Expenditure (Pre-2017)

Until 2017-18, India's budget distinguished between Plan and Non-Plan expenditure, a classification linked to the Five-Year Plans formulated by the Planning Commission (now NITI Aayog).

Plan Expenditure	**Non-Plan Expenditure**
• Expenditure related to new projects and schemes under Five-Year Plans • Both revenue and capital components • Focused on developmental and investment objectives • Examples: MGNREGA, Bharat Nirman, National Rural Health Mission • Reflected annual plan size — an indicator of investment effort	• Expenditure on established, ongoing obligations • Includes interest payments, defence, subsidies, salaries • Generally rigid and difficult to compress quickly • Dominated the budget — 60-70% of total expenditure • Abolished in 2017-18; replaced by capital/revenue classification only

⚠ **Note:** The Plan/Non-Plan distinction was abolished from the Union Budget 2017-18 onwards on the recommendation of the B.N. Srikrishna Committee. The new classification focuses on Revenue vs. Capital expenditure, which is analytically superior and avoids the artificial bifurcation between 'development' and 'non-development' spending.

5.5.4 Transfer vs. Non-Transfer Expenditure

Transfer expenditures are payments made by the government for which no direct quid pro quo (good or service in return) is received. Non-transfer expenditures are payments in return for goods and services actually received.

Transfer Expenditure Examples

- Subsidies on food, fertiliser, LPG, and kerosene
- Old age pensions, widow pensions, and disability allowances
- Unemployment dole (limited in India) and social security payments
- Grants-in-aid to state governments and autonomous bodies
- Scholarship and fellowship payments to students
- PM-KISAN direct income support to farmers (₹6,000/year)

Non-Transfer Expenditure Examples

- Salaries and allowances paid to government employees (service received: labour)
- Payment for procurement of stationery, vehicles, equipment
- Defence capital expenditure: purchase of weapons and military hardware
- Construction contracts for roads and bridges (service: construction)
- Payments to hospitals for Ayushman Bharat treatment (service: healthcare)

5.5.5 Productive vs. Unproductive Expenditure

This is one of the oldest classifications in public finance, associated with classical economists. Productive expenditure increases the productive capacity of the economy, while unproductive expenditure does not.

✓ Productive Expenditure	✗ Unproductive Expenditure
• Creates lasting economic benefits and enhances output capacity • Expenditure on irrigation — increases agricultural productivity • Roads and transport — reduces logistics costs, expands markets • Education — increases human capital and workforce quality • Scientific research — technological innovation and productivity gains • Public health — reduces morbidity, raises labour productivity	• Does not directly increase economic output or productive capacity • Interest payments on past debt — purely a transfer to lenders • War expenditure — destroys rather than creates resources • Expenditure on ceremonial and state functions • Administrative overhead beyond minimum necessary level • Note: Defence spending may be productive indirectly (security for investment)

Note: The productive/unproductive distinction, while intuitive, is not absolute. Defence spending, often classified as unproductive, enables the security environment necessary for economic activity. Context and complementarities must be considered.

5.5.6 Development vs. Non-Development Expenditure

Development expenditure (also called developmental expenditure) promotes economic and social development. Non-development expenditure covers the general administrative and obligatory functions of the state.

Development Expenditure	Non-Development Expenditure
Education (schools, colleges, IITs)	General administration (secretariats)
Health (hospitals, AIIMS, NHM)	Police and internal security
Agriculture (research, irrigation, subsidies)	Interest payments on borrowings
Infrastructure (roads, power, ports)	Pensions and gratuities
Science & technology (ISRO, DRDO)	Defence (though debatable)

Rural development (MGNREGA, PMAY-G)	Maintenance of government buildings

5.6 Central Government Expenditure in India

The Central Government of India is responsible for expenditure on subjects in the Union List of the Seventh Schedule of the Constitution. Its expenditure is presented annually in the Union Budget, which is the supreme financial document of the Republic of India. The budget is divided into the Consolidated Fund of India (CFI) — from which all expenditure is appropriated — and is subject to parliamentary approval through the Appropriation Act.

5.6.1 Structure of Central Government Expenditure

Expenditure Head	Classification	Nature & Key Schemes
Interest Payments	Revenue (Non-Plan)	Largest single expenditure head; reflects accumulated public debt (~20% of total expenditure)
Defence Expenditure	Revenue + Capital	Salaries, operations (Revenue); procurement of arms, aircraft, ships (Capital)
Subsidies	Revenue	Food (FCI), fertiliser, petroleum subsidies — redistributive in nature
Transfers to States	Revenue + Capital	Devolution of taxes, grants-in-aid, and centrally sponsored scheme transfers
Social Services	Revenue + Capital	Education, health, housing — includes Ayushman Bharat, PM Awas Yojana
Infrastructure & Capital	Capital	Roads (NHAI), railways, ports, digital infrastructure — asset-creating expenditure
Pensions	Revenue	Civilian and defence pensions; major non-productive obligation
Economic Services	Revenue + Capital	Agriculture, energy, industry, commerce — productive public investment

Administrative Services	Revenue	Running cost of ministries, judiciary, police, Parliament
Loans & Advances	Capital	Loans to states, PSUs, and foreign governments

5.6.2 Trends in Central Government Expenditure

Central Government expenditure has risen substantially both in absolute terms and as a share of GDP over the past two decades. The following table presents key trends:

Year	Revenue Exp. (₹ Lakh Cr.)	Capital Exp. (₹ Lakh Cr.)	Total Exp. (₹ Lakh Cr.)	Total Exp. as % of GDP
2010-11	11.09	13.45	24.54	13.0%
2014-15	16.63	4.75	21.38	12.2%
2018-19	21.41	3.17	24.58	12.2%
2020-21	30.11	4.39	34.50	17.7%
2022-23	31.18	7.50	38.68	14.9%
2023-24	37.09	10.00	47.09	14.6%

Note: The sharp increase in 2020-21 reflects the COVID-19 fiscal stimulus, including PM Garib Kalyan Package, enhanced MGNREGA allocation, and health emergency expenditure. Post-pandemic, the government has deliberately shifted expenditure composition toward capital formation.

5.6.3 Key Features of Central Government Expenditure

🏛 Distinctive Features of Central Expenditure

- •Defence dominance: India is among the world's top five defence spenders; defence accounts for approximately 13-14% of central expenditure.
- Interest burden: Interest payments constitute ~20% of revenue expenditure, reflecting the accumulated public debt of decades of fiscal deficits.
- Subsidy regime: Major subsidies (food, fertiliser, petroleum) form a significant portion but have been rationalised through DBT (Direct Benefit Transfer) since 2013.
- Transfers to states: A large share of Central expenditure flows to states as tax devolution and grants — reflecting cooperative federalism.
- Capital expenditure push: The government has announced a major capex push, growing from ₹4.1 lakh crore (2021-22) to ₹10 lakh crore (2023-24) — a 143% increase in two years.
- Off-budget liabilities: Historically, some expenditure (fertiliser bonds, oil bonds) was kept off-budget, distorting the true fiscal picture — a practice the government has been moving away from.

5.6.4 Constitutional and Statutory Framework

Central Government expenditure is governed by:

1. **Article 112 — Annual Financial Statement (Union Budget):** requires the government to present a statement of estimated receipts and expenditure each year.
2. **Article 114 — Appropriation Bills:** no money can be drawn from the Consolidated Fund of India without Parliamentary appropriation.
3. **Article 266 — Consolidated Fund of India:** all revenues and borrowings of the Central Government flow into this fund.
4. **FRBM Act, 2003:** provides fiscal rules — targets for fiscal deficit, revenue deficit, and primary deficit — to ensure expenditure discipline.
5. **CAG (Comptroller & Auditor General):** audits all Central Government expenditure and reports to Parliament — the supreme accountability mechanism.

5 .7 State Government Expenditure in India

State governments in India are responsible for a wide range of subjects listed in the State List of the Seventh Schedule, as well as Concurrent List subjects shared with the Centre. Crucially, states are the primary implementers of social sector programmes — education, health,

agriculture, rural development, and public order — that directly affect the daily lives of citizens.

5.7.1 Structure of State Government Expenditure

Expenditure Head	Classification	Key Details & Schemes
Education	Revenue + Capital	Primary, secondary, higher education; salaries of teachers — largest state expenditure in social sector
Health & Family Welfare	Revenue + Capital	Hospitals, PHCs, immunisation, National Health Mission
Agriculture & Allied	Revenue + Capital	Irrigation, soil conservation, agricultural credit and subsidies
Police & Judiciary	Revenue	Law and order maintenance; courts and prisons — state's sovereign function
Rural Development	Revenue + Capital	MGNREGA (state share), PMGSY, PMAY-G — welfare programmes
Urban Development	Revenue + Capital	Smart Cities, AMRUT, municipal infrastructure
Transport & Roads	Capital	State highways, district roads, bridges — key for local connectivity
Social Welfare	Revenue	Pensions, SC/ST welfare, women and child development
General Administration	Revenue	State secretariats, district administration, elected bodies
Energy & Power	Capital	State electricity boards, rural electrification

5 .7.2 Key Features of State Government Expenditure

Distinctive Features of State Expenditure

• Social sector dominance: Education alone accounts for nearly 15-18% of average state expenditure; health another 5-7%. States are the primary providers of basic public services.

• Implementation role: States implement most Centrally Sponsored Schemes (CSS) — receiving Central grants but bearing state share obligations.

• Revenue-Capital imbalance: Many states have historically over-spent on revenue accounts (salaries, pensions, subsidies) and under-invested in capital formation.

• Salary and pension burden: After the implementation of 6th and 7th Pay Commissions, salaries and pensions consume a very large share of state revenues, crowding out development spending.

• Inter-state variation: Fiscal capacity varies enormously — Maharashtra and Karnataka have far larger revenues than Bihar or Jharkhand. Finance Commission equalisation grants partially address this.

• Dependence on Centre: States depend on Central transfers (tax devolution + grants) for 30-40% of their revenue — reflecting vertical fiscal imbalance in Indian federalism.

5.7.3 Sources of State Revenue for Expenditure

State governments finance their expenditure through:

- **Own Tax Revenue:** GST (State share), stamp duty, state excise (liquor), motor vehicle tax, land revenue, entertainment tax.
- **Own Non-Tax Revenue:** Fees and charges from services, interest on state loans, dividends from state PSUs.
- **Central Tax Devolution:** States' share (41%) of the divisible pool of Central taxes as recommended by the Finance Commission.
- **Grants-in-Aid from Centre:** Grants under Article 275, post-devolution revenue deficit grants, and scheme-specific grants.
- **State Market Borrowings:** States can borrow from markets up to 3.5% of GSDP (with fiscal responsibility norms); they also access NSSF and other small savings.

⚠ **Note:** The vertical fiscal imbalance in India — where states have greater expenditure responsibilities than revenue-raising capacity — makes Central transfers essential. This is addressed through the Finance Commission mechanism, the most important institutional arrangement in India's fiscal federalism.

5.8 Central vs. State Government Expenditure: A Comparison

India's federal fiscal architecture distributes expenditure responsibilities between the Centre and states based on constitutional provisions. The following comprehensive comparison illuminates the key differences in scope, structure, and nature of expenditure at the two tiers of government.

Parameter	Central Government	State Governments
Constitutional basis	Union List (Schedule VII) + Concurrent List	State List + Concurrent List
Scale of expenditure	Larger — approx. 60-65% of combined govt. spending	Smaller individually; together ~35-40% of combined
Defence	Exclusive responsibility (Union List, Entry 1)	No role; entirely Central
Education	Higher & technical education; national schemes	Primary, secondary; teacher salaries — bulk responsibility
Health	National health schemes, AIIMS, central labs	Primary healthcare, district hospitals — primary role
Agriculture	Policy, research (ICAR), price support	Implementation; irrigation; local subsidies
Police & Law & Order	Central Police Organisations (CRPF, BSF)	State Police — primary responsibility
Infrastructure	National highways, railways, major ports, airports	State highways, rural roads, local infrastructure
Social Sector	Flagship schemes (PM Awas, MGNREGA funding)	Implementation of CSS + own state schemes
Revenue sources	Income tax, GST (Central share), customs, excise	GST (State share), stamp duty, excise, land revenue
Borrowing power	Borrows directly from market, RBI, external sources	Borrows with Centre's approval; state market borrowings

Transfers	Devolves taxes to states; grants-in-aid	Recipient of central transfers; major revenue source

5.8.1 Cooperative and Competitive Federalism in Expenditure

India's expenditure federalism operates on two simultaneous principles. Under **cooperative federalism**, the Centre and states jointly fund and implement Centrally Sponsored Schemes (CSS) such as MGNREGA, PMAY, Jal Jeevan Mission, and PM Poshan. The Centre bears 60% and states 40% of scheme costs in general category states. Under **competitive federalism**, the NITI Aayog promotes inter-state competition in governance reforms through the Aspirational Districts Programme and performance-linked grant mechanisms.

6.8.2 Challenges in Centre-State Expenditure Coordination

⚠ Key Challenges in Centre-State Expenditure Relations

- Centrally Sponsored Schemes proliferation: Over 200 CSS have created fiscal pressure on states, as they must contribute matching shares and bear implementation costs.
- Conditionality in grants: Central grants often come with conditionalities that limit state flexibility to adapt programmes to local needs.
- State fiscal stress: Several states face high debt burdens — above 30-35% of GSDP — limiting their ability to spend on development.
- Delayed devolution: Delays in Central tax devolution create cash flow problems for states, hampering timely expenditure.
- Off-budget borrowings: States have increasingly resorted to off-budget borrowings through state-owned entities, distorting true fiscal positions.
- GST compensation cessation: The end of GST compensation (2022) has created revenue shortfalls in several states, constraining expenditure.

5.9 Canons of Public Expenditure

Adam Smith laid down canons (principles) of taxation; economists have similarly formulated canons of public expenditure to guide prudent government spending. The major canons are:

Canon	Principle	Application in India
Canon of Economy	Expenditure should avoid wastage; maximum output from minimum outlay	PFMS (Public Financial Management System) for

		expenditure tracking; JAM trinity to plug leakages
Canon of Sanction	No expenditure without prior legislative sanction (Appropriation Act)	Article 114: no withdrawal from CFI without Appropriation Act; Parliamentary oversight
Canon of Benefit	Expenditure should confer maximum social benefit on the community	Prioritising expenditure on health, education, and infrastructure over ceremonial spending
Canon of Elasticity	Expenditure should be adjustable — capable of expansion or contraction	Supplementary demands for grants; FRBM escape clauses for emergencies
Canon of Surplus	Revenue should exceed expenditure over the medium term; avoid chronic deficits	FRBM fiscal deficit targets; Revenue Deficit elimination goal
Canon of Productivity	Expenditure should enhance productive capacity of the economy	Capital expenditure push; PM GatiShakti National Master Plan for infrastructure
Canon of Equitable Distribution	Benefits of expenditure should reach all sections of society	Pro-poor schemes; special provisions for SC/ST/OBC; geographic equity through Finance Commission

5.10 Chapter Summary

This chapter has provided a comprehensive examination of public expenditure in India — its meaning, objectives, importance, classification, and the distinct roles of Central and State governments. The following table encapsulates the chapter's key dimensions:

Dimension	Content	Key Insight
Meaning	Government spending on goods, services, transfers, and debt service to fulfil public functions	Distinct from private expenditure; non-quid-pro-quo in many cases

Objectives	Allocation, distribution, stabilisation, development, merit goods, external effects	Musgrave's three branches + development objective for developing economies
Importance	Capital formation, poverty reduction, regional equity, public goods, welfare	Justified on market failure and distributional grounds
Classification	Revenue/Capital; Plan/Non-Plan; Productive/Unproductive; Transfer/Non-Transfer; Development/Non-Development	Multiple criteria; each serves different analytical purpose
Central Exp.	Defence, interest, subsidies, transfers to states, central infrastructure, national schemes	Union List subjects; ~60% of combined government expenditure
State Exp.	Education, health, agriculture, police, rural development, local infrastructure	State List subjects; large social sector role; implementation agencies

Public expenditure in India is not merely a financial matter — it is a statement of priorities, values, and developmental vision. The challenge for Indian policymakers lies in ensuring that public expenditure is not only adequate in scale but also efficient in delivery, equitable in distribution, and fiscally sustainable over the long run. The FRBM framework, the Finance Commission mechanism, and reforms in expenditure tracking (PFMS) together constitute India's institutional architecture for responsible public spending.

Key Terms

Public Expenditure	Expenditure incurred by government authorities for collective needs, public goods, and social welfare.
Allocation Function	Government's role in providing public goods and correcting market failures through expenditure.
Distribution Function	Use of public expenditure and transfers to reduce income and wealth inequalities.
Stabilisation Function	Counter-cyclical use of public expenditure to moderate economic fluctuations.

Revenue Expenditure	Expenditure that neither creates assets nor reduces liabilities; recurring in nature.
Capital Expenditure	Expenditure resulting in asset creation or liability reduction; investment in nature.
Transfer Payments	Government payments without direct quid pro quo — subsidies, pensions, grants.
Wagner's Law	Adolph Wagner's proposition that public expenditure grows as a share of national income during economic development.
Canons of Public Expenditure	Principles guiding prudent government spending: economy, sanction, benefit, elasticity, surplus, productivity, and equity.
Centrally Sponsored Schemes	Schemes jointly funded by Centre and States; implemented by states but designed and partially funded by the Centre.
Vertical Fiscal Imbalance	The mismatch between states' expenditure responsibilities and their revenue-raising capacity in a federal system.
FRBM Act	Fiscal Responsibility and Budget Management Act, 2003 — provides statutory fiscal rules and deficit targets for India.

Review Questions

Short Answer Questions (2–4 Marks)

1. Define public expenditure. How does it differ from private expenditure?
2. State and explain any three canons of public expenditure.
3. Distinguish between revenue expenditure and capital expenditure with examples.
4. What is the distribution function of public expenditure? Give two Indian examples.
5. Explain Wagner's Law of Increasing State Activity with reference to India.
6. What is transfer expenditure? Give three examples from India's Union Budget.
7. Why was the Plan/Non-Plan distinction abolished in India's Budget from 2017-18?

Long Answer Questions (6–10 Marks)

1. Explain the meaning and objectives of public expenditure with reference to Musgrave's three-branch framework. How does the development function extend this framework for India?

2. Discuss the importance of public expenditure in India's economic development with reference to capital formation, poverty alleviation, human development, and regional equity.

3. Classify public expenditure using at least five criteria. Explain the significance of each classification for fiscal policy analysis.

4. Describe the structure and composition of Central Government expenditure in India. What are the key trends in Central expenditure over the last two decades?

5. Compare and contrast the expenditure responsibilities of the Central and State Governments in India's federal framework. What are the challenges in Centre-State expenditure coordination?

6. Explain the concept of vertical fiscal imbalance in India. How does the Finance Commission mechanism attempt to address this imbalance?

Analytical Questions

1. India's public expenditure as a percentage of GDP is lower than most developed economies. Is this a sign of fiscal prudence or developmental inadequacy? Critically evaluate.

2. 'Capital expenditure is always more beneficial than revenue expenditure.' Do you agree? Discuss with examples from India's Union Budget.

3. Evaluate India's MGNREGA as an instrument of the distribution function of public expenditure. What are its achievements and limitations?

Chapter 6:
Trends in Public Expenditure in India

- Growth of Public Expenditure after Independence
- Sector-wise Trends
  - Education
  - Health
  - Defence
  - Infrastructure
  - Social Welfare
- Changing Pattern of Government Spending

Learning Objectives

1. Trace the historical growth of public expenditure in India from Independence to the present

2. Understand the phase-wise evolution of government spending across planning and post-reform eras

3. Analyse sector-wise expenditure trends in Education, Health, Defence, Infrastructure, and Social Welfare

4. Evaluate the effectiveness and adequacy of public spending in key human development sectors

5. Identify the structural shifts and changing patterns in the composition of government spending

6. Appreciate the role of policy reforms, economic crises, and global events in reshaping expenditure priorities

7. Compare India's sectoral expenditure levels with international benchmarks and targets

6.1 Introduction

The story of public expenditure in India after Independence is, in many ways, the story of the Indian state itself — its ambitions, its constraints, its successes, and its failures. When India became independent in 1947, it inherited a colonial state apparatus that had been designed

primarily for extraction and administration, not for development. Public expenditure was modest, narrowly focused, and largely confined to law and order, debt service, and basic administration.

Over the seven-and-a-half decades since Independence, the scale, scope, and composition of Indian public expenditure has undergone a fundamental transformation. Total Central Government expenditure has grown from a mere ₹197 crore in 1950-51 to over ₹47 lakh crore in 2023-24 — a nominally staggering increase that, even after accounting for inflation and economic growth, represents a profound expansion in the fiscal role of the Indian state.

> *"The government budget is not merely a financial document; it is an instrument of social transformation. Every rupee spent reflects a choice about what kind of India we want to build."*
>
> **— Dr. Manmohan Singh, Union Finance Minister, Budget Speech, 1991**

This chapter traces the growth of public expenditure after Independence, examines sector-wise expenditure trends in five critical domains — Education, Health, Defence, Infrastructure, and Social Welfare — and analyses the changing pattern of government spending, with particular attention to structural shifts in composition, drivers of change, and lessons for fiscal policy.

6.2 Growth of Public Expenditure after Independence

6.2.1 The Scale of Expansion: Key Statistics

₹197 Cr	**₹47 Lakh Cr**	**~15%**	**9.2%**
Central Expenditure 1950-51	Central Expenditure 2023-24	Avg. Expenditure as % of GDP (2000-2023)	Peak Fiscal Deficit/GDP (COVID Year 2020-21)

The growth of public expenditure in India can be understood through both quantitative and qualitative lenses. Quantitatively, the absolute increase has been enormous. Qualitatively, the nature of expenditure has shifted — from a narrow administrative and colonial template, to a planned developmental model, to a liberalised mixed-economy framework, and most recently to a state that seeks to balance fiscal consolidation with welfare obligations and infrastructure investment.

6.2.2 Phase-wise Analysis of Growth

The growth of public expenditure after Independence can be divided into six distinct historical phases, each shaped by the dominant economic philosophy, political priorities, and fiscal constraints of its era.

Phase I | 1947–56 Post-Independence Reconstruction and Early Planning

India inherited a devastated economy with minimal infrastructure. The First Five-Year Plan (1951-56) prioritised agriculture, irrigation, and community development. Total Central expenditure was ₹197 crore (1950-51), rising to ₹485 crore by 1955-56. The Planning Commission was established (1950), laying the institutional foundation for state-led development. Expenditure was modest and revenue-driven; borrowing was limited.

Phase II | 1956–69 Nehruvian Socialism and Planned Industrialisation

The Second (1956-61) and Third (1961-66) Five-Year Plans followed the Mahalanobis model: massive public investment in heavy industry (steel, machine tools, power), with the state taking the commanding heights of the economy. Central expenditure grew sharply. The Industrial Policy Resolution 1956 reserved key sectors for public enterprises. Wars with China (1962) and Pakistan (1965) sharply raised defence expenditure. Expenditure grew from ₹900 crore to over ₹3,500 crore.

Phase III | 1969–80 Bank Nationalisation, Green Revolution, and Expanding Welfare

Bank nationalisation (1969) and major agricultural investments under the Green Revolution expanded the fiscal role of the state. Food subsidy programmes, fertiliser subsidies, and rural credit expansion increased expenditure significantly. The oil crisis (1973-74) strained public finances. Expenditure rose from ₹4,000 crore to over ₹25,000 crore. The Emergency period (1975-77) saw both fiscal expansion and contraction.

Phase IV | 1980–91 Fiscal Expansion and Growing Deficit Crisis

The 1980s witnessed a dramatic and unsustainable expansion of public expenditure. Rajiv Gandhi's government invested heavily in technology and defence modernisation; Indira Gandhi expanded welfare programmes. Subsidies ballooned; interest payments surged as government borrowed heavily. Fiscal deficit reached 8-9% of GDP by 1990-91. The Balance of Payments crisis of 1991 was partly rooted in chronic fiscal excess. Central expenditure crossed ₹1 lakh crore by the late 1980s.

Phase V | 1991–2014 Liberalisation, Fiscal Consolidation, and New Social Programmes

The 1991 reforms reduced direct state participation in production but paradoxically did not shrink public expenditure significantly. Interest payments on accumulated debt continued to rise. New social sector obligations (universalisation of elementary education, NRHM, MGNREGA) added expenditure pressure. FRBM Act (2003) provided a framework for consolidation. UPA's rights-based programmes (RTI, RTE, MGNREGA, Food Security) expanded welfare expenditure significantly. The global financial crisis (2008) triggered a major fiscal stimulus.

Phase VI | 2014–Present Infrastructure Push, DBT Reform, and Post-COVID Recovery

The post-2014 period is characterised by three defining shifts: (i) rationalisation of subsidies through Direct Benefit Transfer (DBT), eliminating leakages; (ii) a massive and historically unprecedented push in public capital expenditure — from ₹3.4 lakh crore (2019-20) to ₹10 lakh crore (2023-24); and (iii) the fiscal shock of COVID-19 (2020-21), when the deficit surged to 9.2% of GDP. The emphasis has shifted from consumption spending to investment-led growth through infrastructure.

6.2.3 Absolute Growth Trend: Central Government Expenditure

The following table presents the absolute growth of Central Government expenditure at selected benchmark years, illustrating the pace of fiscal expansion across eras:

Year	Total Expenditure (₹ Crore)	Revenue Expenditure (₹ Crore)	Capital Expenditure (₹ Crore)	Expenditure as % of GDP
1950-51	197	168	29	~7%
1960-61	981	734	247	~9%
1970-71	3,416	2,456	960	~12%
1980-81	17,019	12,122	4,897	~15%

1990-91	1,05,354	79,884	25,470	~17%
2000-01	3,75,223	2,84,855	90,368	~15%
2010-11	11,08,749	9,11,459	1,97,290	~14%
2019-20	26,86,333	22,46,399	4,39,934	~13%
2020-21	34,50,305	30,11,894	4,38,411	~17.7%
2023-24	47,65,768	37,09,401	10,00,961	~14.6%

Key Note: Figures for 1950-51 through 1990-91 are approximate/rounded and sourced from RBI Handbook of Statistics; 2000-01 onwards from Union Budget documents. GDP-percentage estimates vary by deflator and GDP series used.

6.2.4 Causes of Growth of Public Expenditure in India

The sustained expansion of public expenditure over seven decades is attributable to a combination of structural, institutional, and macroeconomic factors:

Major Causes of Growing Public Expenditure in India

- Expanding developmental role: adoption of planned development required massive state investment in industry, power, transport, and agriculture.
- Defence obligations: wars with China (1962), Pakistan (1965, 1971, 1999) and persistent security challenges necessitated rising defence expenditure.
- Welfare state expansion: constitutional commitments to social justice drove expenditure on education, health, and social protection programmes.
- Rising interest payments: decades of fiscal deficits created a debt stock whose servicing now consumes ~20% of Central revenue expenditure.

- Growing subsidy burden: food, fertiliser, petroleum, and power subsidies expanded dramatically, particularly from the 1970s onwards.
- Population growth: a population that grew from 36 crore (1951) to 140 crore (2023) demanded proportionally more public services.
- Urbanisation: rapid urbanisation created demand for urban infrastructure, housing, water supply, and transport investment.
- Wagner's Law: as per capita income rose, demand for public goods and services increased disproportionately.
- Price inflation: rising price levels increased nominal expenditure on wages, pensions, and procurements even without real expansion.
- COVID-19 pandemic: the health emergency of 2020-21 triggered an extraordinary fiscal expansion in health, food security, and economic relief.

6.3 Sector-wise Expenditure Trends

Understanding the overall growth of public expenditure requires a disaggregated examination of spending across key sectors. The allocation of public resources among competing priorities reveals the developmental vision of successive governments and the effectiveness of fiscal policy in achieving social objectives. The following sections examine five critical sectors: Education, Health, Defence, Infrastructure, and Social Welfare.

6.3.1 Education

Building India's Human Capital — Trends, Programmes, and Challenges

A. Importance of Education Expenditure

Education is widely recognised as the most powerful long-run investment a government can make. Public expenditure on education develops human capital, enhances labour productivity, enables technological innovation, promotes social mobility, and is essential for participatory democracy. In India, where adult literacy stood at just 18% at Independence, the expansion of public education spending has been an existential national priority.

> *"To transform India into a knowledge superpower, we must treat education expenditure not as a cost, but as the highest-return investment the government can make."*
>
> **— National Education Policy, 2020**

B. Historical Trend in Education Expenditure

India's public expenditure on education has grown in absolute terms but has consistently fallen short of targets as a share of GDP. The Kothari Commission (1964-66) famously

recommended raising education expenditure to 6% of GDP — a target that remains unmet six decades later.

Period / Year	Education Expenditure (% of GDP)	Key Milestone / Programme
1950-51	~0.6%	University Education Commission (Radhakrishnan, 1948); minimal school infrastructure
1964-66	~2.3%	Kothari Commission recommends 6% of GDP target — not achieved since
1976	~2.8%	42nd Amendment: Education moved to Concurrent List; Centre gets legislative role
1986	~3.0%	National Policy on Education 1986; Operation Blackboard; Navodaya Vidyalayas
2000-01	~3.8%	Sarva Shiksha Abhiyan launched; push for universal elementary education
2009	~3.3%	Right to Education Act — makes free education a fundamental right (6-14 years)
2014-15	~3.1%	Mid-Day Meal scheme expanded; RUSA for higher education
2019-20	~3.0%	New Education Policy 2020 targets 6% of GDP by 2030
2021-22	~2.9%	PM eVIDYA, DIKSHA digital platforms post-COVID
2023-24	~2.9%	Budget allocation: ₹1.12 lakh crore; PM SHRI schools; National Curriculum Framework

C. Major Education Expenditure Programmes

Flagship Education Expenditure Programmes — India

- Sarva Shiksha Abhiyan (SSA) / SAMAGRA Shiksha: Umbrella scheme for school education from pre-primary to Class XII; covers infrastructure, teacher training, and quality improvement.
- Mid-Day Meal Scheme (PM Poshan): Provides cooked meals to 11.8 crore children in government schools; improves enrollment, retention, and nutrition simultaneously.
- Right to Education Act (2009): Mandated free and compulsory education for children aged 6-14; required massive public investment in school infrastructure and teacher recruitment.
- Rashtriya Madhyamik Shiksha Abhiyan (RMSA): Expanded government secondary schools, improved quality, and increased access at secondary level.
- Higher Education: IIT expansion (from 7 to 23 IITs), 16 IIITs, AIIMS expansion (from 1 to 22+), Central Universities — all representing capital-intensive public investment.
- NEP 2020: National Education Policy targets 6% of GDP for education, 50% Gross Enrolment Ratio in higher education by 2035, and foundational literacy-numeracy for all by 2026-27.
- DIKSHA / PM eVIDYA: Digital education platforms for remote learning, accelerated by COVID-19 pandemic requirements.

D. Key Issues and Challenges

Challenges in Education Expenditure

- Persistent gap from 6% target: India has never reached the Kothari Commission's 6% of GDP target; current spending (~2.9%) lags behind Brazil (6.2%), South Africa (6.6%), and USA (5.4%).
- Quality vs. quantity: despite massive expansion of schools and enrollment, learning outcomes remain poor — ASER surveys show large proportions of Class 5 students cannot read Class 2 text.
- Teacher vacancies: over 1 million teacher vacancies in government schools undermine the impact of infrastructure investment.
- Higher education underfunding: India's public universities are chronically underfunded; the student-to-faculty ratio at many state universities far exceeds UGC norms.
- Urban-rural and gender disparities: public expenditure has not fully equalized educational opportunity; rural, tribal, and girl students remain disadvantaged.

- Declining public share: private education has grown rapidly, raising equity concerns — quality education is increasingly a commodity.

6.3.2 Health

From Basic Primary Care to Universal Health Coverage — A Fiscal Journey

A. Importance of Health Expenditure

Public health expenditure is foundational to human capital development, labour productivity, and social equity. A healthy population is more productive economically and more capable of exercising democratic rights. India's public health system, built largely through public expenditure, has achieved remarkable outcomes — eradicating smallpox, nearly eliminating polio, dramatically reducing infant and maternal mortality — but significant challenges of coverage, quality, and equity remain.

B. Historical Trend in Health Expenditure

India's public health expenditure has been chronically low by international standards — a reflection of competing fiscal priorities and the relative political weakness of health lobbies compared with subsidies or defence. The COVID-19 pandemic has sharply refocused attention on public health investment.

Period / Year	Public Health Exp. (% of GDP)	Key Development
1950-51	~0.2%	Bhore Committee (1946) blueprint for primary healthcare; minimal infrastructure
1960s	~0.6%	Expansion of district hospitals; malaria eradication programme
1983	~0.9%	National Health Policy 1983; primary health centres network expansion
1990s	~0.9%	World Bank-funded health projects; user fees introduced in some states
2005	~0.9%	National Rural Health Mission (NRHM) launched — major expansion of primary care
2013-14	~1.2%	National Urban Health Mission; NRHM becomes NHM

2017	~1.3%	National Health Policy 2017 targets 2.5% of GDP by 2025
2018	~1.4%	Ayushman Bharat launched: PM-JAY (health insurance for 50 crore) + HWCs
2020-21	~1.8%	COVID-19: emergency health expenditure surges; vaccine procurement begins
2021-22	~2.1%	Post-COVID health budget increased 135%; PM AtmaNirbhar Swasth Bharat Yojana
2023-24	~1.9%	Budget allocation: ₹89,155 crore; Mission Indradhanush; mental health focus

C. Major Health Expenditure Programmes

Flagship Health Expenditure Programmes — India

- National Health Mission (NHM): Umbrella mission covering NRHM (rural) and NUHM (urban); funds primary health centres, sub-centres, and community health workers (ASHAs).
- Ayushman Bharat — PM-JAY: World's largest government-funded health insurance scheme; covers ₹5 lakh per family per year for secondary and tertiary hospitalisation for 50 crore beneficiaries.
- Health and Wellness Centres (HWCs): 1.5 lakh sub-centres being converted to comprehensive primary care centres — expanding beyond maternal and child health to NCDs and mental health.
- PM AtmaNirbhar Swasth Bharat Yojana: ₹64,180 crore over 6 years for health system strengthening, disease surveillance, new AIIMS, critical care blocks.
- AIIMS Expansion: From 1 AIIMS (1956) to 22+ functional/upcoming AIIMS; represents massive public capital investment in tertiary care.
- Universal Immunisation Programme: Free vaccines against 13 diseases for all children; one of the world's largest immunisation efforts funded through public expenditure.
- Mental Health: NIMHANS, district mental health programme — public expenditure on an historically neglected sector.

D. International Comparison and Challenges

Country	Public Health Expenditure (% of GDP)	Health Outcomes (Life Expectancy)
India	~1.9%	70.8 years
China	~3.0%	78.2 years
Brazil	~4.0%	74.0 years
USA	~8.5%	78.8 years
UK	~7.8%	81.4 years
Sri Lanka	~1.7%	77.0 years
India Target (NHP 2017)	2.5% by 2025	Aspirational

⚠ Key Challenges in Health Expenditure

- Out-of-pocket expenditure (OOPE): Despite public spending, ~63% of India's total health expenditure is paid out-of-pocket by individuals — among the highest globally — causing catastrophic health expenditure for poor families.
- Urban-rural divide: Public health facilities are concentrated in urban areas; rural PHCs suffer from vacancies, absenteeism, and equipment shortages.
- Doctor and nurse shortage: India has 0.7 doctors per 1,000 population against WHO recommendation of 1 per 1,000; 60-70% work in private sector.
- State-level variation: Kerala and Tamil Nadu have near-universal primary care coverage; Bihar and UP have deeply inadequate facilities — public expenditure alone has not closed this gap.
- Non-Communicable Diseases: Rising burden of diabetes, hypertension, and cancer requires expensive tertiary care that strains public health budgets.
- COVID-19 lesson: India's low public health investment was exposed as a structural vulnerability during the pandemic; sustained increases are now essential.

6.3.3 Defence

Security Expenditure in Independent India — Between Necessity and Fiscal Burden

A. Importance of Defence Expenditure

Defence expenditure is the quintessential function of the state — no other good is more purely public. National security is non-rival and non-excludable; every citizen benefits from a secure nation regardless of whether they contribute to its cost. India's geostrategic position — bordered by two nuclear-armed rival states, with a long history of conflict — makes defence spending a fiscal imperative rather than a choice.

At the same time, defence expenditure represents an opportunity cost: resources devoted to defence are unavailable for education, health, and infrastructure. India's fiscal challenge has always been to maintain adequate defence capacity while investing sufficiently in human and physical capital for development.

B. Historical Trend in Defence Expenditure

Year	Defence Budget (₹ Crore)	Defence as % of GDP	Defence as % of Total Govt. Expenditure	Key Context
1950-51	168	~1.8%	~46%	Post-partition security establishment
1963-64	867	~2.9%	~26%	Post-1962 Sino-Indian war sharp increase
1971-72	1,575	~3.0%	~26%	Bangladesh Liberation War; highest peak
1980-81	3,276	~2.6%	~19%	Modernisation of armed forces
1990-91	15,743	~2.8%	~15%	Post-Cold War; acquisition of advanced systems
2000-01	47,633	~2.4%	~15%	Kargil War impact; nuclear tests 1998

2010-11	1,47,344	~1.9%	~13%	Modernisation; rising personnel costs
2019-20	3,37,553	~1.9%	~13%	Galwan border tensions; OROP implementation
2021-22	4,78,196	~2.0%	~13%	Agnipath scheme; indigenisation push
2023-24	5,93,538	~1.9%	~12%	Record capital budget; AtmaNirbhar Bharat defence

C. Composition of Defence Expenditure

India's defence budget is divided into Revenue Expenditure (salaries, maintenance, operations) and Capital Expenditure (procurement of weapons, aircraft, ships, vehicles). The balance between these components reflects the tension between personnel costs and modernisation.

Component	2015-16	2019-20	2023-24	Significance
Revenue Expenditure	₹1.51 L Cr	₹2.10 L Cr	₹3.54 L Cr	Salaries, pensions, maintenance; ~60% of defence budget
Capital Expenditure	₹78,370 Cr	₹1.03 L Cr	₹1.72 L Cr	Equipment procurement; indigenisation push
Pensions (in Rev.)	₹60,826 Cr	₹1.17 L Cr	₹1.38 L Cr	Fastest growing component; demographic pressure
R&D (DRDO)	₹13,127 Cr	₹16,045 Cr	₹23,264 Cr	Defence technology development; Tejas, Arjun

D. Key Issues in Defence Expenditure

Critical Issues in India's Defence Spending

- Declining share of GDP: India's defence spending at ~1.9-2.0% of GDP is below the NATO target of 2% and well below China's ~2.2%. Given two active borders, this is a strategic concern.
- Personnel vs. modernisation: Rising salaries and pensions (especially after OROP — One Rank One Pension) squeeze the capital budget available for equipment modernisation.
- Indigenisation imperative: India has historically been the world's largest arms importer (Russia, France, USA, Israel). Atmanirbhar Bharat defence initiative aims to reduce import dependence to <30% by 2025.
- • Pension burden: Defence pensions now exceed the capital procurement budget — an unsustainable structural imbalance. Agnipath scheme (2022) attempts to address this by limiting service tenures.
- • Off-budget obligations: Some defence-related expenditure appears under other heads, making true defence spending difficult to compare internationally.
- • Technology gap: China's defence modernisation has accelerated; India faces a widening technology gap in key domains that requires urgent capital investment.

6.3.4 Infrastructure

The Foundation of Growth — Roads, Railways, Power, and Digital India

A. Infrastructure as a Fiscal Priority

Infrastructure — the physical arteries of the economy — is the domain where public expenditure most directly drives economic growth. Roads, railways, ports, airports, power plants, irrigation systems, and digital networks reduce transaction costs, connect markets, and crowd-in private investment. India's infrastructure deficit has historically been among the most binding constraints on growth, making public capital expenditure in infrastructure both necessary and economically justified.

> *"Every rupee spent on infrastructure yields a multiplier of 2.5 to 3.5 rupees in GDP over a five-year horizon. Infrastructure is not expenditure; it is investment."*
>
> **— Economic Survey of India, 2021-22**

B. Historical Trend in Infrastructure Expenditure

Infrastructure expenditure in India has undergone a dramatic transformation — from a centrally planned, public-sector-dominated model to a Public-Private Partnership (PPP) framework, and most recently to a massive state-led capital expenditure push.

Period	Dominant Mode	Key Developments	Scale of Investment
1950s-60s	State-owned enterprises	NHAI predecessor; National Highway Act; heavy power plant creation	₹200-800 crore annually
1970s-80s	PSU investment	NTPC (1975), NHPC; Power Grid; SAIL for steel infrastructure	₹1,000-5,000 crore
1990s	PPP beginnings	Telecom liberalisation; NHDP Phase I begins; power sector reforms	₹5,000-20,000 crore
2000s	PPP expansion	NHDP Phase II-VII; JNNURM for urban infra; airports PPP	₹30,000-1 lakh crore
2014-19	Renewed public push	PM GatiShakti; Sagarmala; Bharatmala; Smart Cities; BharatNet	₹3-6 lakh crore/year
2020-24	Capital Expenditure push	Capital expenditure tripled to ₹10 lakh crore; NIP ₹111 lakh crore pipeline	₹7-10 lakh crore/year

C. Sub-sector wise Infrastructure Expenditure

Roads and Highways

India's road network has expanded from 4 lakh km at Independence to over 63 lakh km — the second largest in the world. The National Highways Authority of India (NHAI) and the Bharatmala programme have driven highway construction at record pace: over 10,000 km of national highways constructed annually since 2017. Capital expenditure on roads and highways crossed ₹2.7 lakh crore in 2023-24.

Railways

Indian Railways is one of the world's largest rail networks and a major recipient of public capital expenditure. Railway capital outlay has surged from ₹45,000 crore (2013-14) to ₹2.65 lakh crore (2023-24) — a near six-fold increase. Vande Bharat Express trains, 100% electrification, dedicated freight corridors, and station redevelopment represent the current investment frontier.

Power and Energy

Power sector investment has been a fiscal priority since the First Five-Year Plan. The Pradhan Mantri Sahaj Bijli Har Ghar Yojana (Saubhagya) electrified 2.8 crore households by 2019. The Revamped Distribution Sector Scheme (RDSS) provides ₹3 lakh crore for distribution network modernisation. India's installed power capacity has grown from 2,301 MW (1950) to over 4,20,000 MW (2023).

Digital Infrastructure

The 2010s witnessed the emergence of digital infrastructure as a critical domain of public expenditure. BharatNet — the world's largest rural broadband project — aims to connect 2.5 lakh gram panchayats with optical fibre at a cost of over ₹61,000 crore. India Stack (Aadhaar, UPI, ONDC) represents public investment in digital public goods that has transformed financial inclusion and public service delivery.

D. National Infrastructure Pipeline

> **Key Note:** The National Infrastructure Pipeline (NIP), announced in 2019, envisages ₹111 lakh crore of infrastructure investment over 2020-25. Of this, the Centre contributes ~39%, states ~40%, and the private sector ~22%. This represents a structural commitment to infrastructure-led growth at an unprecedented scale.

Sector	NIP Allocation (₹ Lakh Crore)	Share of Total	Key Projects
Energy	24.5	22%	Power generation, T&D, renewable energy
Roads	19.6	18%	Bharatmala, expressways, rural roads (PMGSY)
Urban Infrastructure	16.3	15%	Smart Cities, metro rail, water, sewerage
Railways	13.7	12%	High-speed rail, freight corridors, electrification
Rural Infrastructure	9.6	9%	Irrigation, rural roads, rural housing
Digital	4.4	4%	BharatNet, data centres, 5G

Others	22.9	20%	Ports, airports, industrial corridors, health

6.3.5 Social Welfare

From Charity to Rights — The Expanding Social Contract of the Indian State

A. The Evolving Social Welfare State in India

Social welfare expenditure encompasses the government's spending on programmes designed to protect citizens from economic and social vulnerability — poverty, hunger, old age, disability, and social discrimination. In independent India, the social welfare state has evolved from modest, targeted charity programmes of the 1950s to a comprehensive architecture of rights-based entitlements backed by legislative mandates and substantial public expenditure.

The Constitutional Directive Principles of State Policy (Articles 38-51) provide the normative foundation for social welfare spending. The right to work (MGNREGA), the right to food (NFSA), the right to education (RTE Act), and the right to health (Ayushman Bharat) represent successive expansions of the state's welfare obligations — each backed by public expenditure.

B. Growth of Social Welfare Expenditure

Era	Dominant Programmes	Approximate Scale	Approach
1950s	Community Development Programme; National Extension Service	Minimal	Community mobilisation
1960s-70s	Integrated Rural Development; Drought-Prone Area programmes	₹100-500 crore	Employment + assets
1980s	NREP, RLEGP; Jawahar Rozgar Yojana; Indira Awas Yojana	₹500-3,000 crore	Employment generation
1990s	JRY; PMRY; PDS expansion; Antyodaya Anna Yojana	₹5,000-15,000 Cr	Poverty targeting
2000s	MGNREGA (2005); PMGSY; Sarva Shiksha; NRHM	₹20,000-60,000 Cr	Rights-based approach
2010s	MGNREGA; PMAY; PM-JAY; PM-KISAN; DBT revolution	₹1-4 lakh crore	Universal entitlements

2020s	PMGKAY (COVID); MGNREGA surge; PM-KISAN; Ayushman Bharat	₹4-7 lakh crore	Direct transfers + rights

C. Major Social Welfare Programmes: Expenditure and Impact

Major Social Welfare Expenditure Programmes — India

- MGNREGA (Mahatma Gandhi National Rural Employment Guarantee Act, 2005): Guarantees 100 days of unskilled wage employment per year to rural households. Budget allocation has risen from ₹11,300 crore (2006-07) to ₹60,000 crore (2023-24). Provided critical safety net during COVID-19 when allocation surged to ₹1.11 lakh crore (2020-21).
- PM Awas Yojana (Gramin + Urban): Housing for All by 2022. Over 3 crore rural houses and 67 lakh urban houses constructed or under construction; total outlay exceeding ₹2 lakh crore across plan period.
- PM-KISAN: Direct income support of ₹6,000 per year to 11 crore farmer families through DBT. Annual outlay ~₹60,000 crore. Demonstrates shift from input subsidies to direct income transfers.
- National Food Security Act / PDS: Subsidised food grains (5 kg/person/month at ₹1-3/kg) to 81.35 crore beneficiaries — the world's largest food subsidy programme. Food subsidy bill: ~₹1.97 lakh crore (2022-23).
- PM Garib Kalyan Anna Yojana (PMGKAY): Free food grains to 81 crore beneficiaries during COVID-19 and extended through 2023 and beyond; additional expenditure of ~₹3.9 lakh crore over 2020-23.
- Social Security Pensions: National Social Assistance Programme (NSAP) covers old age, widows, and disabled persons. State schemes add significantly; over 3 crore beneficiaries nationally.
- Ayushman Bharat — PM-JAY: Health insurance (₹5 lakh/family/year) for 50 crore beneficiaries; absorbs healthcare costs that would otherwise be catastrophic for poor families.
- PM Ujjwala Yojana: Free LPG connections to 9.5 crore BPL families; reduces indoor air pollution and time poverty of women; outlay ~₹12,000 crore for connections alone.
- Jal Jeevan Mission: Tap water connection to every rural household by 2024 (extended 2026); ₹3.6 lakh crore over mission period; transformed rural health through improved sanitation.

D. The DBT Revolution: Transforming Social Welfare Delivery

One of the most significant structural changes in India's social welfare expenditure has been the Direct Benefit Transfer (DBT) revolution, launched in 2013 and massively scaled since 2016. By routing transfers directly to Aadhaar-linked bank accounts, DBT has fundamentally changed the architecture of welfare spending.

₹36 L Cr	**318 Cr**	**₹2.73 L Cr**	**53+**
Total DBT transferred 2013-2024	Beneficiary payments made via DBT	Estimated savings through DBT (leakage reduction)	Ministries using DBT for schemes

> **Key Note:** The JAM Trinity (Jan Dhan-Aadhaar-Mobile) is the technological backbone of India's welfare expenditure transformation. By 2024, over 52 crore Jan Dhan accounts, 136 crore Aadhaar numbers, and near-universal mobile penetration have enabled direct, leakage-free transfer of welfare benefits at an unprecedented scale.

6.4 Changing Pattern of Government Spending

Beyond the aggregate growth and sector-wise trends, a comprehensive understanding of Indian public expenditure requires analysis of the structural shifts — the changing composition, priorities, and delivery mechanisms of government spending. Six major transformations have reshaped the pattern of Indian public expenditure since Independence.

6.4.1 From Capital Formation to Consumption — and Back Again

In the Nehruvian era, public expenditure was heavily oriented toward capital formation: building steel plants, dams, power stations, and public enterprises. Over the 1980s and 1990s, the composition shifted toward consumption expenditure — subsidies, salaries, interest payments — as fiscal deficits widened and productive investment was crowded out.

The post-2014 period marks a decisive reversal of this trend. The government has explicitly prioritised capital expenditure, growing it from ₹3.36 lakh crore (2019-20) to ₹10 lakh crore (2023-24) — a 198% increase in five years. This represents the most sustained and aggressive public capital expenditure push in India's post-reform history.

Year	Revenue Expenditure (₹ Lakh Cr)	Capital Expenditure (₹ Lakh Cr)	Capital Exp. as % of Total	Capex/GDP
2013-14	14.16	1.84	11.5%	~1.5%
2016-17	17.11	2.15	11.2%	~1.4%
2019-20	22.46	3.36	13.0%	~1.7%
2021-22	29.65	5.54	15.7%	~2.3%
2022-23	31.18	7.50	19.4%	~2.7%
2023-24	37.09	10.00	21.2%	~3.2%

6.4.2 From Subsidies and Leakages to Direct Benefit Transfers

For decades, India's welfare expenditure was channelled through intermediaries — ration shops, fertiliser dealers, LPG distributors — creating enormous opportunities for leakage, diversion, and corruption. Estimates suggested that for every ₹1 of food subsidy spent, only 27-30 paise reached the intended beneficiary.

The DBT revolution, enabled by the JAM Trinity (Jan Dhan bank accounts, Aadhaar biometrics, Mobile connectivity), has fundamentally transformed welfare delivery. Subsidies are now transferred directly to beneficiaries' bank accounts, eliminating intermediaries and plugging leakages. The government estimates savings of over ₹2.73 lakh crore through DBT since 2013.

Key Shifts in Welfare Delivery Pattern

- Pre-DBT: Physical delivery through PDS shops, fertiliser dealers, scholarship cheques — high leakage, exclusion, and corruption.
- Post-DBT: Electronic transfer to Aadhaar-linked accounts — real-time, auditable, and near-universal coverage.
- LPG subsidy: 2.65 crore ineligible connections surrendered after DBT; annual savings of ₹14,000-17,000 crore.

- Fertiliser DBT: being rolled out to replace the subsidy-to-manufacturer model with direct farmer transfers.
- MGNREGA wages: 99%+ disbursed through bank accounts; transparency dramatically improved though delays remain.
- PM-KISAN: ₹6,000/year to 11 crore farmers through DBT — eliminating middlemen entirely.

6.4.3 From Plan/Non-Plan to Revenue/Capital Classification

Until 2016-17, India's budget distinguished between Plan expenditure (linked to Five-Year Plans) and Non-Plan expenditure (ongoing obligations). This distinction created a perverse incentive: Plan expenditure was seen as progressive and development-oriented, while Non-Plan was viewed as administrative overhead — even though many critical maintenance and salaries fell under Non-Plan.

The abolition of the Plan/Non-Plan distinction from the Union Budget 2017-18, following the recommendations of the B.N. Srikrishna Committee, was a major structural reform. The new classification — Revenue vs. Capital — is analytically superior: it separates asset-creating from consumption expenditure, enabling better assessment of the productive impact of public spending.

Key Note: Simultaneously, the Planning Commission was replaced by NITI Aayog (2015), ending the Five-Year Plan framework. India moved from a command-planning model of public expenditure allocation to a more flexible, aspirational, and market-complementary framework.

6.4.4 From Union-Dominated to Cooperative Federal Spending

The 14th Finance Commission (2015-20) made a historic shift: it increased the states' share of Central taxes from 32% to 42% — the largest single increase in tax devolution ever. This fundamentally altered the pattern of public expenditure by giving states greater untied resources, reducing their dependence on Central scheme grants, and enabling them to prioritise expenditure according to local needs.

The subsequent rationalisation of Centrally Sponsored Schemes — reducing their number from over 200 to approximately 28 core schemes — further reduced the Centre's prescriptive control over state expenditure. This shift represents a move from Union-centric to cooperative federal spending, aligning expenditure decisions more closely with the subsidiarity principle.

Pattern Shifts in Federal Fiscal Architecture

- 14th Finance Commission (2015-20): Tax devolution raised to 42% — states gained ₹1.78 lakh crore additional untied resources.
- 15th Finance Commission (2021-26): Devolution maintained at 41%; performance grants introduced to incentivise fiscal responsibility.

- CSS Rationalisation: Over 200 CSS reduced to ~28 core schemes and ~6 optional schemes; reduced states' matching obligation burden.
- Goods and Services Tax (2017): Unified indirect tax system; states receive SGST and IGST share; compensation mechanism for transition period.
- State capital expenditure incentives: Centre provides interest-free 50-year loans to states for capital expenditure under the Scheme for Special Assistance — ₹1.3 lakh crore in 2023-24.

6.4.5 From Broad Subsidies to Targeted and Rationalised Transfers

India's subsidy bill has historically been enormous, poorly targeted, and fiscally unsustainable. Food subsidies benefited the non-poor through PDS leakages; fertiliser subsidies disproportionately benefited large farmers; petroleum subsidies provided equal benefit to the wealthy car-owner and the poor kerosene user.

The changing pattern of government spending since 2014 has involved systematic subsidy rationalisation. The PAHAL scheme for LPG resulted in 2.65 crore ineligible consumers voluntarily surrendering subsidies under the 'Give It Up' campaign. Petroleum subsidies for petrol and diesel were eliminated. Food subsidies are being better targeted through SECC data. Fertiliser subsidy rationalisation through neem-coating and DBT pilots is underway.

Subsidy	Peak Expenditure	Reform Measure	Outcome
Petroleum subsidy	₹1.40 L Cr (2012-13)	Petrol deregulated 2010; diesel 2014; LPG DBT	₹70,000 Cr savings; 2.65 Cr surrenders
Fertiliser subsidy	₹1.08 L Cr (2021-22)	Neem-coating mandate; PM-PRANAM scheme	Rationalisation underway; DBT pilot
Food subsidy	₹2.87 L Cr (2020-21)	Aadhaar-linked PDS; PMGKAY rationalisation	Exclusion error reduced; leakage declining
MGNREGA	₹1.11 L Cr (2020-21)	DBT wages; geo-tagging of assets	Leakage reduced; asset quality improving

6.4.6 From Import-Dependent to AtmaNirbhar Public Expenditure

A significant pattern shift in government spending — particularly in defence and capital goods — is the emphasis on domestic procurement under the AtmaNirbhar Bharat (Self-Reliant India) initiative launched in 2020. Historically, India was the world's largest arms importer, spending billions of dollars on foreign equipment. The positive indigenisation list now mandates domestic procurement for 509+ defence items.

This pattern shift has fiscal multiplier implications: spending on domestic defence production creates domestic jobs, develops Indian manufacturing capability, and retains economic value

within India rather than transferring it abroad. The same principle applies to electronics, pharmaceuticals, and capital equipment procurement under the Production Linked Incentive (PLI) scheme — where government expenditure is directed toward building domestic productive capacity.

6.4.7 Rising Social Protection and Rights-Based Entitlements

Perhaps the most profound pattern shift in Indian government spending over the past two decades is the institutionalisation of rights-based social entitlements backed by legislation. The UPA government's rights-based approach created statutory obligations — Right to Education (2009), Right to Food (NFSA 2013), MGNREGA employment guarantee — that legally committed future governments to maintain minimum expenditure levels regardless of fiscal conditions.

The NDA government continued and expanded this approach: Ayushman Bharat PM-JAY (insurance for 50 crore), PM-KISAN (income support for 11 crore farmers), PM Awas Yojana (housing for all), and Jal Jeevan Mission (tap water for all) represent continuing expansion of universal entitlement programmes. The COVID-19 pandemic further institutionalised the idea of the Indian state as a provider of last resort — with PMGKAY providing free food to 81 crore people.

The Rights-Based Expenditure Architecture

- Right to Education Act (2009): Statutory right for 6-14 age group; requires government school infrastructure and teacher norms — creates legally enforceable expenditure obligation.
- MGNREGA (2005): Employment guarantee as a legal right; state must provide work within 15 days or pay unemployment allowance — demand-driven expenditure.
- National Food Security Act (2013): Subsidised food as a legal right for 67% of population; food subsidy cannot fall below statutory entitlement.
- PM-JAY / Ayushman Bharat: While not yet a legal right, the scale and political visibility make it a near-permanent entitlement with high switching costs.
- Jal Jeevan Mission: Tap water access for every household — creates infrastructure obligation that will require ongoing maintenance expenditure.
- PMGKAY extension: Free food grains extended through 2023 and converted into a regular scheme — demonstrates how emergency measures become permanent entitlements.

7.5 Chapter Summary

This chapter has traced the dramatic expansion of public expenditure in India from Independence to the present — an arc of growth that reflects the evolving ambitions,

constraints, and priorities of the Indian state. The following summary encapsulates the essential learnings across all sections:

Theme	Key Findings	Policy Implication
Growth since Independence	From ₹197 crore (1950-51) to ₹47 lakh crore (2023-24); six distinct historical phases shaped by planning, wars, crises, and reforms	Expenditure growth must be matched by revenue mobilisation and efficiency gains to remain fiscally sustainable
Education	Consistently below 6% of GDP Kothari target; major programmes (SSA, RTE, mid-day meal) have expanded access but quality remains a challenge	Scale-up spending to 6% of GDP; shift focus from input to outcome; address teacher vacancies and learning crisis
Health	Chronically underfunded (~1.5-2% vs. NHP target of 2.5%); COVID-19 exposed vulnerability; Ayushman Bharat is transformative but incomplete	Raise public health spending to 2.5%+ of GDP; reduce OOPE; strengthen primary care through HWCs
Defence	Rising absolute expenditure but declining as % of GDP; personnel costs squeeze modernisation; indigenisation imperative under AtmaNirbhar	Rebalance revenue-capital ratio; accelerate indigenisation; address pension burden through Agnipath
Infrastructure	Unprecedented capital expenditure push (₹10 lakh crore in 2023-24); NIP provides ₹111 lakh crore pipeline; multiplier effects justify high priority	Sustain capex push; improve project execution capacity; deepen PPP for maintenance financing
Social Welfare	From targeted poverty programmes to universal entitlements; DBT revolution transformed delivery; COVID cemented rights-based approach	Ensure fiscal sustainability of entitlements; improve targeting; link food security to nutrition outcomes
Changing Patterns	Six major shifts: capex revival, DBT, plan/non-plan reform, fiscal federalism, subsidy rationalisation,	Pattern shifts must be sustained, deepened, and evaluated for outcomes — not

	AtmaNirbhar and rights-based entitlements	merely tracked as process reforms

Key Terms

Wagner's Law	The empirical tendency for public expenditure to grow as a share of national income as economies develop.
Capital Expenditure	Government spending that creates physical or financial assets; investment-type spending with multi-year returns.
Revenue Expenditure	Government spending on ongoing operations that neither creates assets nor reduces liabilities; consumption-type.
Direct Benefit Transfer (DBT)	System of transferring welfare benefits directly to Aadhaar-linked bank accounts, bypassing intermediaries.
JAM Trinity	Jan Dhan (banking), Aadhaar (identity), Mobile (connectivity) — the technological infrastructure enabling DBT.
National Infrastructure Pipeline	India's ₹111 lakh crore infrastructure investment programme for 2020-25, covering roads, railways, power, and digital.
MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act, 2005 — guarantees 100 days of unskilled employment to rural households.
Ayushman Bharat	Flagship health scheme combining Health and Wellness Centres (primary care) and PM-JAY (health insurance for 50 crore).
One Rank One Pension (OROP)	Pension scheme for defence personnel providing equal pension for equal service regardless of date of retirement; major fiscal obligation.
Indigenisation	Policy of substituting imported goods/services with domestically produced alternatives; especially relevant for defence procurement.

Rights-Based Expenditure	Public expenditure mandated by legislation as a justiciable entitlement, not discretionary — e.g., MGNREGA, NFSA, RTE.
Centrally Sponsored Schemes	Programmes jointly funded by Centre and states, designed centrally but implemented by states with matching contributions.

Review Questions

Short Answer Questions (2–4 Marks)

1. What was the scale of Central Government expenditure in 1950-51 and 2023-24? What does this growth indicate?

2. Explain the six phases of growth of public expenditure in India after Independence.

3. State the Kothari Commission's recommendation on education expenditure. Has India achieved this target?

4. What is the JAM Trinity? How has it transformed the pattern of welfare expenditure in India?

5. Distinguish between One Rank One Pension (OROP) and Agnipath scheme in the context of defence expenditure.

6. What is the National Infrastructure Pipeline? Mention its total outlay and the major sectors covered.

7. Explain the shift from Plan/Non-Plan to Revenue/Capital classification in India's Union Budget.

Long Answer Questions (6–10 Marks)

1. Trace the historical growth of public expenditure in India from Independence to 2024. Identify the major turning points and explain the causes of growth.

2. Analyse the trends in education expenditure in India since 1947. Why has India failed to achieve the Kothari Commission's target of 6% of GDP? What are the key challenges?

3. Examine the growth and composition of public health expenditure in India. How has the Ayushman Bharat scheme attempted to address the problem of catastrophic out-of-pocket health expenditure?

4. Discuss the trends in defence expenditure in India. What is the tension between revenue and capital components? How is the AtmaNirbhar Bharat initiative changing the pattern of defence spending?

5. What are the major changes in the pattern of government spending in India since 2014? Discuss with reference to the capital expenditure push, DBT revolution, and subsidy rationalisation.

6. Evaluate India's social welfare expenditure since Independence. How has the approach shifted from targeted charity programmes to universal rights-based entitlements? What are the fiscal implications?

Chapter 7:
Issues in Public Expenditure

- Rising Fiscal Deficit
- Inefficient Utilization of Funds
- Corruption and Leakages
- Subsidy Burden
- Regional Imbalance
- Debt Trap
- Need for Expenditure Reforms

Learning Objectives

1. Understand why fiscal deficit has become a persistent structural challenge in India
2. Identify the causes and consequences of inefficient utilisation of public funds
3. Examine the problem of corruption and leakages in government expenditure
4. Analyse the economics and politics of India's subsidy burden
5. Appreciate the dimensions and consequences of regional fiscal imbalance
6. Understand India's public debt dynamics and the risk of a debt trap
7. Evaluate the major expenditure reforms needed to improve fiscal quality in India

7.1 Introduction

The growth of public expenditure in India after Independence has been accompanied by a widening catalogue of structural problems that undermine its effectiveness, sustainability, and equity. Quantity without quality, scale without accountability, and ambition without institutional capacity — these contradictions lie at the heart of India's public expenditure challenge.

Despite spending hundreds of lakh crore rupees on development since 1947, India continues to grapple with high poverty, inadequate public services, crumbling infrastructure in many regions, and some of the world's worst social outcome indicators relative to its income level. The explanation lies not merely in the quantum of public expenditure but in the deep-seated issues that afflict how government money is raised, allocated, managed, and delivered.

> *"India's problem is not merely that it spends too little; it is that what it spends is poorly targeted, inefficiently delivered, and often captured by interests other than those it was meant to serve."*
>
> **— Economic Survey of India, 2016-17**

This chapter provides a systematic, analytical examination of seven critical issues in India's public expenditure: the rising fiscal deficit, inefficient utilisation of funds, corruption and leakages, the subsidy burden, regional imbalance, the debt trap, and the overarching need for expenditure reforms. Each issue is examined through its causes, consequences, magnitude, and the policy responses it demands.

₹17.35 L Cr	**~40%**	**₹3.74 L Cr**	**158% of GDP**
Fiscal Deficit 2023-24	Est. leakage in social schemes (pre-DBT)	Total subsidy bill 2022-23	India's total public debt (2022-23)

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Rising Fiscal Deficit
The Most Visible Symptom of Structural Fiscal Imbalance

7.2 Rising Fiscal Deficit

7.2.1 Meaning and Measurement

The fiscal deficit is the excess of total government expenditure over total non-debt receipts. It represents the government's net borrowing requirement from all sources during a fiscal year. While a moderate fiscal deficit is normal and even desirable in a developing economy — financing investment that the private sector will not undertake — a persistently large deficit is symptomatic of structural dysfunction in public finances.

Year	Fiscal Deficit (₹ Lakh Cr)	Fiscal Deficit (% of GDP)	Revenue Deficit (% of GDP)	Key Context
1980-81	0.18	3.5%	1.6%	Beginning of fiscal expansion era
1990-91	1.05	8.4%	3.5%	BoP crisis precipitated by chronic deficits
2002-03	1.35	5.9%	3.6%	FRBM enacted to enforce fiscal discipline
2007-08	1.26	2.5%	1.1%	Best consolidation — pre-global crisis
2008-09	3.37	6.0%	4.5%	Fiscal stimulus post-global financial crisis
2014-15	5.11	4.0%	2.9%	Consolidation resumed post-UPA stimulus
2018-19	6.49	3.4%	2.3%	Near FRBM target of 3%; capex constrained
2020-21	18.21	9.2%	7.4%	COVID-19 pandemic: emergency fiscal expansion
2022-23	17.55	6.4%	4.1%	Post-COVID consolidation path
2023-24	17.35	5.8%	2.6%	Gradual consolidation continuing
FRBM Target	—	3.0%	0.0%	Statutory long-term targets

7.2.2 Causes of Rising Fiscal Deficit

🔍 Root Causes of India's Persistent Fiscal Deficit

- Expenditure inflexibility: Large shares of the budget — interest payments (~20%), defence (~13%), salaries and pensions (~23%) — are constitutionally or legally obligated and cannot be compressed without major reforms.
- Subsidy commitments: Food, fertiliser, and petroleum subsidies have expanded politically, creating powerful constituencies resistant to rationalisation, even when poorly targeted.
- Revenue inadequacy: India's tax-to-GDP ratio (~11%) is among the lowest for a country at its development level; narrow tax base, widespread evasion, and multiple exemptions constrain revenue.
- Off-budget liabilities: Historically, governments moved expenditure off-budget (oil bonds, fertiliser bonds, FCI borrowings) to contain the official deficit, masking the true fiscal position.
- Counter-cyclical shocks: Wars, droughts, oil price spikes, global financial crises, and pandemics periodically require emergency expenditure, causing sharp deficit spikes that prove difficult to reverse.
- Political economy: Electoral incentives encourage expenditure promises (loan waivers, free power, welfare schemes) without commensurate revenue measures, structurally biasing the budget toward deficits.
- Interest burden compounding: Each year's deficit adds to the debt stock, increasing interest payments in subsequent years — creating a self-reinforcing cycle that makes deficit reduction progressively harder.

7.2.3 Consequences of Rising Fiscal Deficit

⚠ Macroeconomic Consequences of High Fiscal Deficit

- Crowding out of private investment: Government borrowing raises interest rates, increasing the cost of capital for private firms and reducing private investment — the most economically damaging consequence.
- Inflationary pressure: If the deficit is monetised (financed by RBI money creation), it increases money supply, raising prices — particularly dangerous for low-income households.
- Debt accumulation: Persistent deficits compound into a growing debt stock; India's public debt exceeds 80% of GDP (including states), raising sustainability concerns.
- Reduced fiscal space: High debt-servicing obligations consume revenue that could finance education, health, and infrastructure — perpetuating the underprovision of public goods.

- Exchange rate and BoP risks: Large fiscal deficits attract current account pressure, currency depreciation, and capital flight — as seen in the 1991 crisis and 2013 taper tantrum.
- Credit rating impact: Rating agencies (Moody's, S&P, Fitch) penalise high fiscal deficits with lower sovereign credit ratings, raising the cost of external borrowing.
- Intergenerational inequity: Today's fiscal deficit is tomorrow's tax burden — current deficit spending transfers obligations to future generations who receive no corresponding benefit.

7.2.4 FRBM Framework and Its Limitations

The Fiscal Responsibility and Budget Management Act, 2003 provided India's first statutory framework for deficit reduction. The NK Singh Committee (2017) revised the targets and introduced an escape clause permitting temporary fiscal relaxation in defined circumstances. Despite this framework, India has repeatedly missed its fiscal consolidation targets.

Important: FRBM targets a fiscal deficit of 3.0% of GDP and revenue deficit of 0.0% of GDP — both remain unachieved as of 2023-24. The NK Singh Committee also recommended creating an independent Fiscal Council to provide independent fiscal assessment, which has not yet been implemented.

Inefficient Utilisation of Funds
Spending Without Results — The Productivity Crisis in Public Finance

7.3 Inefficient Utilisation of Public Funds

7.3.1 The Problem Defined

Inefficient utilisation of public funds refers to the failure to maximise social welfare from a given level of government expenditure. It encompasses a wide range of dysfunctions: funds that are not spent (unspent balances), funds spent on wrong priorities (misallocation), funds spent on the right activities but at excessive cost (wastage), and funds spent that produce no measurable outcome (outcome failure).

India's public expenditure exhibits all four forms of inefficiency. Budget utilisation rates for capital expenditure have historically been poor — ministries regularly return unspent allocations at year-end. Cost overruns in infrastructure projects are pervasive. And despite massive spending on health and education, outcome indicators lag far behind countries that spend comparable amounts.

7.3.2 Manifestations of Inefficiency

A. Time and Cost Overruns in Infrastructure

The Ministry of Statistics and Programme Implementation (MoSPI) tracks all Central Government infrastructure projects above ₹150 crore. Its reports consistently reveal alarming patterns of delay and cost escalation:

Year	Projects Monitored	Projects with Cost Overrun	Total Cost Overrun (₹ Crore)	Avg. Delay (Months)
2015-16	894	321	1,96,872	31
2018-19	1,213	453	2,64,246	34
2020-21	1,678	541	4,26,859	38
2022-23	1,823	617	5,02,493	40
2023-24	1,911	647	5,52,300	41

B. Low Budget Utilisation Rates

Capital expenditure allocations frequently go unspent, particularly in the first half of the fiscal year, because procurement processes are slow, land acquisition is delayed, and bureaucratic approvals are cumbersome. This 'back-loading' of expenditure reduces quality — construction in the final quarter is often rushed and substandard.

Causes of Low Budget Utilisation

- Land acquisition delays: Projects stall for years awaiting land clearance, causing both expenditure delay and cost escalation.
- Multiple statutory approvals: Environmental clearances, forest clearances, CRZ permissions — each a potential bottleneck causing multi-year delays.
- Capacity constraints in spending ministries: Insufficient project management and procurement expertise, particularly in smaller ministries.
- Front-loaded allocations: Budget allocations are often made optimistically without realistic assessment of absorption capacity.

- Tender process delays: Repeated retenders due to low bidder response or quality concerns delay project start.
- Inter-departmental coordination failures: Infrastructure projects crossing ministry boundaries suffer from coordination gaps and blame-shifting.

C. Poor Outcome-to-Input Ratios

India's public expenditure on social sectors exhibits a stark disconnect between inputs and outcomes. The following comparative data illustrates the outcome efficiency problem:

Sector	India's Input (% of GDP)	India's Outcome	Comparable Country	That Country's Input	That Country's Outcome
Education	~2.9%	ASER: 50% Gr.5 cannot read Gr.2	Vietnam	~4.6%	PISA: top quartile globally
Health	~1.9%	MMR: 97/lakh live births	Thailand	~3.7%	MMR: 29/lakh live births
Water & Sanitation	~0.5%	~70% rural tap access (2023)	Bangladesh	~0.4%	Higher rural coverage
Nutrition	~0.3% (ICDS)	45% children stunted (NFHS-4)	Peru	~0.4%	Stunting: 13% (major reduction)

7.3.3 Causes of Inefficient Utilisation

Structural Causes of Expenditure Inefficiency

- Absence of outcome budgeting: India's budget allocates funds by input (salaries, materials) rather than outcomes (students learning, patients cured), providing no accountability for results.
- Weak public procurement systems: Corruption, collusion in tendering, and technical capacity gaps inflate costs and delay delivery.
- Bureaucratic rigidity: Strict financial rules designed to prevent misuse simultaneously prevent timely, flexible responses to ground-level needs.

- Separation of planning and implementation: Schemes designed in Delhi are implemented by district-level agencies with no voice in design, creating mismatch and failure.
- Lack of performance management: Government employees face no consequences for poor programme delivery; there is no incentive structure rewarding outcome achievement.
- Fragmented schemes: Over-proliferation of small schemes with separate implementing agencies, monitoring systems, and reporting requirements creates administrative burden without synergy.
- Weak monitoring and evaluation: Most government programmes lack rigorous impact evaluations; decisions on continuation, scale-up, or termination are not evidence-based.

Corruption and Leakages
The Silent Drain — How Diversion Undermines India's Fiscal Effort

7.4 Corruption and Leakages in Public Expenditure

7.4.1 Dimensions of the Problem

Corruption in public expenditure refers to the diversion of public funds for private gain — through bribery, kickbacks, ghost beneficiaries, inflated procurement costs, or outright embezzlement. Leakages encompass both corrupt diversion and non-corrupt inefficiencies (administrative waste, misdirected transfers) that prevent funds from reaching their intended purpose.

The problem operates at multiple levels: at the design stage (poorly structured schemes that create opportunities for capture), at the implementation stage (service delivery points where discretion enables corruption), and at the accounting stage (where false records conceal misappropriation). India's federal structure, with expenditure flowing through Union ministries → state governments → district agencies → frontline implementers, creates multiple layers at which diversion can occur.

The Scale of the Leakage Problem

Pre-DBT studies estimated that only 27-40 paise of every rupee spent on major welfare schemes like PDS reached intended beneficiaries. The CAG has consistently found large-scale misutilisation, unspent balances transferred to personal accounts, ghost beneficiaries in pension schemes (20-30% in some states), and inflated procurement costs. The

government's own estimate is that DBT has saved ₹2.73 lakh crore in leakages since 2013 — implying the pre-reform annual leakage was in the tens of thousands of crore.

7.4.2 Typology of Corruption in Public Expenditure

Type of Corruption	Mechanism	Affected Schemes	Scale / Evidence
Ghost beneficiaries	Payments made to non-existent or deceased persons	MGNREGA, pensions, scholarships	CAG: 2.5 crore ghost workers in MGNREGA (2013 estimate)
Procurement fraud	Rigged tenders, inflated rates, poor quality materials	Infrastructure, equipment, medicine supply	MoSPI: ₹5.5 lakh crore cost overrun stock in monitored projects
PDS leakage	Diversion of subsidised food to open market by ration dealers	Public Distribution System	Shanta Kumar Committee: only 28% of food subsidy reached poor
Scholarship fraud	Fake student registrations for scholarship capture	Pre-matric, post-matric scholarships	DBT closed 2.5 crore fake scholarship accounts (2015-18)
Land acquisition fraud	Inflated land valuations; fake beneficiary inclusion	Infrastructure, housing schemes	CAG reports in multiple states document systematic inflation
Medical procurement	Overpriced medicines, equipment supplied; fake bills	Centrally Sponsored health schemes	NHRC investigations document large-scale medicine diversion
MGNREGA wage fraud	Wage payments without work; multiple job cards per family	MGNREGA	Geo-tagging mandate and bank-account payments reduced but not eliminated

7.4.3 Structural Enablers of Corruption

🔍 Why Corruption Persists in Indian Public Expenditure

- • Discretionary power without accountability: Officials with discretion over benefits, licences, or contracts face weak accountability and strong incentives to extract rents.
- • Cash-based delivery systems: Pre-DBT, cash disbursements through intermediaries provided ample opportunity for diversion at each stage of the distribution chain.
- • Weak audit and oversight: CAG audits cover only a fraction of expenditure in any given year; internal audit systems are inadequate; parliamentary oversight is intermittent.
- • Low penalty certainty: Prosecution rates for corruption are low; conviction rates even lower; the deterrence effect of anti-corruption laws is minimal.
- • Political protection: Politically connected contractors, service providers, and scheme managers often face no legal consequences even when fraud is documented.
- • Information asymmetry: Beneficiaries often do not know their entitlements, making it impossible for them to demand accountability from service providers.
- • Regulatory capture: Implementing agencies are sometimes staffed by individuals with interests aligned with contractors rather than beneficiaries.

8.4.4 Reforms to Address Corruption and Leakages

✅ Systemic Reforms to Curb Corruption in Public Spending

- DBT and JAM Trinity: Direct transfer to Aadhaar-linked accounts eliminates intermediaries; the most impactful anti-leakage reform in India's history (₹2.73 lakh crore savings).
- PFMS (Public Financial Management System): Real-time tracking of expenditure flows from Central government down to implementing agencies; enables identification of unspent balances.
- GeM (Government e-Marketplace): Online, transparent procurement platform that eliminates discretion in vendor selection and reduces procurement fraud.
- Social audit: Mandatory social audits for MGNREGA (under Section 17) allow communities to verify whether works were actually executed — community-based accountability.
- RTI Act (2005): Right to Information enables citizens to access government records, creating transparency and raising the cost of hiding corruption.

- Whistleblower Protection Act (2014): Provides legal protection to persons who expose corruption, though implementation remains weak.
- DPDP and Digital payments: Expansion of digital payments (UPI) for all government transactions creates an audit trail and reduces cash-based corruption.

7.5 Subsidy Burden

7.5.1 Scale and Composition of Subsidies

Subsidies represent one of the most contested domains of Indian public expenditure — simultaneously a tool of social protection and a source of fiscal unsustainability. India's explicit subsidies (appearing in the Central Budget) amounted to ₹3.74 lakh crore in 2022-23 alone. When implicit subsidies (underpriced public services, below-cost power, railway cross-subsidies) and state-level subsidies are added, the total fiscal cost of India's subsidy architecture runs to several lakh crore rupees annually.

Subsidy	2018-19 (₹ Crore)	2020-21 (₹ Crore)	2022-23 (₹ Crore)	2023-24 (₹ Crore BE)	Nature
Food subsidy	1,01,327	2,17,946	2,87,194	1,97,350	Transfers to poor; also benefits non-poor
Fertiliser subsidy	70,080	1,27,922	2,54,799	1,75,100	Benefits large farmers disproportionately
Petroleum subsidy	24,837	37,480	8,974	11,925	Largely rationalised; LPG for BPL remains
Interest subsidies	16,499	21,987	30,454	22,137	Credit support for agriculture, exports, housing
Other subsidies	13,215	14,680	21,450	19,000	Miscellaneous sectoral support
Total	2,25,958	4,19,897	6,03,091	4,25,512	~1.6-2.2% of GDP at peak

7.5.2 The Economics and Problems of Subsidies

✓ Arguments FOR Subsidies	✗ Arguments AGAINST Subsidies
• Poverty alleviation: food subsidies ensure caloric intake for the poor, preventing malnutrition and hunger • Market failure correction: fertiliser subsidies maintain agricultural investment when credit is unavailable • Equity: subsidies offset regressive aspects of indirect taxation • Macroeconomic stabilisation: food and fuel subsidies dampen inflation for vulnerable households • Political stability: welfare subsidies maintain social cohesion in a diverse, unequal society	• Poor targeting: subsidies frequently benefit the non-poor more than the poor (universal PDS, LPG) • Fiscal burden: large subsidy bills crowd out capital expenditure on roads, schools, and hospitals • Distortionary: fertiliser subsidies distort crop choice and encourage overuse, damaging soil • Power subsidies encourage wasteful consumption and cause DISCOMs to remain financially unviable • Dependency culture: income support without conditions may reduce incentive to work or invest

7 .5.3 The Targeting Problem

The central problem with India's subsidy regime is poor targeting — a significant fraction of subsidies flows to households that do not need them. The Shanta Kumar Committee on restructuring FCI (2015) found that only 28% of the food subsidy actually benefited the poor; the remainder was lost to leakage, diversion, and benefit capture by the non-poor. Several independent studies have found similar results for fertiliser and LPG subsidies.

> ⚠ **Important:** India's food subsidy finances the world's largest food programme (NFSA) covering 81.35 crore beneficiaries — but SECC data suggests only 43-50 crore are genuinely below any reasonable poverty line. Over-inclusion (Type II error) is as large a problem as exclusion of the truly poor (Type I error).

7.5.4 State-Level Subsidies and Competitive Populism

Beyond Central subsidies, state governments run their own subsidy and freebies programmes — free power (Punjab: 300 units/month; Tamil Nadu, Andhra Pradesh), free bus travel for women, free laptops, cash transfers to women, and free water — often without fiscal backing. The Supreme Court has engaged with the 'freebies' debate in several cases, and the Finance Commission has noted that competitive populism among states is creating a structural fiscal deterioration at the sub-national level.

Competitive Populism and the Fiscal Risk

Multiple states now promise free or heavily subsidised electricity, water, bus travel, and cash transfers at election time. The fiscal cost of these promises — often not budgeted — falls on state finances, increasing state fiscal deficits and reducing the space for capital investment. The RBI has warned that several states' debt-to-GSDP ratios are approaching 30-35%, with competitive populism as a significant contributing factor.

Regional Imbalance
Unequal Fiscal Capacity, Unequal Public Services

7.6 Regional Imbalance in Public Expenditure

7.6.1 The Nature of Regional Fiscal Imbalance

India's 28 states and 8 Union Territories exhibit enormous variation in economic development, fiscal capacity, and public expenditure levels. This variation reflects and reinforces spatial inequality: richer states spend more per capita on public services, providing better education, healthcare, and infrastructure, which in turn attracts private investment and further accelerates growth — while poorer states remain trapped in low-expenditure, low-development equilibria.

Regional imbalance in public expenditure operates at two levels: the **vertical imbalance** between the Centre and states (states bear ~60% of development expenditure but raise only ~38% of revenues, necessitating large Central transfers), and the **horizontal imbalance** between rich and poor states (Maharashtra's per capita GSDP is 3.5 times Bihar's, translating into vastly different fiscal capacities).

7.6.2 Inter-State Fiscal Disparities: Evidence

State	Per Capita GSDP (2021-22, ₹)	Per Capita Own Tax Revenue (₹)	Per Capita Total Expenditure (₹)	HDI Rank
Goa	5,60,000	62,000	75,000	Top quintile
Karnataka	2,95,000	27,500	38,500	Mid-upper
Maharashtra	2,70,000	26,800	36,200	Mid-upper

Tamil Nadu	2,65,000	24,200	37,800	Mid-upper
Rajasthan	1,35,000	11,800	32,500	Middle
Madhya Pradesh	1,20,000	9,800	31,200	Mid-lower
Uttar Pradesh	75,000	7,200	24,000	Lower
Bihar	54,000	4,100	22,000	Lowest
Jharkhand	72,000	5,500	23,500	Very low

7.6.3 Causes of Regional Imbalance

Causes of Regional Public Expenditure Imbalance

- Historical divergence: British-era investment concentrated in coastal, commercial regions (Bombay, Calcutta, Madras); landlocked, agrarian states were largely bypassed by development.
- Fiscal capacity differences: States with larger industrial and service sectors generate more GST, stamp duty, and excise revenue; agricultural states with low incomes generate less.
- Debt burden variation: Poorer states often have higher debt-to-GSDP ratios, with larger interest payment obligations crowding out development spending.
- Vertical fiscal imbalance: Central government raises ~62% of taxes but states bear ~60% of expenditure responsibility; the transfer mechanism (Finance Commission, CSS) does not fully close this gap.
- Capacity and governance differences: Richer states have better administrative capacity to design, implement, and absorb public expenditure; poorer states face implementation bottlenecks.
- Private investment concentration: Private sector investment gravitates to states with infrastructure, skilled labour, and stable governance — reinforcing the advantage of already-developed states.
- Climate and geography: Landlocked, resource-poor, disaster-prone states (Bihar floods, Rajasthan drought) face higher expenditure needs but lower revenue capacity.

7.6.4 Corrective Mechanisms and Their Limitations

India's federal architecture incorporates several mechanisms to address regional fiscal imbalance:

Corrective Mechanisms for Regional Balance

- Finance Commission devolution: Formula-based devolution of 41% of Central taxes, with weights for income distance (index of backwardness) favouring poorer states. 15th FC gave 45% weight to income distance.
- Grants-in-Aid (Article 275): Post-devolution revenue deficit grants and performance grants specifically channelled to states unable to meet minimum service standards from their own revenues.
- Centrally Sponsored Schemes: Many CSS (MGNREGA, PMAY-G, JJM) are designed to address backward-region deficits; allocation criteria often favour laggard states.
- Special Category States: Originally 11 states (northeast + J&K + Uttarakhand + HP) received 90:10 Central sharing and other fiscal concessions. This special category was discontinued after 14th FC.
- Aspirational Districts Programme: Targeted Central attention to 112 most backward districts; competitive ranking drives local accountability and Central resource focus.
- NE and tribal area funds: NESIDS, DONER Ministry, Tribal sub-plan — earmarked expenditure for historically marginalised regions.

Important: Despite these mechanisms, inter-state and inter-district disparities in public service quality remain large and may be widening. The 15th Finance Commission's horizontal equity formula improves on past practice, but the structural divergence between high-capacity and low-capacity states requires deeper institutional reform beyond fiscal transfers alone.

Debt Trap
The Compounding Burden of Accumulated Fiscal Deficits

7.7 Debt Trap

7.7.1 Understanding the Debt Trap

A government is in a debt trap when the growth of its debt stock outpaces the growth of its capacity to service that debt — creating a self-reinforcing spiral in which borrowing to pay interest leads to more debt, more interest, and less fiscal space for productive expenditure. India has flirted with debt trap dynamics at multiple points in its post-Independence history, most acutely in 1990-91 and again in the aftermath of the COVID-19 pandemic.

The mathematical condition for debt sustainability is the Domar Condition: the debt-to-GDP ratio stabilises when the primary surplus (fiscal surplus before interest payments) is at least equal to the product of the interest rate and the existing debt-to-GDP ratio, minus the GDP growth rate. When r (real interest rate) > g (real GDP growth rate), debt dynamics become explosive without a primary surplus.

Year	Central Govt Debt (% of GDP)	State Govt Debt (% of GDP)	Combined Public Debt (% of GDP)	Interest Payment (% of Revenue)
2000-01	55.5%	21.0%	76.5%	~40%
2007-08	54.2%	22.8%	77.0%	~36%
2013-14	51.6%	21.7%	73.3%	~35%
2018-19	48.8%	23.3%	72.1%	~26%
2020-21	59.2%	31.0%	90.2%	~30%
2022-23	56.7%	28.8%	85.5%	~26%
2023-24 (BE)	56.0%	—	~81%	~25%
IMF Benchmark	—	—	~60%	<20% (prudential)

7.7.2 Components of India's Public Debt

Structure of India's Public Debt

- Internal debt (~90% of Central debt): Market borrowings (G-secs, T-bills), small savings, provident funds, reserve funds — all claims of domestic creditors on the Indian government.
- External debt (~10% of Central debt): Multilateral loans (World Bank, ADB, IMF), bilateral loans, and external commercial borrowings — foreign currency obligations with exchange rate risk.
- State government debt: States borrow through state development loans (market), small savings (NSSF loans), Central government loans, and off-budget borrowings through state PSUs.
- Off-budget liabilities: FCI borrowings for food security operations, state DISCOM dues, toll-backed NHAI bonds — obligations not captured in the headline deficit that represent contingent government liabilities.
- Contingent liabilities: Government guarantees for PSU loans, sovereign guarantees for infrastructure projects — potential future debt that materialises if guaranteed entities default.

7.7.3 Consequences and Risks of High Public Debt

⚠ Fiscal, Economic, and Social Consequences of High Debt

- Interest payment trap: Interest payments on Central government debt (~₹10.8 lakh crore in 2023-24) consume ~25% of revenue receipts — funds unavailable for schools, hospitals, or infrastructure.
- Crowding out: Government borrowing at scale absorbs savings that would otherwise finance private investment; the larger the debt, the greater the displacement of productive private capital.
- Reduced fiscal counter-cyclicality: Highly indebted governments have less room to increase spending during recessions without triggering debt sustainability concerns.
- Sovereign risk premium: High debt-to-GDP ratios signal credit risk, raising interest rates on new borrowings and creating a feedback loop of higher debt costs.
- Intergenerational burden: Public debt is ultimately financed by future tax revenues; current debt transfers consumption from future generations to the present.
- Currency vulnerability: Particularly for external debt, high debt levels increase vulnerability to currency crises if investor sentiment turns — as nearly occurred in 2013.

- Inflation risk: Monetary financing of debt (RBI buying government securities) increases money supply and inflation, eroding real incomes of the poor.

7.7.4 India's Debt Sustainability Assessment

India's debt situation is serious but not yet critical, for several reasons: the majority of debt is domestic (reducing currency risk); debt is long-duration (reducing rollover risk); the RBI holds significant foreign exchange reserves (US$590+ billion as of 2024); and India's GDP growth rate (6-7% real) exceeds the real interest rate on most government borrowings. However, the post-COVID debt overhang requires sustained fiscal consolidation.

Important: The IMF's Debt Sustainability Analysis for India recommends a medium-term fiscal consolidation path to bring combined (Centre + states) public debt below 80% of GDP. This requires both revenue augmentation and expenditure rationalisation — neither of which is politically easy.

Need for Expenditure Reforms
Transforming Public Spending for Quality, Efficiency, and Equity

7.8 Need for Expenditure Reforms in India

7.8.1 The Reform Imperative

The six issues examined in this chapter — rising fiscal deficit, inefficient utilisation, corruption, subsidy burden, regional imbalance, and debt dynamics — collectively make an overwhelming case for comprehensive expenditure reform. India cannot achieve its developmental aspirations through quantity of spending alone; the quality, targeting, accountability, and efficiency of public expenditure must be fundamentally transformed.

> *"The challenge for India is not just to spend more, but to spend better. Expenditure reform is not about austerity — it is about maximising the development impact of every rupee of public money."*
>
> **— Economic Survey of India, 2019-20**

7.8.2 Proposed Expenditure Reforms

Reform 1 — Outcome Budgeting and Performance-Based Appropriation

India must transition from input-based to outcome-based budgeting. Every expenditure allocation should be tied to measurable outcomes (not just outputs) — literacy rates, not school buildings; mortality rates, not hospital beds. The OUTCOME Budget introduced in 2005-06 was a beginning but remains largely cosmetic. Genuine outcome budgeting

requires independent outcome monitoring, public reporting of results, and consequences for persistent failure to deliver.

Reform 2 — Rationalisation and Restructuring of Subsidies

India's subsidy regime requires three-dimensional reform: better targeting (using SECC data to restrict food subsidy to the genuinely poor); DBT conversion (replacing in-kind with cash transfers where feasible); and gradual price reforms for power, water, and fertiliser. The focus should shift from universal subsidies to targeted income support — a universal basic income pilot, building on the PM-KISAN model, could replace multiple poorly targeted schemes.

Reform 3 — Strengthening Public Financial Management

The PFMS (Public Financial Management System) must be extended to cover all expenditure, from Central government to the last gram panchayat. Real-time fund-flow tracking, automated alerts for dormant accounts, and centralised reconciliation will dramatically reduce unspent balances, ghost accounts, and diversion. The GeM (Government e-Marketplace) must be made mandatory for all government procurement above a defined threshold.

Reform 4 — Independent Fiscal Council and FRBM Strengthening

The NK Singh Committee's recommendation of an independent Fiscal Council — separate from the Finance Ministry — must be implemented. Such a council would provide independent macroeconomic forecasts, assess fiscal risks, and publicly evaluate compliance with FRBM targets. The current self-assessment by the Finance Ministry creates a conflict of interest. Medium-term expenditure frameworks (MTEF) with rolling three-year ceilings would impose discipline beyond the one-year budget horizon.

Reform 5 — Expenditure Review Commission

A permanent, independent Expenditure Review Commission (modelled on the UK's Public Spending Reviews) should periodically evaluate all major expenditure programmes — not just audit compliance, but assess relevance, efficiency, and impact. Schemes that fail to demonstrate outcomes should be restructured or terminated. India currently has no institutional mechanism for such evidence-based expenditure rationalisation.

Reform 6 — Anti-Corruption Architecture Deepening

Beyond DBT, India needs: mandatory social audits extended beyond MGNREGA to all major social schemes; a strengthened Lokpal and Lokayukta with investigative capacity and expedited prosecution; protection for internal whistleblowers; and mandatory asset disclosure by programme managers. The concentration of anti-corruption effort on

investigation and prosecution must be balanced with preventive architecture that removes discretion and creates digital audit trails.

Reform 7 — Fiscal Federalism Reform: Closing the Vertical Gap

States bear the primary delivery responsibility for education, health, and welfare but lack commensurate revenue-raising capacity. Reforms needed include: rationalisation of the GST rate structure to broaden the tax base and increase state revenues; devolution of more flexible grants with fewer conditionalities; state fiscal responsibility legislation harmonisation; and creation of a joint Centre-State monitoring mechanism for CSS outcome delivery.

Reform 8 — Rationalisation of Centrally Sponsored Schemes

Despite reduction from 200+ to ~28 core CSS, the scheme proliferation problem persists. Further rationalisation — merging overlapping schemes, converting conditional grants to block grants for states with good fiscal management, and eliminating redundant Central presence in State List subjects — would reduce administrative burden, improve implementation, and give states fiscal flexibility to address local priorities.

Reform 9 — Capital Expenditure Quality and Absorption Capacity

India's ambitious capex push (₹10 lakh crore in 2023-24) requires commensurate improvement in project preparation, land acquisition, and execution capacity. A dedicated Project Preparation Fund to finance detailed project reports (DPRs) before budget allocation would reduce post-sanction delays. PM GatiShakti's GIS-based infrastructure planning must be deepened to achieve inter-ministerial coordination and eliminate bottlenecks before they arise.

Reform 10 — Debt Management Reform

India should establish an independent Debt Management Office (separated from RBI and Finance Ministry) to develop an optimal borrowing strategy, lengthen the maturity of government debt, and diversify the investor base — including through sovereign green bonds and retail participation through the RBI Retail Direct scheme. A comprehensive debt sustainability framework, updated annually, should inform FRBM targets and guide the pace of fiscal consolidation.

8.8.3 International Best Practices in Expenditure Reform

Country	Reform Implemented	Outcome Achieved	Lesson for India
New Zealand (1990s)	Full accrual accounting; output contracts with agency heads; hard budget constraints	Fiscal surplus achieved; public service quality improved dramatically	Accrual accounting and agency performance contracts can transform incentives
Brazil	Fiscal Responsibility Law (2000); expenditure ceiling amendment (2016)	Fiscal deficit reduced from 10% to 1% of GDP over decade	Statutory expenditure ceilings with constitutional backing are powerful commitments
Chile	Structural balance rule; independent fiscal council; copper revenue stabilisation	Maintained fiscal discipline through commodity cycles; AAA rating	Commodity revenue smoothing and independent fiscal oversight prevent boom-bust spending
Indonesia	Medium-Term Expenditure Framework; performance-based budgeting reform	Improved alignment between planning and budgeting; better outcome reporting	MTEF with sector ceilings disciplines annual budget process within multi-year framework
South Korea	Zero-based budgeting for selected programmes annually; programme evaluation	Systematic termination of ineffective programmes; reallocation to priorities	Periodic zero-based reviews force evidence-based justification for continuation
UK	Public Spending Reviews every 3 years; Fiscal Charter; OBR independent forecasts	Credible fiscal framework; transparent spending reviews; public accountability	Independent OBR model directly applicable to India's proposed Fiscal Council

Chapter Summary

This chapter has systematically examined seven critical issues that undermine the effectiveness and sustainability of public expenditure in India. Together, these issues constitute a structural fiscal challenge that no amount of additional spending alone can resolve — only deep, sustained institutional reform can transform India's fiscal quality.

Issue	Core Problem	Key Data Point	Priority Reform
Rising Fiscal Deficit	Structural gap between expenditure and revenue; political economy of spending	Fiscal deficit: 5.8% GDP (2023-24) vs. 3% FRBM target	Independent Fiscal Council; FRBM strengthening; revenue augmentation
Inefficient Utilisation	Poor outcomes relative to inputs; time/cost overruns; low absorption	₹5.52 lakh crore cost overrun stock in monitored projects	Outcome budgeting; project preparation funds; capacity building
Corruption & Leakages	Diversion of funds from intended beneficiaries; systemic rent extraction	Pre-DBT: only 27-40 paise of welfare ₹ reached beneficiary	Full DBT rollout; PFMS deepening; social audits; GeM procurement
Subsidy Burden	Poorly targeted, fiscally unsustainable, economically distortionary subsidies	₹3.74 lakh crore explicit subsidies (2022-23)	Aadhaar-based targeting; DBT conversion; competitive populism restraint
Regional Imbalance	Rich states spend more, provide better services, attract investment; poor states trapped	Bihar per capita expenditure: ~₹22,000 vs. Goa ~₹75,000	Finance Commission equity weights; CSS rationalisation; state capacity building
Debt Trap	Compounding debt stock; high interest burden; reduced fiscal space	Combined public debt: ~85% of GDP (2022-23)	Fiscal consolidation path; independent Debt Management Office; debt ceiling
Need for Reforms	Across-the-board quality, efficiency, and accountability improvement needed	Multiple dimensions of fiscal dysfunction	10-point reform agenda: outcome budgeting to debt management reform

The overarching lesson is that India's fiscal challenge is not primarily one of resource scarcity — it is one of institutional quality. With the world's fifth-largest economy and a tax-to-GDP ratio of only 11%, India has enormous untapped fiscal potential. The transformation of public expenditure from a system riddled with leakages, inefficiencies, and misdirection into one that effectively delivers development outcomes is the defining fiscal policy challenge of the coming decade.

Key Terms

Fiscal Deficit	Excess of total government expenditure over total non-debt receipts; equals the government's net borrowing requirement.
Revenue Deficit	Excess of revenue expenditure over revenue receipts; indicates government is borrowing for consumption purposes.
FRBM Act	Fiscal Responsibility and Budget Management Act, 2003 — statutory framework for India's fiscal consolidation with deficit targets.
Crowding Out	Reduction in private sector borrowing and investment caused by increased government borrowing raising interest rates.
Outcome Budgeting	Budgeting approach that links expenditure allocations to measurable outcomes rather than merely to inputs or outputs.
Ghost Beneficiaries	Fraudulent beneficiaries in welfare schemes — non-existent or deceased persons registered to capture transfers.
DBT (Direct Benefit Transfer)	System transferring welfare benefits directly to Aadhaar-linked bank accounts, bypassing intermediaries.
Domar Condition	Condition for debt sustainability: primary surplus ≥ (r – g) × debt-to-GDP ratio, where r = interest rate and g = GDP growth rate.
Vertical Fiscal Imbalance	Mismatch in a federal system between the revenue-raising capacity and expenditure responsibilities across levels of government.
Horizontal Imbalance	Differences in fiscal capacity and service delivery capacity among units at the same level (e.g., between Indian states).
PFMS	Public Financial Management System — Central government's real-time expenditure tracking platform from allocation to utilisation.

Off-Budget Liabilities	Government obligations not recorded in the official budget — FCI borrowings, NHAI bonds — that mask the true fiscal position.
Competitive Populism	Political dynamic in which parties outbid each other with welfare promises and subsidies, without regard for fiscal sustainability.
Fiscal Council	An independent body providing macroeconomic forecasts and evaluating government compliance with fiscal rules (recommended by NK Singh Committee).

Review Questions

Short Answer Questions (2–4 Marks)

1. What is the fiscal deficit? How does it differ from revenue deficit? What are the FRBM targets for each?
2. Explain the concept of 'crowding out'. How does a high fiscal deficit lead to crowding out of private investment?
3. Define leakages in public expenditure. What were the estimated leakages in India's welfare schemes before the DBT revolution?
4. What is the Domar Condition for debt sustainability? Apply it to India's current debt situation.
5. Distinguish between vertical and horizontal fiscal imbalance in India's federal system with examples.
6. What are ghost beneficiaries? Give two examples of schemes where ghost beneficiaries were a major problem.
7. Explain competitive populism in the context of state government subsidies and its fiscal consequences.
8. What is outcome budgeting? How does it differ from traditional input-based budgeting?

Long Answer Questions (6–10 Marks)

1. Examine the causes and consequences of rising fiscal deficit in India. How effective has the FRBM Act been in containing the deficit?
2. Analyse the problem of inefficient utilisation of public funds in India. What structural reforms are needed to improve expenditure quality?
3. Discuss the problem of corruption and leakages in India's public expenditure. How has the JAM Trinity transformed welfare delivery? What more needs to be done?
4. Critically examine India's subsidy burden. Is the subsidy system well-targeted? What reforms would you recommend to make subsidies both equitable and fiscally sustainable?

5. Explain the nature and causes of regional imbalance in public expenditure in India. How effective are the Finance Commission and Centrally Sponsored Schemes in addressing this imbalance?

6. What is a debt trap? Analyse India's public debt dynamics and assess the risk of a debt trap. What fiscal and institutional reforms are needed to ensure debt sustainability?

7. Outline a comprehensive agenda for expenditure reform in India. Prioritise three reforms you consider most urgent and justify your choice.

Higher Order Thinking Questions

1. 'India's problem is not low public expenditure but poor public expenditure.' Critically evaluate this statement with evidence from at least three sectors.

2. The Finance Commission devolves 41% of Central taxes to states to correct regional imbalance. Yet inter-state disparities remain large. What does this tell us about the limits of fiscal transfers as a tool for equity?

3. Compare India's approach to fiscal consolidation (FRBM) with that of Brazil (Fiscal Responsibility Law) and Chile (structural balance rule). What institutional elements could India borrow from these experiences?

4. Analyse the political economy of India's subsidy system. Why do subsidies persist despite evidence of poor targeting? What political conditions would be necessary for comprehensive subsidy reform?

Unit 3:

Theory of Taxation: ability to pay and benefit principle of tax. Taxable capacity. Incidences of Taxation. Classification of taxes: direct and indirect taxes. Principle of taxation in developing Economy.

Chapter 1:
Introduction to Taxation

- Meaning of Taxation
- Objectives of Taxation
- Importance of Taxation in Public Finance
- Features of a Good Tax System
- Role of Taxation in Economic Development

Meaning of Taxation • Objectives • Importance in Public Finance

Features of a Good Tax System • Role in Economic Development

1.1 Meaning of Taxation

Taxation is the process by which a government or public authority levies compulsory financial contributions from individuals, corporations, and other entities to fund public expenditure and services. It is one of the oldest and most fundamental instruments of fiscal policy and sovereign governance.

The word 'tax' is derived from the Latin word taxare, meaning 'to estimate' or 'to assess'. In contemporary usage, taxation refers to the entire system — including the laws, procedures, institutions, and administrative machinery — through which governments raise revenue compulsorily from the public.

1.1.1 Definitions of Tax

Several eminent economists and legal scholars have defined taxation from different perspectives:

Philip E. Taylor:

A tax is a compulsory payment to government without expectation of direct benefit to the taxpayer.

Bastable:

A tax is a compulsory contribution of the wealth of a person or body of persons for the service of the public powers.

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

From these definitions, the following essential characteristics of a tax can be identified:

- It is a compulsory payment — payment cannot be refused.
- It is levied by the government or a public authority.
- It is used for public purposes and common welfare.
- It does not entail any direct quid pro quo (i.e., no specific benefit in return).
- It is based on legal authority — no tax can be levied without the sanction of law.

1.1.2 Tax vs. Other Public Levies

It is important to distinguish taxation from other forms of government receipts:

Type	Nature	Key Difference from Tax
Tax	Compulsory, no direct benefit.	*Baseline definition.*
Fee	Paid for specific service rendered.	*Direct benefit to payer.*
Fine/Penalty	Imposed for violating law.	*Punitive, not revenue-oriented.*
Special Assessment	Charged for specific public improvements.	*Benefit is localized.*
Toll	Charged for use of specific public infrastructure.	*Usage-based payment.*

1.2 Objectives of Taxation

Modern taxation is not merely a tool for revenue collection. Governments use tax policy to achieve a wide array of economic, social, and political objectives. These objectives have evolved considerably from the classical era to the contemporary welfare state model.

1.2.1 Revenue Generation

The primary and most traditional objective of taxation is to raise revenue for the government to finance public expenditure. This includes funding defence, law enforcement, infrastructure, health, education, and other public goods. Without taxation, governments would be unable to meet their fiscal obligations.

1.2.2 Redistribution of Income and Wealth

Progressive taxation systems are designed to reduce income inequality by taxing higher incomes at steeper rates. The revenue collected is then channelled into social welfare programmes — subsidies, grants, pensions, and direct transfers — that benefit lower-income segments of society. Taxation thus serves as a mechanism for economic justice.

1.2.3 Economic Stabilisation

Taxation is a critical instrument of counter-cyclical fiscal policy. During periods of economic boom and inflation, higher taxes reduce disposable income and aggregate demand, thereby cooling the economy. During recessions, tax cuts stimulate spending and revive economic activity. This role of taxation as an automatic stabilizer is central to Keynesian economics.

1.2.4 Regulation of Economic Activity

Governments use taxation to encourage or discourage specific economic behaviours:

- Pigouvian taxes on externalities: Carbon taxes, sin taxes on tobacco and alcohol, and environmental levies are used to discourage activities that impose costs on society.
- Tax incentives: Deductions, exemptions, and credits encourage investment in priority sectors such as renewable energy, research and development, and affordable housing.
- Import duties and tariffs: Protect domestic industries from foreign competition and influence trade balances.

1.2.5 Mobilisation of Resources for Development

In developing economies, taxation serves to mobilise domestic resources for capital formation and developmental expenditure. Rather than relying excessively on borrowing or foreign aid, governments use tax revenues to fund infrastructure, public enterprises, and social programmes critical for long-term development.

1.2.6 Social Objectives

Certain taxes are designed to achieve social goals such as population control, healthcare promotion, or environmental conservation. Taxes on luxury goods serve to moderate conspicuous consumption, while tax concessions to charitable institutions and NGOs encourage social welfare activities.

Key Insight:

The objectives of taxation are not always mutually compatible. For instance, maximising revenue and ensuring equity may conflict when high marginal tax rates lead to capital flight or tax avoidance. Policymakers must carefully balance competing objectives.

1.3 Importance of Taxation in Public Finance

Public finance is the study of the role of the government in the economy — how it raises revenue, incurs expenditure, and manages its financial position. Taxation occupies the central place in public finance as the principal source of government revenue in most countries.

1.3.1 Primary Source of Government Revenue

In developed and developing economies alike, taxes constitute the bulk of government receipts. Direct taxes (income tax, corporate tax) and indirect taxes (GST, VAT, customs duties) together provide the fiscal foundation for government operations. Non-tax revenues such as fees, grants, and profits of public enterprises are relatively minor by comparison.

1.3.2 Financing Public Expenditure

Governments must provide public goods — defence, law and order, public health infrastructure, education — which markets cannot supply efficiently due to the non-excludability and non-rivalry of consumption. Taxation finances these non-marketable goods and ensures equitable access to them across society.

1.3.3 Instrument of Fiscal Policy

Taxation is one of the two pillars of fiscal policy (the other being government expenditure). By adjusting tax rates and structures, governments influence aggregate demand, employment levels, price stability, and economic growth. The budget — which details both taxation and spending plans — is the most visible manifestation of fiscal policy.

1.3.4 Reduction of Fiscal Deficit

A major concern in public finance is the fiscal deficit — the gap between government expenditure and revenue. Effective taxation policy that broadens the tax base, improves compliance, and reduces evasion is essential to containing the fiscal deficit and maintaining macroeconomic stability. A high fiscal deficit leads to increased borrowing, higher interest payments, and inflationary pressures.

1.3.5 Intergovernmental Fiscal Relations

In federal systems, taxation assumes added importance in defining the fiscal relationship between central and state (or provincial) governments. The division of taxing powers, the sharing of revenues (devolution), and the system of grants-in-aid are all central issues in fiscal federalism. The structure of taxation thus has significant implications for political decentralisation and regional equity.

1.3.6 Role in Public Debt Management

Tax revenues determine the government's capacity to service existing public debt. A robust and growing tax base provides confidence to creditors about the government's solvency and creditworthiness, enabling it to borrow at lower interest rates. Conversely, a narrow or shrinking tax base signals fiscal fragility and can trigger sovereign debt crises.

1.4 Features of a Good Tax System

The design of a tax system has profound implications for economic efficiency, social equity, and administrative feasibility. Economists and public finance scholars have articulated several criteria that a well-designed tax system should satisfy. Adam Smith's four 'canons of taxation,' first laid out in The Wealth of Nations (1776), remain foundational in this regard.

Feature	Description	Significance
Equity	Taxes should be fair and proportional to ability to pay.	*Canon of Equity (Adam Smith)*
Certainty	Tax liability must be clear and not arbitrary.	*Reduces evasion and builds compliance.*
Convenience	Payment should be easy and at the right time.	*E.g., deduction at source (TDS).*
Economy	Cost of collection must be minimal.	*Administrative efficiency.*
Productivity	Must generate adequate revenue for the state.	*Supports public expenditure.*
Elasticity	Revenue should rise with national income.	*Automatic stabilizer effect.*
Simplicity	System should be understood by taxpayers.	*Reduces complexity and litigation.*
Neutrality	Should not distort economic decisions.	*Minimizes deadweight loss.*

1.4.1 Adam Smith's Canons of Taxation

Adam Smith articulated four classical canons that continue to underpin contemporary tax design:

1. Canon of Equity: Subjects ought to contribute to the support of government in proportion to their ability to pay.
2. Canon of Certainty: The tax each individual is bound to pay ought to be certain and not arbitrary.
3. Canon of Convenience: Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

4. Canon of Economy: Every tax ought to be contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury.

1.4.2 Modern Additions

Contemporary tax theory has augmented Smith's canons with additional criteria suited to modern economic realities:

- Buoyancy and Elasticity: Tax revenue should grow in proportion to (or faster than) national income, reducing the need for frequent rate revisions.
- Diversity: The tax system should draw from multiple sources to avoid over-dependence on any single tax base, thereby spreading risk.
- Minimum Tax Gap: The system should be designed to minimise the difference between taxes legally owed and taxes actually collected (the 'tax gap').
- International Competitiveness: In an era of globalisation, tax policy must attract foreign investment and prevent base erosion and profit shifting (BEPS).

Adam Smith's Insight:

Smith's canons were revolutionary for their time, establishing that taxation is not merely a financial instrument but also a matter of justice, administrative design, and the relationship between the citizen and the state.

1.5 Role of Taxation in Economic Development

Economic development — the process of sustained improvement in living standards, productive capacity, and institutional quality — requires substantial resources. In developing countries particularly, taxation plays a multifaceted and indispensable role in mobilising those resources and directing them toward developmental ends.

1.5.1 Capital Formation

Economic development requires investment in physical capital (infrastructure, machinery, technology) and human capital (health, education, skills). Taxation provides governments with the resources to invest in these areas when private markets under-invest due to externalities, long gestation periods, or lack of profitability. Public investment, financed through taxation, often 'crowds in' private investment by improving the business environment and reducing costs.

1.5.2 Financing Social Sector Expenditure

Access to education, healthcare, clean water, and sanitation are preconditions for human development. Since these services have significant public good characteristics, their provision cannot be left entirely to markets. Tax revenues finance public expenditure on social sectors, thereby improving human development indices and enabling broader participation in the economy.

1.5.3 Reducing Economic Inequality

High levels of economic inequality can retard development by limiting access to opportunities, reducing social mobility, and generating political instability. Progressive taxation — combined with redistributive expenditure — addresses structural inequality, ensuring that the gains of economic growth are more widely shared. Reducing inequality also expands domestic consumer markets, supporting aggregate demand-led growth.

1.5.4 Encouraging Investment through Tax Incentives

Tax policy can be used as a strategic tool to channel investment toward priority sectors. Governments offer:

- Tax holidays: Exemption from corporate taxes for a specified period to attract new businesses.
- Accelerated depreciation: Allows faster write-off of capital expenditure, reducing tax liability in early years.
- Investment tax credits: Direct credits against tax liability for qualifying investment expenditure.
- Special Economic Zones (SEZs): Areas with reduced tax burdens to attract export-oriented industry.

While such incentives can be effective, they must be carefully designed to avoid revenue loss without commensurate development benefits.

1.5.5 Import Substitution and Export Promotion

Trade taxes — tariffs, customs duties, and export subsidies — have historically been used by developing countries to protect nascent industries (import substitution industrialisation) and to promote exports through duty drawbacks and preferential rates. While the merits of such policies remain debated, they illustrate the developmental role of trade taxation.

1.5.6 Combating Inflation

In developing economies subject to inflationary pressures — often arising from supply constraints or excessive monetary expansion — taxation serves as a non-monetary anti-inflationary tool. Higher taxes reduce disposable income and dampen aggregate demand, helping to control price levels without resorting entirely to contractionary monetary policy.

1.5.7 Strengthening Institutions and Governance

The development of an effective tax administration is itself a mark of institutional maturity and state capacity. Building a tax system requires investment in legal frameworks, information systems, human resources, and enforcement mechanisms. Countries with strong tax institutions tend to exhibit greater transparency, accountability, and rule of law — all of which are conducive to long-term development.

Developmental Perspective:

The United Nations Sustainable Development Goals (SDGs) explicitly recognise domestic resource mobilisation through taxation as essential to financing development. Tax capacity — the ability to raise adequate revenue efficiently and equitably — is considered a hallmark of developmental statehood.

Chapter Summary

Section	Key Takeaway
Meaning of Taxation	Taxation is a compulsory, legally sanctioned levy by the government used to fund public expenditure, with no direct quid pro quo to the taxpayer.
Objectives	Modern taxation aims to raise revenue, redistribute income, stabilise the economy, regulate behaviour, and mobilise resources for development.
Importance in Public Finance	Taxes are the primary revenue source, financing public goods, enabling fiscal policy, reducing deficits, and supporting intergovernmental fiscal relations.
Features of a Good Tax System	A sound system should satisfy equity, certainty, convenience, economy, productivity, elasticity, simplicity, and neutrality.
Role in Economic Development	Taxation finances capital formation, social services, inequality reduction, and institutional development — making it indispensable for sustainable growth.

Review Questions

1. Define taxation. How does a tax differ from a fee, a fine, and a toll? Illustrate with examples.
2. Critically examine the objectives of taxation in a modern welfare state. Are these objectives always compatible with one another?
3. 'Taxation is the cornerstone of public finance.' Discuss this statement with reference to the role of taxation in government revenue, fiscal policy, and public debt management.

4. Outline Adam Smith's four canons of taxation. How relevant are they to the design of tax systems in the twenty-first century?
5. Analyse the role of taxation in promoting economic development in developing countries. Use relevant examples to support your answer.
6. What is meant by 'tax elasticity' and 'tax buoyancy'? Why are these concepts important for fiscal planning?
7. Discuss the potential conflicts between equity and efficiency in tax system design. How can policymakers balance these competing objectives?

Chapter 2:
Principles of Taxation

- Meaning of Principles of Taxation
- Canon of Taxation by Adam Smith
    - Canon of Equality
    - Canon of Certainty
    - Canon of Convenience
    - Canon of Economy
- Modern Principles of Taxation

2.1 Meaning of Principles of Taxation

The principles of taxation refer to the fundamental guidelines or criteria that a sound tax system ought to satisfy in order to be fair, efficient, and effective in achieving the objectives of the state. While Chapter 1 examined why taxes are levied, this chapter examines how taxes ought to be designed and administered. A tax may successfully raise revenue and yet still be considered a poor tax if it is unjust in its distribution, unpredictable in its application, inconvenient in its collection, or wasteful in its administration.

These principles serve as a benchmark against which any existing or proposed tax can be evaluated. They guide policymakers in framing tax legislation, help administrators design collection mechanisms, and give taxpayers and economists a standard for assessing whether a particular tax is equitable and efficient. The most influential and enduring articulation of these principles was provided by the Scottish economist Adam Smith in his 1776 work *An Inquiry into the Nature and Causes of the Wealth of Nations*, where he laid down four canons of taxation that continue to underpin modern public finance theory, including India's own tax policy framework.

2.2 Canons of Taxation by Adam Smith

Adam Smith argued that a good tax system must be judged not merely by how much revenue it raises, but by how it is designed and implemented in relation to the taxpayer. He proposed four canons — equality, certainty, convenience, and economy — each addressing a distinct dimension of a well-functioning tax. These canons remain foundational even in a modern, complex economy like India's, where both direct taxes (such as income tax and corporate tax) and indirect taxes (such as GST and customs duty) are expected to conform to these standards, even though they were originally articulated in the context of a largely agrarian, pre-industrial economy.

2.2.1 Canon of Equality

The canon of equality, also referred to as the canon of equity or ability to pay, holds that citizens should contribute to the support of the government in proportion to their respective abilities, meaning in proportion to the income or revenue they enjoy under the protection of the state. This does not mean everyone should pay the same amount of tax; rather, the tax burden should be distributed fairly according to each taxpayer's capacity to bear it.

Equality in taxation is generally understood through two related concepts. Horizontal equity requires that taxpayers in similar economic circumstances be taxed similarly, so two individuals earning the same income through the same kind of activity should bear a comparable tax burden. Vertical equity requires that taxpayers with greater ability to pay should bear a proportionately greater tax burden than those with lesser ability.

Indian Example: India's personal income tax structure under the Income Tax Act, 1961, is built around the canon of equality through its progressive slab system. Under the new tax regime applicable for the financial year 2024-25, individuals earning up to a basic threshold pay no tax at all, while income above that level is taxed in graduated slabs, with the highest slab attracting the steepest rate. An individual earning ₹15 lakh annually thus pays a higher proportion of income in tax than one earning ₹5 lakh, reflecting the principle that those with greater capacity should contribute more. GST also attempts a partial application of this canon through differentiated rate slabs, where essential goods such as food grains are exempted or taxed at minimal rates, while luxury items such as automobiles and aerated drinks attract the highest GST rate along with a compensation cess, ensuring that the burden of indirect taxation does not fall disproportionately on lower-income consumers.

2.2.2 Canon of Certainty

The canon of certainty holds that the tax which an individual is required to pay should be certain and not arbitrary. The time of payment, the manner of payment, and the quantum to be paid should all be clear and plain to the taxpayer and to every other person, leaving no room for arbitrary discretion on the part of tax collectors. Smith regarded uncertainty in taxation as more damaging than even a degree of inequality, since unpredictable taxation opens the door to corruption, harassment, and arbitrary exercise of power by tax officials.

Certainty benefits not only the individual taxpayer, who can plan personal and business finances with confidence, but also the government, which can estimate its expected revenue with reasonable accuracy for budgetary planning.

Indian Example: The Income Tax Act, 1961, along with the annual Finance Act, clearly specifies tax slabs, rates, due dates for filing returns, and the precise method of computing taxable income, leaving little room for arbitrary assessment when followed correctly. The introduction of the Faceless Assessment Scheme in 2020 by the Income Tax Department was a significant step toward greater certainty and transparency, as it removed direct physical interaction between taxpayers and assessing officers, thereby reducing scope for arbitrary or discretionary demands. Under the GST regime, the GST Council publishes clear rate schedules classifying goods and services under fixed tax slabs of 0, 5, 12, 18, and 28 percent (along with

cess where applicable), so a business selling a particular product can determine its tax liability with certainty before a transaction even occurs.

2.2.3 Canon of Convenience

The canon of convenience states that every tax ought to be levied at the time and in the manner that is most likely to be convenient for the taxpayer to pay it. A tax that is technically fair and certain may still discourage compliance if its method or timing of collection imposes undue hardship on the taxpayer. Convenience increases the likelihood of voluntary compliance and reduces resistance or evasion.

Indian Example: The system of Tax Deducted at Source (TDS) is one of the clearest applications of the canon of convenience in India. Rather than requiring a salaried employee to pay a large lump sum of income tax at the end of the financial year, the employer deducts tax in small monthly instalments directly from the salary, aligned with the employee's receipt of income. This spreads the burden across the year in a manner convenient to the taxpayer's cash flow. The Advance Tax mechanism similarly allows businesses and professionals with tax liability above a specified threshold to pay tax in quarterly instalments rather than as a single annual payment. The digitization of GST and income tax filing through online portals, with payment options through net banking, UPI, and debit cards, has further enhanced convenience by allowing taxpayers to file returns and make payments from anywhere, at any time, without visiting a tax office in person.

2.2.4 Canon of Economy

The canon of economy requires that the cost of collecting a tax be kept to the minimum possible relative to the revenue the tax generates. If the administrative cost of assessment, collection, and enforcement of a particular tax is excessively high compared to the revenue it yields, the tax is considered economically inefficient, regardless of how fair or certain it may be in design. An economical tax system also avoids placing undue compliance costs on the taxpayer, such as excessive paperwork or the need to hire expensive professional assistance merely to fulfil routine tax obligations.

Indian Example: The unification of multiple indirect taxes — including central excise duty, service tax, VAT, octroi, and entry tax — into a single Goods and Services Tax in July 2017 was substantially motivated by the canon of economy. Under the earlier regime, businesses had to maintain separate registrations, file separate returns, and deal with multiple tax authorities across different states, all of which involved significant administrative and compliance costs for both businesses and the government. The GST Network (GSTN), a technology platform that handles registration, return filing, and invoice matching electronically, has considerably reduced the cost of tax administration. Likewise, the move toward e-filing of income tax returns and the pre-filling of return forms using data already available with the tax department (from banks, employers, and other sources) has lowered both the government's collection costs and the taxpayer's compliance costs, making the overall system more economical.

2.3 The Four Canons at a Glance

The diagram above summarizes how the four canons relate to one another, radiating from the central idea of a sound tax system: equality concerns who bears the burden and how much, certainty concerns predictability of liability, convenience concerns the ease of payment, and economy concerns the efficiency of collection. While Smith treated them as somewhat independent standards, in practice they interact closely — for instance, a tax that is highly certain and convenient (like TDS) also tends to be more economical to administer, since fewer disputes and defaults arise.

2.4 Beyond Smith: Modern Extensions to the Canons

While Adam Smith's four canons remain the classical core of tax theory, modern public finance economists have added further principles to address the complexities of contemporary economies. These include the canon of productivity (a tax should yield sufficient revenue to justify its administrative cost), the canon of elasticity (revenue should grow naturally as the economy expands), the canon of flexibility (the system should adapt to changing economic conditions), the canon of simplicity (tax laws should be easily understood without excessive professional assistance), and the canon of diversity (a government should not depend on a single tax source but draw revenue from a diversified base, reducing vulnerability to sector-specific shocks). India's tax system, which draws revenue from direct taxes on income and corporate profits as well as indirect taxes like GST and customs duty, illustrates the application of the canon of diversity, since a downturn in one sector or tax head does not collapse total government revenue.

Summary

Adam Smith's four canons of taxation — equality, certainty, convenience, and economy — continue to serve as the bedrock of sound tax policy more than two centuries after they were first articulated. India's evolving tax architecture, from the progressive income tax slabs that embody equality, to the Faceless Assessment Scheme that strengthens certainty, to TDS and digital payment systems that enhance convenience, to the GST reform that pursues economy in administration, demonstrates how these classical principles continue to shape modern tax design. A tax system that successfully balances all four canons is more likely to achieve high compliance, minimize disputes, and generate stable revenue, making these principles as relevant to policymakers today as they were in eighteenth-century Britain.

Review Questions

1. What is meant by the "principles of taxation," and why are they important in designing a tax system?
2. State and explain Adam Smith's four canons of taxation with the help of Indian examples for each.
3. Distinguish between horizontal equity and vertical equity, and explain how India's income tax system reflects both.
4. How does the Faceless Assessment Scheme strengthen the canon of certainty in Indian taxation?

5. Explain how the TDS mechanism embodies the canon of convenience.
6. Discuss how the introduction of GST in India reflects the canon of economy.
7. What additional canons have modern economists proposed beyond Adam Smith's original four?

Chapter 3:
Ability to Pay Principle

- Meaning of Ability to Pay Principle
- Features of Ability to Pay Principle
- Equal Sacrifice Approaches
    - Equal Absolute Sacrifice
    - Equal Proportional Sacrifice
    - Equal Marginal Sacrifice
- Merits and Demerits of Ability to Pay Principle

This chapter examines one of the foundational principles of public finance — the Ability to Pay Principle. We explore its theoretical meaning, essential features, and the three canonical approaches to equal sacrifice: Equal Absolute Sacrifice, Equal Proportional Sacrifice, and Equal Marginal Sacrifice. Throughout, real-world illustrations drawn from India's income tax structure illuminate how the principle operates in practice. The chapter concludes with a balanced evaluation of its merits and demerits.

3.1 Meaning of the Ability to Pay Principle

The **Ability to Pay Principle** is a normative doctrine of taxation which holds that tax burdens should be distributed among citizens in proportion to their economic capacity to bear those burdens. In its simplest formulation, those who earn more should pay more — not merely in absolute rupee terms, but in a manner that reflects the relative ease or difficulty with which the tax payment is made.

The principle rests on the intuition that a tax of ₹10,000 levied on a daily-wage earner in rural Rajasthan represents a far heavier sacrifice than the same ₹10,000 extracted from a wealthy industrialist in Mumbai. True fairness, therefore, demands that taxation be calibrated not to nominal income but to the marginal utility of income — that is, to what each additional rupee of income is worth to the taxpayer.

The intellectual roots of this principle trace to classical economists such as **John Stuart Mill** and **A.C. Pigou**, who argued that a just tax system is one which imposes *equal sacrifice* across all taxpayers. The principle is sometimes called the *faculty theory of taxation* and stands in contrast to the **Benefit Principle**, which links tax liability to the benefits received from government expenditure.

Indian Context: Constitutional Grounding

Article 39(b) and (c) of the Constitution of India direct the State to ensure that the operation of the economic system does not result in the concentration of wealth to the common detriment, and that the ownership and control of material resources are distributed to best serve the common good. The Ability to Pay Principle operationalises this constitutional vision in the domain of taxation, underpinning India's progressive income tax structure under the Income Tax Act, 1961.

3.2 Features of the Ability to Pay Principle

The Ability to Pay Principle is characterised by several defining features that distinguish it from other approaches to tax distribution.

3.2.1 Subjective Measure of Ability

Ability to pay is not measured purely by income or wealth in absolute terms. It is assessed in terms of the **sacrifice** or **disutility** that a tax imposes on the payer. Because the marginal utility of income diminishes as income rises (a principle known as the *Law of Diminishing Marginal Utility*), higher-income individuals experience less sacrifice per rupee of tax paid, making it equitable to demand a higher share from them.

3.2.2 Progressive Taxation

A direct consequence of the ability-to-pay approach is progressive taxation — a system in which the effective tax rate rises as income increases. India's personal income tax slab structure is a classic illustration: a person earning ₹5 lakh per annum pays at 5%, whereas one earning ₹15 lakh or above faces a 30% marginal rate (under the old regime).

Income Range (₹)	Tax Rate (Old Regime, FY 2024-25)	Nature
Up to ₹2,50,000	Nil	Exempt
₹2,50,001 – ₹5,00,000	5%	Lowest slab
₹5,00,001 – ₹10,00,000	20%	Middle slab
Above ₹10,00,000	30%	Highest slab
Above ₹5 crore (surcharge)	37% surcharge on tax	Super-rich levy

Table 4.1: India's Income Tax Slab Structure — Illustration of Progressive Taxation

3.2.3 Concern for Vertical and Horizontal Equity

Vertical equity requires that people with greater ability to pay contribute proportionately more — the rich pay more than the poor. **Horizontal equity** demands that individuals in equivalent

economic circumstances bear equivalent tax burdens. India's income tax system attempts to embed both by taxing identical incomes at identical rates while imposing surcharges on the wealthy.

3.2.4 Applicability to Direct Taxes

The principle is primarily applicable to direct taxes — income tax, wealth tax, and capital gains tax — where the nexus between the taxpayer's income and the tax demand is transparent. It is far more difficult to apply to indirect taxes such as the Goods and Services Tax (GST), which falls equally on all consumers regardless of their incomes, often burdening the poor disproportionately.

3.2.5 Ethical and Social Dimension

Beyond technical economics, the ability to pay principle embeds a moral claim: taxation is not merely a transactional exchange but an expression of social solidarity. By requiring the more affluent to contribute a larger share, the principle supports redistributive transfers — welfare schemes, subsidies, and public services — that benefit lower-income groups.

3.3 Equal Sacrifice Approaches

The ability to pay principle is operationalised through the concept of **equal sacrifice**. The foundational idea is that a fair tax system should impose a *comparable degree of sacrifice* on all taxpayers. Three principal interpretations of what 'equal sacrifice' means have emerged in the literature, each implying a different tax structure.

> **Key Notation**
> Let Y = Income before tax | T = Tax payment | MU(Y) = Marginal utility of income at income level Y | TU(Y) = Total utility of income at level Y. All three sacrifice approaches rely on the assumption that marginal utility of income diminishes as income rises.

3.3.1 Equal Absolute Sacrifice

Under the **Equal Absolute Sacrifice** (EAS) approach, the tax system is designed so that every taxpayer surrenders the *same absolute amount of utility*, regardless of their income level. Formally:

$$TU(Y) - TU(Y - T) = \text{Constant} \quad \text{for all taxpayers}$$

That is, the loss in total utility experienced by each taxpayer after paying tax must be equal, irrespective of their pre-tax income.

Implication for Tax Rates

Because the marginal utility of income declines as income rises, achieving an equal absolute loss of utility requires that higher-income individuals pay more tax in absolute terms. Depending on the rate of decline of marginal utility, this approach may imply proportional, progressive, or in exceptional cases even regressive tax rates — though in practice, with reasonable utility functions, it tends toward progressivity.

Illustration with Indian Example

Consider two Indian taxpayers: Suresh, a small shopkeeper in Varanasi earning ₹5 lakh annually, and Rakesh, a senior corporate executive in Bengaluru earning ₹25 lakh annually. Suppose the marginal utility schedule is such that an equal utility sacrifice of 50 utils corresponds to a tax of ₹10,000 for Suresh and ₹40,000 for Rakesh. Under EAS, this differential is justified because the same absolute utility loss of 50 utils demands a much larger rupee sacrifice from Rakesh, whose marginal utility of money is lower.

Taxpayer	Annual Income	Tax Paid	Utility Lost	Sacrifice Type
Suresh (Small trader)	₹5,00,000	₹10,000	50 utils	Equal Absolute
Rakesh (Corporate exec.)	₹25,00,000	₹40,000	50 utils	Equal Absolute

Table 4.2: Equal Absolute Sacrifice — Illustrative Example

Assessment

- **Advantage:** Intuitively fair — each person gives up the same 'pain' in utility terms.
- **Limitation:** Utility is not observable or measurable in practice, making precise implementation impossible. The implied tax rate also varies with assumptions about the utility function.

3.3.2 Equal Proportional Sacrifice

The **Equal Proportional Sacrifice** (EPS) approach requires that every taxpayer sacrifice the *same proportion of their total utility* from income. Formally:

$$[TU(Y) - TU(Y - T)] / TU(Y) = \text{Constant} \quad \text{for all taxpayers}$$

In other words, the fractional reduction in utility is the same for everyone. A rich person loses the same fraction of their total utility as a poor person, even though the absolute rupee amounts differ substantially.

Implication for Tax Rates

Equal proportional sacrifice generally implies a progressive tax structure. Since wealthier individuals derive a larger total utility from income and their marginal utility declines faster, maintaining the same proportional utility sacrifice requires extracting a higher proportion of their income.

Illustration with Indian Example

Imagine Priya, a school teacher in Pune earning ₹6 lakh per year, and Anand, a real estate developer in Hyderabad earning ₹60 lakh per year. If Priya's total utility from income is 600 utils and Anand's is 1,200 utils, and the equal proportional sacrifice is set at 10%, then:

- Priya must sacrifice 60 utils → say, ₹30,000 in tax (5% of income).
- Anand must sacrifice 120 utils → say, ₹9,00,000 in tax (15% of income).

Taxpayer	Income	Total Utility	Sacrifice (10%)	Tax Paid	Effective Rate
Priya (Teacher)	₹6,00,000	600 utils	60 utils	₹30,000	5%
Anand (Developer)	₹60,00,000	1,200 utils	120 utils	₹9,00,000	15%

Table 4.3: Equal Proportional Sacrifice — Illustrative Example

Assessment

- **Advantage:** Feels proportionally fair — everyone gives up the same fraction of their total utility from income.
- **Limitation:** Like EAS, relies on unmeasurable utility. Also, the resulting tax rate structure depends critically on the assumed shape of the utility-income function.

3.3.3 Equal Marginal Sacrifice

The **Equal Marginal Sacrifice** (EMS) approach, associated most prominently with **A.C. Pigou**, takes the principle furthest. It requires that the last (marginal) unit of tax imposed on each taxpayer should involve the *same marginal sacrifice* — the same loss of marginal utility. Formally:

$$MU(Y_1 - T_1) = MU(Y_2 - T_2) = \ldots = MU(Y_n - T_n)$$

This is sometimes called the **Least Aggregate Sacrifice** principle, because it can be shown mathematically that equating marginal sacrifices across taxpayers also *minimises the total sacrifice* imposed on society as a whole. It is the most utilitarian of the three approaches.

Implication for Tax Rates

Equal marginal sacrifice implies a sharply progressive tax — in its extreme form, it suggests taxation should level incomes down to a common point (sometimes called 'levelling'), so that every taxpayer ends up with the same marginal utility of money. This is because, given

diminishing marginal utility, two people with different post-tax incomes must have different marginal utilities; equalising marginal utilities requires equalising post-tax incomes.

Illustration with Indian Example

Consider the Indian government's approach to taxing super-rich individuals. Under EMS logic, a billionaire industrialist — say with a net income of ₹500 crore — has an extremely low marginal utility of the last rupee. The government therefore imposes a surcharge of 37% on individuals earning above ₹5 crore (under the old regime). The intent is to equate (approximately) the marginal sacrifice of the super-rich with that of middle-income taxpayers, thereby minimising the aggregate utility loss across society.

EMS and the Surcharge in India

India's personal income tax structure levies a surcharge on high incomes: 10% surcharge for income between ₹50 lakh and ₹1 crore; 15% for ₹1–2 crore; 25% for ₹2–5 crore; and 37% for above ₹5 crore (old regime). While officially not framed in utility-sacrifice language, the economic rationale aligns closely with the Equal Marginal Sacrifice approach — the marginal utility of income is so low at these levels that a higher marginal tax rate is needed to produce an equivalent sacrifice.

Assessment

- **Advantage:** Welfare-maximising — minimises aggregate sacrifice across society.

  Provides the strongest theoretical basis for progressive taxation.
- **Limitation:** In its pure form, it implies complete income equalisation, which is politically infeasible and may destroy incentives for work and investment. Comparing marginal utilities interpersonally remains scientifically impossible.

3.3.4 Comparative Summary of the Three Sacrifice Approaches

Dimension	Equal Absolute Sacrifice	Equal Proportional Sacrifice	Equal Marginal Sacrifice
Core idea	Same total utility loss for all	Same fraction of total utility lost	Same marginal utility loss at the margin
Tax structure implied	Progressive (typically)	Progressive	Strongly progressive / levelling
Utilitarian basis	Weak	Moderate	Strong (minimises aggregate sacrifice)
Practical difficulty	High	High	Highest

Indian relevance	Basic progressive slabs	Differential slab rates	Surcharge on super-rich

Table 4.4: Comparison of Equal Sacrifice Approaches

3.4 Merits and Demerits of the Ability to Pay Principle

No principle of taxation is without strengths and weaknesses. A balanced evaluation of the ability to pay principle reveals both its enduring appeal and its significant practical challenges.

✓ Merits	✗ Demerits
Promotes Equity and Fairness: By ensuring that the tax burden falls more heavily on those with greater economic capacity, the principle embodies the fundamental notion of fairness in public finance.	Measurement Problem: Ability is abstract. Neither utility nor sacrifice is directly measurable, making precise implementation an approximation at best.
Reduces Income Inequality: Progressive taxes redistributed through government spending can narrow the gap between the rich and poor — a key policy goal in a country like India with a high Gini coefficient (~0.35).	Disincentive Effect: High marginal tax rates on the rich may discourage work, saving, and investment, potentially slowing economic growth — a concern raised repeatedly in debates over India's surcharge levels.
Social Solidarity: The principle reflects a moral commitment to shared responsibility. It transforms taxation from a transactional fee into an expression of national solidarity — consistent with India's Directive Principles.	Subjectivity: Different taxpayers experience different utility functions. What constitutes an 'equal' sacrifice is ultimately a value judgement, not a scientific determination.
Supports Government Revenue: Progressive taxes based on ability to pay tend to generate substantial revenue, particularly in growing economies where high-income groups expand rapidly, as in India's IT sector.	Tax Evasion and Avoidance: High rates incentivise tax evasion and avoidance. India's shadow economy — estimated at 20-25% of GDP by some studies — is partly attributable to the high burden imposed on the formally employed.
Constitutional Alignment: In India, the principle aligns with Article 38 and Article 39 of the Constitution, which mandate reduction of inequalities in income and wealth.	Neglects Benefits Received: The principle ignores the link between taxes paid and services received. A wealthy taxpayer may derive fewer government services (e.g., uses private healthcare) yet pays far more — raising questions of fairness from a different angle.

Flexible and Adaptable: The principle can be adapted to different contexts — income tax, wealth tax, inheritance tax — making it a versatile foundation for the entire direct tax architecture.	Political Misuse: Governments may use 'ability to pay' rhetoric to justify excessively high taxes on the productive class for populist reasons, distorting economic incentives beyond optimal levels.

3.5 The Ability to Pay Principle in India: A Critical Perspective

India's direct tax system is deeply influenced by the ability to pay principle, though its implementation has faced recurrent criticism.

3.5.1 Strengths of India's Implementation

- The Income Tax Act, 1961 establishes a progressive slab structure with a zero-tax threshold (currently ₹2.5 lakh under the old regime; ₹3 lakh under the new), exempting the very poor from direct taxation entirely.
- Various deductions and exemptions — under Sections 80C, 80D, 80G and others — allow taxpayers to reduce their taxable income based on socially valued expenditures (insurance, provident fund, charity), reflecting a nuanced view of 'ability'.
- The surcharge structure progressively taxes the super-rich, embodying elements of Equal Marginal Sacrifice doctrine.

3.5.2 Weaknesses and Unresolved Tensions

- India's tax base remains narrow — only about 7-8 crore individuals file income tax returns out of a population of 140 crore — meaning that the burden of financing the state falls disproportionately on the formal salaried class.
- Agricultural income, regardless of its magnitude, is exempt from central income tax under Section 10(1) of the Income Tax Act — a glaring departure from the ability to pay principle, which protects wealthy landowners from direct taxation.
- Indirect taxes, particularly GST, are regressive in character and impose a heavier relative burden on lower-income households, partially offsetting the progressive impact of income taxation.

Policy Note: Expanding the Tax Base

Several economists — including the Tax Reform Committee chaired by Raja Chelliah in 1991 and more recently the Vijay Kelkar Committee — have argued that India's reliance on a narrow taxpayer base undermines the spirit of the ability to pay principle. Universal income taxation with appropriate thresholds, combined with a rationalised exemption structure, would better realise the principle's promise of equitable burden sharing across the entire population.

3.6 Conclusion

The Ability to Pay Principle remains one of the most compelling and widely applied doctrines in the theory of public finance. Its core claim — that those who can bear a larger burden without equivalent hardship should do so — resonates with both economic logic and moral intuition. The three equal sacrifice approaches (Equal Absolute, Equal Proportional, and Equal Marginal) provide distinct theoretical frameworks for translating this general principle into operational tax policy, each with its own merits and limitations.

In India, the principle finds expression in the progressive income tax structure, the surcharge regime, and the various relief provisions for lower-income groups. Yet the principle's full potential is constrained by a narrow tax base, the regressive character of indirect taxes, and the political economy of exemptions. Deepening India's commitment to the ability to pay principle will require expanding the tax net, rationalising agricultural income exemptions, and redesigning indirect taxation to reduce its regressive impact.

As India continues its journey toward becoming a **Viksit Bharat** (Developed India) by 2047, the equitable distribution of the fiscal burden — guided by the ability to pay principle — will be central to sustaining both economic growth and social cohesion.

Key Terms at a Glance

Ability to Pay Principle • Benefit Principle • Equal Absolute Sacrifice • Equal Proportional Sacrifice • Equal Marginal Sacrifice • Least Aggregate Sacrifice • Diminishing Marginal Utility • Progressive Taxation • Vertical Equity • Horizontal Equity • Faculty Theory of Taxation • Surcharge

Review Questions

- Define the Ability to Pay Principle and distinguish it from the Benefit Principle.
- Explain why the Law of Diminishing Marginal Utility provides the theoretical foundation for the Ability to Pay Principle.
- Compare and contrast Equal Absolute Sacrifice and Equal Proportional Sacrifice with suitable numerical examples.
- Why is Equal Marginal Sacrifice also called the Least Aggregate Sacrifice principle? Derive this result intuitively.
- Critically evaluate the Ability to Pay Principle with reference to India's income tax structure. What are its limitations in the Indian context?
- 'Agricultural income exemption in India is a violation of the Ability to Pay Principle.' Discuss.

Chapter 4:
Benefit Principle of Taxation

- Meaning of Benefit Principle
- Features of Benefit Principle
- Relationship between Tax and Public Services
- Advantages and Limitations of Benefit Principle
- Difference between Ability to Pay and Benefit Principle

4.1 Meaning of Principles of Taxation

Every system of governance involves the collection of taxes. But the mere act of levying taxes does not by itself constitute sound fiscal policy. Taxation must be guided by a coherent set of principles — normative standards derived from economics, ethics, administrative theory, and political philosophy — that determine what a good tax looks like, how it should be structured, and what it should and should not do.

The principles of taxation are the foundational rules and criteria that guide the design, evaluation, and reform of tax systems. They answer fundamental questions: Is this tax fair? Does it distort economic behaviour unnecessarily? Is it administratively feasible? Does it generate adequate revenue? Is it transparent and predictable?

> **Definition:**
> *Principles of taxation are the normative guidelines and theoretical benchmarks — rooted in economic analysis, ethical reasoning, and administrative experience — against which the merits and defects of any tax or tax system are assessed. They constitute the intellectual framework for optimal tax design.*

The intellectual history of tax principles spans centuries. Ancient writers on statecraft — from Kautilya's Arthashastra in India to Roman fiscal thought — recognised that taxation must be measured, just, and productive. But it was the Scottish political economist Adam Smith who, in his landmark work An Inquiry into the Nature and Causes of the Wealth of Nations (1776), provided the first systematic and enduring articulation of tax principles — his celebrated four canons of taxation.

4.1.1 Why Principles of Taxation Matter

Tax principles matter at multiple levels:

- For legislators and policymakers: They provide a normative checklist against which proposed taxes can be evaluated before enactment.
- For tax administrators: They guide the design of assessment procedures, enforcement mechanisms, and taxpayer services.
- For economists: They form the basis of optimal tax theory — the formal analysis of how to raise a given amount of revenue with the least economic cost and greatest equity.
- For taxpayers and civil society: They provide criteria for evaluating whether the existing tax system is just and efficient, and for advocating reform.
- For international organisations: Institutions such as the IMF, World Bank, and OECD use principles of taxation to advise developing countries on tax system reform and modernisation.

4.1.2 Classification of Tax Principles

Tax principles can be broadly classified into three categories:

Category	Principles	Underlying Concern
Equity Principles	Equality, Ability to Pay, Benefit Principle, Horizontal & Vertical Equity	Is the tax fair? Does it distribute the burden justly?
Efficiency Principles	Neutrality, Economy, Minimum Distortion, Deadweight Loss Minimisation	Does the tax distort economic decisions? What is the excess burden?
Administrative Principles	Certainty, Convenience, Simplicity, Minimum Tax Gap	Is the tax easy to administer, comply with, and enforce?
Revenue Principles	Productivity, Adequacy, Elasticity, Buoyancy, Diversity	Does the tax raise enough revenue reliably and sustainably?

The sections that follow examine these principles in detail, beginning with Adam Smith's four classical canons before turning to the broader framework of modern tax theory.

4.2 Adam Smith's Canons of Taxation

Adam Smith (1723–1790), the father of modern economics, devoted considerable attention to taxation in Book V of The Wealth of Nations. He argued that a civilised society requires public expenditure — on defence, justice, and public works — that must be financed through taxation.

However, the manner in which taxes are levied is not a matter of indifference: poorly designed taxes cause economic harm, social injustice, and administrative waste.

Smith articulated four fundamental maxims — now known as the four canons of taxation — that he believed every tax should satisfy. These canons have exercised profound influence over tax theory and practice for nearly 250 years, and remain embedded in contemporary tax reform discourse worldwide.

> **Adam Smith (1776) — The Wealth of Nations, Book V, Chapter 2:**
> *The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.*

4.2.1 Overview of the Four Canons

Canon	Core Principle	Practical Application	Value Protected
Equality	Contribution proportional to ability to pay.	Progressive tax structures; income-based rates.	Equity & Fairness
Certainty	Tax liability must be clear and definite.	Clear legislation; advance rulings; published rates.	Transparency
Convenience	Collection at the most suitable time and method.	TDS (Tax Deducted at Source); advance tax instalments.	Compliance
Economy	Minimal cost of collection relative to yield.	Rationalised tax administration; e-filing; single window.	Efficiency

4.3 Canon of Equality (Equity)

CANON 1 — *Aequitas*
The Canon of Equality

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities — that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

4.3.1 The Core Idea

The canon of equality is the foundational equity principle of taxation. Smith's argument was straightforward: those who benefit more from the protection and services of the state — those who earn more income, own more property, and engage in more commerce — should contribute proportionately more to its support. The rich should pay more in absolute terms, and ideally in proportional terms, than the poor.

Smith's formulation is rooted in the benefit theory of taxation — the idea that tax liability should be related to the benefits received from government. However, his emphasis on proportionality to income also anticipates the ability-to-pay theory, which became dominant in subsequent centuries. The equality canon thus bridges both approaches.

4.3.2 Horizontal and Vertical Equity

Modern tax theory distinguishes two dimensions of equity that flow from Smith's equality canon:

Type of Equity	Meaning	Example
Horizontal Equity	Taxpayers in similar economic circumstances should bear similar tax burdens. Like should be treated alike.	Two individuals earning ₹10 lakh from different sources (salary vs. business) should pay the same income tax.
Vertical Equity	Taxpayers in different economic circumstances should bear appropriately different tax burdens. Unlike should be treated unlike.	A person earning ₹1 crore should pay a larger fraction of income in tax than a person earning ₹5 lakh.

4.3.3 Ability to Pay Principle

The ability-to-pay principle — closely linked to Smith's equality canon — holds that the tax burden should be distributed according to each taxpayer's capacity to bear it without excessive sacrifice. This leads naturally to the concept of progressive taxation, where marginal tax rates increase with income, reflecting the principle of diminishing marginal utility of money: an additional rupee means less to a wealthy person than to a poor one.

The ability-to-pay principle has several operational implications:

- Exemption of minimum subsistence income from taxation (the 'basic exemption limit' in Indian income tax).
- Progressive rate structures — higher incomes taxed at higher marginal rates.
- Deductions and rebates for essential expenditures (education, health insurance, housing loan repayment).
- Wealth taxes and estate duties to address accumulated wealth disparities.

4.3.4 Equality in Practice: The Indian Income Tax

India's personal income tax structure embodies the canon of equality through:

- A basic exemption limit (₹2.5 lakh under the old regime; ₹3 lakh under the new regime).
- Progressive tax slabs rising from 5% to 30% for regular income.
- A surcharge on income above ₹50 lakh, reaching 37% for income above ₹5 crore (a 'supertax' element).
- Exemptions for agricultural income — recognising the income fragility of farmers.
- Deductions under Sections 80C, 80D for savings and health insurance, recognising differential capacity.

4.3.5 Limitations and Criticisms

The canon of equality, while universally endorsed in principle, faces several practical challenges:

- Measuring ability to pay is difficult — cash income, consumption, wealth, and leisure are all relevant but hard to assess simultaneously.
- Progressive taxation may create disincentive effects on work, saving, and investment — threatening economic efficiency.
- Tax avoidance and evasion — more accessible to high-income earners — can hollow out the intended equity of a progressive system.
- Indirect taxes (VAT, GST) tend to be regressive — poor households spend a larger fraction of income on consumption than rich ones — undermining equality at the system level.

> **Key Insight:**
> *The equality canon is not about numerical equality of tax payments. A flat rate of 10% on all incomes achieves proportionality but not progressivity. Modern welfare-state thinking goes further than Smith, arguing that true equality requires progressive rates that compress after-tax income differentials and fund social insurance for the disadvantaged.*

4.4 Canon of Certainty

CANON 2 — *Certitudo*
The Canon of Certainty

The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.

4.4.1 The Core Idea

The canon of certainty addresses the relationship between the tax system and the rule of law. Smith was deeply critical of arbitrary taxation — situations where the amount, timing, or manner of payment could be varied by the whim of the tax collector. In such systems, taxpayers could never plan their financial affairs with confidence, and the tax officer wielded discretionary power susceptible to corruption.

According to Smith, certainty protects taxpayers from arbitrary assessments and reduces the opportunity for extortion by tax officials. It also enables rational economic planning: a businessman who knows exactly what tax he will owe can make investment and pricing decisions with greater confidence. Uncertainty, by contrast, acts as an invisible tax on entrepreneurship.

4.4.2 Dimensions of Tax Certainty

Tax certainty encompasses several distinct dimensions:

Dimension	Explanation
Certainty of Liability	Taxpayers must be able to determine with confidence whether they are subject to a particular tax.
Certainty of Amount	The formula or rate for computing the tax must be unambiguous, so that the exact amount can be calculated.
Certainty of Timing	The due date for payment and the period to which the tax applies must be clearly prescribed.
Certainty of Method	The channel, procedure, and documentation for payment must be specified without ambiguity.
Certainty of Treatment	Similar transactions or taxpayers should receive the same treatment — predictability of interpretation by authorities.

4.4.3 Certainty and the Rule of Law

The certainty canon is inseparable from the principle of nullum tributum sine lege — 'no taxation without law'. Every tax must be authorised by legislation, and that legislation must be sufficiently clear and specific that both taxpayers and officials can determine the legal tax liability without ambiguity. In India, Article 265 of the Constitution expressly provides that 'no tax shall be levied or collected except by authority of law,' giving constitutional force to the certainty canon.

4.4.4 Modern Instruments for Ensuring Certainty

Contemporary tax systems have developed a range of tools to operationalise the certainty canon:

- Advance rulings: Taxpayers can seek a binding ruling from the tax authority on the tax treatment of a proposed transaction before undertaking it — eliminating retrospective uncertainty.
- Safe harbour rules: Pre-specified margins and methods for transfer pricing, presumptive taxation, and deductions that, if followed, guarantee the tax treatment without scrutiny.
- Consolidated tax codes: Comprehensive, codified statutes that integrate all relevant rules in a single accessible document rather than scattered notifications and circulars.
- Clear definitions: Statutory definitions of 'income', 'supply', 'resident', 'business connection', etc., reduce interpretive disputes.
- Annual budget circulars and explanatory memoranda: Explain the intent of new provisions, guiding both taxpayers and assessors.

4.4.5 Consequences of Uncertainty

When the certainty canon is violated, several harmful consequences follow:

- Compliance costs rise as taxpayers engage tax lawyers and advisors to navigate ambiguous provisions.
- Litigation proliferates — India's income tax jurisprudence is among the most voluminous in the world, largely because statutory provisions are contested due to ambiguity.
- Investment is deterred, especially foreign investment, which is highly sensitive to policy and regulatory uncertainty.
- Tax evasion is facilitated — where rules are unclear, taxpayers may take aggressive positions that erode the tax base.
- Corruption is enabled — discretionary powers given to tax officials in ambiguous statutes create rent-seeking opportunities.

> **Smith's Warning:**
> *The insolence and partiality of tax collectors are rendered more or less intolerable according as the tax is well or ill defined. A vague or obscure tax invites corruption and erodes the moral legitimacy of the entire fiscal system.*

4.5 Canon of Convenience

CANON 3 — *Commoditas*
The Canon of Convenience

Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. A tax upon the rent of land or of houses, payable at the same terms at which such rents are usually paid, is levied at the time when it is most likely to be convenient for the contributor to pay.

4.5.1 The Core Idea

The canon of convenience recognises that taxation is not only a fiscal act but also an administrative interaction between the taxpayer and the state. Even a perfectly fair and well-defined tax can become burdensome if its timing, method, or procedure is incompatible with the taxpayer's financial circumstances or practical capabilities.

Smith's insight was that a tax collected at the wrong time — for example, demanding an annual lump-sum from an agricultural labourer at the onset of the planting season, when cash is scarce — would be experienced as far more burdensome than the same amount collected after harvest, when income has been received. Convenience is thus a matter of both timing and mechanism.

4.5.2 Dimensions of Tax Convenience

- Timing convenience: Tax should be collected when the taxpayer has the means to pay. Land tax after harvest; income tax after income is received; estate duty after assets are inherited.
- Procedural convenience: The process of payment — filing returns, making calculations, using forms — should be simple and accessible to the average taxpayer.
- Locational convenience: Payment should be possible through widely accessible channels — post offices, banks, online portals — rather than requiring physical attendance at distant government offices.
- Documentation convenience: The documentary requirements for compliance should be proportionate to the transaction and not excessively burdensome.
- Language and literacy convenience: Tax forms and instructions should be in accessible language, ideally in regional languages, for a diverse taxpaying population.

4.5.3 The TDS System: Convenience Par Excellence

The most celebrated modern application of the convenience canon is Tax Deducted at Source (TDS). Under TDS, the payer of income — an employer, a bank paying interest, a purchaser of property — deducts tax at the time of payment and deposits it directly with the government. The recipient need not save a lump-sum to pay tax at year-end; the tax is collected at the moment income is generated.

TDS achieves convenience in multiple dimensions: it aligns tax collection with income generation; it distributes the payment burden across the year rather than concentrating it in a single instalment; and it removes the risk that taxpayers spend the income before tax is due. India's extensive TDS system — covering salaries, interest, rent, professional fees, and contractor payments — is a direct operationalisation of Smith's third canon.

4.5.4 Digital Revolution and Convenience

The digital transformation of tax administration has dramatically enhanced the convenience of compliance in recent decades:

- E-filing of income tax returns: India processes over 70 million e-returns annually. Pre-filled returns (using Form 26AS and Annual Information Statement data) reduce the data entry burden on taxpayers.
- GSTN portal: The Goods and Services Tax Network enables online filing of monthly and quarterly returns, input credit matching, and e-invoicing across millions of businesses.
- Faceless assessment: India's faceless assessment scheme eliminates the need for taxpayers to appear in person before assessing officers, reducing compliance costs and corruption.
- Instant PAN: Aadhaar-linked instant PAN allocation takes minutes, removing barriers to formalisation.
- Mobile payment gateways: Tax payments through UPI, net banking, and mobile wallets bring the payment mechanism to the taxpayer's fingertips.

4.5.5 Advance Tax System

The advance tax system — requiring taxpayers with significant tax liability to pay in quarterly instalments (15%, 45%, 75%, and 100% by specified dates) rather than as a lump-sum at year-end — reflects the convenience canon by aligning tax outflows with the taxpayer's periodic income flows.

> **Policy Insight:**
> *The convenience canon has a paradox: what is convenient for the taxpayer may be inconvenient for the government (e.g., deferred payment), and what is convenient for tax collection may burden the taxpayer (e.g., immediate demand). Modern tax design resolves this through withholding systems that achieve both: government receives revenue continuously while taxpayers never hold a large tax liability.*

4.6 Canon of Economy

CANON 4 — *Oeconomia*
The Canon of Economy

Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.

4.6.1 The Core Idea

The canon of economy is Smith's most sophisticated maxim. He recognised that the total cost of a tax is not limited to the revenue it raises: there are additional costs — the economic, administrative, and social costs of the tax — that represent a burden over and above the mere transfer from taxpayers to the treasury. A well-designed tax minimises these excess costs.

Smith identified four specific ways in which taxes may impose excess burdens:

Source of Excess Cost	Adam Smith's Original Analysis
Large tax officer establishment	A great number of officers may be required for levying and collecting tax, whose salaries consume the greater part of the produce of the tax.
Tax that obstructs industry	A tax may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes.
Penalties and forfeitures	By the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals.
Harassment by tax collectors	By subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression.

4.6.2 The Concept of Deadweight Loss

Modern economics has formalised Smith's canon of economy through the concept of deadweight loss (also called excess burden or welfare cost of taxation). When a tax is levied on a good or activity, it changes relative prices, causing consumers and producers to alter their behaviour — consuming less, working less, or substituting toward untaxed alternatives. These

behavioural distortions reduce economic efficiency beyond the mere transfer of resources to the government.

The deadweight loss of a tax represents the value of transactions that no longer occur due to the tax — transactions that would have been mutually beneficial in the absence of taxation. The classic measure is the Harberger triangle in a supply-demand diagram: the area between the supply and demand curves in the region between the taxed and untaxed equilibrium quantities.

> **Ramsey Rule:**
> *The Ramsey Rule (1927) — an application of the economy canon — states that to minimise deadweight loss, taxes should be set inversely proportional to the price elasticity of demand. Goods with inelastic demand (e.g., necessities) should bear higher taxes to minimise behavioural distortion, while elastic goods should be taxed lightly. However, this conflicts with the equity canon, since necessities often consume a larger share of poor households' budgets.*

4.6.3 Administrative Economy

Beyond the theoretical concept of deadweight loss, the economy canon also demands administrative economy — the cost of running the tax machinery itself should be minimal relative to revenue collected. This encompasses:

- Staff costs: The number of tax officials and their remuneration.
- Technology costs: Investment in IT systems, data analytics, and enforcement infrastructure.
- Compliance costs: The time, money, and effort that taxpayers spend complying with the tax (recordkeeping, return preparation, professional fees).
- Litigation costs: Legal proceedings arising from tax disputes — a massive hidden cost in complex systems.

A widely used measure is the 'cost of collection ratio' — the administrative cost of collecting each unit of revenue. In well-administered systems, this ratio should be under 1%. India's income tax department's cost-revenue ratio has generally been below 0.75%, though the full cost including taxpayer compliance costs is much higher.

4.6.4 Simplification as Economy

One of the most powerful applications of the economy canon in modern policy is tax simplification. Complex tax codes impose high compliance costs on taxpayers, generate litigation, and require large administrative establishments. Simplification — reducing the number of rates, eliminating narrow exemptions, standardising procedures — can dramatically reduce excess burdens without sacrificing equity or revenue.

India's introduction of the Goods and Services Tax (2017) was partly motivated by the economy canon: replacing a fragmented cascade of central excise, state VAT, service tax, and local levies with a unified destination-based tax was designed to reduce compliance costs, eliminate tax-on-tax distortions, and simplify administration across the supply chain.

Compliance Cost Research:

International studies estimate that taxpayer compliance costs can amount to 5–15% of revenue collected — a massive deadweight loss. In developing economies with complex tax codes and poor digitisation, compliance costs are disproportionately high for small businesses. Every rupee saved in compliance cost is, from Smith's perspective, a tribute to the canon of economy.

4.7 Modern Principles of Taxation

Adam Smith's four canons were revolutionary and remain foundational. But they were formulated in the context of eighteenth-century economies — predominantly agricultural, pre-industrial, and without the complex financial instruments, multinational corporations, digital commerce, and global capital mobility that characterise contemporary economies. Modern tax theory has extended and supplemented the canons with additional principles better suited to present-day fiscal challenges.

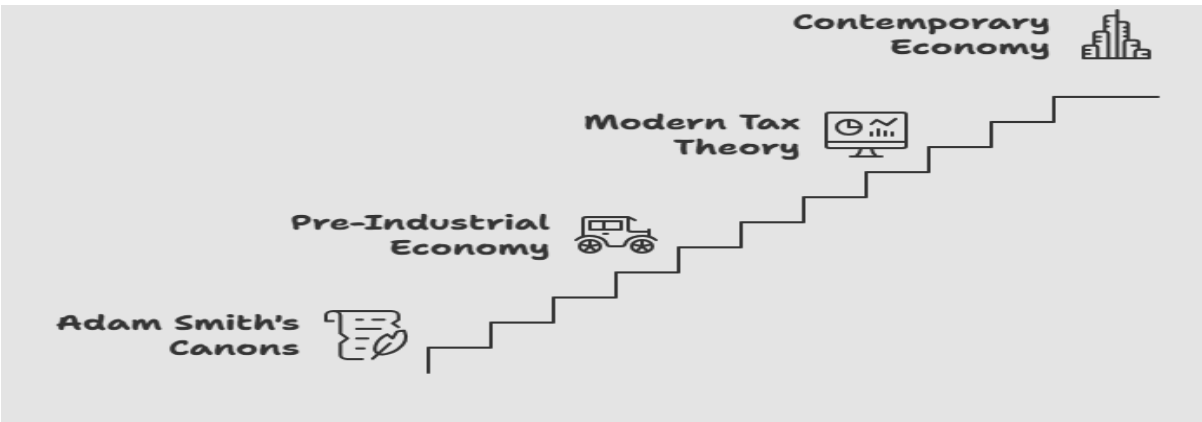

Figure 6: Evolution of tax theory

The modern principles of taxation are not replacements for Smith's canons but enrichments of them — responses to phenomena that Smith could not have anticipated: the rise of the welfare state, Keynesian fiscal stabilisation, globalisation, digital business models, and the challenge of sustainable development.

4.7.1 Overview

Principle	Core Idea	Application / Example	Goal
Equity	Horizontal & vertical fairness in tax burden.	Progressive income tax; GST exemptions for essentials.	Fairness

Efficiency / Neutrality	Minimum distortion of private economic decisions.	Broad base, low rates; uniform GST rates across sectors.	Allocative efficiency
Simplicity & Certainty	Easy to understand; no ambiguity in liability.	Single return filing; advance rulings; consolidated codes.	Compliance & trust
Productivity & Adequacy	Revenue must meet government expenditure needs.	Buoyant tax bases; reducing exemptions; base broadening.	Fiscal sustainability
Elasticity & Buoyancy	Revenue grows with economic growth automatically.	Income-elastic taxes; progressive rate structures.	Automatic stabilisation
Diversity	Multiple tax bases to spread fiscal risk.	Mix of direct and indirect taxes; property and wealth taxes.	Revenue stability
Ability to Pay	Burden based on taxpayer's economic capacity.	Surcharges on super-rich; exemptions for low incomes.	Social justice
Benefit Principle	Taxes linked to benefits received from public services.	Fuel levies for roads; user charges for services.	Allocative accountability
Minimum Tax Gap	System designed to minimise tax evasion and avoidance.	TDS, third-party reporting, GAAR, BEPS measures.	Revenue integrity
International Competitiveness	Tax system must attract and retain mobile capital.	Competitive corporate rates; treaty network; no BEPS.	Investment climate

4.7.2 Principle of Equity

Modern equity theory extends Smith's equality canon in two directions. First, it distinguishes horizontal equity (equal treatment of equals) from vertical equity (unequal treatment of unequals in proportion to their differences) — the latter justifying progressive taxation. Second, it incorporates intergenerational equity: tax systems should not unduly burden future generations through unsustainable deficits or environmental degradation that is left for posterity to remediate.

Equity is also increasingly understood to include gender equity (recognising the disproportionate burden of indirect taxes on women) and geographic equity (accounting for regional cost-of-living differences and differential access to public services).

4.7.3 Principle of Efficiency and Neutrality

Efficiency in taxation means that the tax system should cause the minimum possible distortion to the allocation of resources by market mechanisms. A neutral tax is one that does not change the relative prices of goods, services, labour, or capital — and therefore does not cause taxpayers to substitute untaxed for taxed activities. The ideal of tax neutrality is associated with the concept of a lump-sum tax (which cannot in practice be realised) or a comprehensive income/consumption tax with a uniform rate.

In practice, all taxes create some distortion. The efficiency principle, therefore, counsels designers to:

- Prefer broad-based taxes with low rates over narrow-based taxes with high rates (to minimise substitution effects).
- Avoid taxing inputs to production (cascading taxes), which distort production decisions across the supply chain.
- Align GST/VAT rates across sectors to minimise inter-sectoral distortions.
- Limit preferential rates, exemptions, and deductions that erode the base and require compensating rate increases.

4.7.4 Principle of Productivity and Fiscal Adequacy

The productivity principle holds that the tax system must yield sufficient revenue to meet the legitimate expenditure needs of the government. A tax system that is theoretically elegant but fiscally inadequate cannot sustain the public investments and services on which economic development depends. The fiscal adequacy principle requires that the tax-to-GDP ratio be adequate to finance essential public goods without recourse to excessive borrowing.

India's tax-to-GDP ratio — approximately 11–12% — is significantly below that of comparable economies and below the levels needed to finance the Sustainable Development Goals. Enhancing productivity through base broadening, reducing exemptions, and improving compliance is a major fiscal priority.

4.7.5 Principle of Elasticity and Buoyancy

A tax system is elastic if its revenue grows proportionately with the tax base (usually GDP or national income). It is buoyant if revenue grows more than proportionately, even without changes in tax rates. High elasticity and buoyancy are desirable because they allow government revenues to grow automatically with the economy, reducing the need for politically difficult tax rate increases and making the tax system an automatic fiscal stabiliser.

Buoyancy can be decomposed into:

- Base effect: Growth in the underlying tax base due to economic expansion.
- Compliance effect: Improvement in tax compliance as enforcement strengthens and the informal economy shrinks.

- Policy effect: Changes in tax rates, exemptions, or coverage that expand or contract the effective base.

4.7.6 Principle of Diversity

Over-reliance on a single tax source creates fiscal vulnerability: if that source contracts (e.g., corporate profits fall in a recession, or import duties decline due to trade liberalisation), government revenue falls sharply. The diversity principle requires that the tax system draw from multiple bases — income, consumption, property, wealth, and international trade — so that the revenue portfolio is resilient to economic shocks.

This principle also has an equity rationale: different taxes fall on different groups with different income and consumption patterns. A diverse tax mix can achieve a more equitable overall distribution of the tax burden than any single tax could accomplish alone.

4.7.7 Principle of Simplicity

The simplicity principle holds that the tax law and administrative procedures should be as clear, accessible, and straightforward as possible — minimising the compliance costs for taxpayers and the administrative costs for the government. Complex tax systems with multiple rates, extensive exemptions, frequent amendments, and opaque procedures are expensive to operate on both sides of the taxpayer-government relationship.

Simplicity supports:

- Voluntary compliance — taxpayers who understand their obligations are more likely to comply.
- Equity — wealthy taxpayers are better positioned to exploit complexity through aggressive tax planning; simpler systems level the playing field.
- Efficiency — reducing compliance costs is itself an efficiency gain.
- Transparency — citizens can hold their government accountable for its tax policies only if those policies are comprehensible.

4.7.8 Principle of Minimum Tax Gap

The tax gap — the difference between taxes legally owed and taxes actually collected — represents a major source of fiscal loss in most countries. It arises from three sources: non-filing (failure to submit returns), underreporting (declaring less than actual income or transactions), and underpayment (reporting correctly but failing to remit). Modern tax administration increasingly focuses on minimising the tax gap through:

- Third-party information reporting: Employers, banks, and businesses report income payments to the tax authority, enabling cross-matching with taxpayer declarations.
- Data analytics and AI: Machine learning models identify high-risk non-filers and underreporters for targeted audit.
- General Anti-Avoidance Rules (GAAR): Statutory provisions that deny tax benefits to transactions whose predominant purpose is tax avoidance.
- BEPS measures: The OECD/G20 Base Erosion and Profit Shifting project combats corporate tax avoidance through profit shifting across jurisdictions.

4.7.9 Principle of International Competitiveness

Globalisation has transformed the context of corporate taxation. In an era of mobile capital, multinational enterprises, and digital business models, countries compete for foreign direct investment partly through their tax systems. A country with an excessively high corporate tax rate risks capital flight, profit shifting, and loss of investment to lower-tax jurisdictions.

India reduced its base corporate tax rate from 30% to 22% (for existing companies) and introduced a concessional 15% rate for new manufacturing companies in 2019, recognising the international competitiveness dimension. The OECD's Pillar Two agreement on a Global Minimum Tax of 15% for large multinationals represents a collective effort to limit harmful tax competition while preserving some degree of national autonomy.

4.7.10 Principle of Sustainability

The sustainability principle — an addition relevant to twenty-first century fiscal policy — holds that the tax system should support rather than undermine the long-term sustainability of the economy, environment, and society. This encompasses:

- Environmental taxation: Carbon taxes, pollution levies, and natural resource royalties that internalise environmental externalities and incentivise green investment.
- Intergenerational equity: Avoiding tax structures that deplete natural capital or leave future generations with unsustainable public debt.
- SDG financing: Ensuring the tax-to-GDP ratio is adequate to finance the Sustainable Development Goals and long-term public investments.

4.8 Evolution: Smith's Canons and Modern Principles

Smith's four canons and the modern principles of taxation are not competing frameworks — they are successive layers of a cumulative body of tax wisdom. The canons provide the moral and practical foundations; the modern principles extend them to account for the complexity of contemporary economic life. The table below maps the evolution:

Smith's Canon	Modern Equivalent(s)	Key Evolution
Equality	Equity (horizontal & vertical) + Ability to Pay + Benefit Principle	Smith focused on proportionality; modern theory adds progressive taxation and multi-dimensional equity.
Certainty	Simplicity + Certainty + Minimum Tax Gap	Modern era adds anti-avoidance rules, advance rulings, and digital compliance tools.
Convenience	Simplicity + Digital Compliance + Withholding Systems	TDS, GST input credits, and mobile filing go far beyond Smith's era of paper assessment.

Economy	Efficiency + Neutrality + Low Administrative Cost	Modern economics adds deadweight loss analysis, optimal tax theory, and incentive effects.
(Not in Smith)	Productivity, Elasticity, Diversity, International Competitiveness, BEPS	New realities: welfare states, globalisation, corporate mobility, and digital economy taxation.

The most significant extensions in modern tax theory are:

- Optimal tax theory (Mirrlees, Diamond, Saez): Formal mathematical models that characterise the tax system minimising welfare loss subject to revenue and equity constraints.
- Behavioural tax policy: Drawing on insights from behavioural economics, tax design that accounts for cognitive biases, present-bias, and nudge effects on compliance.
- Digital economy taxation: New frameworks for taxing digital services that transcend traditional jurisdictional boundaries — addressing a gap Smith could never have anticipated.
- Global minimum tax: The Pillar Two framework — a collective departure from purely national tax sovereignty — represents a genuinely new principle absent from Smith's framework.

> **Enduring Relevance:**
> *Nearly 250 years after The Wealth of Nations, Smith's four canons remain embedded in every serious discussion of tax reform worldwide. The IMF's tax policy guidelines, the OECD's tax design principles, and India's Finance Commission reports all invoke, in modern dress, the core insights of equality, certainty, convenience, and economy that Smith articulated with such clarity and force.*

Chapter Summary

Topic	Key Takeaway
Meaning of Principles	Principles of taxation are the normative criteria — derived from economics, ethics, and public administration — that guide the design of a fair, efficient, and effective tax system.
Canon of Equality	Taxation should be proportional to the taxpayer's ability to pay. Every person should contribute in proportion to income derived from the state's protection.

Canon of Certainty	Each taxpayer must know with certainty the amount, manner, and timing of their tax liability. Arbitrary taxation destroys voluntary compliance.
Canon of Convenience	Taxes should be collected at the time and in the manner most convenient to the taxpayer — e.g., deduction at source, quarterly instalments.
Canon of Economy	The cost of collection must be minimised relative to the revenue yield. Taxes that consume a large fraction in administration are inefficient.
Modern Principles	Equity, efficiency, neutrality, simplicity, productivity, elasticity, diversity, ability to pay, benefit principle, minimum tax gap, international competitiveness — reflecting the complexity of modern economies.

Review Questions

1. What are the principles of taxation? Why are they necessary for sound tax policy design? Classify tax principles into equity, efficiency, administrative, and revenue categories.
2. State and explain Adam Smith's four canons of taxation. Why did Smith consider these maxims essential for a just and efficient tax system?
3. 'The canon of equality is the most important of Smith's canons.' Do you agree? Discuss the relationship between equality, the ability-to-pay principle, and progressive taxation.
4. Examine the canon of certainty. What are the consequences of tax uncertainty for investment and compliance? How do advance rulings and clear legislation promote certainty?
5. Explain the canon of convenience with examples from the Indian tax system. How has the digital revolution enhanced tax convenience?
6. What is the canon of economy? Explain the concept of deadweight loss and its relationship to the economy canon. How does the Ramsey Rule apply this principle?
7. Critically evaluate the modern principles of taxation. In what ways do they extend Adam Smith's framework to meet the challenges of contemporary economies?

Chapter 5:
Taxable Capacity

- Meaning of Taxable Capacity
- Factors Affecting Taxable Capacity
  - Income Level
  - Standard of Living
  - Economic Development
  - Population
- Absolute and Relative Taxable Capacity
- Importance of Taxable Capacity in Tax Policy

Concepts	**Factors**	**Policy**
Meaning • Definitions Absolute vs Relative	Income • Living Standards Development • Population	Tax-to-GDP Ratio Indian Examples & Reform

5.1 Meaning of Taxable Capacity

Every economy has a finite capacity to bear the burden of taxation. Beyond a certain threshold, additional taxation begins to harm economic activity, depresses savings and investment, erodes the productive base, or imposes unacceptable hardship on households. The concept of taxable capacity captures this frontier — the maximum level of taxation an economy can sustain without causing economic deterioration or social distress.

Taxable capacity is thus a normative and analytical benchmark: it defines the upper limit of what the government can legitimately and sustainably extract from the economy through taxation. It is distinct from what the government actually collects (the tax-to-GDP ratio) and from what it needs to collect (the expenditure requirement). The gap between actual tax collection and taxable capacity reveals the untapped fiscal potential of an economy — sometimes called the 'tax effort gap'.

> **Findlay Shirras:**
> *Taxable capacity is the limit which is reached when the taxpayers feel that they cannot pay any more and which, if transgressed, will lead to disorder and social upheaval.*

> **J.S. Mill:**
> *The maximum amount which can be raised by taxation consistently with leaving the taxpayers sufficient income to meet their subsistence and customary requirements and to maintain the economy's productive capacity.*

> **Colin Clark:**
> *Based on empirical research across multiple countries, Clark proposed that when government taxation exceeds approximately 25% of national income, inflation and economic instability tend to follow — suggesting this as an approximate ceiling for taxable capacity.*

5.1.1 Taxable Capacity: A Multi-Dimensional Concept

Taxable capacity operates simultaneously on several planes:

Dimension	Explanation
Economic Dimension	The surplus of national income over subsistence and essential private expenditures — the pool from which tax revenue can be drawn without harming the economy's reproductive capacity.
Administrative Dimension	The government's capacity to identify, assess, and collect taxes effectively. Even if the economic base is large, weak administration limits effective taxable capacity.
Political Dimension	The politically tolerable limit of taxation — the level beyond which taxpayer resistance, electoral backlash, or social unrest constrains tax extraction, regardless of theoretical economic capacity.
Legal-Constitutional Dimension	The limits imposed by constitutional provisions, treaty obligations, and legal exemptions on the government's power to tax.
Behavioural Dimension	The point at which higher tax rates cause behavioural changes — tax evasion, capital flight, labour supply reduction — that reduce total tax yield despite higher rates (the Laffer curve effect).

5.1.2 Taxable Capacity vs. Tax Effort

Two related but distinct concepts illuminate fiscal analysis:

- Taxable capacity: The maximum revenue a country could raise given its economic structure and development level.
- Tax effort: The actual tax collection as a proportion of the estimated taxable capacity. A low tax effort indicates that the country is not exploiting its potential — a structural compliance or administrative failure.

IN Indian Context — Tax Effort Gap

India's estimated taxable capacity is approximately 20-22% of GDP, based on studies by economists using structural models that account for income levels, economic structure, and trade openness. India's actual tax-to-GDP ratio (combined Centre and States) is approximately 11-12%. This implies a tax effort ratio of barely 55-60% — meaning India collects only about 55-60 paise of every rupee it is theoretically capable of collecting. The gap — estimated at 8-10% of GDP — represents the fiscal cost of informality, agricultural exemptions, tax expenditures, and compliance deficits.

5.1.3 The Laffer Curve and Taxable Capacity

The Laffer Curve — popularised by economist Arthur Laffer in the 1970s — provides a simple but powerful illustration of the upper boundary of taxable capacity. It shows that total tax revenue is zero at both a 0% tax rate (no tax) and a 100% tax rate (all income confiscated; no incentive to produce). Between these extremes, there is a revenue-maximising tax rate — the peak of the Laffer Curve — beyond which higher rates reduce economic activity and compliance so severely that total revenue falls.

The taxable capacity ceiling corresponds approximately to the Laffer Curve peak: the tax rate (and corresponding revenue level) beyond which further taxation is self-defeating. Identifying this peak empirically is difficult, but the concept clearly demonstrates that taxable capacity is finite and that over-taxation is counterproductive.

IN Indian Context — Laffer Effect in India

India's reduction of the peak income tax rate from 97.75% (1973-74) to 30% (current) is a textbook application of Laffer Curve reasoning. When marginal rates were near 100%, tax avoidance and evasion were pervasive — a 1978 Wanchoo Committee report estimated black money equal to the entire tax revenue. After rate reductions under the 1985 Rajiv Gandhi budget and subsequent reforms, direct tax revenue as a proportion of GDP increased substantially as compliance improved and avoidance diminished.

5.2 Factors Affecting Taxable Capacity

Taxable capacity is not fixed or immutable — it is shaped by a complex of economic, demographic, social, and institutional factors that determine how large a surplus the economy generates above essential private consumption, and how readily that surplus can be tapped through the tax system. Understanding these factors is essential for realistic fiscal planning, tax reform design, and development strategy.

Factor	General Principle	Indian Illustration	Dimension
Income Level	Higher national and per capita income expands the surplus available for taxation.	India's rising per capita income (₹1.97 lakh, FY24) has steadily expanded the income tax base.	Primary determinant
Standard of Living	High living standards leave more surplus beyond subsistence, increasing taxable capacity.	Urban middle class has higher taxable capacity than rural poor despite similar nominal income.	Consumption-side gauge
Economic Development	Industrialisation, formalisation, and financial deepening create broader, more taxable economic activities.	Post-1991 liberalisation expanded the corporate and services tax base dramatically.	Structural determinant
Population Size & Structure	Large, young, and productive populations widen the potential taxpaying base.	India's demographic dividend: 600+ million working-age population is a fiscal asset if formalised.	Demographic dimension
Wealth & Asset Distribution	Concentrated wealth may indicate high individual capacity but narrow aggregate base.	India's wealth is highly concentrated; low property tax collection despite rising asset values.	Equity dimension
Nature of Economy	Monetised, formal, and service-based economies are more easily taxed than informal, subsistence ones.	India's informal sector (≈45% of GDP) substantially reduces effective taxable capacity.	Formalisation gap

Expenditure Commitments	High unavoidable private expenditures (food, healthcare, education) reduce surplus for taxation.	High out-of-pocket health spending (60%+ of total) reduces household taxable surplus.	Burden-side factor
Fiscal Deficit & Debt	Existing debt service obligations reduce the government's effective taxable capacity by pre-empting revenue.	India's central debt-to-GDP (≈58%) constrains net fiscal space from taxation.	Fiscal space factor

5.2.1 Income Level

Income is the most fundamental determinant of taxable capacity. The relationship is straightforward: a higher level of national income and per capita income means a larger surplus over subsistence needs, which is the economic base from which taxation can be drawn. As income rises, a progressively smaller share is needed for bare necessities, and a progressively larger share is available as a 'surplus' that can be taxed without impairing living standards or productive capacity.

This relationship operates at both the aggregate and individual level:

- At the aggregate level: A higher GDP provides a larger base for both direct and indirect taxation. A 1% tax rate on a ₹300 lakh crore economy yields three times more revenue than on a ₹100 lakh crore economy.
- At the individual level: A person earning ₹50 lakh can afford to pay 30% in income tax and still maintain a comfortable standard of living. A person earning ₹3 lakh cannot afford to pay 30% without severe hardship.

Income Elasticity of Taxable Capacity

The relationship between income and taxable capacity is more than proportional: as income rises, taxable capacity grows faster than income itself. This is because subsistence expenditures (food, clothing, basic shelter) are relatively fixed in absolute terms, so the surplus above them — the taxable margin — grows at a faster rate than total income. This is why the tax-to-GDP ratio tends to rise with economic development, even without changes in tax rates.

IN Indian Context — India's Income Growth and Tax Base Expansion

India's nominal GDP grew from approximately ₹45 lakh crore in 2010-11 to over ₹295 lakh crore in 2023-24 — more than a 6.5-fold increase. Over the same period, gross tax revenue grew from approximately ₹7.9 lakh crore to over ₹33 lakh crore — more than a 4-fold increase in absolute terms, though the tax-to-GDP ratio remained relatively stagnant at 10-11%. The muted response of the tax ratio despite income growth reflects the structural factors — large informal sector, agricultural exemption, and tax expenditures — that constrain India's effective taxable capacity.

Per Capita Income and the Tax Threshold

India's income tax system treats the threshold of exemption and the slabs within its progressive structure on the basis of per capita income. The income exemption limit in the context of progressive taxation duly captures the level of income at, which the taxable capacity is considered is zero. With this increase in income per capita, more people cross this line and come under the tax net - a natural widening of the income tax base with no alteration in rates. A number of factors have also grown significantly along the lines of income, confirming reports of both growing incomes and compliance — both of which broaden effective taxable capacity in India The number of income-tax filings in India increased from around 3.8 crore in 2013-14 to over 8 crore in 2023-24.

Agricultural Income and the Capacity Gap A major peculiarity in India's tax structure is that agricultural income is exempt from central income tax (it is in fact a matter of constitutional obligation to keep the two separate; Article 246 read with Entry 82 of the Union List which excludes agricultural income from the Centre's taxing power). Agriculture accounts for nearly 18-20% of India's GDP. Exempting such a large base of income is a conscious political decision that drastically constrains the effective taxable capacity of India. It is estimated that taxing agricultural incomes beyond a reasonable limit could bring in additional revenue amounting to 0.3-0.5% of GDP.

5.2.2 Standard of Living

Living standards are closely related to capacity to tax, but the correlation is more complicated than a simple income-level one. Living standards are the quality and quantity of goods and services consumed by households and the related lifestyle of these households. Two countries with the same income per capita can have vastly different living standards and so different capacities to tax. The key point is that taxable capacity is a function not only of how much people make (the income side of the ledger) but also what they have to spend to live at want to live (the expenditure side). The difference between income and necessary expenditure – the surplus – is that which can be taxed.

The Subsistence vs. Surplus Frame of Reference Economists have traditionally identified:

• Subsistence-related expenditures: The minimum consumption needed to maintain one's physical health and social engagement ─ food, clothing, basic shelter, healthcare, education for children, and other basics of daily life.

• Other related spending: Costs associated with maintaining a socially-acceptable living standard for a particular class or group – a culturally articulated normative standard which can change widely from one society to another.

• Surplus: The income that is left after subsistence and other 'normal' expenditures, and the real economy amenable to taxation.

A society with a high standard of living but equally high conventional expenditure requirements (such as expensive housing markets, private education costs, or high medical care costs) may have a smaller effective surplus than a lower-standard-of-living society with lower conventional expenditure norms.

IN Indian Context — Urban vs. Rural Taxable Capacity in India

Urban and rural populations in India are so different in terms of income and living standards. Urban residents have higher incomes and higher costs of living—rental housing, private schooling, private healthcare and urban transport take up large portions of urban income. Rural houses have less income but also less norms-based consumption to fulfil. Yet, significant out-of-pocket expenditure on health in rural India (health spending is more than 60% privately financed on average) and on food (which makes up 50-55% of rural, compared to 30-35% of urban household budgets) reduce rural taxable surplus. This spatial aspect of taxable capacity is encoded in India's income tax regime: urban salaried class pays a higher share of income tax and rural income is largely untaxed.

Cost of Living Adjustments

The living standard factor also implies that comparisons of taxable capacity between areas must consider differences in price levels. A family of four making ₹10 lakh in Mumbai has to spend far more on essentials than a family making the same income in a Tier-II or Tier-III city — and is thus left with lesser effective taxable surplus despite earning same nominal income. This is partially taken care of by the standard deductions and HRA exemptions in India' income tax.

5.2.3 Economic Development

Economic development — the structural transformation of an economy from low-productivity, subsistence-oriented, and informal activities toward high-productivity, diversified, formal, and technologically advanced activities — is one of the most powerful drivers of expanding taxable capacity. Development increases taxable capacity through multiple channels simultaneously.

Channels Through Which Development Expands Taxable Capacity

Channel	Mechanism
Income Growth	Development raises per capita income, directly expanding the surplus available for taxation as analysed above.
Formalisation	As businesses register, maintain accounts, and transact through the banking system, their income and transactions become visible and taxable.
Urbanisation	Urban economic activities — manufacturing, services, trade — are more easily identified and taxed than dispersed rural subsistence activities.

Financial Deepening	Developed financial markets create records of income, investment, and transactions — essential information for accurate tax assessment.
Infrastructure Development	Roads, power, and connectivity reduce the cost of doing business formally, increasing the incentive to formalise and the coverage of the tax net.
Human Capital Development	Higher education and literacy improve taxpayers' ability to understand and comply with tax obligations, increasing voluntary compliance.
Institutional Strengthening	Development builds stronger tax administration — better IT systems, more skilled officials, clearer laws — expanding effective collection capacity.

IN Indian Context — Post-1991 Liberalisation and India's Expanding Tax Base

The liberalisation of the Indian economy from 1991 onwards had multiple effects on its taxable capacity. This growth was on the back of a burgeoning base of income and consumption, as GDP grew by an average 6-7% annually. Services — IT, telecom, financial services, retail — expanded from less than 40% of GDP to more than 55%, and brought large swathes of activity that was previously untaxed, or under-taxed, into the formal economy. Corporate India grew exponentially, with listed companies' profits as an increasingly significant source of corporate taxes. The introduction of the Permanent Account Number (PAN) system and the Tax Information Network (TIN) as well as the Annual Information System (AIS) have contributed to the enhancement of the administrative capacity to tax by making the income flows more visible.

The Informal Sector as a Constraint on Taxable Capacity

A large informal sector constitutes the single most important structural bottleneck to India's potential taxable capacity. The informal economy — made up of unregistered enterprises, day labor, and subsistence farming — produces income and activity that is mostly invisible to the tax apparatus. Estimates India's informal economy is 45-50% of GDP & employs 80-90% of workforce.

India's GST rollout (2017) has made inroads into this problem by mandating businesses above a turnover of ₹40 lakh to register, to generate invoices digitally and to file returns. The growth of GST registration has been from around 65 lakh taxpayers at the time of rollout to over 1.4 crore by 2024, providing a sizeable formalisation dividend and increasing the effective taxable capacity.

5.2.4 Population

Population is a complex effect on taxable capacity. At its most basic level, more people means more potential taxpayers — more people to pay individual income tax, more consumers to produce GST, more property owners to pay local taxes. But the link between population and taxable capacity is not straightforward, being influenced by the population's age structure, productivity, employment and income distribution.

The Size of the Population:- A larger population other things being equal results in a larger base for the per-capita taxes. India's 1.4bn population presents the world's largest potential tax base. Yet 'all else' is very rarely equal — India's large population is accompanied by low per-capita income, huge numbers of subsistence farmers, and a massive informal economy. The vast population leads to a theoretically large tax base, but structural factors constringe the percentage of tax paying population with any meaningful taxable capacity.

Age Structure and Dependency Ratios

The taxable capacity of a population depends largely on its age-structure, since:

• A young population (large proportion of children and teenagers) has a high dependency ratio — more mouths to feed that do not work per working adult, which leads to less taxable surplus per household.

• Working age population (15-64 years) is the main source of taxable income. A high proportion of working adults (the "demographic dividend") indicates more potential taxpayers per capita.

• An elderly (large proportion of aged) population tends to reallocate the sources of income from wages (which are easily taxed) towards pensions and transfers (which are often tax-exempt or lightly taxed), which may lead to a decline in the taxable capacity in the future.

IN **Indian Context — India's Demographic Dividend**

India is reaping the rewards of its demographic dividend – the working-age population (ages 15-64) is the largest it has ever been, and will remain so for the coming decades. By 2024, about 68% of the population of India is between the working ages with nearly 600 million of its people of working age. That is a huge potential expansion of India's taxable capacity – if these people are productively employed, in formal employment, and getting paid above the tax threshold. If at least 30 per cent of working-age Indians were formal-sector income taxpayers, direct tax revenues in India would rise dramatically, the economic survey of India has on several occasion highlighted this fiscal aspect of demographic dividend. Realizing this potential requires investments in education, skill development, and formalization – a long-run challenge for taxable capacity.

Population density and taxable capacity of the local government Population density influences the administrative aspect of the taxable capacity. Urban areas with a high population density are much less expensive to administer – per capita administrative cost of assessing, collecting and enforcing taxes is much lower in Mumbai or Delhi than in the scattered population of rural Rajasthan or tribal populations of the Northeast. Due to the geographic

concentration of the population, of India, there are thus considerable differentials in administrative taxable capacity within the country.

Rate of Population Growth A burgeoning populace imposes fiscal strain in two conflicting directions: it increases the long-run taxpaying foundation (long-term positive for taxable capacity) but it also raises present demands upon education, health, and infrastructure expenditures on the public. Where population growth exceeds economic growth, per-capita income stagnates and taxable capacity remains constrained even as the population grows.

5.3 Absolute and Relative Taxable Capacity

The concept of taxable capacity must be further refined by distinguishing between its absolute and relative dimensions. This distinction is crucial in the context of fiscal federalism, intergovernmental transfers, and cross-country comparisons of tax systems.

5.3.1 Overview Comparison

Dimension	Absolute Taxable Capacity	Relative Taxable Capacity
Definition	The maximum amount of revenue a government can raise through taxation without causing serious economic harm or reducing productive capacity.	The comparison of the taxable capacity of two or more countries, states, or regions in relation to their relative ability to bear taxes.
Focus	The absolute ceiling on tax revenue — what is the maximum the economy can yield?	Comparative analysis — who can bear more tax relative to their economic position?
Measurement Basis	National income, consumption base, wealth stock, and institutional tax administration capacity.	Per capita income differentials, cost-of-living differences, public expenditure needs, and economic structure.
Time Frame	A snapshot of the economy's maximum fiscal yield at a given time under given conditions.	Dynamic comparison across jurisdictions over time, adjusting for structural differences.
Policy Use	Setting the upper limit for the tax-to-GDP ratio; identifying fiscal headroom.	Intergovernmental fiscal equalisation — Finance Commission devolution formula; grants-in-aid.

Indian Application	India's absolute taxable capacity is often estimated at 20-22% of GDP; actual tax-to-GDP is ≈11-12%, suggesting substantial unrealised capacity.	States with higher per capita income (Goa, Maharashtra) have greater relative taxable capacity than poorer states (Bihar, UP) — the basis for Finance Commission equalisation.
Key Limitation	Difficult to measure precisely; depends on contested assumptions about the limits of taxation without harm.	Comparison is sensitive to the choice of benchmark state and adjustment methodology.

5.3.2 Absolute Taxable Capacity

The term 'absolute taxable capacity' means the amount of tax revenue which the government can collect from an economy without adversely affecting economic activity or productive capacity, or without inflicting undue social pain. It is, in effect, the limit on the tax-to-GDP ratio for an individual country at an individual point in time.

There are various ways to try and measure absolute taxable capacity:

- Income approach: National income above subsistence and customary consumption.
- Regression approach: Perform cross-country regression of tax revenue on structural variables (per capita income, share of mining, trade openness, urbanisation) and use the result to estimate a 'normal' tax level for a given country based on it's substitute.
- Production function approach: Determines the highest tax that can be imposed while maintaining the capital stock and labour force at levels consistent with sustainable growth.
- Historical precedent: Consider the path of countries of similar development levels that housed 'tax havens' with comparably high tax to GDP ratios without significant economic disruption.

IN Indian Context — India's Absolute Taxable Capacity: The IMF Estimate

IMF studies using structural regression models consistently estimate India's absolute taxable capacity at approximately 20-22% of GDP. This estimate accounts for India's income level, economic structure (large agriculture, growing services), trade openness, and institutional development. India's actual combined (Centre plus States) tax-to-GDP ratio of approximately 11-12% is thus well below its estimated absolute capacity — suggesting that the binding constraint is not economic capacity but administrative effectiveness, structural informality, and deliberate tax expenditure policy (exemptions, deductions, and preferential rates that reduce effective tax collections).

5.3.3 Relative Taxable Capacity

Relative taxable capacity is the comparative capacity of jurisdictions, whether these are states within a federation or countries in an international setting, to raise revenue from their own economies at similar levels of tax effort. It is a relational concept: Jurisdiction A is said to have higher relative taxable capacity than B if and only if A can raise more revenue at the same tax rates applied to similar tax bases.

Relative taxable capacity is calculated by:

- Per capita income differences: Richer jurisdictions have higher income per capita and, in turn, larger tax bases per resident.
- Economic structure: Regions that specialise in formal, industrial or services-based production have more taxable economies.
- Natural resource endowments: Mineral-rich states can also raise a part of their revenue through royalties and mining levies on their natural wealth, making them tax capacity defying states.
- Urbanisaion: more urbanated areas have densified, more formal economic activity that is less costly to collect from.

IN Indian Context — Inter-State Relative Taxable Capacity: Finance Commission Analysis

The most important use of relative taxable capacity in India is in the Finance Commission's devolution formula. The 15th FC adopted the 'income distance criterion' to account for inter-state variations in relative taxable capacity: it compares each state's per capita income to that of the three richest states (used as a benchmark), and states with higher differences are entitled to receive higher shares of devolution of central taxes. This meant that Bihar, Uttar Pradesh, and Madhya Pradesh — the states with the lowest per capita incomes — again received highest devolution per capita under the income distance criterion in 2024-25, somewhat compensating for their low intrinsic taxable capacities. On the other hand, Goa (per capita income above ₹5 lakh and one of the highest in India) and Maharashtra were given less per-capita devolution reflecting higher relative taxable capacity.

5.3.4 Absolute vs. Relative: The Equalisation Logic

The difference between absolute and relative taxable ability is at the basis of the logic of fiscal equalisation in federal systems.

Consider two states:

- State A (High Capacity): Per capita GSDP of ₹4 lakh, urban, industrialised. At a common 15 % own-tax effort, State A raises ₹60,000 per capita in own-state taxes — enough to provide for reasonable public services.
- State B (Low Capacity): Per capita GSDP of ₹1 lakh, largely rural, large agricultural sector. With the same 15% hard work, State B is able to raise only ₹15,000 per capita – which is inadequate for providing similar public services. If citizens in both states

deserve similar public services (education, healthcare, roads), the system cannot provide these solely through state own-revenues. Central transfers to State B are not charity — rather, they serve as a vehicle for equalising the capacity to deliver common public services, to redress for the gap in relative taxable capacity.

4.4 Importance of Taxable Capacity in Tax Policy

The concept of taxable capacity is not merely an academic abstraction — it is a practical policy tool of the highest importance. An accurate understanding of a country's taxable capacity — and the factors that constrain or expand it — is indispensable for effective fiscal governance, rational tax reform, and sustainable economic development.

Policy Role	Principle	Indian Application
Setting the Tax Ceiling	Prevents over-taxation that can shrink the tax base, depress investment, or trigger capital flight.	FRBM norms and Finance Commission caps on state borrowing reflect recognition of taxable capacity limits.
Determining Tax-to-GDP Ratio Targets	Guides medium-term fiscal consolidation plans and revenue mobilisation strategies.	India's Medium-Term Expenditure Framework (MTEF) targets raising tax-to-GDP from ~11% toward 15-16%.
Designing Rate Structures	Informs where marginal rates can be raised without harming behaviour or reducing yield.	Introduction of surcharges on high incomes (>₹50 lakh); 37% surcharge above ₹5 crore.
Intergovernmental Transfers	Finance Commissions use relative taxable capacity to equalise fiscal resources across states.	15th FC's income distance criterion — states below national average receive larger devolution shares.
Tax Expenditure Analysis	Helps assess which exemptions and deductions can be withdrawn without exceeding taxable capacity.	Rationalisation of Section 80C deductions and removal of LTCG exemption (Budget 2018).
Development Planning	Identifies the domestic resource mobilisation needed to finance public investment without external borrowing.	India's Five-Year Plans estimated taxable capacity alongside outlays to determine feasibility.

Debt Sustainability	Taxable capacity determines the government's ability to service and reduce debt burdens.	India's debt-to-GDP ratio management: RBI's fiscal sustainability reports reference taxable capacity benchmarks.
Informal Sector Policy	Measuring the gap between actual and potential taxable capacity reveals the cost of informality.	GST's widening of the tax net and Jan Dhan-Aadhaar-Mobile (JAM) Trinity aim to reduce informality.

5.4.1 Tax-to-GDP Ratio as the Operational Measure

In practical policy analysis, taxable capacity is generally by proxy embodied in the tax-to-GDP ratio — the share of national income that is claimed as tax revenue. This indicator is by far the most commonly used reference point for evaluating the performance of a country in terms of fiscal mobilization. An unusually low ratio of tax revenue to GDP compared to what would be expected on the basis of capacity indicates underachievement, and a taxing close to the capacity ceiling implies that the economy will be considered to be taxing its potential to the fullest.

Country	Tax-to-GDP	Assessment	Key Driver
Denmark	46.5%	Very High	Universal welfare state; high income levels; strong compliance culture.
France	45.4%	Very High	Comprehensive social security; VAT at 20%; high income taxes.
Germany	39.5%	High	Social insurance contributions; progressive income tax.
United Kingdom	33.5%	High	Broad income tax base; NICs; 20% VAT.
Brazil	33.5%	High (for developing)	High indirect taxes; social contributions; significant complexity.
South Africa	27.0%	Moderate-High	Broad income and VAT base; progressive income tax.
China	21.0%	Moderate	VAT and enterprise income tax dominant; growing middle class.

India	**11.5%**	Low (relative to potential)	Large informal sector; narrow direct tax base; compliance gaps.
Pakistan	10.5%	Low	Narrow base; agricultural exemption; significant evasion.
Bangladesh	9.0%	Very Low	Heavily trade-dependent revenues; low income levels.

IN **Indian Context — India's Tax-to-GDP Challenge**

India's combined (Centre plus States) tax-to-GDP ratio of approximately 11-12% is significantly below that of comparable large emerging economies and well below the estimated 20-22% absolute taxable capacity. The IMF and World Bank have consistently highlighted this gap as a major constraint on India's development financing. The 15th Finance Commission's Fiscal Strategy Report noted that India needs to raise its tax-to-GDP ratio by at least 3-4 percentage points to finance the National Infrastructure Pipeline (NIP), achieve the Sustainable Development Goals, and reduce dependence on market borrowings. Key levers identified include: rationalising GST exemptions (currently over 200 exempted categories), bringing more high-income individuals into the direct tax net, improving property tax collection at the local body level, and phasing in taxation of large agricultural incomes above a reasonable threshold.

5.4.2 Taxable Capacity and the Finance Commission

The devolution formula of the Finance Commission of India is so structured as to factor in the notion of taxable capacity — specifically relative taxable capacity among the States. The income distance principle (explained in Section 4.3) normalises relative taxable capacity to calculate the amount of equalisation transfers on the horizontal. The 15th Finance Commission assigned the highest weightage of 45 % to the income distance in its devolution formula, which is the largest weight, signify the primacy of relative taxable capacity in intergovernmental fiscal equity.

Furthermore, Finance Commissions examine the states' own tax effort (at what rate do particular states tap their potential taxable capacity) and suggest grants or corrective measures to encourage fiscal endeavor. The 15th FC's criterion for rewarding fiscal discipline (weight 3%) had an impact favoring states with lower fiscal deficits and better revenue performance, though it was also a model of the tax effort aspect of taxable capacity."

5.4.3 Tax Expenditure and Taxable Capacity

Tax expenditures—such as the Revenue that is foregone in consequence to exemptions, deductions, preferential rates, and credits—are a constraint on an effective taxable capacity that is self-appplied. India’s annual Revenue Foregone Statement(now called Statement of

Revenue Impact of Tax Incentives) reveals that tax expenditures in the form of direct and indirect taxes run into several lakh crore of rupees every year. Streamlining such expenditures – abolishing antiquated, wasteful, or unequal exemptions – is one of the quickest ways to increase effective taxable capacity without raising nominal tax rates.

IN Indian Context — Tax Expenditure Reform: Budget 2020 New Tax Regime

An optional scheme that would have lower tax rates of 5%, 10%, 15%, 20%, 25% and 30% and forgo most deductions and exemptions (Section 80C, 80D, HRA, LTA, standard deduction as per the old regime) was introduced under Union Budget 2020 for individuals – the New Tax Regime. It was meant to simplify the tax system and reduce tax expenditures — increasing effective taxable capacity by broadening the base even while lowering rates. The Finance Ministry also said that moving completely to the new regime could lead to a substantial increase in the number of taxpayers paying tax without gaming exemptions.Budget 2023 made the new regime for individual taxpayers as the default option, a further strong reinforcement of this policy direction.

5.4.4 Taxable Capacity and Debt Sustainability

The taxable capacity is what ultimately limits the ability of a government to roll over its public debt. The size of the primary balance necessary to stabilise the debt-to-GDP ratio is a function of the interest rate-growth differential and the initial debt level -- but the ability of the government to run such a primary surplus is limited by its taxable capacity. High debt and low taxable capacity: these two key ingredients are a recipe for fiscal vulnerability, as countries cannot service their debts without either raising taxes beyond what they can bear, or cutting spending that supports development.

India's central government debt to GDP ratio of about 57-58% needs to be supported by primary surpluses(or small deficits) on steady basis to prevent build up of debt. Increasing the taxable capacity by means of formalisation, broadening the tax base, and better compliance is thus a revenue goal and a debt sustainability consideration.

5.4.5 Taxable Capacity in Development Planning

India’s tradition of planning—from the Planning Commission’s five-year plans to the National Infrastructure Pipeline and a Viksit Bharat @2047 roadmap today—has always had to face up to the constraint of taxable capacity. Development plans demand heavy upfront public investment in infrastructure, in health, in education—but the financing of that investment is contingent ultimately on the government’s capacity to extract domestic resources through taxation.

The fiscal strategy documents of NITI Aayog and the Medium-Term Expenditure Framework (MTEF) of the Ministry of Finance include projections relating to the financing of development, incorporating assumptions on the potential for ex-ante assessment of taxable capacity and tax mobilisation. Realistic development planning requires aspirational expenditures to be factored with an informed view of what the economy can be taxed at – not over-estimating taxable capacity (thereby causing unfinanceable deficits) and certainly not under-estimating it (thereby dis-investing the development aspirations).

IN Indian Context — Viksit Bharat and the Taxable Capacity Imperative

India's vision of reaching developed nation status (Viksit Bharat) by 2047 — with a GDP of $30-35 trillion — entails a gigantic magnification of taxable capacity. A$30 trillion economy at the modest tax-to-GDP ratio of 12 per cent would imply about $3.6 trillion in annual tax revenues. It would give three times as much as now, that is $6 trillion, at a realistic potential of 20 per cent. This massive growth in taxable capacity over a quarter century would require sustained GDP growth, hastened formalisation, digitisation of the economy (making tax identification easier), property tax reform, and gradual rationalisation of exemptions. The fiscal math of Viksit Bharat is in essence a fiscal math of expanding taxable capacity.

Chapter Summary

Topic	Core Concept	Indian Dimension
Meaning of Taxable Capacity	The maximum revenue a government can raise through taxation without impairing the economy's productive capacity or taxpayers' welfare.	Defined by Findlay Shirras as the limit beyond which taxation causes economic harm.
Factors — Income Level	Higher income = larger surplus = greater taxable capacity. India's per capita income growth is the single most important driver of expanding taxable capacity.	Direct income tax base has grown with rising incomes; however, agriculture remains exempt.
Factors — Standard of Living	High living standards indicate surplus beyond subsistence, enabling higher taxation. However, costs of living affect net taxable surplus.	Urban India has higher taxable capacity per rupee of income than rural India due to higher incomes and lower subsistence costs.
Factors — Economic Development	Industrialisation, formalisation, and financial deepening expand and diversify the tax base.	Post-1991 liberalisation transformed India's tax base from trade taxes to income and services taxes.
Factors — Population	Large working-age populations expand the potential taxpaying base, but young and poor populations reduce average capacity.	India's demographic dividend is a long-run fiscal asset contingent on formalisation and skill development.

Absolute Taxable Capacity	The maximum tax revenue attainable by a single country. India's estimated at 20-22% of GDP; actual collection at ~11-12% reveals a significant gap.	Gap explained by informality, agricultural exemption, compliance deficits, and tax expenditures.
Relative Taxable Capacity	Comparative capacity among states or countries, used in equalisation. Finance Commission uses income distance to adjust inter-state transfers.	Maharashtra and Goa have high relative capacity; Bihar and UP have low capacity — a key driver of devolution formula design.
Importance in Tax Policy	Guides rate-setting, devolution, debt management, development planning, and informal sector policy.	Critical for India's goal of raising tax-to-GDP ratio toward 15-16% to finance SDGs and public investment.

Review Questions

1. Define taxable capacity. Distinguish between the economic, administrative, political, and behavioural dimensions of taxable capacity. What is the relationship between taxable capacity and the Laffer Curve?
2. Explain the concept of tax effort. Why does India's actual tax-to-GDP ratio fall significantly below its estimated taxable capacity? What structural factors explain this gap?
3. Critically analyse the role of income level as a determinant of taxable capacity. How has India's income growth since 1991 affected its taxable capacity, and what structural constraints have limited its realisation?
4. 'Standard of living both reflects and constrains taxable capacity.' Discuss this statement with reference to the distinction between subsistence and conventional expenditures in the Indian context.
5. Examine the relationship between economic development and taxable capacity. How does formalisation of the economy expand India's effective taxable capacity?
6. Explain how population size, age structure, and the demographic dividend influence taxable capacity. What is the fiscal significance of India's current demographic profile?
7. Distinguish between absolute and relative taxable capacity. How does the Finance Commission of India use the concept of relative taxable capacity in designing its devolution formula?
8. Discuss the importance of taxable capacity in tax policy design. How does taxable capacity inform decisions about tax rates, exemptions, intergovernmental transfers, and debt management in India?

Chapter 6:
Incidence of Taxation

- Meaning of Incidence of Taxation
- Impact and Incidence of Tax
- Tax Shifting
- Forward and Backward Shifting
- Tax Evasion and Tax Avoidance
- Effects of Tax Incidence on Consumers and Producers

\Who ultimately pays a tax? The entity that writes a cheque to the government is rarely the entity that bears the economic burden of that tax. The gap between the two — between the legal and economic incidence of taxation — is one of the most consequential questions in public finance. Its answer determines whether a tax system is progressive or regressive, efficient or distortionary, equitable or exploitative. This chapter examines the theoretical foundations of tax incidence, the mechanisms of tax shifting, the phenomena of tax evasion and avoidance, and the differential effects of taxation on consumers and producers — with systematic reference to Indian fiscal experience.

1. Meaning of Incidence of Taxation

1.1 Defining Tax Incidence

The incidence of a tax refers to the final resting place of the tax burden — that is, the identification of which economic agents ultimately bear the reduction in real purchasing power caused by the imposition of a tax. Tax incidence analysis is distinct from, and more complex than, the mere identification of who is legally required to pay a tax, because market mechanisms frequently transfer the economic burden from the legally designated taxpayer to others.

The study of tax incidence has two principal dimensions: (i) **statutory (formal) incidence** — who is legally liable to remit the tax to the government; and (ii) **economic (effective) incidence** — who actually experiences a reduction in real income or wealth after market adjustments to the tax have worked themselves out. Welfare economics and tax policy are primarily concerned with economic incidence.

Classical Definition

"The incidence of a tax is on the person who ultimately bears the money burden of the tax." — Hugh Dalton, Principles of Public Finance (1954). Modern economists extend this to include all welfare effects — not just money burden but changes in real wages, returns to capital, consumer prices, and welfare losses from distorted behaviour.

1.2 Statutory vs. Economic Incidence

The distinction between statutory and economic incidence is fundamental. Consider the GST on mobile phones in India, levied at 18%. The manufacturer (or importer) is legally required to deposit the tax with the government — this is the statutory incidence. However, if the manufacturer passes the tax to the consumer through higher prices, or absorbs it through lower margins, or passes it backward to component suppliers through lower procurement prices, the economic incidence diverges from the statutory incidence.

Concept	Who Pays?	Indian Example
Statutory Incidence	The legally designated taxpayer — the entity liable to file returns and remit tax	Petroleum refining company pays central excise duty on petrol
Economic Incidence	The entity that actually bears the loss of real income after all market adjustments	Consumer pays higher petrol price; or refinery shareholders absorb lower returns
Formal vs. Effective	These can coincide or diverge completely depending on market structure and elasticities	In perfectly competitive markets, formal and effective incidence typically diverge

1.3 Factors Determining Ultimate Incidence

The ultimate resting place of tax incidence is determined by a set of economic forces that govern the bargaining power of buyers and sellers in markets:

- Price elasticity of demand: Consumers with inelastic demand (few substitutes, necessities) bear a larger share of any tax; elastic demand enables consumers to escape by reducing consumption, forcing the burden back on producers.
- Price elasticity of supply: Producers with inelastic supply (fixed capacity, immobile resources) absorb more of the tax; elastic supply allows producers to exit or reduce output, shifting burden to consumers.

- Market structure: Under perfect competition, incidence is determined purely by relative elasticities. Under monopoly, the monopolist may absorb part of a per-unit tax rather than fully passing it on, depending on the demand curve's shape.
- Factor mobility: In the long run, capital that can move between sectors or countries escapes taxation; immobile labour and land ultimately bear the burden of taxes that capital has evaded through mobility.
- Time horizon: Short-run and long-run incidence often differ. In the short run, supply is less elastic; in the long run, capital and labour adjust, altering incidence patterns.

> **Indian Example — Petrol Tax Incidence**
> India levies among the world's highest taxes on petrol — a combination of Central Excise Duty, State VAT (ranging 20%–35% across States), and cess. Because demand for petrol is relatively price-inelastic (limited substitutes for commuters and transporters in the short run), the incidence falls predominantly on consumers. In contrast, when the Centre temporarily reduced excise duty on petrol in November 2021, pump prices fell by nearly Rs. 5–8 per litre within days — confirming that the burden had been borne by consumers, not producers.

1.4 Theories of Tax Incidence

Several theoretical frameworks have been developed to analyse tax incidence across different market structures and time horizons:

Theory / Model	Key Insight	Application
Partial Equilibrium (Marshall)	Incidence determined by relative demand and supply elasticities in a single market	Incidence of GST on cigarettes, petrol, luxury goods
General Equilibrium (Harberger, 1962)	A tax in one sector generates factor movements that affect prices and wages in all other sectors	Corporation tax in India shifts capital, affecting wages in labour-intensive manufacturing
Expenditure Incidence	True incidence = tax burden minus benefit of public spending financed by the tax	Poor households pay excise taxes but receive MGNREGS, PDS — net incidence may be progressive
Lifetime Incidence	Incidence assessed over an individual's lifetime, not a single year — relevant for pension and capital taxes	Provident fund tax implications assessed over working lifetime

Differential Incidence	Compare two taxes yielding equal revenue; asks who is better or worse off under each	Replace income tax with GST of equal yield — who gains and loses?

2. Impact and Incidence of Tax

2.1 Meaning of Impact

The Burden of Tax The Burden of Tax and the Incident of Tax The effects of a tax or the 'Burden' of a tax concern the first person to whom the tax is applied by law, i.e., the person who is legally obligated to pay the tax to the government is referred to as the 'taxbearer.' The impact is the pure and immediate effect of tax wedge on the legal labor market, as defined in the statutes, and it is unaffected by any post-market adjustments. It's the official aspect of the tax burden.

IMPACT	The immediate, legally-designated point of first contact of a tax — the person or entity on whom the tax is formally imposed and who is required by statute to remit it to the government. Impact does not consider subsequent market shifting.

Impact is a purely legal concept. When the Central Government levies GST on a textile manufacturer, the impact is on the manufacturer — regardless of whether the manufacturer subsequently raises prices, absorbs the tax, or negotiates lower input prices from suppliers.

2.2 Meaning of Incidence

Who bears the cost of a tax is the question of tax incidence (after all adjustments in the market — changes in price, quantity, factor reallocation — have been made). Tax burden is the economic side of tax incidence. That is, the question is: who loses the most real income or welfare as a consequence of the tax?

INCIDENCE	The ultimate cost of a tax in an entire market is the decline in real income or welfare of an economic agent once all price and quantity adjustments in the market, triggered by the tax imposition, have been completed. Incidence is a function of elasticities, market structure, and factor mobility.

2.3 The Impact-Incidence Distinction: A Framework

The relationship between impact and incidence can diverge in three distinct ways, each producing a different distributional outcome:

Scenario	Impact Falls On	Incidence Falls On	Mechanism	Indian Example
Full forward shifting	Producer / Manufacturer	Consumer	Producer raises price by full tax amount	GST on packaged food fully passed to consumers through price increase
Full backward shifting	Importer / Buyer	Supplier / Worker	Buyer reduces purchase price by full tax amount	Import duty on steel absorbed by foreign exporters who reduce export price
Impact = Incidence	Taxpayer	Same Taxpayer	No shifting possible — inelastic supply or regulatory price ceiling	Income tax on salary — salaried employee cannot shift burden
Partial shifting	Producer	Shared between consumer and producer	Price rises by less than full tax; producer absorbs remainder	Excise duty on cigarettes — partial price rise, partial margin reduction
Diffuse general equilibrium	Corporation	Labour, consumers, and capital in other sectors	Capital exits taxed sector, reducing wages in related industries	Higher corporation tax reduces capital formation, lowering real wages

Indian Example — Impact vs. Incidence of Tobacco Taxes

Implication of NCCD and GST compensation cess on cigarettes is that it imposes the entire burden of the duty on the cigarette manufacturers. But, as demand for cigarettes is relatively price-inelastic in India (addiction leads to very limited substitutability), manufacturers pass almost the entire burden to smokers. The burden of taxation also falls largely on consumers — and particularly low-income consumers, who spend a greater share of their income on cigarettes. This regressivity of tobacco taxation has already been established in several NCAER/World Bank studies on India.

2.4 Distinction between Impact and Incidence: Summary

IMPACT of a Tax	INCIDENCE of a Tax
• Legal / formal concept • First contact point of the tax • Fixed by statute; does not depend on market behaviour • Determined by the tax law • Cannot be transferred — it is an administrative designation • Example: GST deposited by manufacturer with government	• Economic / welfare concept • Final resting place of the burden • Determined by market forces — demand/supply elasticities • Determined by economic conditions • Can fall on a different person through tax shifting • Example: Consumers pay higher prices due to GST

3. Tax Shifting

3.1 Meaning and Nature of Tax Shifting

Tax shifting is the process by which the entity on whom a tax is legally imposed transfers its economic burden, wholly or partly, to another party through adjustments in market prices and terms of trade. It is the mechanism that creates the divergence between impact and incidence. Tax shifting is not tax avoidance — it is a **legal** and **automatic** economic process that occurs through the normal operation of market forces.

TAX SHIFTING	The process by which the legal taxpayer transfers the economic burden of a tax to another party — forward to consumers through higher prices, or backward to suppliers and workers through lower procurement prices or wages. Tax shifting is a market phenomenon, not a deliberate act of tax planning.

3.2 Conditions Facilitating Tax Shifting

Not all taxes can be shifted with the same ease. The extent of shifting is affected by several economic conditions:

- Elasticity Differential: It is easier to shift the burden when the demand elasticity for the good or service being taxed is smaller than the supply elasticity — inelastic demand can bear the price increases while elastic supply means producers can change output without price decreases too large.

- Competitive Market Structure: In competitive markets shifting is a pure elasticity matter. In monopolistic or oligopolistic markets, the firm's market power also affect the amount of shifting.
- Type of Tax: Specific taxes (per-unit taxes, e.g. an excise duty per cigarette) and ad valorem taxes (a percentage of price, as with GST) differ slightly in their shifting properties. Lump-sum taxes (fixed quantities unrelated to output) are not shiftable in the short run.
- Factor Specificity: If factors of production are specific to a sector (like highly specialised workers or land that can only be used for growing one type of crop), they are unable to avoid the tax burden through mobility – and so the incidence stays with them.
- Time Period: Shifting in the short run is constrained by fixed costs of production and contractual commitments; shifting in the long run is more complete as all inputs can change.

3.3 Elasticity and the Tax Shifting Outcome

The precise division of the tax burden between buyers and sellers in a competitive market is determined by the formula derived from supply and demand elasticities:

Economic Formula for Tax Incidence

Consumer's share of tax burden = Es / (Es + |Ed|) Producer's share of tax burden = |Ed| / (Es + |Ed|) Where: Es = Price Elasticity of Supply; Ed = Price Elasticity of Demand Implication: If Ed = 0 (perfectly inelastic demand), consumers bear 100% of tax. If Es = 0 (perfectly inelastic supply), producers bear 100% of tax. The more inelastic one's side, the more burden one bears.

Indian Example — GST on Essential vs. Luxury Goods

Demand for essential food items (atta, rice, dal — zero-rated under GST) is highly inelastic; had they been taxed, consumers would bear most of the burden. Demand for luxury automobiles is elastic (consumers delay purchases, choose alternatives); thus when GST + cess on luxury vehicles reached 48–50%, manufacturers partly absorbed the burden through discounts, confirming that elastic demand prevents full forward shifting. The 2017 GST rate rationalisation explicitly used this principle — lower rates on inelastic necessities, higher rates where demand is more elastic.

3.4 The Phenomenon of Tax Capitalisation

A unique type of backward shifting works its way in asset markets via the capitalization of taxes. When a stock is taxed as an asset (property tax), the present value of its future tax liabilities is discounted and subtracted from the market price of the asset. Consequently, the imposition of the tax causes its entire burden to be borne by the asset owner at the date of introduction — later buyers pay a lower price that already factors in the tax, and so they are left unharmed.

> **Indian Example — Property Tax Capitalisation in Mumbai**
>
> When the Brihanmumbai Municipal Corporation (BMC) increased property tax rates in 2010–12, real estate analysts observed that the increased tax liability was partly capitalised into lower property prices in affected areas — particularly for older properties. The buyer of such a property after the tax increase paid a market price already adjusted downward to reflect the higher tax burden, illustrating tax capitalisation in India's most liquid property market.

4. Forward and Backward Shifting

4.1 Forward Shifting: Meaning and Mechanism

Forward shifting is the passing on of tax incidence by a taxable entity to downstream market participants whether they are buyers, consumers or producers at a subsequent production stage. This is also the most usual shifting for indirect taxes like excises duties, GST, customs duties. The mechanism is simple: the seller increases the price of a good or service by the tax amount (or nearly so), thereby obtaining from the buyer the tax liability.

FORWARD SHIFTING	Transfer of the tax burden from the legal taxpayer to buyers or consumers through an increase in the selling price of the taxed good or service. The burden moves in the same direction as the product flow — from producer to consumer.

Conditions Favouring Full Forward Shifting

- Demand is not sensitive to price changes (because consumers have few options and the good is a necessity)
- Supply is price elastic (suppliers can, and do, reduce supply and sell it somewhere else easily)
- The market is competitive, and the price is variable
- Goods are perishable (producers cannot stockpile to wait out the tax period)
- Time period allows for supply response.

Conditions Preventing Full Forward Shifting

- Demand is price-sensitive (buyers cut back drastically when prices rise) .
- There are plenty of substitutes — consumers switch when the prices go up.
- The price is set by the government (passing through is barred by price controls).
- The market is oligopolistic with sticky prices and fear of rivals not following price hikes.

Indian Example — Forward Shifting in the Tobacco Industry

India's cigarette industry faces a multi-layered tax structure: National Calamity Contingency Duty (NCCD), GST, and GST compensation cess. Despite very high tax burdens (effective tax incidence exceeds 70% of retail price for most cigarette categories), manufacturers are largely able to shift taxes forward because demand is inelastic. ITC Limited — which controls over 75% of the cigarette market — typically announces price increases within weeks of budget tax hikes, passing the incremental tax to consumers. Research by the International Union Against Tuberculosis and Lung Disease (2019) confirmed that Indian cigarette consumers bear over 80% of the tobacco tax burden, validating near-complete forward shifting.

Indian Example — Forward Shifting of Petrol Taxes

India imposes Central Excise Duty (currently Rs. 19.90/litre on petrol) plus State VAT (varying 20–35% across States) on petroleum products. Since petrol demand is relatively inelastic for households and transporters in the short run, nearly the entire tax is shifted forward to consumers. India's petrol prices have among the highest tax components in Asia — taxes constitute 45–55% of the retail selling price, almost entirely borne by end-consumers.

5.2 Backward Shifting: Meaning and Mechanism

Backward shifting is the result of the statutory taxpayer shifting the tax burden backwards in the supply chain — to its suppliers of inputs, its employees, or producers of raw materials. The taxed firm does not raise the price paid by consumers, but rather reduces the price it pays to suppliers, or the wages paid to its workers, shifting the burden of the tax upstream.

BACKWARD SHIFTING	Transfer of the tax burden from the legal taxpayer to suppliers of inputs, labour, or raw materials through a reduction in the prices paid for those inputs. The burden moves in the opposite direction to the product flow — from buyer to supplier.

Conditions Favouring Backward Shifting

- An interesting special case arises when the supply of inputs or labour is price-inelastic (workers or suppliers have no easy means to find alternative buyers)

- Demand for the output is elastic (the firm will lose customers if it raises prices)
- Input markets are competitive (but the buying, taxed, firm has monopsony or bargaining power)
- The inputs are highly specific to the taxed industry (have no other uses)

Indian Example — Import Duty and Backward Shifting onto Foreign Exporters

When India imposes customs duties on imported goods, the extent of backward shifting to foreign exporters depends on how important the Indian market is to them. For goods where India is a dominant buyer — such as certain categories of cashew nuts imported from Vietnam and Tanzania, or specific electronic components — import duties have in practice been partly absorbed by foreign exporters through price reductions, rather than being passed fully to Indian consumers. This constitutes backward shifting across national borders.

Indian Example — Backward Shifting and Agricultural Procurement Taxes

States like Punjab and Haryana levy procurement taxes (mandi fees, rural development fund levies) on the purchase of food grains at Agricultural Produce Market Committees (APMCs). Since farmers have limited access to alternative buyers and their produce is perishable, these charges are often shifted backward — with the effective purchase price offered to farmers being lower to offset the procurement levies. Studies by the Commission for Agricultural Costs and Prices (CACP) have identified mandi fees as a factor suppressing farm-gate prices in regulated markets.

4.3 Side-by-Side Comparison: Forward vs. Backward Shifting

Parameter	Forward Shifting	Backward Shifting
Direction	Toward consumers / buyers downstream	Toward suppliers / workers upstream
Mechanism	Seller raises the selling price by tax amount	Buyer lowers the purchase price by tax amount
Who Ultimately Bears Burden	Consumers / end-users of the taxed good	Input suppliers, workers, raw material producers
Favoured When	Inelastic demand; elastic supply of final good	Elastic demand for final good; inelastic supply of inputs

Common Tax Types	GST, excise duty, customs duty, sales tax	Import duties (partial), procurement levies, cess on inputs
Indian Examples	GST on FMCG goods, petrol excise, tobacco cess	APMC mandi fees, import duties on bulk commodities
Short-run vs. Long-run	More complete in the long run	More complete when input supply is chronically inelastic
Regressive Impact?	Often regressive — poor spend higher share on taxed goods	Regressive if shifts onto low-wage unorganised workers

4.4 Mixed Shifting: The Realistic Case

In reality, most shifting is mixed — some of the burden is passed forward to consumers, some is absorbed by producers or shifted backward to suppliers of inputs, and the remainder stays with the legal taxpayer in the form of lower profits. The exact split depends on the particular elasticities of demand and supply in effect in the market when the tax is imposed.

Indian Example — GST on Cement Industry

When GST was fixed at 28% on cement in 2017 (the highest slab), cement manufacturers (statutory impact) faced a dilemma: forward shifting would increase housing costs and reduce construction demand; backward shifting was limited because sand, lime, and energy inputs had their own regulated price structures. In practice, mixed shifting occurred — cement prices rose modestly (partial forward shift), manufacturer margins compressed (partial absorption), and some labour costs were reduced through contract renegotiation (partial backward shift). The GST Council eventually reduced cement to 18% in 2023, recognising the housing cost implications of the high rate.

5. Tax Evasion and Tax Avoidance

5.1 Conceptual Distinction

Tax evasion and tax avoidance are two separate reactions of taxpayers to tax burden – both result in less money collected from the government, but they are very different in terms of their legality, means, and implication for the policy.

TAX EVASION	TAX AVOIDANCE
• Illegal — violates tax law	• Legal — exploits loopholes within tax law • Arranging transactions to minimise tax liability using provisions the law permits

• Deliberate concealment or misrepresentation of taxable income, assets, or transactions • Subject to criminal prosecution, penalties, and imprisonment • Constitutes tax fraud — both civil and criminal liability • Reduces government revenue without any legal planning basis • Examples: Cash income not declared, fake invoices, hawala transactions	• Not subject to criminal prosecution; may attract anti-avoidance provisions • Technically lawful but may be voided by courts under the substance-over-form doctrine • Reduces government revenue through legal but unintended use of fiscal provisions • Examples: Routing income through tax havens, excessive depreciation claims, treaty shopping

5.2 Tax Evasion: Detailed Analysis

Tax evasion is a crime involving the use of illegal means to evade taxes and is different from tax avoidance, which is using legal means to reduce one's tax liability. It requires criminal mind and it can be punishable by prosecution or fine or with jail under relevant tax laws.

Common Methods of Tax Evasion in India

- Income concealment: Deriving income — especially from business, profession or property — and not disclosing it in returns of income tax. Common in cash-heavy industries: retail trade, real estate, construction, and hospitality.
- Overbilling sales and underbilling purchases: The practice of companies under-reporting their sales (thus reducing GST liability) or over-stating purchase claims (higher input tax credit) — the most common form of GST fraud in India.
- Fake ITC claims: Producing fake invoices of non-existent transactions and claiming ITC on them under GST – a form of evasion that is bleeding the exchequer by way of thousands of crores every year.
- Hawala and benami deals: Circulating money through informal money transfer mechanisms (hawala) or owning properties in fake names (benami) to hide wealth from the taxman.
- Off-shore hiding: Stashing undisclosed income in foreign bank accounts -- highlighted in an unprecedented manner through the HSBC Geneva list (2011) and Panama Papers (2016), that exposed the presence of hundreds of Indian nationals holding undisclosed foreign assets.
- Underinvoicing and smuggling: Misdeclaring imported merchandise as a breath of low-duty items or smuggling merchandise to dodge customs duties altogether.

Indian Example — GST Fake Invoice Fraud

The GSTN (Goods and Services Tax Network) detected over 7,400 fake ITC frauds involving Rs. 57,000 crore in GST evasion between 2020 and 2023. Fraudsters created shell companies, generated fake invoices for non-existent supplies, and claimed input tax credits — defrauding the treasury without any actual goods or services changing hands. The Government responded with biometric Aadhaar authentication for GST registration and enhanced data analytics to detect circular trading patterns.

Indian Example — Demonetisation as Anti-Evasion Measure

The demonetisation of Rs. 500 and Rs. 1,000 notes in November 2016 was partly motivated by the goal of surfacing black money — unreported cash income evading taxation. The RBI reported that Rs. 15.41 lakh crore (99.3%) of demonetised currency was deposited, triggering scrutiny of large deposits. The Income Tax Department subsequently identified approximately 18 lakh suspect accounts for inquiry, illustrating both the scale of cash-based evasion in India and the enforcement challenges.

Legislative Framework Against Tax Evasion

- Income Tax Act 1961: Default in remitting TDS,filing false returns&abetment of evasion punishable with imprisonment under Sections 276B–277A of the Income Tax Act.
- GST Law: A Penalty of 100% of the tax evaded and prosecution on fraudulent claim of ITC is imposed under the CGST Act, 2017 (Sections 122–138).
- Black Money (Undisclosed Foreign Income and Assets) Act – 30% tax + 90% penalty + criminal prosecution for undisclosed foreign assets.
- Benami Transactions (Prohibition) Amendment Act: 7 years imprisonment and confiscation of benami property.
- Prevention of Money Laundering Act, 2002 (PMLA)(Specifies Power of Certain Authorities to Attach Property Proceeds of Crime) also Seeks to Attach Proceeds of Scheduled Offences and Product of Large Tax Evasion.

5.3 Tax Avoidance: Detailed Analysis

Tax avoidance is a tax planning technique, conducted within the law, that can nevertheless be artificial and is generally considered to be unethical. Avoidance differs from evasion in that the former is legal and often involves no concealment or misrepresentation, while the latter is illegal and involves deception, and is conducted off the books; however, avoidance can also be illegal when it constitutes as tax evasion.

Popular techniques of tax avoidance in India

● Treaty shopping: Investment flows are routed through treaty shopping countries to avail the benefit of Lower withholding under the DTAAs. Mauritius was the most notorious example — FDI routed through Mauritius enjoyed near-zero capital gains tax under the India-Mauritius DTAA, a breach taken advantage of widely till the treaty was modified in 2016.

● Transfer pricing abuse: Multi-national companies crafting fictitious prices for intra-group transactions, such as a subsidiary in India paying inflated royalties to a parent firm located in a jurisdiction that has low taxes, in order to shift profits out of India's relatively high-tax system. ● Dividend stripping and bonus stripping: Buy mutual fund units before dividend declaration to make a tax-deductible loss and get the dividend tax free – a very old avoidance device hit by special anti-abuse rules.
● Thin capitalization: Funding Indian operations through debt, rather than equity (which means associated companies can pocket enormous interest deductions which reduce their taxable profits).
● Shell companies and layered ownership structures: Forming chains of holding companies in tax neutral jurisdictions to defer or eliminate domestic tax on returns to investments.

Indian Example — Vodafone Tax Controversy (2007–2020)

In one of India's most celebrated tax avoidance cases, Vodafone International Holdings BV acquired the Indian telecom business of Hutchison by purchasing shares of a Cayman Islands holding company — rather than directly acquiring Indian assets. The Indian government claimed capital gains tax of approximately Rs. 11,000 crore on the transaction. The Supreme Court ruled in 2012 that the transaction was outside India's tax jurisdiction. Parliament subsequently retrospectively amended the Income Tax Act (2012 amendment) to tax such indirect transfers — a move widely criticised as undermining investor confidence. The controversy was ultimately resolved through the Taxation Laws (Amendment) Act, 2021, which withdrew the retrospective tax demands.

GAAR: India's General Anti-Avoidance Rule

India had earlier introduced the General Anti Avoidance Rule (GAAR) in Income Tax Act through Chapter X-A (w.e.f. April 2017) which applies to all arrangements entered on or after 1st April 2017 to tackle aggressive tax avoidance. An 'impermissible avoidance arrangement' — one whose primary purpose is to obtain a tax benefit and that lacks commercial substance — may be disregarded, aggregated with other arrangements, or recharacterized by the tax authority. GAAR also permits the Approving Panel to pierce the form of a transaction to its substance and to disallow tax benefits that are deemed to be sham or abusive.

Basis of Distinction	Tax Evasion	Tax Avoidance	Tax Planning
Legality	Illegal — criminal offence	Legal but may be voided by courts	Fully legal and sanctioned
Method	Concealment, falsification, fraud	Exploiting loopholes, artificial structures	Using explicit statutory deductions and incentives

Intent	Deliberate and knowing violation of law	Intentional use of unintended provisions	Legitimate minimisation using intended provisions
Government Response	Prosecution, penalties, imprisonment	Anti-avoidance rules (GAAR), treaty amendments	No adverse response; encouraged by government
Indian Example	Fake GST invoices, cash income concealment	Mauritius route FDI, Vodafone structure	Section 80C investments, HRA exemption, SEZ benefits
Effect on Revenue	Direct and illegal revenue loss	Legal but unintended revenue loss	Intended revenue cost — designed into policy

6. Effects of Tax Incidence on Consumers and Producers

6.1 Overview: The Welfare Economics of Tax Incidence

The consequences of a tax are multifaceted and diverse, and the overall effect on consumer and producer welfare depends on how these various consequences are weighted. These are important consequences to understand for the assessment of the fairness and efficiency of any system of taxation. Four concepts in the analysis are key: consumer and producer surplus, tax revenue, and deadweight loss.

Welfare Concepts Consumer Surplus: The amount consumers benefit by paying a price that is less than what they are willing to pay. Producer Surplus: The amount producers gain when they receive a price that is higher than the lowest they would be willing to accept. Deadweight Loss (Excess Burden): Reduction in consumer and producer surplus caused by a tax that is not recouped as tax revenue — it is pure economic waste induced by the distortion of market behaviour.

6.2 Effects on Consumers

The levying of an indirect tax — excise duty, GST, customs duty — on a commodity or service has the following impact upon the consumers of the commodity or service: (a) Price Effect — Effect on Real Income or Purchasing Power of the Consumers As the tax is passed on the consumers, the price of the good or service increases in the market. It is also a reduction in consumers real purchasing power — they buy fewer goods with that much less nominal income. The price effect is more pronounced for commodities with elastic demand, as reduction in consumption due to the increase in price is easier to accord with.

Indian Example — GST Price Effect on Households

The National Statistical Office's Household Consumption Expenditure Survey (2022–23) reveals that low-income Indian households spend approximately 50–55% of total consumption expenditure on food and essential non-food items. GST on essential goods (even at reduced 5% rates) and on services like transportation, healthcare, and education imposes a proportionately higher price burden on poorer households — making the tax system's consumer impact regressive in this dimension.

(b) Quantity Effect — Reduction in Consumption and Welfare

Post-tax increases in prices result in compression in quantity demanded by consumers. This reduction is a loss of consumer welfare – consumers are pushed below the level of their ideal consumption. For some goods—addictive ones above all—this quantity reduction is an instrumentally a policy goal (corrective taxation).

(c) Consumer Surplus Loss A tax-induced loss in consumer surplus—for example, due to a higher tax on cigarettes with a corresponding fall in consumption—has two components: (i) a transfer through tax revenue (to the government) from the consumers; and (ii) a deadweight loss, which is the loss of consumer and producer surplus that is not captured in tax revenue.

(d) Distributional Effects: Progressivity and Regressivity Somewhat surprisingly, in the survey evidence there appears to be little discussion of how the sex bias affects tax progressivity. The taxes that are most progressive are also those with the smallest revenue burden.

5 Consumer Incidence

As discussed above, the distribution of tax burdens among income groups is estimated utilizing consumer incidence analysis – which examines how the price burden of select taxes is allocated across different household income deciles.

Tax	Consumer Impact	Progressive/Regressive	Indian Context
Income Tax (Personal)	Reduces disposable income; no price effect on goods	Progressive — higher income = higher rate	Standard deduction, section 80C benefits skew to formal sector workers
GST on Essentials (5% slab)	Small price rise on food, medicine; modest consumer burden	Mildly regressive — poor spend more share on essentials	Exemptions on unbranded food reduce regressivity

GST on Luxury Goods (28% slab)	Large price rise on cars, ACs, premium goods	Progressive — consumed predominantly by high-income households	Cess on top of 28% GST further targets luxury consumption
Petrol / Diesel Excise	Direct increase in transport and fuel costs	Regressive — transport costs are higher share of income for poor	No GST on petroleum; Centre + States levy separately
Tobacco / Alcohol Excise	Sharp price increase; intended demand reduction	Regressive in income terms; progressive in harm reduction	Sin tax rationale overrides pure progressivity concern
Customs Duty	Consumer pays higher price for imported goods	Depends on good — luxury imports progressive; essential imports regressive	Zero customs on drugs and medical equipment vs. 100% on luxury cars

6.3 Effects on Producers

Tax incidence on producers operates through different channels depending on whether the tax falls directly on producers (corporate income tax, minimum alternate tax) or on the goods they produce (excise duty, GST):

(a) Reduction in Producer Surplus / Profit Margins

If forward shifting is partial – because demand is elastic, or price rises are competitively constrained – then producers have to bear some of the tax in the form of a profits squeeze. This involves a loss in producer surplus and in profit for the whole industry.

> **Indian Example — Impact of Corporation Tax on Producer Surplus**
>
> The 2019 reduction of the base corporate tax rate from 30% to 22% (and from 25% to 15% for new manufacturing companies) under the Taxation Laws (Amendment) Ordinance was explicitly designed to improve producer surplus — particularly for capital-intensive manufacturers. The government estimated an annual revenue sacrifice of approximately Rs. 1.45 lakh crore, offset by expected increases in investment, capacity creation, and employment. The BSE Sensex rose over 5% on announcement day — reflecting market assessment of improved post-tax returns to equity holders.

(b) Investment and Capital Formation Effects

Delayed and uncertain taxes on producers decrease the expected after-tax return to investment, thus discouraging investment in capital. This dynamic incidence effect —

transmitted via lower future productivity — is in some sense more important than the static distributional effect. India's move to the Faceless Assessment Scheme (2020) and slashing of corporate tax rates was driven, at least in part, by this concern for investment incidence.

(c) Effect on Employment and Wages When producer taxes erode margins, firms may react by cutting employment or wage growth, or by shifting production towards more capital-intensive processes as a means of evading levies tied to payroll (Provident Fund contributions, ESI, professional tax). Labour-intensive sectors, such as textiles, leather, food processing, are very vulnerable to the employment consequences of producer taxation.

> **Indian Example — MSME Sector and Tax Burden on Employment**
>
> India's MSME sector provides employment to around 120 million people and contributes 30% of the GDP. The hassle of compliance with GST—return filing on a monthly basis, e-way bills, provisions related to tax deduction at source (TDS) / tax collection at source (TCS)—brought with it disproportionately high administrative costs for small producers with little of the accounting infrastructure that large firms enjoyed. The MSME Development Institute's research revealed that the cost of GST compliance was 3 to 5 per cent of turnover for small manufacturers, working out to be an extra tax on employment-intensive production. This resulted in the bringing down of the GST return to a single page and the introduction of the Composition Scheme for small taxpayers.

(d) Output and Market Exit Effects

Market thinning (ie, reduced competition) results when such "exit" occurs, which can imply that relatively few, low-cost suppliers remain. This thinning of the market diminishes the level of competition and consumer choice, and may result in horizontal integration. Over time, decreased competition may also allow the entities that survive to pass more of the tax burden on to consumers through higher prices, transferring the incidence back to them.

(e) Distorting Effects on Production Decisions Variable taxation on goods, sectors or production methods distorts producers' choices on what to produce, how to produce and where to produce. Differential state tax treatment — a legacy of India's pre-GST fragmented taxation system — led firms to set up warehouses in each state to avoid CST, resulting in economically inefficient production geography. The removal of these inter-state tax distortions by GST was expected to translate into substantial efficiency gains for Indian producers.

6.4 Combined Consumer-Producer Incidence: The Deadweight Loss

The combined welfare effect of a tax on both consumers and producers can be decomposed into three components:

Component	Who Experiences It	Economic Nature	Indian Estimation
Tax Revenue	Transferred from consumer/producer to government	Transfer — not a net social loss; finances public goods	Union + State tax revenue: approximately Rs. 47 lakh crore (2023-24)
Consumer Surplus Loss (to tax revenue)	Consumers — this portion becomes tax revenue	Transfer from consumer to government	Implicit in every indirect tax paid by households
Producer Surplus Loss (to tax revenue)	Producers — this portion becomes tax revenue	Transfer from producer to government	Implicit in every direct and indirect business tax
Deadweight Loss (excess burden)	Both consumers and producers — lost permanently	Net social loss — neither party gains; pure efficiency cost	IMF (2019) estimated India's tax-induced distortions at 1.2–1.8% of GDP annually

Indian Example — Pre-GST Cascading Tax and Deadweight Loss

India's pre-GST indirect tax system — involving Central Excise, State VAT, Service Tax, Entry Tax, and Octroi operating in cascading layers — generated substantial deadweight losses. The National Institute of Public Finance and Policy (NIPFP) estimated that tax-on-tax cascading effectively raised the implicit tax rate on manufactured goods by 25–40% above the statutory rate. GST's comprehensive input tax credit mechanism, by eliminating cascading, was estimated to reduce this deadweight loss and lower effective tax rates on producers by 4–8 percentage points — one of the principal efficiency arguments for the GST reform.

Conclusion

Analysis of tax incidence shows that the ”who pays?” question in taxation, i.e. who has to put the money to the public fisc, is very different from ”who bears the burden?” or who’s welfare is reduced by taxation. This prism through which forward and backward shifting is viewed is at the center of tax policy analysis. A tax provision that looks fair in the written code could be downright regressive when its economic impact on consumers or labor is taken into account through the economics of shifting. India's fiscal experience illustrate these principles in a rich and instructive way. The almost complete forward shifting of petroleum and tobacco excises, the complicated mixed shifting on GST, the backward shifting in agricultural procurement levies, the enormous scale of GST fraud and income concealment as evasion, the Vodafone controversy as a landmark in avoidance jurisprudence, and the distributional impacts of the corporation tax cut — all these are universal economic principles playing out in the particularities of a national context. To develop a fair and efficient tax system requires a

comprehensive consideration of incidence: not just 'who pays?', but 'who ultimately bears the incidence, and how does that compare with its ability else to pay taxes?' This research discipline, the melding of economics, law, and public finance, is what undergirds good tax policy in a democratic, developing economy.

> **Core Principle**
> The true test of a tax is not who remits it to the government but on whom its economic burden ultimately comes to rest. Statutory incidence is a legal convention; economic incidence is the reality that determines equity, efficiency, and the distributional character of a fiscal system.

Key Terms

Term	Definition
Tax Incidence	The final resting place of the economic burden of a tax — whose real income is reduced after all market adjustments
Statutory Incidence	The legal designation of who must pay a tax; the formal impact point fixed by statute
Economic Incidence	The actual reduction in real income or welfare experienced after market price and quantity adjustments
Impact of a Tax	The point of first contact of a tax — the entity on whom it is initially imposed by law
Tax Shifting	The transfer of tax burden from the legal taxpayer to another party through market price adjustments
Forward Shifting	Transfer of tax burden toward consumers through higher selling prices
Backward Shifting	Transfer of tax burden toward input suppliers or workers through lower input prices or wages
Tax Capitalisation	Absorption of future recurring tax liabilities into a lower asset price at the time of the tax introduction
Deadweight Loss	The efficiency cost of a tax — loss of consumer and producer surplus not captured as revenue; pure social waste

Tax Evasion	Illegal non-payment or underpayment of taxes through concealment, fraud, or misrepresentation
Tax Avoidance	Legal but artificial arrangement of transactions to minimise tax liability using unintended provisions of tax law
Tax Planning	Legitimate minimisation of tax liability by using explicitly intended statutory provisions, deductions, and incentives
GAAR	General Anti-Avoidance Rule (Chapter X-A, Income Tax Act) — allows tax authority to deny benefits of impermissible avoidance arrangements lacking commercial substance
Progressive Tax	A tax whose burden as a proportion of income rises with income — higher-income households bear a larger share
Regressive Tax	A tax whose burden as a proportion of income falls with income — lower-income households bear a larger proportionate share
Consumer Surplus	The benefit consumers receive from paying less than their maximum willingness to pay
Producer Surplus	The benefit producers receive from selling at a price above their minimum acceptable price
Price Elasticity of Demand	Responsiveness of quantity demanded to a price change — determines consumers' ability to escape tax burden
Price Elasticity of Supply	Responsiveness of quantity supplied to a price change — determines producers' ability to shift tax to consumers

Review Questions

1. Distinguish between the impact and incidence of a tax. Using the example of GST on a consumer good in India, trace how the impact and incidence can differ, and identify the economic conditions that determine where the incidence ultimately falls.

2. 'The person who pays a tax to the government and the person who bears its economic burden are frequently different.' Discuss this statement with reference to the theory of tax shifting and two Indian examples of forward and backward shifting respectively.

3. Explain the role of price elasticity of demand and supply in determining tax incidence. Using India's petroleum tax as a case study, explain why the incidence falls predominantly on consumers rather than oil companies.

4. Critically examine the distinction between tax evasion and tax avoidance. With reference to Indian examples (GST fake invoice fraud and the Vodafone case), analyse the different policy responses available to the government in each case.

5. Explain the concept of deadweight loss (excess burden) of a tax. How did India's pre-GST cascading tax structure generate deadweight losses, and how did the GST reform address this problem?

6. Analyse the effects of indirect tax incidence on consumers with different income levels. Is India's indirect tax system — comprising GST, petroleum excise, and tobacco cess — progressive, regressive, or neutral in its distributional impact? Support your answer with empirical examples.

7. 'Forward shifting is facilitated by inelastic demand while backward shifting is facilitated by inelastic supply of inputs.' Illustrate these propositions with reference to two Indian industries, one where forward shifting predominates and one where backward shifting has been observed.

Chapter 7:
Classification of Taxes

Direct Taxes

- Meaning and Features
- Examples
    - Income Tax
    - Corporate Tax
    - Wealth Tax
- Advantages and Disadvantages

Indirect Taxes

- Meaning and Features
- Examples
    - GST
    - Customs Duty
    - Excise Duty
- Advantages and Disadvantages

CHAPTER 4

Classification of Taxes

Direct Taxes and Indirect Taxes — Concepts, Indian Examples and Case Studies

Public Finance / Business Economics — Reference Chapter

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4.2.1 Meaning and Features

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4.3 Indirect Taxes

4.3.1 Meaning and Features

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4.3.3 Advantages and Disadvantages

Case Study: The GST Rollout, 2017

4.4 Direct Tax vs Indirect Tax — At a Glance

4.5 Chapter Summary

4.6 Review Questions

4.1 Introduction

Taxation is the principal instrument through which a modern government raises revenue to finance public expenditure — defence, infrastructure, healthcare, education and welfare programmes. In India, the power to levy taxes is distributed between the Union Government, State Governments and Local Bodies under the Seventh Schedule of the Constitution. Every tax that is levied, whatever its name, falls into one of two broad categories based on how its final burden is borne: Direct Taxes and Indirect Taxes.

This chapter explains the meaning, features, advantages and disadvantages of both categories, illustrates each with current Indian examples, and examines two real case studies — the evolution of India's direct tax regime and the landmark rollout of the Goods and Services Tax (GST) — to show how this classification plays out in practice.

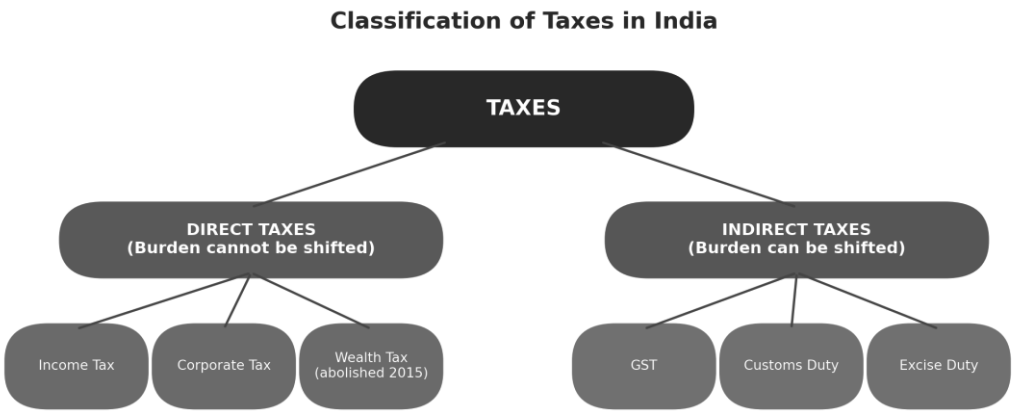

Fig. 4.1 — Classification of Taxes in India

4.2 Direct Taxes

4.2.1 Meaning and Features

A direct tax is a tax whose burden (both the liability to pay and the ultimate economic incidence) falls on the same person. It is levied directly on the income, profits or wealth of an individual or an organisation, and by law that person cannot shift the burden to someone else. In India, direct taxes are administered by the Central Board of Direct Taxes (CBDT) under the Income-tax Act, 1961 (recently proposed to be replaced by the Income-tax Bill, 2025).

Key features of direct taxes:

- Impact and incidence coincide — the person who pays is the person who bears the burden.
- Based on the ability-to-pay principle, making the system progressive in nature.
- Cannot ordinarily be shifted forward to another party (e.g., an employee cannot pass on income tax to an employer).
- Collected periodically, typically annually, based on the assessee's income for a financial year.
- Requires the taxpayer to be identified and assessed individually (PAN-based tracking in India).

4.2.2 Examples of Direct Taxes in India

(a) Income Tax

Income Tax is levied on the total income earned by an individual, Hindu Undivided Family (HUF), firm or association of persons during a financial year, under the Income-tax Act, 1961. India currently operates two parallel slab systems: the 'Old Regime' (with deductions and exemptions such as Section 80C, HRA, etc.) and the 'New Regime', which is now the default regime and offers lower rates but fewer exemptions.

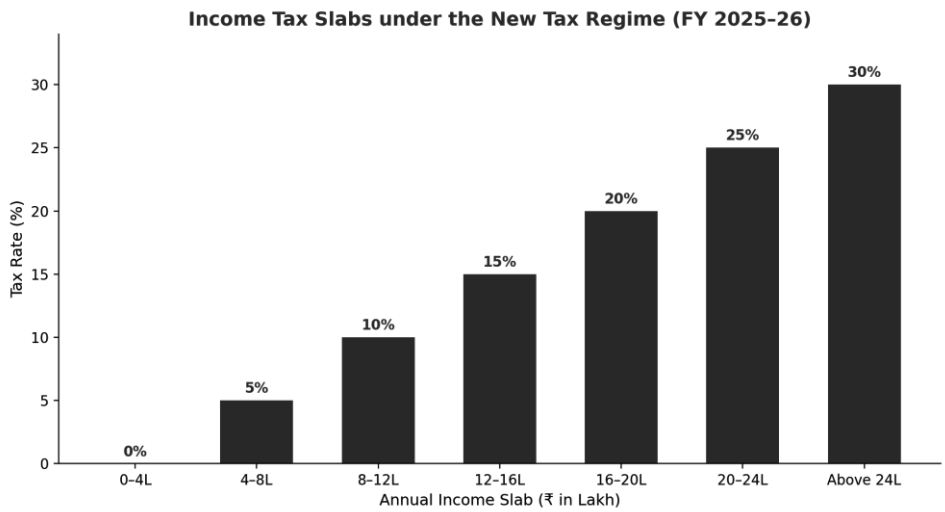

Fig. 4.2 — Income Tax slabs under the New Tax Regime, FY 2025–26

Under Budget 2025-26, the government raised the standard deduction and made income up to ₹12 lakh effectively tax-free under the new regime, sharpening its appeal to salaried taxpayers and simplifying compliance.

(b) Corporate Tax

Corporate Tax (also called Corporation Tax) is levied on the net profits of domestic and foreign companies operating in India. Following the 2019 reform, the base corporate tax rate for existing domestic companies was reduced from 30% to 22% (effective rate about 25.17% with surcharge and cess), while new manufacturing companies incorporated after October 2019 can opt for a concessional rate of 15% (effective about 17.16%), provided they do not claim specified exemptions.

- Levied under the Income-tax Act, 1961 on companies registered under the Companies Act.
- Domestic companies are taxed on global income; foreign companies are taxed only on India-sourced income.
- Includes Minimum Alternate Tax (MAT) for companies reporting low taxable profits despite healthy book profits.

(c) Wealth Tax

Wealth Tax was a direct tax levied annually on the net wealth (value of specified non-productive assets such as urban land, jewellery, and unoccupied residential property) of individuals, HUFs and companies exceeding a threshold, under the Wealth-tax Act, 1957. It was abolished with effect from Assessment Year 2016-17 in the Union Budget 2015-16 because its collection cost was disproportionately high relative to the revenue it generated. In its place, the government levied an additional 2% surcharge on the super-rich (those with taxable income above ₹1 crore), which was administratively simpler and yielded significantly more revenue.

4.2.3 Advantages and Disadvantages of Direct Taxes

Advantages	Disadvantages
Progressive and equitable — based on the taxpayer's ability to pay.	Easier to evade through under-reporting of income or fake deductions.
Reduces income inequality by taxing higher incomes at higher rates.	Collection is costly and administratively intensive (assessment, scrutiny, litigation).
Creates civic awareness, as taxpayers feel a direct link between tax paid and public services received.	Can discourage savings, investment and entrepreneurial effort at very high rates.

Advantages	Disadvantages
Revenue is elastic — grows automatically as national income grows.	Narrow base in India — only a small share of the population files returns, limiting revenue potential.
Certainty of liability, as rates and slabs are known in advance.	Considered inconvenient, since it requires periodic filing, record-keeping and sometimes advance payment.

CASE STUDY — From 30% to 22% — India's Corporate Tax Rate Cut, 2019

In September 2019, facing a slowdown in private investment and manufacturing growth, the Government of India announced one of the sharpest corporate tax cuts in the country's history through the Taxation Laws (Amendment) Ordinance, 2019.

The base rate for existing domestic companies was cut from 30% to 22%, and a concessional 15% rate was introduced for new manufacturing companies set up after 1 October 2019 that commence production before a specified deadline, provided they forgo other exemptions.

The immediate revenue loss was estimated at roughly ₹1.45 lakh crore annually. However, policymakers argued the move would improve India's competitiveness against manufacturing hubs like Vietnam and Bangladesh, boost the 'Make in India' and Production-Linked Incentive (PLI) initiatives, and eventually widen the tax base through higher compliance and investment.

Lesson: this case illustrates a central trade-off in direct tax policy — lowering rates can, over time, broaden the base and sustain revenue even though headline collections fall in the short run.

4.3 Indirect Taxes

4.3.1 Meaning and Features

An indirect tax is levied on the production, sale or consumption of goods and services, and its burden can be shifted from the person who initially pays it (usually a manufacturer, trader or service provider) to another person — typically the final consumer — through the price of the good or service. In India, indirect taxes are administered chiefly by the Central Board of Indirect Taxes and Customs (CBIC).

Key features of indirect taxes:

- Impact (who pays first) and incidence (who ultimately bears the burden) differ — the burden is shifted forward.
- Levied on transactions (sale, manufacture, import) rather than on income or wealth directly.
- Generally regressive in effect, since everyone pays the same rate regardless of income.
- Collected at the point of sale or import, making evasion comparatively harder.
- Broad-based — falls on almost the entire population, including those below the income-tax threshold.

4.3.2 Examples of Indirect Taxes in India

(a) Goods and Services Tax (GST)

GST is a comprehensive, multi-stage, destination-based tax on the supply of goods and services, introduced on 1 July 2017 through the 101st Constitutional Amendment Act. It replaced a web of Central and State levies — including Central Excise Duty, Service Tax, VAT, Octroi and Entry Tax — with a single unified tax, giving rise to the slogan 'One Nation, One Tax'.

Fig. 4.3 — The three components of GST in India

GST operates through Input Tax Credit (ITC), under which tax paid on inputs can be set off against tax payable on output, preventing the earlier problem of 'tax on tax' (cascading). Current GST slabs for most goods and services are 0%, 5%, 12%, 18% and 28%, with additional cess on luxury and sin goods such as tobacco and automobiles.

(b) Customs Duty

Customs Duty is levied on goods imported into, and in limited cases exported from, India under the Customs Act, 1962 and the Customs Tariff Act, 1975. It serves two purposes: raising revenue and protecting domestic industry from cheaper foreign competition. Components include Basic Customs Duty (BCD), Social Welfare Surcharge, and Integrated GST (IGST) charged on the imported value.

(c) Excise Duty

Central Excise Duty was traditionally levied on the manufacture of goods within India. After GST subsumed excise duty on most goods, it now survives mainly on a small set of items kept outside GST — petroleum products (petrol, diesel, ATF, natural gas) and tobacco/alcohol for human consumption, which continue to attract Central Excise Duty and State Excise levies, since these are large and politically sensitive revenue sources for both Centre and States.

4.3.3 Advantages and Disadvantages of Indirect Taxes

Advantages	Disadvantages
Broad base — collected from virtually every consumer, including those outside the income-tax net.	Regressive in effect — a poor and a rich consumer pay the same tax on the same product.
Difficult to evade, since it is collected at the point of sale/import and backed by invoice trails (e-invoicing, e-way bills).	Adds to inflation, since the tax is built into the price of goods and services.
Convenient for the payer — paid in small amounts with each purchase rather than as one lump sum.	Burden is often invisible to the consumer, reducing 'tax consciousness' and civic awareness.
Can be used to discourage consumption of demerit goods (tobacco, alcohol, luxury cars) via higher rates/cess.	Compliance burden on businesses — registration, periodic returns, reconciliation of Input Tax Credit.

Advantages	Disadvantages
Administratively efficient with digital systems like the GST Network (GSTN).	Multiple rate slabs (in the case of GST) can create classification disputes and litigation.

CASE STUDY — The GST Rollout — 1 July 2017

At the stroke of midnight on 1 July 2017, Parliament held a special midnight session to launch the Goods and Services Tax, described as independent India's most significant indirect tax reform.

GST subsumed 17 Central and State taxes — including Central Excise Duty, Service Tax, VAT, Central Sales Tax, Octroi and Luxury Tax — into a single tax with a common set of rates across the country, structured as CGST + SGST for intra-state supply and IGST for inter-state supply.

The transition was disruptive in the short term: small businesses struggled with the online GSTN portal, multiple return filings, and initial glitches; sectors like textiles and logistics saw temporary slowdowns.

Over time, GST simplified inter-state trade by removing check-posts and cascading taxes, formalised large parts of the economy, and steadily improved monthly collections, which now regularly cross ₹1.7–1.8 lakh crore.

Lesson: this case shows how indirect tax reform can improve efficiency and widen the tax base, but requires careful transition management, since compliance costs fall disproportionately on small and medium enterprises in the short run.

4.4 Direct Tax vs Indirect Tax — At a Glance

The table below summarises the essential differences between the two categories discussed in this chapter.

Basis	Direct Tax	Indirect Tax
Incidence & Impact	Fall on the same person (cannot be shifted)	Can be shifted to another person (e.g., consumer)
Levied on	Income, profit or wealth	Goods and services (consumption)
Progressivity	Generally progressive — higher income, higher rate	Generally proportional/regressive — same rate for all
Collection point	Directly from the taxpayer (assessee)	Collected by seller/service provider and deposited with the Government
Examples	Income Tax, Corporate Tax, Wealth Tax (abolished)	GST, Customs Duty, Excise Duty
Administering law (India)	Income-tax Act, 1961	CGST/SGST/IGST Acts, 2017; Customs Act, 1962
Evasion potential	Relatively easier to evade (under-reporting of income)	Harder to evade at the point of sale; but input-tax-credit fraud is a risk
Effect on prices	No direct effect on price of goods	Directly affects the price of goods and services

It is worth noting that India's tax mix has been shifting. As per Union Budget estimates, direct taxes accounted for a little over 56% of India's gross tax revenue in FY 2024-25 — the highest share in two decades — overtaking indirect taxes, whose share has fallen partly due to the 2019 corporate tax rate cut. For every rupee the Union Government collects, roughly 39 paise

comes from direct taxes (income and corporate tax) and about 18 paise from GST, the balance coming from customs, excise and other levies.

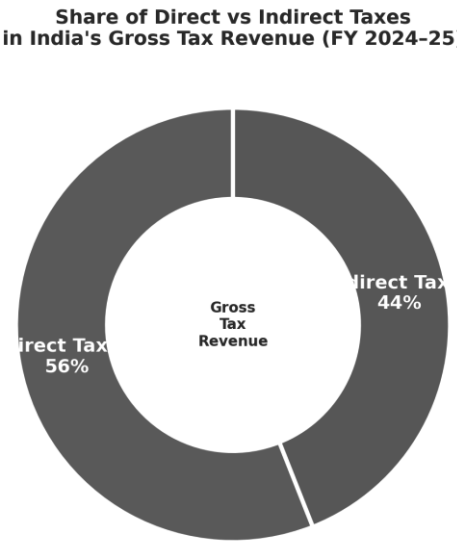

Fig. 4.4 — Share of Direct vs Indirect Taxes in India's Gross Tax Revenue, FY 2024–25 (illustrative, based on Union Budget estimates)

4.5 Chapter Summary

- Taxes are broadly classified into Direct Taxes and Indirect Taxes based on whether their burden can be shifted.
- Direct taxes (Income Tax, Corporate Tax, and the now-abolished Wealth Tax) are levied on income, profit or wealth; impact and incidence fall on the same person, making them progressive but harder to enforce.
- Indirect taxes (GST, Customs Duty, Excise Duty) are levied on the production, sale or consumption of goods and services; their burden can be shifted to the final consumer, making them broad-based but regressive.
- India's corporate tax rate cut of 2019 (30% → 22%, and 15% for new manufacturing units) illustrates how direct tax policy is used to spur investment.
- The GST rollout of 1 July 2017 unified a fragmented indirect tax structure into 'One Nation, One Tax', built on CGST, SGST and IGST with Input Tax Credit to avoid cascading.
- India's tax mix has gradually tilted back towards direct taxes, which crossed 56% of gross tax revenue in FY 2024-25, though indirect taxes remain crucial for broad-based, hard-to-evade revenue collection.
- A sound tax system uses a balanced mix of both direct and indirect taxes to achieve efficiency (easy collection, wide base) and equity (ability-to-pay, progressivity) simultaneously.

4.6 Review Questions

A. Very Short Answer Questions (1–2 marks)

1. Define a direct tax and give one example.
2. What is meant by 'incidence' of a tax?
3. Name the Act under which Income Tax is levied in India.
4. In which year was Wealth Tax abolished in India?
5. Expand CGST, SGST and IGST.
6. Name two goods that remain outside GST and continue to attract Excise Duty.

B. Short Answer Questions (3–5 marks)

7. Distinguish between the impact and incidence of a tax with an example of each type of tax.
8. Explain any three features of indirect taxes.
9. Why is a direct tax considered progressive while an indirect tax is considered regressive?
10. Briefly explain the concept of Input Tax Credit under GST.
11. What were the main reasons for abolishing Wealth Tax in India?

C. Long Answer / Essay Questions (8–10 marks)

12. Explain the meaning and features of direct taxes. Discuss their advantages and disadvantages with suitable Indian examples.
13. Discuss the meaning and features of indirect taxes. Critically examine their advantages and disadvantages, using GST as an example.
14. With reference to the 2019 corporate tax rate cut, discuss how direct tax policy can be used as a tool of economic reform.
15. Describe the background, structure and impact of the GST rollout of 2017 in India. What challenges did businesses face during the transition?
16. "A good tax system must balance direct and indirect taxes." Discuss this statement with reference to India's current tax-revenue mix.

D. Multiple Choice Questions

17. Which of the following is a direct tax?
    (a) GST
    (b) Customs Duty
    (c) Corporate Tax
    (d) Excise Duty

18. GST in India was implemented with effect from:

a. 1 April 2016
b. 1 July 2017
c. 1 January 2018
d. 26 January 2019

19. The base corporate tax rate for existing domestic companies was cut to:

a. 18%
b. 22%
c. 25%
d. 30%

20. Which tax is described as 'regressive in effect'?

a. Income Tax
b. Corporate Tax
c. Wealth Tax
d. GST

Answer Key (MCQs): 1 — (c) Corporate Tax | 2 — (b) 1 July 2017 | 3 — (b) 22% | 4 — (d) GST

Chapter 8:
Taxation in a Developing Economy

- Role of Taxation in Developing Countries
- Objectives of Taxation in Developing Economy
    - Resource Mobilization
    - Reduction in Inequality
    - Economic Stability
    - Employment Generation
- Problems of Taxation in Developing Economies
- Reforms in Tax System

8.Introduction

Tax is one of the best leverages a government can use in directing the economic and social fate of a country. In developed economies, taxation has a predominant revenue-collection role with a rather limited redistributive function, as the organization of production, employment and infrastructure has already reached a certain level of development. But in a developing economy, taxation has to achieve much more. It must provide the means of development, redress glaring inequalities of income and wealth, bring stability to a fragile and oftentimes wobbling economy, and generate employment for a labour force which is expanding at a terrific pace. As the economist Nicholas Kaldor once remarked, "a country too poor to save has to be made ‘artificially' poorer by fiscal policy in order to release resources for growth." This one small concept sums up the special and difficult role taxation assumes in the process of economic growth. This chapter discusses the purpose and goals of taxation in a developing country, the practical difficulties that impede effective utilization of the tax system, and the reforms normally proposed and taken to transform taxation into a real means of development.

8.1. Role of Taxation in Developing Countries

In Taxation is an instrument of economic policy, and essential to such policy. Roles for the Army can be considered in the following categories:

(**a) Instrument of Resource Mobilization** Increasing savings and investment is a major challenge in most developing countries. With voluntary savings not sufficient to finance the investment necessary for growth, taxation emerges as the main instrument of forcibly collecting resources from the society for community investment in infrastructure, industry, and social services like education and health.

(b) When it comes to economic planning The majority of Third World states now have adopted or are in the process of formulating some of form of planned development such as the Five Year Plan etc. The implementation of such plans require a source of funding that is provided by the taxation and which can also be used as an indirect form of regulation that the government can direct economic activities to priority areas such as agriculture, small-scale industry, or export promotion by taxing activity to the sector and providing concessions to other sectors.

(c) Instrument of Social Justice Developing countries usually have either inherit or acquire very high income and wealth inequality. Progressive taxation: (taxing the richer at a higher rate than the poorer) reduces this gap and the benefits of economic growth are more widely and fairly distributed.

(d) Instrument of Economic Stability Inflationary pressures tend to exist in developing countries as a result of development spending, supply bottlenecks, and deficit financing. Taxation also takes the wind out of the public's purchasing potential which mitigates inflation and promotes price stability.

(e) Instrument of Resource distribution Selective taxation—heavy duties on luxury goods, tax holidays for priority industries, depreciation allowances for capital investment—the government can influence the flow of private resources, channeling investment into areas deemed vital for development.

Example: Historically, India's Income Tax Act and Central Excise/GST regime has granted relief to small scale industries and export-oriented units, but under the GST Compensation Cess, luxury goods and demerit goods (tobacco, aerated drinks) incur steeper rates of tax. This is an example of a tax levied to raise income while simultaneously affecting the resource allocation.

8.2. Objectives of Taxation in a Developing Economy

(a) Resource Mobilization

The foremost objective of taxation in a developing economy is to mobilize resources for economic development. Since the government must undertake large-scale investment in infrastructure (roads, power, irrigation), social overheads (education, health), and public enterprises, it needs a steady and growing stream of revenue. Taxation, being a compulsory and non-repayable transfer, is the most dependable source of such revenue, as opposed to borrowing, which creates future repayment obligations, or deficit financing, which risks inflation.

As Richard Musgrave and Peggy Musgrave note in their classic treatment of public finance, taxation performs an "allocation branch" function precisely because *markets alone will not generate the level of public goods and infrastructure investment that development requires.*

Example: The introduction of the Goods and Services Tax (GST) in India in 2017 was aimed, among other things, at widening the tax base and improving compliance, thereby increasing the resources available to the government without necessarily raising tax rates.

(b) Reduction in Inequality

Emerging economies also tend to experience more extreme inequality of income and wealth, with a small elite capturing large shares of national income versus the rest of the population that mostly lives around subsistence levels. This is to be taxed back from them more through the taxation system - mainly progressive direct taxes (income tax, wealth tax, estate duty) - and then utilized to fund welfare schemes, subsidies, and social services that are of help to the poor. Simon Kuznets, who studied income distribution in the process of development, contended that inequality increases in the initial phases of growth and subsequently declines — this has often been referred to as the "Kuznets curve." Among the policies being used to resist this initial expansion in its size is〜 therefore, a fiscal one, taxation. Example: Income slabs in progressive income tax system – in which higher income groups pay tax at greater rate – reliefs are provided to the poorest of poor, directly serve as mechanism to redistribute income in many developing nations like India, Bangladesh, Kenya etc.

(c) Economic Stability

Inflation and business cycle swings can impact developing countries more severely as they rely heavily on agriculture (which is prone to weather shocks); the importation of goods (which can be affected by exchange rate volatility); and on large-scale development spending (which can expand the money supply without a matching immediate increase in output). Taxation is a stabilizing instrument: higher taxes in periods of inflation reduce disposable income and dampen excess demand; tax relief in a downturn can encourage spending and investment. Example: Many countries temporarily raise excise taxes on nonessential and luxury consumption to counter high inflation and lower aggregate demand, while offering tax breaks such as accelerated depreciation to stimulate investment in a downturn.

(d) Generating Employment In developing countries, unemployment and underemployment are endemic because the population is growing faster than the economy can create productive jobs. Tax policy can be structured to favor labour intensive industries, small and medium enterprises, and rural employment schemes, by way of tax holidays, investment allowances, and reduced rates of duty on raw materials for these industries. On the other hand, imposing more tax on capital-intensive industries may lead to hinder the mechanical strength of industries in countries that have abundant labour but limited level of capital. Example: Tax concessions for those who set up shops in underdeveloped or rural areas, and eased compliance requirements for micro, small, and medium enterprises (MSMEs) are typical tax policy features for a country like India that explicitly focuses on creating employment in places outside the metros.

8.3. Problems of Taxation in Developing Economies

Nevertheless the tax system in developing countries is subject to severe structural and administrative constraints:

1. Narrow Tax Base: A very high percentage of population is living below or at the minimum limit of subsistence and hence is out of the direct tax net. Agricultural income, which is a large component of national income in many developing nations, is frequently not subject to income tax at all.
2. Large Informal/Unorganized Sector: Much of the economic activity occurs in the shadows making it difficult to assess and collect taxes on such activities. This also incite the growth of "Black Economy" or parallel economy.
3. Tax Evasion and Avoidance: Poor administrative system, complicated laws and low degree of tax morality are the reasons for common evasion. The rich tend to use loopholes and avoidance schemes, some of which can be perfectly legal, that undermine the progressiveness of the tax system.
4. Administrative Inefficiency: Implications of the tax collection system in most developing countries are insufficient capacity and outdated systems, with tax agencies overwhelmed, ill-equipped and overworked leading to an expensive, delayed and corrupt system of tax collection.
5. Political Constraints: Politically influential groups — large landholders, industrial lobbyists — are able to block or significantly retard the plucking of feathers from their own wings (i.e., the imposition of tax on agricultural income in many countries), thereby weakening the capacity of the tax system for redistribution.
6. Excessive Reliance on Indirect Taxes: As direct taxes are hard to collect from a poor and largely undocumented population, so the developing nation's tax structure is skewed heavily towards indirect taxes (customs duties, excise, sales tax/GST). Since indirect taxes tend to be regressive – they hit the poor relatively harder – this compromises the equity goal of taxation.
7. Inflationary Effects of Indirect Taxes: A high dependence on indirect taxes may also generate cost-push inflation since taxes on raw materials and on goods of mass consumption lead to price increases throughout the country.
8. Multiplicity and complexity of laws: Unceasing amendments in tax laws, proliferation of multiple and overlapping levies from various layers of governments (Union, State and Local) and tedious formalities make it difficult to comply with the laws, increasing the cost of compliance, and also deter voluntary compliance.

   It was saying, there are enough good tax laws, but the problem is the "lack of will and administrative capacity" to enforce them." This is still the case in many developing economies, even today.

8.4. Reforms in the Tax System

To address these issues and enable taxation to become a real source of development, the following reforms are commonly advocated and to some extent adopted:

(a) Broadening the Tax Base Bringing more sources of income and economic activities — including, to the extent possible, high agricultural incomes — under the tax umbrella, and cutting down on exemptions that distort the base.

(b) Simplifying the Tax Laws Cutting down on the complexity and number of tax rules, so that it would be cheaper and easier to comply (which should also reduce the scope for evading and bribing).

(c) Rationalization of Tax Rates Adopting more reasonable, rationalized tax rates rather than very high marginal rates, owing to the fact that very high rates encourage evasion more than compliance. This principle is what underlines the worldwide movement since the 1980s and 1990s of lowering top marginal income tax rates and broadening the base.

(d) Enhancing Tax Collection Efficiency Upgrading tax systems by introducing information technology, using digital trails of payment, data analytics, and interconnectivity of information (e.g., connecting tax files with bank accounts, financial transactions) to prevent evasion.

(e) Harmonisation of Indirect Taxes The myriad of indirect taxes will be replaced by a unified, transparent system. Introduction of a Value Added Tax (VAT) or a comprehensive Goods and Services Tax (GST), like that introduced by India in 2017 would be a best practice example of such reform, to mitigate cascading taxation and enhance compliance through input tax credit treatment.

(f) Strengthening the Direct Tax Base so that Developmental Expenditures can be Financed by Real Tax Revenues, rather than by the Inflationary Deficit Financing or Excessive Borrowing, with a Gradually Declining Reliance on Deficit Financing.

(g) Promoting Voluntary Compliance Fostering a tax morale through taxpayer education, easier return filing, faster refunds, and use of tax revenue for public good in a visible way such that citizens see taxation as a fair exchange and not a burden that is arbitrarily imposed.

(h) Presumptive and Simplified Schemes for Small Taxpayers A presumptive taxation scheme for small businesses and professionals, which calculates tax liability on a simpler basis, helps ease the compliance burden for small taxpayers who cannot keep large books of accounts, and at the same time brings them into the tax net. Example: India's tax reforms since the early 1990s, including the lowering of peak customs duties, rationalization of income tax slabs, introduction of VAT at the state level, and now the implementation of GST, reflect a continuing approach to broaden the base, rationalize rates, and modernize administration consistent with the principles discussed herein.

8.5 Conclusion

In a poor country the burden of taxation is much more than that of finding a certain sum of money. It should simultaneously raise the necessary resources for growth, for reducing deep-

seated inequality, for stabilizing a fragile economy, and for employing a burgeoning population—goals that it can sometimes be difficult to synchronize. At the same time, the tax system faces constraining factors such as narrow tax bases, large informal sectors, weak administration, and political opposition to reforms. The various reforms of recent years—base broadening, rationalization of rates, modernization of administration, transition to integrated indirect tax systems (for example, the GST in India) and so on—can be seen as part of a continuing struggle to contain this contradiction, and to make taxation, in Kaldorian terms, a genuine source of "development finance" rather than simply an administrative exaction.

Review Questions

1. Explain the role of taxation in a developing economy. How does it differ from the role of taxation in a developed economy?
2. "Taxation in developing countries is expected to achieve multiple, sometimes conflicting, objectives." Discuss with reference to resource mobilization, reduction in inequality, economic stability, and employment generation.
3. Discuss the objective of resource mobilization through taxation in a developing economy, with suitable examples.
4. How can taxation be used as an instrument to reduce income inequality in a developing economy?
5. Explain how taxation contributes to economic stability in a developing economy.
6. Discuss the role of taxation in generating employment opportunities in a developing economy.
7. What are the major problems faced by the tax system in developing economies? Illustrate with examples.
8. "Developing countries rely excessively on indirect taxes." Examine the reasons for and consequences of this over-dependence.
9. Discuss the major reforms needed in the tax system of a developing economy to make it an effective instrument of development.
10. Write short notes on: (a) Tax Base Widening, (b) Presumptive Taxation, (c) GST as a Tax Reform, (d) Tax Evasion and Avoidance.

References for further reading: N. Kaldor, "Indian Tax Reform" (1956); R.A. Musgrave and P.B. Musgrave, "Public Finance in Theory and Practice"; Government of India, Reports of the Tax Reforms Committee.

Unit 4:

Indian Fiscal Federalism: vertical and horizontal imbalances, Competitive to cooperative federalism. Constitutional provisions of assignment of functions and sources of revenue. Centre-State financial relations in India. Local bodies Finance, Role of Finance Commission of India.

Chapter 1:
Introduction to Fiscal Federalism

- Meaning of Fiscal Federalism
- Features of Fiscal Federalism
- Objectives of Fiscal Federalism
- Importance of Fiscal Federalism in India
- Evolution of Fiscal Federalism in India

Introduction

Every federal country must answer a basic question: how should the power to tax and the responsibility to spend be divided between the different levels of government—national, state/provincial, and local? The branch of public finance that studies this question is known as **Fiscal Federalism**. It examines how financial powers, resources, and responsibilities are distributed among the various tiers of a federal government, and how this distribution affects economic efficiency, equity, and stability. As the economist Wallace Oates, one of the pioneers of this field, put it, *"fiscal federalism is concerned with understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government."* In a vast and diverse country like India, with sharp regional variations in resources, population, and development levels, fiscal federalism is not merely an academic subject but a living, evolving arrangement that shapes the everyday functioning of the government at every level.

This chapter introduces the meaning, features, and objectives of fiscal federalism, discusses its importance in the Indian context, and traces its evolution from the framing of the Constitution to the present day.

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1. Meaning of Fiscal Federalism

Fiscal federalism is the process of division of financial powers, functions and responsibilities (taxation, expenditure, borrowing and transfers) among different levels of government in a federal system i.e. the Union (Central) government, the State governments and local bodies (Panchayats and Municipalities in the case of India). In easy language, it consists of answers to two interrelated questions:

1. Taxing who on what? — the distribution of tax capacities among levels of government.
2. Who spends on What? And How Is the Gap Financed? — which concerns the allocation of expenditure responsibilities and the instrument through which a country's own source revenues and its expenditures can be lined up. In its classical version articulated by Richard Musgrave, the government's public finance functions can be decomposed into three branches—allocation, distribution, and stabilization—and fiscal federalism essentially is an inquiry as to the level of government at which each of these functions should be performed. In essence, the theory asserts that the stabilization and distribution roles are more appropriately assigned to the Federal government (given that a state cannot easily manage its own inflation or redistribute income without compromising its competitiveness vis-à-vis other states), whereas the allocation role — the provision of local public goods such as water, local roads, and sanitation — is more efficiently carried out by state and local governments, who have superior knowledge of local preferences and conditions. Illustration: In India, defence, foreign affairs, currency and national highways are Union subjects (functions having nationwide impact) while police, public health, agriculture and local government are State subjects (functions requiring more local knowledge and application of administration).

2. Features of Fiscal Federalism

(a) Division of Taxing Powers A federal constitution specifies which level of government has the power to tax what commodities, usually by a non-overlapping assignment of subjects (as with Indian Union List, State List and Concurrent List under the Seventh Schedule).

(b) Division of Expenditure Responsibilities As well as the powers to tax, the levels of government also share the responsibilities to expend for services such as defence, education, health, law and order.

(c) Vertical Fiscal Imbalance In the majority of federations, the Central government has more tax revenue than it needs to cover its expenditure responsibilities, and the states/communities have more expenditure responsibilities than they can finance with their own revenue. This discrepancy is referred to as vertical fiscal imbalance, and it requires the Centre to make transfers to the states.

(d) Horizontal Fiscal Imbalance States vary considerably in the ability to generate revenue as well as in their developmental priorities. An industrialised city has a strong tax base, whereas some others are underdeveloped. Such disparities among states at the same level of government are called horizontal fiscal imbalance and are corrected by means of equalizing transfers.

(e) Intergovernmental Transfers Vertical and horizontal imbalances imply that fiscal federalism is always linked with an apparatus of transfers — shared taxes, grants-in-aid, and loans or the like — from upper tiers of government to lower tiers, often, determined by an independent or constitutionally mandated agency (in India, the Finance Commission).

(f) Fiscal sovereignty within a unitary system-within federalism isstrivedfor to ensure sub-national governments are accorded sufficient autonomy to enable it to make sui generis

taxation and expendituredecisions in accordance with local needs, whilst preserving the overall unity of thenation and macroeconomic stability.
(g) Mechanisms for Institutional Coordination Under a Federal System The federal system necessarily involves the existence of permanent or ad hoc institutions to harmonize fiscal relations -- in India, a brief account is called for of the Finance Commission, the erstwhile Planning Commission (now NITI Aayog), and the Goods and Services Tax (GST) Council.

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3. Objectives of Fiscal Federalism

(a) Active Taxing and Spending Powers The fiscal provisions in a federal constitution must harmonize with and even support the implication from the division of powers that the "best lie of government" can perform each function. To that end, fiscal federalism seeks an agreement on (a) the principle of subsidiarity (i.e., each function is to be assigned to the best suited level of government) to ensure the most efficient employment of public resources.
(b) Fair Distribution of Resources Fiscal federalism also seeks to promote a balanced distribution of financial resources among the member states and their constituent regions, by means of ensuring equal access to public services to all its members, particularly that of its poor citizens. (ii) Equitable Distribution of Resources: As there is variation among regions in their revenue potential and development priorities, fiscal federalism should ensure equitable sharing of financial resources among the states and regions so that the citizens of poorer states are not subjected to denial of reasonable public service standards.
(c) Correction of Fiscal Imbalances A major objective is to address vertical imbalance (between the Centre and the states as a whole) and horizontal imbalance (among states) through suitable transfer systems.
(d) Macroeconomic Stability Fiscal federalism is also intended to safeguard the Centre's capacity to implement effective countercyclical fiscal policy and preserve aggregate macroeconomic stability while allowing fiscal autonomy for sub-national units.
(e) Encouraging in Competitive and Collaborative Federalism International best practice in the area of tax design for achieving competitive federalism embraces three principles, namely, the strengthening of cooperative federalism based on harmonious relations among the Center-State and States– State governments, within the dimensions of shared responsibility in protecting the common interest (co-operative federalism), and the recognition that States are embedded in a competitive framework where attract investment and improve governance (competitive federalism).
(f) Empowerment of Local Self-Government A particularly important objective of fiscal federalism has thus certainly been the empowerment of the third tier of government—Panchayats and Municipalities—through securing additional financial resources to perform their functions in particular after the 73rd and 74th Constitutional Amendments in India.

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4. Importance of Fiscal Federalism in India

The differences between the various regions of India are immense, and fiscal federalism is what stably unites these diversities on the one hand and enables expansive growth on the other. In addressing India's vast regional diversity one must understand that its states differ all along

the lines of geography, resources, language, and level of development. Fiscal federalism allowed such diversity to be accommodated within a single political and economic union.

2. Regional balanced growth: Resources are redistributed from the richer to the poorer states through Finance Commission awards and other centrally sponsored schemes to reduce regional disparity in income and development.

3. Democratic Decentralisation: By devolving financial powers to the states and further to the local bodies in the form of Panchayati raj institutions and Urban Local Bodies, fiscal federalism promotes grassroot democracy, and participatory democracy as it makes governance people's friendly.

4. Efficient Public Service Delivery: Because citizens are closer to State and local governments, these two levels are more likely to have superior knowledge of local needs (in areas like education, health, and infrastructure) and to be more responsive in those areas, which in turn makes fiscal federalism important for efficient service delivery.

Example: Sample: The 15th Finance Commission (2021–26) suggested a 41% devolution of central taxes to the states from the divisible pie, along with some grants for local bodies and those for health and disaster management—to show how fiscal federalism puts the objectives of equity and balanced growth into the ground.

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5. Evolution of Fiscal Federalism in India

(a) Constitutional Context (1950 onwards) The Indian Constitution provided the necessary framework for the fiscal federalism through the Seventh Schedule, which segregates subjects into the Union List, State List and Concurrent List and Articles 268 to 293, which concern with taxation and revenue sharing, grants-in-aid, and borrowing powers between the Union and states. Article 280 made provision for the constitution of a Finance Commission at an interval of five years to make recommendation as to the distribution of the central taxes with the states and the principles for grants-in-aid.

(b) Beginnings and Planning Commission Dominance (1950s–1980s) Since there was the constitutionally mandated Finance Commission, the Planning Commission (formed in 1950, an extra-constitutional entity) played a predominant role in allotting plan resources to states, particularly utilising discretionary and scheme-based grants. This created a dual system of transfers, with statutory transfers through the Finance Commission and plan transfers through the Planning Commission, leading to conflicting and imbalance concerns.

(c) Fiscal Federalism and Economic Reforms (1991 onwards) The1981 forthe major bring of the of economic liberalization reforms changes as a result. As the economy opened, states competed for private investment, resulting in what is commonly referred to as "competitive federalism. "Simultaneously the increasing recourse to centrally sponsored schemes in areas that are officially within the domain of states has given the Centre more say in their future

development, a prospect which has kept the issue of the potential diminution of state autonomy under much interrogation."

(d) 73rd and 74th Constitutional Amendments (1992) With these reforms, the PRI and ULB systems were given constitutional protection as a true third tier of government. They also required the formation of State Finance Commissions to make recommendations on the devolution of resources from state governments to local bodies, thus bringing the principles of fiscal federalism to the village level.

(e) FRBM Act 2003 In the interest of imparting greater fiscal rigor to the Centre-state fiscal relations, the FRBM Act prescribed targets for the reduction of fiscal and revenue deficits, and a majority of the states also passed their own FRBM Acts, thereby reinforcing rule-based fiscal federalism.

(f) From Planning Commission to NITI Aayog (2015) The government dissolved the Planning Commission in 2015 and established the NITI Aayog (National Institution for Transforming India) in its place, which, unlike the Planning Commission, does not distribute plan funds to states. The dual-transfer system was abolished with this change and the flow of statutory transfers was consolidated mainly through the route of the Finance Commission, which is a landmark change in Indian fiscal federalism.

(g) GST (2017) The introduction of GST in 2017 was perhaps the most important recent event of Indian fiscal federalism. It subsumed a lot of Central and State indirect taxes into one unified tax and was to be administered uniformly across the country by the Union and the states through a common administrative authority, the GST Council, a constitutional body consisting of the Union Finance Minister and the State Finance Ministers. This was a new "cooperative federalism" approach whereby the Centre and states would work together in deciding tax rates and tax policy, but also led to concerns that states would lose the ability to tax independently a major source of their revenue.

As the political economist Govinda Rao, a leading scholar of Indian public finance, has observed, Indian fiscal federalism has moved "from a hierarchical, Centre-dominated system towards a more negotiated, cooperative arrangement," even as tensions between fiscal autonomy and fiscal coordination persist.

Conclusion

Fiscal federalism is the basis on which a federal nation such as India allocates its financial powers and obligations between the Union, State and local levels of government and addresses the disparities that such devolution of financial powers tends to create. Its components—sharing of taxation and expenditure powers, vertical and horizontal disequilibria, and intergovernmental transfers—are constructed to contribute to the aims of efficiency, equity and stability. In India, fiscal federalism has been critical in holding together an immensely diverse country, nurturing equitable regional development, and decentralized democracy. Its development from the 1950 constitutional framework, through the Planning Commission

regime, the 73rd and 74th Amendments, the FRBM Act, the establishment of NITI Aayog to the GST regime, is one of continually negotiating fou]ndations of national coherence and regional particularism; central coordination and state autonomy.

Review Questions

1. What is meant by fiscal federalism? Explain its meaning with reference to the division of financial powers in a federation.
2. Discuss the main features of fiscal federalism.
3. Distinguish between vertical fiscal imbalance and horizontal fiscal imbalance, with suitable examples.
4. What are the principal objectives of fiscal federalism?
5. Explain the importance of fiscal federalism in the context of India's regional and economic diversity.
6. Trace the evolution of fiscal federalism in India from the framing of the Constitution to the present.
7. Discuss the role of the Finance Commission in India's fiscal federal structure.
8. How did the 73rd and 74th Constitutional Amendments impact fiscal federalism in India?
9. "The introduction of GST marks a new phase of cooperative federalism in India." Discuss.
10. Write short notes on: (a) Planning Commission vs. NITI Aayog, (b) FRBM Act, (c) GST Council, (d) Competitive Federalism.

Chapter 2:
Vertical and Horizontal Imbalances

Vertical Imbalance

- Meaning of Vertical Fiscal Imbalance
- Causes of Vertical Imbalance
- Revenue and Expenditure Mismatch between Centre and States

Horizontal Imbalance

- Meaning of Horizontal Fiscal Imbalance
- Causes of Regional Imbalances among States
- Measures to Reduce Horizontal Imbalances

2.1 Meaning of Vertical Fiscal Imbalance

In a federal system, governmental responsibilities are divided between at least two levels — a national (central) government and regional or local governments such as states, provinces, or municipalities. Both levels have associated rights and responsibilities when raising revenues and spending. Vertical Fiscal Imbalance (VFI) is a term used to describe a revenue-expenditure mismatch at a level of government. In plain English, VFI means the Union is earning more taxes than it requires to function whereas the states are spending more than what they can collect. The difference must be made up by fiscal transfers from the upper to the lower layer.

2.1.1 Definitions

> **R.L. Watts:**
> *Vertical fiscal imbalance refers to the structural gap between the revenue-raising capacity and the expenditure requirements of different levels of government within a federation.*

> **Robin Boadway & Frank Flatters:**
> *VFI arises when there is a mismatch between the own-revenue capacity of each level of government and its expenditure needs, necessitating intergovernmental transfers to restore fiscal equilibrium.*

2.1.2 Conceptual Framework

Vertical fiscal imbalance can be expressed as a simple structural identity:

VFI = Expenditure Responsibility of Sub-national Government
MINUS Own Revenue Capacity of Sub-national Government
This gap must be filled by transfers from the Centre.

A positive VFI (expenditure > own revenue) is common in most federations, as it induces a dependency on the Centre that can be used to sustain policy coordination and to avoid fiscal disintegration. But a too large VFI also weakens state autonomy, accountability and fiscal discipline. 2.1.3 VFI in the Indian Context India a crescendos vertical fiscal imbalance sends a classic signal. The more productive and buoyant tax bases - the income tax, the corporation tax, the customs duties and the central excise - are assigned mainly to the Union in the Constitution of India (Seventh Schedule). Concomitantly, states are vested with a majority of socially sensitive expenditure functions, for example education, health, agriculture, law and order, irrigation and rural development. The Finance Commission Article 280 – VFI The Finance Commission of India (Article 280 of the Constitution) is the unique constitutional institution to consider the VFI and recommend the devolution of the central taxes to the states and grants-in-aid to fill the gap in the taxes and expenditure.

> **Constitutional Note:**
> *Article 246 read with the Seventh Schedule distributes legislative (and consequently fiscal) powers. The Union List contains 97 subjects, the State List 66, and the Concurrent List 47. In case of conflict, Union law prevails — a design that inherently concentrates fiscal power at the Centre.*

2.2 Causes of Vertical Fiscal Imbalance

Vertical imbalance: an inbuilt feature of federalism is the underdevelopment of tax bases at the subnational level As noted in section 1.1, vertical fiscal imbalance is not simply an accident that occur within federal systems: it is a structural and intrinsic characteristic of federalism, resulting from the intentional concentration of the power to raise revenue at the federal level and the decentralisation of delivery of services at the subnational level. VFI is the result of several causes.

2.2.1 Constitutional Centralization of Taxation Powers In nearly all federations, the hardest to tax and most elastic tax bases — income taxes, corporate taxes, and excise duties — belong to the national government. This is in line with scale economies in tax administration, preventing harmful tax competition among states, and with macroeconomy management. In India, the most elastic taxes are assigned to the Centre under Articles 268-271 while the States have to make do with less elastic taxes such as stamp duties, land revenues, and state excise on liquor.

2.2.2 Decentralisation of Expenditure Responsibilities Provision of public goods like education, health care, water supply, sanitation, social welfare, and police is best provided at the sub-national level as local governments are generally more aware of local tastes and circumstances. This logic of 'subsidiarity' implies that not only do the states get saddled with the most expensive expenditure responsibilities, they also do not have the revenue sources to fund them.

2.2.3 Inelasticity of State Tax Bases

The revenues of the state are not nearly as sensitive to the growth of the economy as those of the central state. Expenditure on land revenue, stamp duty and state excise liquor is relatively inelastic — they do not expand along the same line with the rise of income levels. Prior to GST, states' own-tax revenue as a proportion of GDP was seeing no growth; post GST (2017), states gave up their most vibrant indirect tax base (VAT on manufactured goods) for a segment of the integrated GST pool, leading to new dependencies.

2.2.4 Unfunded Mandates Social laws that the Centre often passes — the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), the Right to Education Act, the National Food Security Act — but which require the most outlay on State governments. Although the Centre may issue grants, the associated matching commitments and administrative burdens tend to be concentrated on the states, exacerbating the vertical gap. 2.2.5 Borrowing Powers of the States are Limited The Fiscal Responsibility and Budget Management (FRBM) Act and its counterparts at the level of the state prohibit the state governments from incurring large fiscal deficits. And states can borrow only from certain permitted sources and need to seek Central approval for market borrowings in excess of prescribed limits. This undermines states' capacity to privately fund their own spending needs, tying their purse strings to Central handouts.

2.2.6 Expansion of Centrally Sponsored Schemes (CSS) For years, the Central government's mantra has been proliferation of Centrally Sponsored Schemes, which are a means through which funds are directed to State Governments for specific purposes subject to conditions. It helps to meet certain expenditure demands, but CSS tend to distort state priorities, compel states to contribute towards programmes from their meagre resources, and increase their administrative workload — all this without addressing the fundamental VFI.

2.2.7 Asymmetric Information and Administrative Capacity Central tax administration tends to be more developed and better funded than state tax administration. This asymmetry of administrative capacity can thus lead states to be unable to fully exploit formal taxing powers — a de facto VFI that precedes the constitutional VFI.

> **Empirical Note:**
> *The 15th Finance Commission (2020–25) estimated that states' share in central taxes and grants constitutes over 40% of their total revenue receipts, underscoring the depth of structural VFI in India. States' own revenues cover barely 55–60% of their total expenditure needs.*

2.3 Revenue and Expenditure Mismatch between Centre and States

Mismatch between revenues and expenditures is the fiscal concrete expression of vertical imbalance. There are two sides to this analysis – the revenue side (who raises what) and the spending side (who spends on what). Assigning these two aspects to different layers in the constitutional sphere is what results in the structural distance VFI is.

2.3.1 Revenue Assignment:

The Central Dominance The following are the major sources of revenue which the Indian Constitution vests in the Centre: Income Tax on non-agricultural ayment to states under finance Commission formula income (shared with states under Finance Commission formula). Corporate tax - collected fully by center (shared via divisible pool). Customs duties — purely Central, but very important for trade regulation. Central Goods and Services Tax (CGST) — Centre component of unified GST. Integrated GST (IGST) – on inter-state transactions, collected at the centre and distributed.

• Central Excise on petroleum products, alcohol for human consumption and tobacco (post-GST residuals). States are, in contrast, under obligation for:

• State Goods and Services Tax (SGST) — on intra-state supply of goods and services.

• Stamp duty and registration fees (on property transfer).

• Excise on alcohol in states (not under GST).

• Land revenue and agricultural income tax. • Taxes on motor vehicles, entertainment, and professions.

2.3.2 Expenditure Assignment: The State Burden

The states are obligated under the Constitution to provide the following important and costly service: •Education: primary, secondary and tertiary education (State List, Entry 25 Concurrent with Centre for higher education).

• Health and family welfare: public hospitals, primary health centres, disease control;

• Agriculture and agriculture related activities: irrigation, soil conservation, animal husbandry; • Law and order: police, jails, public order;

• Rural development: land reforms, rural housing, MGNREGS co-funding." (Dry Land Areas) Urban development: municipal services, town planning, slum improvement.

• Social welfare: welfare of scheduled castes, tribes, women, children. Together, these heads of spending constitute a substantial proportion - well over 60% - of India's combined government expenditure, and yet under 35–40 % of its combined government revenue is raised by the states.

2.3.3 Comparative Overview Table

Revenue Source	Assigned To	Expenditure Head	Assigned To
Income Tax	Centre (90%) + States (10%)	**Law & Order / Police**	States exclusively
Corporation Tax	Centre exclusively	**Primary Education**	States exclusively
GST (IGST)	Centre — then shared	**Defence & Armed Forces**	Centre exclusively
GST (SGST)	States exclusively	**National Highways**	Shared (Centre-led)
Customs Duties	Centre exclusively	**Public Health (State)**	States predominantly
Central Excise	Centre (shared formula)	**Social Welfare Schemes**	Centre + States (CSS)
Stamp Duty	States exclusively	**Rural Development**	Centre + States
Land Revenue	States exclusively	**Urban Local Bodies**	States / ULBs

2.3.4 Bridging the Gap: Transfer Mechanisms

The gap between states' own revenues and their expenditure obligations is bridged through a system of intergovernmental transfers:

Transfer Type	Constitutional Basis	Nature
Tax Devolution	Article 270 — Finance Commission	Share of central taxes (currently 41%) devolved unconditionally to states.
Grants-in-Aid (Article 275)	Finance Commission recommendation	Statutory grants to states with revenue deficits or special needs.
Discretionary Grants (Article 282)	Executive discretion	Grants for public purposes — used to fund CSS and centrally-directed schemes.

State Disaster Relief Fund	Finance Commission	Compensates states for natural disaster expenditures.
GST Compensation	GST (Compensation to States) Act 2017	Guaranteed states a 14% annual revenue growth; ceased after 5 years (2022).

2.3.5 Consequences of Revenue-Expenditure Mismatch

An uncorrected or inadequately bridged revenue-expenditure mismatch has several adverse consequences:

- Fiscal stress on states: States resort to high-cost borrowings, deferred salaries, or expenditure compression in development sectors.
- Erosion of state fiscal autonomy: Dependence on Central transfers reduces states' ability to set independent spending priorities.
- Accountability deficit: When states spend money collected by the Centre, the link between tax payment and service delivery weakens, reducing fiscal accountability.
- Distorted service delivery: CSS conditionalities force states to spend on Central priorities rather than locally-defined needs.
- Sub-optimal public goods provision: States underinvest in core services when revenue shortfalls are not adequately compensated by transfers.

> **Policy Concern:**
> *The 14th Finance Commission (2015–20) significantly increased the states' share of central taxes from 32% to 42%, the largest single increase in devolution in Indian history. The 15th FC marginally reduced this to 41% to account for the creation of Jammu & Kashmir and Ladakh as Union Territories.*

2.4 Meaning of Horizontal Fiscal Imbalance

While vertical fiscal imbalance concerns the mismatch between revenue and expenditure across different tiers of government, Horizontal Fiscal Imbalance (HFI) refers to disparities in fiscal capacity, revenue-generating ability, and development levels among units at the same tier of government — that is, among states inter se, or among local bodies within a state.

In India, HFI is manifested as the vast and persistent differences in per capita income, per capita own-tax revenue, public expenditure capacity, human development indicators, and physical infrastructure between richer states (such as Maharashtra, Karnataka, Tamil Nadu, and Gujarat) and economically lagging states (such as Bihar, Uttar Pradesh, Jharkhand, and Odisha).

2.4.1 Definitions

> **Robin Boadway:**
> *Horizontal fiscal imbalance refers to differences in fiscal capacity across states at the same level of government — that is, differences in the ability to raise revenues at a standard rate of taxation — that result in unequal standards of public services unless offset by equalisation transfers.*

> **IMF Fiscal Affairs Department:**
> *Horizontal imbalance arises when subnational governments with similar tax structures and rates generate different levels of revenue owing to differences in the underlying tax base, reflecting the uneven geographic distribution of economic activity and natural resources.*

2.4.2 Measuring Horizontal Imbalance

HFI is typically measured using several indicators:

Indicator	What It Measures
Per Capita GSDP	Absolute differences in economic output per person across states.
Per Capita Own Tax Revenue	Differences in states' own fiscal mobilisation capacity.
Human Development Index (State)	Composite measure: income, literacy, and life expectancy divergences.
Tax Effort Index	Whether states exploit their potential tax base fully (actual vs. possible revenue).
Per Capita Public Expenditure	How much states spend per resident on public goods and services.
Fiscal Capacity Gap	Difference between a state's potential revenue (at standard effort) and average potential.

2.4.3 HFI in India: A Snapshot

The divergence between Indian states is among the most extreme in any large federation. Some illustrative data points from recent Finance Commission reports:

- Per capita GSDP in Goa is over 5 times that of Bihar, one of the starkest intra-national income gaps globally.
- Own-tax revenue per capita in Maharashtra is nearly 4 times that of Uttar Pradesh.
- Literacy rates range from over 94% (Kerala) to below 64% (Bihar and Rajasthan in earlier data).
- Infant Mortality Rates in Madhya Pradesh and Uttar Pradesh remain over three times those in Kerala and Tamil Nadu.

> **Key Distinction:**
> *VFI is a structural feature common to all states — all states face a gap between their own revenues and expenditure needs. HFI is about the size of that gap varying enormously across states, with poor states facing much larger gaps than rich states for the same level of service delivery.*

2.5 Causes of Regional Imbalances among States

Regional imbalances among states are the product of multiple interacting factors — historical, geographic, economic, institutional, and political. These causes are mutually reinforcing: poor regions tend to remain poor because poverty limits investment, which limits growth, which limits the tax base, which limits public services, which perpetuates poverty. Breaking this cycle requires conscious redistributive policy.

2.5.1 Unequal Natural Resource Endowments

States differ enormously in their endowments of natural resources — minerals, fertile agricultural land, water resources, coastline access, and forest cover. States such as Jharkhand, Chhattisgarh, and Odisha are rich in minerals but their resource royalties under the Mines and Minerals Act have historically been kept low by Central policy. Conversely, states with fertile plains and assured water (Punjab, Haryana) achieved rapid agricultural growth during the Green Revolution.

2.5.2 Historical Patterns of Industrial Location

Colonial-era industrial development was concentrated in coastal regions (Mumbai, Kolkata, Chennai) and resource-rich zones, creating cumulative advantages. Post-Independence, public sector enterprises were somewhat dispersed, but private investment continued to cluster in already-developed regions. This historical industrial geography continues to shape contemporary fiscal disparities.

2.5.3 Agglomeration Economies and Self-Reinforcing Growth

Economic geography theory explains why growth tends to cluster: once a region achieves a critical mass of economic activity, it attracts skilled labour, investment, and infrastructure in a self-reinforcing cycle. Agglomeration economies — the efficiency gains from proximity — make it rational for firms to locate in already-prosperous regions. This leaves lagging states in a structural disadvantage, unable to compete for mobile capital.

2.5.4 Infrastructure Deficit in Lagging States

Adequate physical infrastructure — roads, railways, ports, electricity, broadband connectivity — is a prerequisite for attracting private investment and enabling economic diversification. Lagging states typically suffer from infrastructure deficits, partly because they lack the fiscal capacity to invest in infrastructure and partly because private infrastructure investment avoids low-income markets. This creates a vicious cycle: poor infrastructure deters investment, which keeps the tax base narrow, which limits infrastructure spending.

2.5.5 Human Capital Disparities

Differences in literacy, educational attainment, health outcomes, and skill levels across states reflect decades of divergent public expenditure and social development. States with better human capital attract more investment, achieve higher productivity, and generate greater tax revenues — further widening the gap with educationally and health-deprived states. BIMARU states (Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh) historically exemplify this human capital-development nexus.

2.5.6 Demographic Pressures

Several lagging states also have faster-growing populations, younger age structures, and higher dependency ratios. Rapid population growth outpaces the expansion of public services and employment, perpetuating poverty and limiting per capita fiscal capacity. States such as Bihar and Uttar Pradesh — with among the highest fertility rates in India — face particular difficulty in improving per capita outcomes even when aggregate economic growth is respectable.

2.5.7 Administrative and Institutional Capacity

The quality of public administration, governance, and institutional capacity varies significantly across states. States with better-managed civil services, stronger rule of law, and more effective local government institutions tend to provide better public services, attract more investment, and mobilise tax revenues more efficiently. Institutional weakness in lagging states constrains their ability to utilise even the transfers they receive from the Centre.

2.5.8 Central Policy Bias

Critics argue that Central government policies — particularly the location of public sector undertakings, the allocation of railway lines, the routing of national highways, and the distribution of infrastructure investments — have historically favoured already-developed states or political considerations over developmental equity. Such allocation biases can widen rather than narrow inter-state disparities.

2.5.9 Summary: Causes Compared

Cause (Vertical)	Explanation	Cause (Horizontal)	Explanation
Centralisation of Taxing Powers	Constitutional assignment of buoyant taxes to the Centre.	**Differential Natural Resource Endowments**	Mineral-rich vs. resource-poor states diverge in fiscal capacity.
Decentralisation of Expenditure	States bear large welfare and social sector mandates.	**Historical Patterns of Industrial Location**	Coastal/connected states attracted early industrialisation.
Tax Base Inflexibility at State Level	States limited to inelastic taxes (stamp duty, land revenue).	**Agglomeration Economies**	Growth self-reinforces in prosperous regions.
Unfunded Mandates	Centre shifts spending to states without matching transfers.	**Infrastructure Gaps**	Poor states lack roads, power, and connectivity for growth.
Borrowing Restrictions on States	FRBM constrains state deficit financing.	**Human Capital Disparities**	Literacy, health outcomes differ sharply across states.

2.6 Measures to Reduce Horizontal Imbalances

Addressing horizontal fiscal imbalance requires both fiscal equalisation (bridging immediate revenue gaps) and structural interventions (addressing the root causes of regional economic disparities). India has deployed a range of instruments under both categories, though the persistence of inter-state disparities suggests that existing measures remain insufficient.

2.6.1 Finance Commission Equalisation Transfers

The Finance Commission is the principal constitutional mechanism for horizontal equalisation. It determines the formula by which the divisible pool of central taxes is distributed among states and recommends grants-in-aid. The distribution formula explicitly accounts for:

- Income distance criterion: States with lower per capita income receive a larger share — the poorer the state relative to the national average, the greater its allocation.
- Population: Larger populations increase a state's entitlement, favouring populous lagging states.

- Forest cover: Compensates states for ecological services and opportunity costs of conservation.
- Tax effort and fiscal discipline: Rewards states that mobilise their own revenues effectively.
- Demographic performance: The 15th FC awarded states that reduced fertility rates, rewarding development progress.

The 15th Finance Commission (2020–25) allocated 41% of central taxes to states, with the income distance criterion carrying 45% weight — explicitly prioritising equalisation.

2.6.2 Grants-in-Aid under Article 275

Article 275 of the Constitution empowers Parliament to provide grants to states that are in need of assistance. These grants are specifically redistributive — they are not proportional to population or wealth but target states facing revenue deficits after receiving their share of devolved taxes. Post-devolution revenue deficit grants provided by the 15th FC to 17 fiscally stressed states are a concrete example.

2.6.3 Centrally Sponsored Schemes (CSS)

CSS provide central funding for priority social sector programmes — MGNREGA, Pradhan Mantri Awas Yojana (PMAY), National Health Mission (NHM), Samagra Shiksha Abhiyan — with a larger Centre-to-state funding ratio for poorer states. While CSS impose conditionalities and reduce state autonomy, they do direct disproportionate resources toward lagging states, partially addressing HFI.

2.6.4 Special Category Status

The National Development Council (now NITI Aayog) recognised certain states as 'Special Category States' (SCS) — typically hill states, states with long international borders, ecologically sensitive states, and states with small economies and low revenue bases. SCS receive:

- A 90:10 Centre-to-state funding ratio for CSS (compared to 60:40 for general category states).
- Priority in allocation of Central assistance.
- Tax concessions and industrial incentives to attract private investment.

Historically, 11 states — including the Northeastern states, Sikkim, Himachal Pradesh, Jammu & Kashmir, and Uttarakhand — held SCS status. This status was discontinued after the 14th Finance Commission's enhanced devolution, though the Northeastern states continue to receive special treatment.

2.6.5 Backward Regions Grant Fund (BRGF)

The BRGF (now restructured as the Aspirational Districts Programme) targeted the 250 most backward districts in India, providing additional funds for infrastructure and social development. By concentrating resources at the sub-state level rather than the state level, BRGF could address intra-state regional disparities in addition to inter-state imbalances.

2.6.6 Aspirational Districts Programme

Launched in 2018, the Aspirational Districts Programme (ADP) identifies 112 districts across India that lag on key development indicators — health, nutrition, education, financial inclusion, basic infrastructure, and livelihood. A convergence of Central government ministries focuses intensive attention on these districts, with monthly ranking and public reporting to incentivise improvement. This granular approach complements state-level equalisation by addressing within-state horizontal imbalances.

2.6.7 Infrastructure Development in Lagging Regions

Targeted infrastructure investment in lagging states — through schemes such as Pradhan Mantri Gram Sadak Yojana (PMGSY) for rural roads, the Bharatmala project for highways, the Sagarmala project for coastal development, and the North East Road Network — aims to reduce the connectivity deficit that deters private investment. Infrastructure serves as a catalyst for economic diversification and revenue base expansion in lagging states.

2.6.8 Tax Incentive Zones

Industrial policy has been used to attract private investment to lagging regions through tax incentives — income tax holidays, concessional customs duties on capital goods, and reduced GST rates for specific industries in specific zones. Special Economic Zones (SEZs), industrial corridors, and investment regions have been developed with a geographic bias toward lagging states, though their effectiveness in transforming regional fortunes remains debated.

2.6.9 Strengthening Local Government Finance

Horizontal imbalance is also manifested at the sub-state level — between urban and rural areas, and between prosperous and backward districts within the same state. The 73rd and 74th Constitutional Amendments devolved significant functions to Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs). State Finance Commissions (SFCs) are mandated to recommend devolution of state tax revenues to local bodies, addressing the third tier of fiscal imbalance.

2.6.10 Equalisation: The Comprehensive Framework

Measure	Legal Basis	Mechanism	Objective
Finance Commission Devolution	Article 280	Shares central taxes with states; adjusts for fiscal capacity gaps.	Equalisation
Grants-in-Aid	Articles 275 & 282	Non-matching and conditional grants to backward states.	Redistribution
Centrally Sponsored Schemes (CSS)	Executive Policy	Transfers for health, education, MGNREGS with state co-funding.	Development

Special Category Status	NDC/NITI Policy	Higher central share (90:10) for hilly, remote, and NE states.	Affirmative Action
Backward Regions Grant Fund	Ministry of Panchayati Raj	Targeted funds for 250 most backward districts.	Regional Equity
PMGSY / Infrastructure Transfer	Ministry of Rural Dev.	Rural connectivity roads funded centrally in poor states.	Infrastructure
Tax Incentive Zones	Income Tax Act / SEZ Act	Industrial incentives to attract investment to lagging regions.	Investment
Revised Devolution Formula (15th FC)	Finance Commission	Increased states' share to 41%; added forest cover criteria.	Equalisation

2.6.11 Limitations of Existing Measures

Despite these instruments, inter-state disparities in India have persisted and in some dimensions widened. Several limitations constrain the effectiveness of current measures:

- Insufficient equalisation: The Finance Commission formula, while equity-oriented, does not fully close the fiscal capacity gap between rich and poor states.
- CSS conditionalities: While redistributive in intent, CSS impose administrative burdens and may distort state priorities toward Central schemes at the expense of locally-determined needs.
- Slow structural transformation: Fiscal transfers address symptoms but not root causes — poor infrastructure, low human capital, weak institutions — which require long-term investment and governance reform.
- Political economy constraints: Richer states resist overly redistributive devolution formulas, creating political constraints on equalisation.
- Data gaps: Accurate measurement of fiscal capacity and expenditure needs remains challenging, limiting the precision of equalisation formulas.

> **Reform Imperative:**
> *Leading public finance scholars argue that India needs a more robust fiscal equalisation framework — one that fully offsets differences in fiscal capacity rather than merely moderating them — alongside sustained investments in education, health, and infrastructure in lagging states to address the structural roots of horizontal imbalance.*

Chapter Summary

Topic	Core Concept	Policy Response
Vertical Fiscal Imbalance (VFI)	Gap between revenue-raising capacity and expenditure responsibility between Centre and States.	Fiscal transfers, Finance Commission devolution, grants-in-aid.
Causes of VFI	Constitutional revenue centralisation, expenditure decentralisation, inelastic state taxes, unfunded mandates.	Restructuring of CSS, broader state tax autonomy, FRBM flexibility.
Revenue-Expenditure Mismatch	Centre commands buoyant taxes; states bear high-cost welfare duties.	Devolution, GST compensation, grants under Articles 275 and 282.
Horizontal Fiscal Imbalance (HFI)	Disparities in fiscal capacity and development levels among states at the same tier.	Equalisation transfers, special category status, regional funds.
Causes of HFI	Unequal resource endowments, agglomeration, historical industrial patterns, human capital gaps.	Infrastructure investment, tax incentive zones, targeted schemes.
Measures to Reduce HFI	Finance Commission formula revisions, CSS, Special Category Status, BRGF, PMGSY.	Address root causes: education, health, connectivity in lagging states.

Review Questions

1. Define Vertical Fiscal Imbalance. How does it arise in a federal system? Illustrate with reference to the Indian Constitution.
2. Examine the causes of vertical fiscal imbalance in India. How do constitutional revenue assignments and expenditure decentralisation contribute to VFI?
3. Critically analyse the revenue-expenditure mismatch between the Centre and States in India. What mechanisms exist to bridge this gap?
4. Distinguish between Vertical Fiscal Imbalance and Horizontal Fiscal Imbalance. Why is this distinction important for fiscal federalism?
5. Discuss the causes of regional economic and fiscal disparities among Indian states. What role do agglomeration economies and historical industrial patterns play?
6. Evaluate the measures adopted in India to reduce horizontal fiscal imbalances. How effective has the Finance Commission been as an equalisation instrument?

7. 'Fiscal transfers are necessary but not sufficient to address horizontal imbalances.' Critically examine this statement with reference to the experience of Indian states.
8. What is Special Category Status? On what grounds is it granted, and what fiscal advantages does it confer? Is the concept still relevant after the 14th Finance Commission's enhanced devolution?

Chapter 3:
Competitive and Cooperative Federalism

Competitive Federalism

- Meaning and Features
- Advantages and Challenges
- Role in Economic Development

Cooperative Federalism

- Meaning and Features
- Centre-State Coordination
- Importance in Policy Implementation

Competitive vs Cooperative Federalism

Humanize the following sentences and assure %85 of all sentence are changed without modifying the meaning:Ever since its inception, federalism hasr\ been a puzzle and not a template. In current democratic models it appears in two complementary forms – competitivve federalism, in which subnational units compete among themseleves to attract investment, talent and policy leadership; and cooperative federalism, in which various levels of government combine resources, share responsibility and co-design policy towards collective national ends. This chapter considers both arrangements, and more, in detail with focus on the Indian scenario.with focus on the Indian scenario.

PART I: COMPETITIVE FEDERALISM

3.1 Meaning and Conceptual Foundations

Competitive federalism refers to a system of governance in which constituent units — states, provinces, or regions — compete against one another to attract mobile resources such as capital, skilled labour, and investment, primarily through differentiating their policies on taxation, regulation, public services, and governance quality. The concept draws its intellectual lineage from Charles Tiebout's 1956 model of local public finance, which argued that citizens 'vote with their feet' by migrating to jurisdictions that best match their preferences for public services and tax burdens.

In a federal system, competitive dynamics emerge naturally when: (i) units possess substantial fiscal and regulatory autonomy; (ii) factors of production are mobile across units; (iii) information about relative governance quality is publicly available; and (iv) the central government refrains from excessive equalisation transfers that eliminate incentive differentials.

> *"Competitive federalism harnesses the self-interest of subnational governments, converting it into a mechanism for public benefit — much as market competition converts self-interested firm behaviour into consumer welfare." — Adapted from Weingast (1995), Market-Preserving Federalism*

3.2 Distinguishing Features

Competitive federalism is a set of interrelated features that inform its operation and defines the normative and practical matrix:

(a) Fiscal Autonomy and Tax Competition States have the power to set their tax rates, offer exemptions, and/or create incentive schemes to attract businesses. It is this degree of fiscal sovereignty that makes competition meaningful and this is the main means of competition. States can also impose concessional stamp duties, waive sales taxes, or provide free or subsidized land to attract industries from other states.

(b) Regulatory Differentiation Units can differentiate their regulation (of labour, environmental clearances, single window investment approvals) to signal how business-friendly they are. Those that make procedures easier are becoming more competitive than those that have bureaucratic red tape.

(c) Policy Experimentation and Innovation Competitive federalism is a laboratory for public policies. The Chief Minister of a state innovating on a successful scheme — like Gujarat's model of industrial cluster or Rajasthan's model on water conservation — makes such a difference that his/her approach sets a template which other states can look to and replicate. The diffusion of best practice is a key welfare-enhancing characteristic of the competitive model.

(d) Accountability to Mobile Constituents State governments are under hard budget constraints and stronger instruments of accountability when firms and high-skilled workers can move. Poor governance has a direct impact on capital and talent flight and hence this would have consequences fiscal as well as political for the trailing administration." (e) Connecting the Dots: Aligning Resource Flows to Development Sp In a competitive federal system, the national government can exacerbate inter-state competition by making resource transfers — whether block grants, scheme allocations, or infrastructure investment— contingent upon

performance metrics that include rankings on doing business, fiscal management, or areas like health and education.

3.3 Advantages of Competitive Federalism

- This leads to better allocative efficiency, as resources move towards states that are the most productive users. Capital allocation among states tracks, at least loosely, the signals produced by cross-section returns. To Promote Good Governance: The risk of capital and population exodus disciplines governments, curtailing rent-seeking and enhancing service provision.
- Diversity of Policies and Experiments: A policy laboratory with a multitude of experiments running in parallel across states provides more information about what works than one centrally prescribed programme.
- Preference Revelation: Tiebout-style mobility enables citizens and firms to sort into like-preference jurisdictions and hence raise their own welfare (and that of others).
- Check on Government Overreach: Just as competition constrains the growth of government at the local level by making it impossible for any one state to levy excessively high taxes without driving away capital, so competition among states can restrain it at the national level.
- Promotion of Economic Growth: It is in competitive states' self-interest to encourage the policies that foster growth of their own economies and this has led to increased aggregate national growth rates.

> *India's 'Ease of Doing Business' rankings, introduced in 2014-15, operationalised competitive federalism by publicly scoring states on investment climate parameters — triggering a visible race among states to reform their administrative and regulatory frameworks.*

3.4 Challenges and Critiques

Competitive federalism, while efficient in many ways, does generate well-known pathologies that need to be managed with care:

(a) the Race to the Bottom Competition for mobile capital can lead states to progressively weaken labor protections, environmental standards, and public safety regulations in a race to the bottom that reduces social welfare. Every state, worried about capital flight, runs to match or better its rivals' concessions even though collectively they would all like to see a higher regulatory floor.

(b) Fiscal Externalities and Beggar-Thy-Neighbour Policies A state's tax cuts steal revenue from its neighbours. When many states do the same thing, public revenue falls overall across the federation, without being transformed into greater productive efficiency.

(c) Horizontal Inequality, Regional Divergence States that enjoy natural geographical advantages (coastal access,mineral resources, or a good climate) routinely attract more investment regardless of governance quality. Competition, then, rewards natural endowment not governance effort, and regional inequality is perpetuated.

(d) Ignoring Immobile Public Goods Government intervention tilts towards mobilisation of mobil-e factors (industry, FDI), and away from public goods that serve immobile populations

(primary health care, rural infrastructure, social protection), while the underinvestment in these non-marketable public goods that occur in a competition for resources is far exceeding what is optimal for the society. The most exit-susceptible receive the brunt of the damage.
(e) Distortions in Incentive Regimes The proliferation of concessions, subsidies and duty waivers - introduced competitively by states - has consequent fiscal impact and often doesn't result in the expected job or technology spillover. Investment that would have been made anyhow gets credit for benefits intended to lure marginal investment.

3.5 Role of Competitive Federalism in Economic Development

Competitive federalism has been a (un-)stated tenet of India's economic development since the 1991 reforms. With the dismantling of centralized controls on industrial licensing, the states emerged as key players in investment location. The following are of particular relevance:

(a) Attracting People from Overseas and from Inside the Country States like Maharashtra, Karnataka, Tamil Nadu, Telangana and Gujarat have vied aggressively for manufacturing and service sector investment with specialized industrial parks, plug and play infrastructure and expedited clearance processes. This contest has produced national industrial expansion and the attraction of multinational corporations.

b) Infrastructure Development Interstate rivalry has produced investments in roads, power, ports and logistics. States with the best infrastructure — the dedicated freight infrastructure in Gujarat, or the port capacity in Andhra Pradesh — secured a continuing investment edge, thus demonstrating the growth dividend from strong governance.

c) Human Capital Investment States competing for knowledge-economy investment such as IT, pharmaceuticals, and aerospace have invested in technical education, university partnerships, and skill development ecosystems. IT investment in Bengaluru, Hyderabad, and Pune is also largely attributable to decisions on education and infrastructure made by the states themselves.

(d) Agricultural Innovation Agricultural competition between states has driven policy innovation including in procurement and market reform (APMC liberalisation) and even in the use of irrigation. States that opened up agricultural markets and include more support of farmer incomes won agri-investment and supplied paradigms of rural growth that can be emulated.

3.6 Summary: Competitive Federalism at a Glance

Dimension	Description
Core Mechanism	States compete for mobile resources through policy differentiation

Primary Instrument	Fiscal incentives, regulatory reform, infrastructure quality
Key Benefit	Efficiency, innovation, accountability, policy learning
Key Risk	Race to bottom, regional divergence, neglect of immobile citizens
Indian Context	EoDB rankings, industrial corridor policy, state investment summits
Theoretical Basis	Tiebout (1956), Weingast (1995), Oates (1972)

PART II: COOPERATIVE FEDERALISM

3.1 Meaning and Conceptual Foundations

Cooperative federalism is a theory of intergovernmental relations in which national and subnational governments collaborate—rather than compete—to develop, fund, and administer public policies. Rather than operating in separate spheres as in dual or layer-cake federalism, cooperative federalism involves functional mixing, joint program administration and mutually agreed coordination between national and subnational governments.

The notion became popular in American constitutional discourse during the 1930s, in connection with the New Deal's shared federal-state programs, and was developed by Morton Grodzins and Daniel Elazar through the image of a marble cake – policies, funds, and administrative duties blending and swirling around different levels of the government, separated in theory but inseparable in practice.

> *"The American form of government is best described as one government performing many tasks rather than many governments each performing separate tasks. It is a marble cake, not a layer cake." — Morton Grodzins, The American System (1966)*

Cooperative federalism in India was given constitutional space through the concurrent list of the seventh schedule and institutional space through planning commissions, finance commissions and the inter-governmental council. The disbanding of the Planning Commission in 2015 and its replacement by NITI Aayog, which has an explicit mandate to promote cooperative and competitive federalism concurrently, represented a major institutional development.

3.2 Distinguishing Features

(a) Shared Jurisdiction and Functional Overlap Cooperative federalism presupposes concurrent jurisdictions — fields of authority in which central government and state

governments exercise legislative and executive power, and are bound to interact rather than having the options of either go it alone or cooperate.

(b) Joint Programme Design and Financing Cooperative federalism flagship programmes are generally centrally sponsored schemes in which the central government supports the states with financial assistance, leaving the responsibility of implementation to the states. National Health Mission, Pradhan Mantri Awaas Yojana, MGNREGS – that is the repertoire of the tradition.

(c) Intergovernmental Consultative Mechanisms Cooperative federalism calls for regularized forum for consultation, bargaining and consensus-making. Among these in India are the National Development Council (NDC), the Inter- State Council (ISC), NITI Aayog's Governing Council, and now the Goods and Services Tax (GST) Council — variables that illustrate differentiated institutional structures for central-state dialogue.

(d) Administrative Interdependence Cooperative federalism's multi-level administrative chain for policy implementation: central ministry formulates the policy and releases money, state government modifies and implements the scheme, and district and panchayats execute at ground level. That interdependence, in turn, necessitates coordination at every interface.

(e) Fiscal Federalism and the Transfers System An effective cooperative federalism is one that utilizes fiscal transfers — formula-based devolution, grants, and equalisation payments — to bring the resource base of states in line with their expenditure obligation, so as to ensure equitable cooperative participation even among asymmetric states.

(f) Norm-Based Rather than Competition-Based Behaviour In contrast to competitive federalism, which is based on incentive structures, cooperative federalism is rooted in shared norms of reciprocity, constitutional obligation, and political will to coordinate. There has to be trust between levels of government, that may have very different political orientations, if not more.

3.3 Centre-State Coordination: Mechanisms and Institutions

High-quality cooperative federalism in India functions via an intricately woven fabric of constitutional norms, statutory bodies and political conventions. To gauge the health of cooperative intergovernmental relations, one must understand these processes.

(a) Finance Commission Drawing up once in five years under Article 280, the Finance Commission is the linchpin of India's fiscal federalism framework. It calculates the vertical share of central taxes devolved to states as well as the horizontal distribution formula among states, balancing equity criteria (per capita income, area, fiscal capacity) with efficiency incentives. The Fifteenth Finance Commission (2020-25) has devolved 41% of divisible pool

revenues to states and included performance grants to incentivise state-level outcomes in health, education and governance.

b) NITI Aayog and the Governing Council The National Institution for Transforming India (NITI Aayog), which was established as a replacement to the Planning Commission in 2015, is also the principal instrument for the promotion of cooperative federalism. Its Governing Council, which includes all Chief Ministers and Lieutenant Governors, is the highest national development strategy consultative forum. Unlike the Planning Commission, NITI Aayog does not have the powers to allocate funds — a design choice to avoid donor-recipient dynamics and rather recognise states as equal partners.

(c) GST Council

The Goods and Services Tax Council — established under Article 279A — represents perhaps the most significant institutional innovation in Indian cooperative federalism. A constitutional body comprising the Union Finance Minister and state Finance Ministers, the GST Council operates on a weighted voting system that gives the Centre one-third and states collectively two-thirds of votes, with decisions requiring a three-fourths majority. This design ensures that neither the Centre nor any coalition of states can unilaterally override fiscal decisions, institutionalising genuine collaborative governance.

> *The GST Council's functioning — with consensus achieved on over 99% of decisions across its first 50 meetings — demonstrated that cooperative federalism can deliver stable, high-stakes policy outcomes even amid political diversity across state governments.*

(d) Inter-State Council

Inter-State Council is established under Article 263 which acts as the source of formal agency for discussing and inquiring into questions of general interest to the states and also between the Centre and states. Although its historical impact has been mixed, it serves as a constitutional safety valve for inter-state conflict and coordination failures.

(e) Zonal Councils of the States Established by the States Reorganisation Act, 1956, India's five Zonal Councils bring together geographically contiguous states and Union Territories to deliberate on regional common challenges such as river water disputes, border management, regional infrastructure, and law and order coordination. They complement the national intergovernmental system with sub-national regional dialogue.

(f) Centrally Sponsored Schemes Centrally Sponsored Schemes (CSS) are the concentrated form of cooperative federalism. They are flagships programmes – such as MGNREGS, the Pradhan Mantri Gram Sadak Yojana, and Ayushman Bharat — which are co-financed by the Centre and the states in different proportions (usually 60:40 for general states and 90:10 for special category states), and the states have the responsibility for implementing them adhering to the central framework guidelines.

3.4 Importance in Policy Implementation

Democratic idea under cooperative federalism is depicted in (lakab) with reference to the federal administrative machinery of the USA in handling India′s federalism.

(**a) Closing the Policy-Implementation Gap** Cooperative federalism is significant at various stages in the policy implementation process: India's problem of governance has traditionally been one of getting things done rather than making policies. Central ministries have expertise and capacity for research and finance, state governments have an administrative apparatus, local knowledge, and connectivity at the grassroots. Co-operative federation : Co-operative federalism synergises these strengths – central design, state delivery.

(b) Responding to Contextual Heterogeneity Contextual Heterogeneity Response to context up to top: Punjab's agriculturally rich plains are incomparable to Meghalaya's forest-community vis a vis Rajasthan's arid pastoralist region. Cooperative federalism allows the national programmes to be customised to the states, while keeping the coherence of the national objectives and ideals.

(c) Dealing with Externalities and Public Goods

External and Public Goods Several important policy areas — environmental protection, river water management, communicable disease control, national highway networks — produce cross-border externalities that no single state homes them. Cooperative federalism gives the institutional vehicle for resolving these externalities through joint action, cost sharing, and regulatory harmonisation.

> *The coordinated national response to COVID-19 — involving central procurement, state distribution, district-level administration, and joint monitoring through daily inter-governmental video conferences — exemplified cooperative federalism under crisis conditions.*

(d) Equitable Development and Fiscal Equalisation

Fiscal federalism under cooperative federalism with Finance Commission devolution, grants and CSS is one way whereby resources are redistributed from the rich states to the poor ones to enable the latter to offer services of the same standard as those in the richer states. Absent this redistributive aspect, federalism would simply codify the regional inequalities resulting from geography, history, and factor endowments.

(e) Political Stability and National Integration Cooperative federalism, which is administrative by nature, has a political relevance also: it has significance as a stage where centre–periphery conflicts can be negotiated, regional demands accommodated, and national cohesion forged in a multi party-multi cultural polity. The ability of states — including those led by opposition parties — to engage substantively in national policy processes matters for the legitimacy and longevity of the federal compact.

(f) Social Sector Agenda getting a Boost The best social achievements in India — declines in Infant Mortality, rises in school enrolment, extension of rural electrification — have been

outcomes of cooperative federal systems integrating central finance, national norms, and state administrative endeavour. Success in cooperatively implementing the NRHM's efforts to reduce maternal mortality in Rajasthan and Uttar Pradesh demonstrates how cooperative implementation can produce results in states with fragile capacity on their own.

3.5 Cooperative Federalism: Summary Framework

Dimension	Description
Core Mechanism	Collaborative governance across levels through shared programmes
Primary Instruments	CSS, Finance Commission devolution, GST Council, NITI Aayog
Key Benefit	Equitable development, policy scale, externality management
Key Risk	Dependence asymmetry, delays, political friction, implementation gaps
Indian Context	MGNREGS, Ayushman Bharat, National Education Policy rollout
Theoretical Basis	Grodzins (1966), Elazar (1962), Musgrave (1959)

PART III: COMPETITIVE VS COOPERATIVE FEDERALISM — A COMPARATIVE SYNTHESIS

The division between competitive and cooperative federalism is, in reality, a continuum rather than a dichotomy. In fact, most functional federal systems make use of both types of approaches at the same time, in different policy areas and varying degrees of intensity. Knowing when to promote each model, and what kind of institutional design to mobilize in order to combine these two models, is the main intellectual challenge of the current federalism literature.

3.6 Comparative Analysis

Parameter	Competitive Federalism	Cooperative Federalism
Fundamental Logic	Market analogy: states as competing suppliers of governance	Partnership analogy: governments as co-producers of public goods

Coordination Mode	Horizontal — state to state	Vertical — centre to state; also horizontal via councils
Resource Allocation	Market-determined by investment flows	Negotiated through fiscal transfer mechanisms
Policy Uniformity	High diversity; states diverge significantly	Greater uniformity through national standards
Best Suited For	Economic policy, investment climate, ease of doing business	Social policy, public goods, externality management
Risk Profile	Race to bottom; regional polarisation	Dependence; implementation delays; political friction
Accountability	Market accountability (capital/labour mobility)	Political and administrative accountability
Indian Institutions	EoDB rankings, investor summits, MSME policy	GST Council, Finance Commission, NITI Aayog, CSS

3. 7 The Indian Synthesis: Complementary Federalism

India's federalism is increasingly understood to fall under the rubric of something called "composite federalism" – the simultaneous engagement of competitive and co-operative forms of federalism within a nested system of governance. This complementarity is visible on at least three planes:

- Domain Differentiation: Economic and industrial issues (FDI attraction, infrastructure investment, ease of doing business) are managed by competition; social issues (health, education, rural development) and fiscal redistribution by cooperation.
- Sequential Complementarity: States first formulate particular models by competing (i.e., Aadhaar-linked benefit delivery in Andhra Pradesh); effective models are then scaled up nationally by cooperative techniques.
- Incentive Layering: Cooperative schemes (CSS) have performance-linked elements that bring competition-related incentives under the cooperative modality, rewarding States that perform better with higher grant disbursements.

> *NITI Aayog's mandate explicitly encompasses both dimensions: 'to evolve a shared vision of national development priorities… with the active involvement of States (cooperative federalism)' while also 'nurturing an overall enabling environment, through a competitive spirit among States, via the constructive process of sharing of best practices.' — NITI Aayog Founding Resolution, January 2015*

3.8 Challenges to Both Models in India

(a) Asymmetric State Capacity

Both modelling exercises assume an administrative capacity that is disparately distributed among the Indian states. Competitive federalism penalizes low capacity states no matter how well intentioned they are with governance; cooperative federalism results in unequal outcomes if those implementing the program in different states (respective recipients of equal central support) possess differing capacities.

(b) Political Divergence

The politics of coalition and opposition disrupts interactional cooperative federalism as states ruled by parties opposing the Centre rechrist as 'non-Centre' proponents of the GST Council's comporários they were coerced into agreeing upon them. Political trust — a necessary condition of cooperative governance – is subject to cyclical tension due to electoral competition.

(c) Fiscal Stress and Debt Dynamics State fiscal strain, especially post-pandemic, has limited the ability of states to provide matching grants for CSS, hindering cooperative implementation. At the same time, they sought investment by competing for incentives against other states, sometimes exacerbating fiscal disequilibria.

(d) Data Deficits True competitive federalism is going to need good comparative data so states can learn from each other, and investors can compare quality of governance. Good cooperative federalism, on the other hand, needs data on outcomes to evaluate program effectiveness. Both are undermined by gaps in India's national statistical capacity beneath the state level.

Conclusion

Competitive and cooperative federalism are not competing constitutional logics but complementary tools within the governance toolkit of a complex federal democracy. Competitive federalism spurs on efficiency, creativity, and responsibility where market-like incentives may function — in economic policy, business environment, and service delivery innovations. Cooperative federalism establishes fairness, manages externalities, and provides scale in areas where the notion of competition would lead to undersupply, "race-to-the-bottom" patterns or regional fragmentation. The transformation of India's federal system since 1991 — accelerated by the GST reform, the creation of NITI Aayog, and the operationalisation of performance-linked federalism — is indicative of a gradual institutional learning about the appropriate sphere and and utilizing the scale advantages of cooperative programs to propagate the benefits of shape of each model. The most important governance innovation in the next few decades is likely to be a clever hybridization of the "competitive" dynamics within "cooperative" contexts – harnessing the disciplining power of inter-state comparison to boost

program execution, competitive best practices. For the students of public administration, political science or economics, the importance of studying these two models goes beyond a mere exercise in conceptual classification. This is a rendition of the classic question of democratic politics: how politicians — for central governments, states, and citizens — come to be oriented toward the collective good of a nation that is, in India's case, at once one and many.

> *Key Takeaway: In a healthy federal democracy, competitive and cooperative federalism are not alternatives but complements — competition disciplines governance while cooperation ensures equity and scale. The art of federal design lies in deploying each mechanism in its appropriate domain.*

Key Terms

Term	Definition
Competitive Federalism	A model where subnational units compete for mobile resources through policy differentiation
Cooperative Federalism	A model of governance based on joint programming and collaboration across governmental levels
Tiebout Model	Theory that citizen mobility creates market-like efficiency in local public goods provision
Race to the Bottom	Downward competitive pressure on regulatory and fiscal standards across jurisdictions
Marble Cake Federalism	Grodzins' metaphor for functional overlap and interdependence across government levels
Centrally Sponsored Scheme	Joint central-state funded programme where states implement central framework policies
Finance Commission	Constitutional body determining fiscal devolution from Centre to states (Art. 280)
GST Council	Constitutional body (Art. 279A) for cooperative tax governance between Centre and states
Fiscal Federalism	The study of fiscal relationships, resource allocation, and transfers across governmental levels

Complementary Federalism	Integration of competitive and cooperative mechanisms in domain-appropriate configurations

Review Questions

1. Distinguish between competitive and cooperative federalism. In which policy domains is each model most appropriate, and why?

2. Critically evaluate the 'race to the bottom' argument against competitive federalism. Under what conditions is this risk most severe, and how can it be mitigated?

3. Examine the GST Council as an institutional model for cooperative federalism. What design features make it a significant constitutional innovation?

4. 'India's federal system is neither purely competitive nor purely cooperative, but complementary.' Elaborate with reference to specific institutions and programmes.

5. How does the Finance Commission's devolution formula balance equity and efficiency objectives? Discuss with reference to a recent Finance Commission's recommendations.

6. Analyse the role of cooperative federalism in India's social sector outcomes, citing evidence from at least two major centrally sponsored schemes.

Chapter 4:
Constitutional Provisions Related to Fiscal Federalism

- Constitutional Framework of Financial Relations
- Division of Powers under the Constitution
- Union List, State List, and Concurrent List
- Constitutional Provisions regarding Taxation
- Articles Related to Centre-State Financial Relations

The financial structure of the Indian Constitution is among its most complex and significant machinery. In formulating taxing powers, expenditure obligations and transfers of funds between the Union and the States, the Constitution adopted a fiscal feder system intended to achieve a balance between unity and diversity, efficiency and equity, and central coordination and subnational autonomy. The Chapter critically analyzes the constitutional bases for these financial relations, drawing illustratively on Indian practice and judicial pronouncements.

4.1. Constitutional Framework of Financial Relations

4.1.1 The Federal Financial Architecture: An Overview

The Indian constitution, unlike many other federal constitutions, does not just outline the shape intergovernmental finance should take but instead lays down a detailed national system of fiscal relations which has defined Indian public finance since 1950. Part XII of the Constitution (Articles 264 to 300A) is the main source text of this temple supplemented significantly by the Seventh Schedule (lists of Legislative Powers) and handful of stand-alone provisions regarding taxation, borrowing, grants and audit. The architects of India's constitution — very aware of the uneven development across India's disparate provinces — built the fiscal federal system around three organising principles: (i) assigned revenue autonomy wherein each level of government has exclusive taxing powers in specified fields; (ii) fiscal transfers – a formal system of revenue sharing and grants from the Union to States to mitigate vertical and horizontal fiscal imbalances; and (iii) fiscal discipline – limits on both the Union and States' borrowing powers to maintain macroeconomic stability..

India's fiscal federal architecture was described by Dr. B.R. Ambedkar as 'a novel feature of the Indian Constitution' — neither fully centralised like a unitary system nor fully decentralised like classical federalism, but a carefully calibrated middle path suited to India's development imperatives and political diversity.

4.1.2 Part XII of the Constitution: The Financial Provisions

Part XII of the Constitution, spanning Articles 264 to 300A, is organised thematically to address the full scope of Union-State financial relations:

Articles	Subject Matter
264–267	General financial provisions: Consolidated Fund, Contingency Fund, Public Account, Comptroller and Auditor General
268–281	Distribution of revenues: allocation of taxes between Centre and States, Finance Commission
282–291	Grants and financial assistance: grants-in-aid, grants for specific purposes, estate duty
292–293	Borrowing by the Government of India and by State Governments
294–300	Miscellaneous financial provisions: succession to property, liabilities, contracts, suits
300A	Right to property: no person to be deprived of property except by authority of law

4.3 The Consolidated Fund of India and States

Article 266 enshrines the Consolidated Fund of India (CFI) as the depository of Union revenues — being the tax receipts, non-tax revenues, and loan recoupments, and from which all refunds to the Union and credits to the Union are made, and Union expenditure is the drawing-back to the extent of subjecting them to parliamentary authorization. Correspondingly, there is a Consolidated Fund for each State u/s 266(1) for tax and other income of the State, and for expenditure of the State. Article 267 also provides for the establishment of the Contingency Fund of India (and State Contingency Funds), for unforeseen expenditures of the Union (and States) to be placed at the disposal of the President (Governors), until regular parliamentary/legislative approval is received. The Public Account (Art 266(2)) contains money received by the government either as trust – provident fund, judicial deposit, small scale savings – which are not consolidated fund.

Indian Example — The CFI in Practice: Every rupee collected as income tax, GST (Union share), customs duty, or non-tax revenue (RBI surplus, dividends from PSUs) flows first into the Consolidated Fund of India. In 2023-24, the CFI received over Rs. 33 lakh crore, making it the largest single fiscal pool in the country's history.

4.4 Comptroller and Auditor General (Article 148)

Article 148 declares the CAG of India as the highest audit authority, separate from executive control. It audits the accounts of the Union and of the States, and its reports are placed before the Parliament and the State Legislatures, as the tool for fiscal accountability under the Constitution. The CAG's independence is also safeguarded by security of tenure similar to a Supreme Court judge to a judge of the High Court in the appointment of which he also has a role. The CAG's is a critical role particularly in the context of cooperative federalism: when monies are transferred from the centre to states under CSS, the CAG follows the money through two levels, and presents a consolidated audit report that neither audits of the central ministries alone nor audits of the states alone could capture.

4.2. Division of Powers under the Constitution

4.2.1 The Seventh Schedule: India's Legislative Architecture

Legislative — and consequently financial — powers are divided between the Union and States by the Seventh Schedule to the Constitution, which contains three Lists. This three-fold segmentation is the basic tool of India’s fiscal federalism and defines what level of government can tax whom, regulate which sector, and be accountable for which public service.

Constitutional Basis: Article 246 — 'Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I (Union List) in the Seventh Schedule… the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II (State List)… [and] both Parliament and a State Legislature have power to make laws with respect to any of the matters enumerated in List III (Concurrent List).'

4.2.2 Residuary Powers: Article 248

A unique aspect of the Indian constitutional framework, as contrasted with classical federations such as the USA and Australia, is that the residue of legislative and taxation powers is placed in the Union Parliament rather than the States. Article 248 read with Entry 97 of the Union List empowers the Parliament to legislate exclusively on “any matter not included in the Concurrent List or State List.” This residual authority has major fiscal implications—since in 1950 the common types of economic activity and tax bases were predictable, now new types of economic activity and new tax bases that were unforeseeable then will be within Union jurisdiction.

Indian Example — Residuary Power and the Service Tax: When the Government of India introduced the service tax in 1994, there was no explicit constitutional entry for taxing services. The Centre invoked its residuary power under Entry 97 of the Union List to levy the tax. The constitutionality was challenged but upheld. This entry was subsumed into GST in 2017, which created an explicit constitutional basis through Article 246A.

4.2.3 Article 246A: GST — A New Constitutional Dimension

Introduced through the 101st Amendment Act, 2016, article 246A is the biggest post-independence overhaul of the Indian fiscal federal system. It provides both Parliament and the State Legislatures the concurrent power to make laws 'in respect of goods and services tax levied by the Union or any State'. This unprecedented simultaneous taxation power — with Parliament having the say on the inter-state supply — reshaped the constitutional shape of indirect taxation, eradicating the previous cascading multi-tax.

4.3. Union List, State List, and Concurrent List

4.3.1 Union List (List I): Central Legislative and Fiscal Domain

The Union List contains 100 entries (originally 97) covering subjects of national importance and those requiring uniform treatment across the country. Fiscally significant entries include matters of both regulatory importance and direct revenue relevance:

Entry	Subject	Fiscal Significance
Entry 82	Taxes on income other than agricultural income	Income Tax — Union's largest direct tax; Rs. 18.23 lakh cr in 2023-24
Entry 83	Duties of customs including export duties	Customs duty — major trade tax; protects domestic industry
Entry 84	Duties of excise on tobacco, petroleum products	Central Excise (post-GST on specified goods)
Entry 85	Corporation Tax	Tax on company profits; second-largest direct tax
Entry 86	Taxes on capital value of assets (excluding agricultural land)	Wealth tax (abolished 2015); capital transactions
Entry 87	Estate duty in respect of property other than agricultural land	Inheritance taxation; Union domain

Entry 88	Duties in respect of succession to property	Union's succession duty powers
Entry 92A	Taxes on the sale or purchase of goods in the course of inter-state trade	Central Sales Tax; now subsumed in IGST under GST
Entry 92B	Taxes on consignment of goods in inter-state movement	Superseded by GST regime
Entry 97	Residuary powers	All matters not in State or Concurrent Lists

Union List subjects also include the Defence Forces, atomic energy, railways, national highways, currency, banking and insurance regulation, and international treaties — all of which have profound indirect fiscal implications through their demand for public expenditure.

> *Indian Example — Direct Tax Collections: In 2023-24, Union direct tax collections (income tax + corporation tax) crossed Rs. 19 lakh crore for the first time, constituting nearly 55% of Union gross tax revenues — underscoring the fiscal weight of Union List taxation entries.*

4.3.2 State List (List II): State Legislative and Fiscal Domain

The State List has 61 entries since the 42nd Amendment, (originally it had 66) and describes the scope of State lawmaking and taxing powers. The States have a normal reign when it comes to legislative authority on these matters, but Parliament can legislate on these matters under Articles 249, 250, 252 and 253, during emergencies and exceptional situations.The entries on the State List that were financially significant were::

Entry	Subject	Fiscal Significance
Entry 45	Land Revenue	Primary tax on agricultural land; significant in rural states
Entry 46	Taxes on agricultural income	States tax farm income; not shared with Centre
Entry 47	Duties in respect of succession to agricultural land	State inheritance on agricultural property
Entry 48	Estate duty in respect of agricultural land	State domain for agricultural wealth

Entry 49	Taxes on lands and buildings	Property tax; key revenue for urban local bodies
Entry 50	Taxes on mineral rights	Mining royalties; critical for mineral-rich states
Entry 51	Duties of excise on alcoholic liquors and narcotics	Liquor excise; states' single largest own-tax revenue
Entry 52	Taxes on entry of goods into a local area (Octroi/Entry Tax)	Largely replaced by GST; urban local body revenue
Entry 54	Taxes on sale and purchase of petroleum, alcohol (post-GST)	Petroleum products kept outside GST; state revenues
Entry 56	Taxes on goods and passengers carried by road or inland waterways	State transport revenues
Entry 57	Taxes on vehicles	Motor vehicle tax; substantial state revenue source
Entry 60	Taxes on professions, trades, callings, and employments	Professional tax; up to Rs. 2,500 per annum per person
Entry 62	Taxes on luxuries and entertainments	Entertainment tax; partially subsumed in GST
Entry 63	Rates of stamp duty in respect of documents	Stamp duty on property registrations; major state revenue

> *Indian Example — Liquor Excise as Fiscal Lifeline: Excise duty on alcohol (Entry 51) is constitutionally excluded from GST and remains the largest component of states' own tax revenue in many states. In 2022-23, Delhi's excise revenue was approximately Rs. 9,500 crore; Karnataka's was over Rs. 26,000 crore. For states like Telangana and Andhra Pradesh, liquor excise contributes 15-20% of own tax revenues — illustrating the fiscal significance of State List exclusions.*

4.3.3 Concurrent List (List III): Shared Legislative Domain

There is a Concurrent List with 52 items which deals with the subjects of the legislation of both the Union and the State. If there is a conflict between centre and state laws on the subjects of the concurrent list, it is the central law that prevails, until the time the State law is granted

the assent of the President, whether it takes place before or after.Entries of fiscal and economic consequence in the Concurrent List include:

● Entry 17: Transfer of property other than agricultural land; registration of deeds and documents … …Stamp duty and the taxation of property transfer in common law countries are governed by this provision.

● Entry 20: Economic and social planning — permits central planning legislation to direct state fiscal commitments

● Entry 25: Education (w.e.f. 42nd Amendment) — mandates joint responsibility for spending on education

● Entry 26: Legal, Medical and Other Professions: Economic aspect of professional regulation

● 33. Production, supply, and distribution of certain commodities — in so doing, it confers on the Centre and States joint power to regulate (through monetary laws) product markets

● 34. Price control: Both the Centre and the States are competent to legislate with regard to prices of commodities, which have direct fiscal impact.

● 44: Stamp duties other than duties or fees levied by means of judicial stamps (except rates of stamp duty for papers mentioned in item 63 of the List of States).

> *Indian Example — Education Expenditure and the Concurrent List: Following the 42nd Constitutional Amendment (1976), education was moved from the State List to the Concurrent List. This enabled the Centre to legislate on the Right to Education Act (2009) and create national standards, while simultaneously establishing a cost-sharing framework under Samagra Shiksha where Centre and States share programme expenditure in prescribed ratios.*

4.3.4 Comparative Overview of the Three Lists

Dimension	Union List (List I)	State List (List II)	Concurrent List (List III)
No. of Entries	100 entries	61 entries	52 entries
Who Can Legislate	Parliament only	State Legislature only (normally)	Both Parliament and State Legislatures

In Case of Conflict	Union law prevails	State law prevails (exclusive)	Union law prevails (Art. 254)
Key Tax Entries	Income tax, customs, corporation tax, IGST	Liquor excise, land revenue, stamp duty, property tax	Stamp duties (partial), economic planning
Residuary Power	Vests with Parliament (Entry 97)	Not applicable	Not applicable
Emergency Override	Not needed (already Union)	Parliament can legislate (Arts. 249, 250, 252, 253)	Parliament can override state law

4.4. Constitutional Provisions regarding Taxation

4.4.1 General Principles of Constitutional Taxation

The Constitution lays down certain broad principles that are required to be followed while exercising the power to tax at the Union and the State levels. These constitute a series of structural constraints upon the taxing powers of governments, which are intended to eliminate the possibility of arbitrary, discriminatory, or otherwise economically distorting taxation:

● No tax shall be imposed except by the authority of law and no tax shall be collected except under the authority of law (Article 265) — principle of necessity in taxation

● Money Bills and tax legislation are to be dealt with under special parliamentary procedures (Arts 109-117)

● The freedom guaranteed under Article 301 to carry on trade, commerce and intercourse has the effect of prohibiting the imposition of a tax which obstructs the flow of trade between one State and another).

● Article 14 provides equality before law and equal protection of the laws and that the State shall not discriminate among its citizens in matters of taxation.

● Article 19(1)(g) secures the right to the practice of any profession — In Re. taxation which might become so onerous as to be confiscatory.

4.4.2 Article 265: No Taxation Without Statutory Authority

Article 265 *Tax Legality*	No tax shall be levied or collected except by authority of law. This provision ensures that every tax imposed — whether by the Union or a State — must have express statutory backing. Executive orders, administrative circulars, or delegated legislation cannot by themselves create tax liability unless the parent statute explicitly authorises them.

Article 265 has been the subject of much litigation in the Supreme Court. The Court ruled that procedural defects go to the root of tax collection in Collector of Customs v. Nathella Sampathu Chetty (1962). In the more recent case of Bharat Sanchar Nigam Ltd. v. Union of India (2006), the Court invoked the Article 265 principle to address ambiguity in the Centre's power to tax services and the States' power to tax trade in goods — a natural tension that has been papally resolved structurally by the GST Constitution Amendment.

4.3 Article 269: Taxes Levied and Collected by the Union but Assigned to States

Article 269 *Assigned Revenues*	Taxes levied and collected by the Government of India but assigned to States. The proceeds of estate duty and succession duty in respect of property other than agricultural land, and terminal taxes on goods or passengers carried by railway, sea, or air, are assigned in their entirety to States.

Article 269A (inserted by the 101st Amendment, 2016) specifically governs the levy and collection of GST on inter-state supplies of goods or services. It provides that such tax shall be levied and collected by the Government of India and be apportioned between the Union and States in the manner prescribed by Parliament — operationalised through the IGST Act, 2017.

> *Indian Example — IGST Apportionment: When a Delhi-based business sells goods to a buyer in Maharashtra, IGST (Integrated Goods and Services Tax) is collected by the Central Government under Article 269A. The revenue is then apportioned: the importing state (Maharashtra) receives the SGST component (roughly half), the Centre retains the CGST component, with the exporting state (Delhi) receiving no share — preventing double taxation while compensating the consuming state.*

4.4 Article 270: Taxes Levied and Distributed Between the Union and the States

Article 270 *Divisible Pool*	All taxes and duties referred to in the Union List — except duties and taxes referred to in Articles 268, 268A, and 269, surcharges, and any cess levied for specific purposes — shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner prescribed under Article 280(3)(a).

Article 270 is the source of the whole tax devolution in India. The ‘divisible pool’ under Article 270 consists of the income tax, corporation tax, customs duties, and excise duties on most goods. The Finance Commission decides how the States are to be financed by what proportion of the divisible pool (currently, the recommendation of the 15th Finance Commission is 41% to States) and also the manner in which it is to be distributed horizontally among States.

Tax	Collected By	Distributed?	Basis
Income Tax (non-agricultural)	Union	Yes — divisible pool	FC formula: income distance, area, population, forest cover
Corporation Tax	Union	Yes — divisible pool	Same FC formula
Customs Duties	Union	Yes — divisible pool	Same FC formula
Central Excise (post-GST residual)	Union	Yes — divisible pool	Same FC formula
CGST	Union	No — Union retains	Under GST architecture
IGST (Union share)	Union	Partial — Centre's portion retained	IGST Act apportionment
Surcharges & Cesses	Union	No — Union retains 100%	Art. 270(1) exclusion
Liquor Excise	State	No — State retains 100%	State List Entry 51
Land Revenue	State	No — State retains 100%	State List Entry 45

4.5 Article 271: Surcharges for Purposes of the Union

Article 271 *Surcharges*	Notwithstanding Articles 269 and 270, Parliament may at any time increase any of the duties or taxes referred to in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

Art 271 is a constitutionally allowed means, for a Union, to increase its revenue share without expanding the size of the divisible pool. As surcharges can not be shared with States, the Union has exploited this provision — as well as a similar mechanism of education and other cesses — to mobilise large sums of money outside the fiscal federal sharing regimen.

Indian Example — Cesses and Surcharges as Non-Shareable Revenue: In 2023-24, cesses and surcharges received by the Union Government outstripped Rs. 5.8 lakh crore from among other things — Health and Education Cess (4% on income tax), Swachh Bharat Cess (discontinued), Krishi Kalyan Cess (discontinued), and PMGKAY surcharges. Because none of these go into the divisible pool, States have been vocal about concerns that the proliferation of cesses chips away at their share of Union revenue. This concern was specifically highlighted by the 15th Finance Commission.

4.6 Article 301-304: Freedom of Trade and Tax Restrictions

In Part XIII, articles 301 to 307 guarantee the freedom of trade, commerce and intercourse in the entirety of the territory of India. Article 301 provides that "trade, commerce and intercourse shall be free" in India; Articles 302 to 305 lay down a few exceptions in which the Parliament or State Legislature can curtail the said freedom. Article 304 also authorizes States to levy non-discriminatory taxes on goods coming from other States if such taxes do not 'restrain' the freedom guaranteed in Article 301 – a contention often raised in the litigation regarding octroi and entry tax.

Indian Example — State Entry Taxes and Article 301: Several States levied entry taxes on goods entering their territory, creating de facto fiscal barriers to inter-state trade. The Supreme Court's nine-judge constitutional bench in Jindal Stainless Ltd. v. State of Haryana (2016) upheld the competence of States to levy entry taxes provided the tax is non-discriminatory (same rate on local and imported goods). The entire controversy became academic post-GST, which subsumed entry taxes under the unified indirect tax framework.

4.5. Articles Related to Centre-State Financial Relations

4.5.1 Finance Commission: Articles 280–281

The Finance Commission is the linchpin of India's intergovernmental fiscal relations in the Constitution. The Commission is the instrumentality by which the Constitution provides that fiscal federalism is subject to revision from time to time by a body of experts rather than by the dictation of the Centre.

Article 280 *Finance Commission*	The President shall, within two years of the commencement of this Constitution and thereafter at the expiration of each fifth year or at such earlier time as the President may consider necessary, by order, constitute a Finance Commission consisting of a Chairman and four other members to be appointed by the President. It is the responsibility of the Finance Commission to recommend to the President as to: (a) the sharing between the Union and States of the net proceeds of Union taxes and its distribution among States; (b) the norms that govern grants-in-aid to States; (c) the steps to be taken to boost the Consolidated Fund of a State to meet the demands of Panchayats and Municipalities; and (d) such other matters as the President may refer to it.

Fifteen Finance Commissions have been constituted since 1951.Each has progressively refined the devolution formula by increasing share of States in central taxes and by adding criteria for horizontal distribution:

Finance Commission	Period	Vertical Share to States	Key Innovation
1st FC (K.C. Neogy)	1952-57	Not fixed; tax-specific grants	Established devolution framework
5th FC (Mahavir Tyagi)	1969-74	~50% of income tax; excise grants	Per capita income equalisation
10th FC (K.C. Pant)	1995-2000	29% of income tax + excise	Fiscal deficit incentives
11th FC (A.M. Khusro)	2000-05	29.5% of divisible pool	FRBM convergence criteria
13th FC (Vijay Kelkar)	2010-15	32% of divisible pool	GST transition incentives
14th FC (Y.V. Reddy)	2015-20	42% of divisible pool	Largest increase; reduced tied transfers
15th FC (N.K. Singh)	2020-25	41% of divisible pool	Performance grants; J&K reorganisation

Article 281 The Finance Commission shall submit its report to the President, and the President shall cause the report to be laid before each House of the Parliament with a statement of the action taken thereon. The dissenting recommendations of the Commission are only advisory,

and, by and large, these have been accepted in spirit by successive Governments, reflecting the constitutional authority and political legitimacy of the Commission.

4.5.2 Grants-in-Aid: Articles 275 and 282

Article 275 *Statutory Grants*	Legislation may be enacted by Parliament to provide for such grants from the Consolidated Fund of India as it may be considered necessary to the States to enable them to defray the expenses of schemes of development for the purpose of promoting the welfare of Scheduled Tribes or for the elevation of the level of administration in Scheduled Areas. Also, pending the recommendation of the Finance Commission, the amounts of money which the President may specify by order shall be charged on the Consolidated Fund of India as grants-in-aid of the revenues of certain States.

Article 282 *Discretionary Grants*	The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.

The article 275 grant is a formula-based, Finance Commission recommended transfer which is meant to cover the gap between a State's revenue or capacity to expend. They are predictable and non-discretionary. On the other hand, article 282 grants are completely discretionary — used by the Centre to meet the cost of Centrally Sponsored Schemes (CSS) and Central Sector Schemes whether the subject is attached to the Union or State List.

Indian Example — Controversy over Article 282: The Centre has been heavily relying on Article 282 to directly finance CSS — without using the route of either the Finance Commission or devolution — which has led to regular Centre-State conflict. States say that Article 282 grants have conditions attached to them and there are reporting and implementation requirements which impinge on State autonomy. The 14th Finance Commission consciously raised the share of formula-based devolution (from 32% to 42%) in a bid to reduce states' reliance on discretionary Article 282 grants.

4.5.3 Borrowing Powers: Articles 292 and 293

Article 292 *Union Borrowing*	The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as Parliament may from time to time by law fix, and to the giving of guarantees within such limits, if any, as Parliament may so fix.

Article 293 *State Borrowing*	The executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as the Legislature of such State may from time to time by law fix, and to the giving of guarantees. A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan made to the State by the Government of India.

Article 293(3) creates a critical fiscal constraint: States that owe outstanding loans to the Centre must obtain Central consent before borrowing from markets. This provision gives the Centre a powerful instrument of fiscal oversight over fiscally imprudent States.

Indian Example — Article 293 and FRBM: Under the Fiscal Responsibility and Budget Management (FRBM) Act framework, the Centre sets annual borrowing limits for States as a percentage of GSDP (currently 3.5%, with additional 0.5% conditional on power sector reforms). States borrowing beyond this without consent violate Article 293. During COVID-19, the Centre enhanced States' borrowing limit from 3% to 5% of GSDP for 2020-21 under Article 293(3), providing crucial fiscal space.

4.5.4 Consolidated Fund Charges: Article 112(3) and Related Provisions

Some items of expenditure are 'charged' on the Consolidated Fund — these are not subject to the vote of the legislature and cannot be reduced by either Houses of Parliament or by the State Legislatures. These are Salary of the President, Governors, judges of the Supreme Court and High Courts, CAG, Election Commissioners and interest on public debt. This insulation of vital constitutional expenditure from the yearly political strain is an important financial federal protection.

4.5.5 Distribution of Non-Tax Revenues and Natural Resources

Although the Constitution specifies the distribution of tax revenues, it is the non-tax revenues from natural resources that raise more challenging questions under residuary powers and concurrent powers. Key provisions include:

● Royalties in mineral resources (Entry 50, State List): States get the royalties on mines and minerals as per the Mines and Minerals (Development and Regulation) Act. The rates are decided by the Centre, but States get the revenue — a cause of federal friction, more so for mineral rich States like Jharkhand, Odisha and Chhattisgarh.

● Forest revenue: States levy forest royalties under the Forest Rights Act and other applicable laws; the constitutional support is drawn from the State List (Entry 17A, after 42nd Amendment is it a matter of Concurrent List under forests).

● Offshore royalties: Revenue from offshore oil and gas production is allocated to the Union (Article 297 vests all resources in the seabed under territorial waters in the Union).

> *Indian Example — Mining Royalties Dispute: Odisha and Jharkhand — two of India's most mineral-rich but economically lagging States — have longstanding disputes with the Centre over royalty rates for coal, iron ore, and bauxite. The Supreme Court's nine-judge bench in State of West Bengal v. Kesoram Industries (2004) and subsequent cases have progressively clarified the boundary between the Union's regulatory power over minerals and States' fiscal entitlement to royalties. In 2024, the Supreme Court ruled that States can levy taxes on mineral-bearing land over and above royalties — a landmark fiscal federal judgment.*

4.5.6 Intergovernmental Immunities and Tax Limitations

Article 289 of the TFEU provides that State property and income are exempt from Union taxation and Article 285 states that Union property shall be exempt from taxation by the Member States. These mutual immunities are designed to keep one level from interfering in the fiscal operations of the other, and each is subject to certain qualifications such as the power of Parliament to declare certain activities taxable notwithstanding ownership by a government..

> *Indian Example — PSU Taxation and Article 285: The constitutional immunity of Union property was progressively narrowed by Parliament through the Finance Acts, which subjected income of government undertakings to income tax. In Union of India v. DESU (1997), the Supreme Court affirmed that Article 285's exemption covers only property but not commercial income of government entities engaged in trade — enabling States to collect professional tax and local body levies from Union government employees and PSU operations.*

4.6. Constitutional Amendments and Fiscal Federalism: The GST Revolution

4.6.1 The 101st Constitutional Amendment Act, 2016

With the One Hundred and First Amendment Act (2016) bringing in the Goods and Services Tax, it is the biggest overhaul of India's fiscal federal structure since the adoption of the Constitution. The Amendment inserted the Article 246A (concurrent power to tax on goods and services), Article 269A (for levy and collection of the IGST), Article 279A (establishment of the GST Council) and also made other amendments in the Seventh Schedule to the extent of removing the taxation entries which are now subject to GST.

Constitutional Change	Before 101st Amendment	After 101st Amendment
Tax on goods (intra-state)	State VAT (State List Entry 54)	SGST under Article 246A

Tax on services	Service Tax (Union, residuary Entry 97)	CGST + SGST under Article 246A
Tax on inter-state sale of goods	CST (Entry 92A, Union List)	IGST under Article 269A
Entry Tax	State List Entry 52	Subsumed in SGST
Tax coordination body	No constitutional body	GST Council under Article 279A
Revenue neutrality	No constitutional guarantee	Compensation to States for 5 years (now lapsed)

Indian Example — GST Revenue Growth: Post-GST implementation (July 2017), GST collections grew from approximately Rs. 89,000 crore per month in 2017-18 to over Rs. 1.87 lakh crore per month in April 2024 — a record high. The constitutionally mandated 5-year compensation mechanism (2017-2022) ensured States were protected against revenue losses, reflecting cooperative fiscal federalism in action.

4.6.2 Article 279A: The GST Council

Article 279A *GST Council*

With the One Hundred and First Amendment Act (2016) bringing in the Goods and Services Tax, it is the biggest overhaul of India's fiscal federal structure since the adoption of the Constitution. The Amendment inserted the Article 246A (concurrent power to tax on goods and services), Article 269A (for levy and collection of the IGST), Article 279A (establishment of the GST Council) and also made other amendments in the Seventh Schedule to the extent of removing the taxation entries which are now subject to GST.

The constitutionalization of the GST Council was a game changer for the institutionalization of cooperative federalism in the Indian fiscal system. Its requirement of super-majority consensus (75% weighted votes) in all matters ensured that neither the Centre nor any combination of States could dominate the other — a structural safeguard of federal parity in India's largest indirect tax.

4.7. Comparative Overview: Key Constitutional Articles at a Glance

Article	Subject	Significance for Fiscal Federalism
246	Legislative powers — 3 Lists	Foundational distribution of legislative and taxing authority
246A	Concurrent GST power (101st Amdt)	Restructured indirect taxation; joint Centre-State power
248	Residuary powers to Parliament	Novel tax forms belong to Centre
265	No tax without legal authority	Legality principle — no executive taxation
266	Consolidated Funds and Public Accounts	Fiscal repositories for both levels of government
267	Contingency Fund	Emergency fiscal reserves for Centre and States
269	Taxes assigned to States	Centre collects, States receive — assigned revenues
269A	IGST levy and distribution	Inter-state supply taxation framework under GST
270	Divisible pool distribution	Centre-State tax sharing; Finance Commission operationalisation
271	Surcharges for Union purposes	Non-shareable revenue; contested by States
275	Statutory grants to States	Formula-based, Finance Commission-recommended transfers
279A	GST Council (101st Amdt)	Institutionalised cooperative fiscal governance
280	Finance Commission	Core institution of vertical and horizontal fiscal balancing
281	Finance Commission report	Accountability and transparency in fiscal federalism
282	Discretionary grants	Basis for Centrally Sponsored Schemes

285	Union property — State tax exemption	Intergovernmental fiscal immunity
289	State property — Union tax exemption	Reciprocal intergovernmental immunity
292	Union borrowing power	Deficit financing and national debt management
293	State borrowing — Centre consent	Central oversight of State fiscal imprudence
300A	Right to property	Constitutional basis of property taxation limits
301-304	Freedom of trade and commerce	Tax discrimination across State borders prohibited

Conclusion

The provisions for fiscal federalism in Indian Constitution are well designed and integrated system of powers, transfers and institutional safeguards. Through an allocation of tax powers to Union and States via the three Lists, by prescribing an independent Finance Commission to periodically recast the terms of resource sharing, by instituting well-defined procedures for grants and borrowing monitoring, and more recently by enshrining GST laws in a single reference to a procedure based taxation system article 279A) in the Constitution, India crafted a fiscal federal design that has withstood – and evolved – over seven decades of India's development. There are also three systemic tensions in this arrangement which continue to characterize and characterize the evolution of Indian fiscal federalism. First, the vertical imbalance — States do roughly 60 percent of total public expenditure but have access to only around 40 percent of total revenues, resulting in a structural reliance on central transfers. Second, the horizontal inequity — disaggregation of per capita fiscal capacity between the richest and poorest States in India has increased in spite of equalisation transfers thus raising doubts on adequacy of devolution formula. Third, there is the autonomy-accountability tension wherein the States wish more untied fiscal resources while the Centre craves greater accountability assurances in respect of large-scale transfers. For students of public administration and political science these are not merely quotations from the Constitution—they are the language of Indian governance. Every major policy intervention, from MGNREGS to Ayushman Bharat to the Smart Cities Mission, reflects the fiscal federal structure laid down in these articles. To master this architecture, then, is not only to understand the essentials of Indian constitutionalism but also how the Indian state really operative in practice.

The constitutional framework of fiscal federalism is best understood not as a static distribution of resources but as a dynamic system of incentives, constraints, and institutions that shapes the behaviour of both the Union and States in pursuit of their fiscal and developmental goals. Its continuous evolution — through Finance Commission recommendations, constitutional amendments, and judicial interpretation — reflects the living character of India's constitutional democracy.

Key Terms and Concepts

Term	Definition
Fiscal Federalism	The study of how public revenues and expenditures are allocated across levels of government in a federal system
Divisible Pool	The pool of Union tax revenues (under Art. 270) that is shared between the Centre and States per Finance Commission formula
Vertical Imbalance	The gap between States' revenue capacity and their expenditure responsibilities, necessitating central transfers
Horizontal Imbalance	Inter-State differences in per capita fiscal capacity, addressed through redistributive devolution formulae
Consolidated Fund	Primary fiscal repository of the Union/States (Art. 266); all revenues and expenditures flow through it
Finance Commission	Constitutional body (Art. 280) recommending fiscal devolution from Centre to States every five years
Grants-in-Aid (Art. 275)	Formula-based statutory grants from Centre to States to bridge revenue-expenditure gaps
Discretionary Grants (Art. 282)	Non-formula grants used by Centre to fund CSS; basis of ongoing Centre-State fiscal tension
Article 293 Consent	Requirement of Central consent for State borrowing when State has outstanding Central loans
GST Council (Art. 279A)	Constitutional body for cooperative indirect tax governance; three-fourths weighted majority for decisions

IGST (Art. 269A)	Integrated GST levied on inter-state supplies; collected by Centre, apportioned to consuming State
Surcharge (Art. 271)	Additional levy on Union taxes entirely retained by Centre; excluded from divisible pool
Assigned Revenues (Art. 269)	Taxes collected by Centre but entirely assigned to States — e.g., estate duty
Article 246A	Concurrent GST power; inserted by 101st Amendment, 2016; basis of the GST legal framework

Review Questions

1. Explain the constitutional basis of India's fiscal federalism. How do the three Lists of the Seventh Schedule allocate taxing powers between the Union and States? Illustrate with examples of at least three tax entries from each List.

2. Critically analyse Articles 270 and 271 together. How does the proliferation of surcharges and cesses under Article 271 affect States' share of Union revenues? What reforms have been suggested to address this?

3. 'The Finance Commission is the cornerstone of India's fiscal federal architecture.' Discuss with reference to Article 280, the evolution of devolution percentages across Finance Commissions, and the 15th Finance Commission's key recommendations.

4. Distinguish between Article 275 (statutory grants) and Article 282 (discretionary grants). Why have States historically preferred Article 275 grants over Article 282 grants? What was the significance of the 14th Finance Commission's decision to raise devolution from 32% to 42%?

5. How did the 101st Constitutional Amendment Act, 2016 restructure India's fiscal federal architecture? Discuss the significance of Articles 246A, 269A, and 279A separately, with illustrative examples from GST implementation.

6. What is the significance of Article 293 in Centre-State financial relations? How has the FRBM framework operationalised Article 293 constraints on State borrowing? Discuss with reference to COVID-19 fiscal relaxations.

7. 'India's fiscal federal architecture suffers from a structural vertical imbalance.' Examine the constitutional provisions that create this imbalance and the mechanisms designed to correct it. Do you think the current architecture adequately compensates States for their expenditure responsibilities?

Chapter 5:
Assignment of Functions and Sources of Revenue

Assignment of Functions

- Functions of Central Government
- Functions of State Governments
- Functions of Local Governments

Sources of Revenue

- Revenue Sources of Centre
- Revenue Sources of States
- Shared Taxes and Grants-in-Aid

Learning Objectives

On completion of the chapter, you will be able to:

• Explain the separation and distribution of powers between the Central, State and Local Governments

• List the major sources of revenue at each level of government

• Discuss the sharing arrangements for taxes and grants-in-aid

• Assess the importance of the Finance Commission in the fiscal machinery of India.

PART I: ASSIGNMENT OF FUNCTIONS

A federal system separates political authority vertically among two or more levels. There is a provision in India's Constitution for three tier federalism at the Union Government at the top, 28 State Governments in the middle and more than 2.5 lakhs Local Self-Government bodies at the base. The Seventh Schedule is the bedrock of functional division: it divides duties via three lists – the Union List, State List and Concurrent List. The logic behind functional assignment is to follow the "principle of fiscal equivalence" where the geographic extent of the benefits associated with a public good should be coextensive with the jurisdiction providing the public good. Goods with national spillovers are centrally provided; goods consumed in specific localities are locally provided.

5.1 Functions of the Central (Union) Government

The Seventh Schedule's Union List (List I) encompasses 97 topics on which the Parliament is granted the power to legislate and execute. These are matters in which uniformity or the advantages of a single national provision are so important that they justify a centralized supply. 4.1.1 Key Functions

• Defense and National Security ◦ Maintenance of the Army, Navy and Air Force, and of nuclear weapons and military cantonments. ◦ For example: Ministry of Defence whose budget (Union Budget 2024-25) exceeds ₹6 lakh crore.

• Foreign affairs ◦ Treaties and diplomatic relations, UN participation.

• Currency, Coinage and the Reserve Bank of India ◦ The RBI is a Central subject, being established on the basis of the RBI Act, 1934. • Railways ◦ It is centrally run: Indian Railways is one of the world's largest rail networks, spanning 67,956 km.

• Posts and Telecommunications ◦ Posts and telecom spectrum allocation are part of DoT (Department of Telecommunications).

• Atomic Energy and Space ◦ ISRO and DAE are Central undertakings. (Indian Space Research Organisation) & DAE (Department of Atomic Energy) respectively and are central undertakings.

• Inter-State Trade and Commerce

• Banking, Insurance and Stock Markets ◦ SEBI, IRDAI and the control of scheduled banks are Central topics.

> **Indian Example: Union Railway Budget (Now merged with General Budget)**
>
> Until 2017, India presented a separate Railway Budget. Post-merger with the General Budget, railways remain a Union subject receiving ₹2.52 lakh crore capital outlay in 2024-25, reflecting the scale of centralised infrastructure provision.

4.1.2 Rationale for Central Provision

Function	Rationale	Indian Example
Defence	National public good; spillovers across all states	Border security in J&K benefits all states
Currency	Monetary union prevents race-to-the-bottom	RBI's monetary policy applies nationwide
Railways	Scale economies; inter-state coordination	Mumbai–Delhi Rajdhani route crosses 5 states

Nuclear Energy	Security, externalities, international obligations	DAE's Kudankulam Plant, Tamil Nadu

5.2 Functions of State Governments

There are 66 subjects enumerated in the State List where the State Legislatures have exclusive legislative powers. These are services based whose returns are predominantly regional or local and for which local know-how and preferences are the relevant factors for deciding how to satisfy demand. The Concurrent List (List III) consists of 52 subjects in respect of which both Parliament and the State Legislatures can make laws, but the Union law prevails over the State law in case of conflict.

4.2.1 Important Functions of State under List 2

• Public Order and Police ◦ State Police forces; law and order maintenance. Example: Maharashtra Police, UP Police.

• Public Health and Hospitals ◦ Government hospitals, primary health centers, sanitation. Example: Aarogyasri in Andhra Pradesh and Telangana.

• Agriculture ◦ Revenue from land, irrigation, and agricultural marketing. Illustration: APMC (agricultural produce market committee) laws.

• Education (Primary and Secondary) ◦ Class XII school education (concurrent subject, but states implement it).

• Local Government ◦ The constitution and powers of municipalities and Panchayats.

• Roads and Bridges (State Highways) ◦ State PWDs Look after Intra-state roads.

• Land Reforms And Revenue ◦ Records of revenue, land tithing (in relation to state jurisdiction).

• Electricity ◦ Distribution companies (State Electricity Boards/DISCOMs). For instance: MSEDCL in Maharashtra.

Indian Example: Ayushman Bharat vs. State Variants

Health is primarily a State subject. While the Centre launched Ayushman Bharat – PM-JAY providing ₹5 lakh health cover per family, several states implemented their own schemes: Tamil Nadu's Chief Minister's Comprehensive Health Insurance Scheme, Kerala's KASP, and West Bengal's Swasthya Sathi — illustrating how states tailor services to local needs.

5.2.2 Key Functions under the Concurrent List

Concurrent Subject	Central Role	State Role
Education (Higher)	UGC, IITs, IIMs, NIT funding & standards	State Universities, colleges affiliation
Electricity	Inter-state grids, nuclear power, CERC	DISCOMs, State Electricity Regulatory Commissions
Labour Laws	ESI Act, PF, Industrial Disputes Act	State-level inspections, implementation
Forests	National Forest Policy, Project Tiger, CAMPA	State Forest Departments, revenue forestry
Economic Planning	NITI Aayog, Five-Year Planning (historical)	State Planning Boards, district plans

5.3 Functions of Local Governments

The third tier was accorded the status of constitutional body through 73rd and 74th amendments for Rural Panchayati Raj Institutions and Urban Local Bodies respectively. The Eleventh Schedule (Article 243G) enumerates 29 functions to be exercised by the Panchayats, and the Twelfth Schedule (Article 243W) is a 18 item list of the functions of the Municipalties. 4.3.1 PRIs - Rural Local Bodies India has three-level panchayat strucure i.e. Gram Panchayat (village level), Panchayat Samiti (block level) and Zila Parishad (district level).

• Agriculture, land reclamation, minor irrigation

• Primary and secondary education (delivery)

• Health and sanitation (primary health centres, village sanitation)

• Drinking water supply • Rural housing (PMA Was Yojana – Rural implementation)

• Poverty reduction measure (implementation of MGNREGS)

• Keeping up of public goods, rural roads

Indian Example: Gram Panchayat Development Plan (GPDP)

Under MGNREGS, Gram Panchayats prepare the Gram Panchayat Development Plan. In 2023-24, MGNREGS generated 264 crore person-days of employment, with Gram Panchayats as the primary implementing agency — showcasing devolution of both functions and funds.

5.3.2 Urban Local Bodies (ULBs)

Urban Local Bodies comprise of Lidc (Large cities), Mwsd (medium towns) and Npp (transitional urban areas).

- Urban planning and land-use regulation
- Roads, bridges and street lighting
- Water supply and sanitation
- Solid waste management
- Slum upgradation and improvement
- Public health and hospitals (dispensaries)
- Regisration of births and deaths
- Markets and fairs

Indian Example: Brihanmumbai Municipal Corporation (BMC)

BMC, with an annual budget of ₹59,954 crore (2024-25), is among India's wealthiest ULBs. It manages over 2,000 km of roads, 27 hospitals, and serves a population of ~20 million. BMC's own-source revenue from property tax and octroi substitutes illustrates the potential of urban local finance.

PART II: SOURCES OF REVENUE

In a system of fiscal federalism, each level of government needs to have sufficient financial resources at its disposal to enable it to perform the activities assigned to it. Article 246 contains the legislative powers, while Articles 264-293 cover the financial relations between the Union and the States. The RevenueSources are arranged along three different dimensions: own-tax revenue, own-non-tax revenue, and transfers. 4.4 Central Government Revenue Co The Union Government's right to levy a tax is vested in the Moot List and the Finance Commission's proposals. Article 270 relates to taxes exercises and gathered by the Union but apportioned in the middle of the Union and the States. The Consolidated Fund of India is the most important fund of the government.

5.4.1 Tax Revenue Income Tax (over individuals and HUFs) By CBDT Collected by the Central Board of Direct Taxes (CBDT).Personal income tax revenue was ₹10.78 lakh crore in 2023-24. Corporate Tax

• Tax on company profits. Base rate cut from 30 percent to 22 percent in 2019 (15% for new domestic manufacturing companies). Goods and Services Tax (GST) — CGST component The Central GST component of the dual GST structure.◦ Central GST under the GST dual GST formation. GST (came into effect on 1st July, 2017) replaced 17 indirect taxes. Customs Duty

• Imposed on imports and exports. The Basic Customs Duty, the IGST on imports. ₹2 revenue: 33 lakh crore (2023- 24).

• Central Excise (outside GST on petroleum, tobacco) Excise on petroleum products – a major source of the Central revenue (~₹3.5 lakh crore per annum).

• Securities Transaction Tax (STT) and Other Financial Taxes

5.4.2 Non-Tax Revenue

- Dividends and profits from PSUs — e.g. ONGC, NTPC, Coal India
- Interest payments on loans extended to states and PSUs
- Proceeds of spectrum auction (DoT) — 5G spectrum auction garnered ₹1.5 lakh crore in 2022
- Fees and fines (passport, Central judiciary, regulatory fees)
- Disinvestment receipts (capital receipts — e.g., the LIC IPO in 2022 raised ₹21,000 crore)

Revenue Head	Amount (₹ Lakh Crore, 2024-25 BE)	% of Total Revenue
Gross Tax Revenue	38.31	~67%
— Income Tax	11.87	~21%
— Corporate Tax	10.20	~18%
— GST (CGST + IGST share)	10.68	~19%
— Customs + Excise	5.56	~10%
Non-Tax Revenue	5.07	~9%
Capital Receipts (incl. borrowings)	13.65	~24%

Source: Union Budget 2024-25, Ministry of Finance, Government of India. BE = Budget Estimate.

5.5 Revenue Sources of State Governments

States raise revenues from two main sources: their own revenue resources (tax and non-tax) and transfers from the Union (sharing of Central taxes + grants-in-aid). State finance post-GST has become ultra-important as the states gave up a lot of their independent indirect tax powers for a predictable stream of revenue.

4.5.1 State's Own Tax Revenuesd s • State GST (SGST) ◦ States still keep their percentage in GST. Tax rates are decided by the GST Council, a constitutional body under article 279A.

• State Excise Duty (Alcohol) • State Excise Duty (on Alcohol) ◦ Liquor taxation is an important source of State revenue. Goa to collect Rs 23,000 cr in state excise (2023-24). Alcohol is not within GST.

• Stamp Duty and Registration Charges

• Stamp Duty and Registration Fees ◦ Imposed on real estate deals., Impost on property transactions. In 2023-24, Maharashtra made 40,000 cr; Karnataka made 25,000 cr from the stamp duty.

• Electricity Duty

• Electricity Tax although no such tax exists ◦ States impose a tax on use of electricity (not in GST).

• Vehicle Tax / Motor Vehicles Tax

• State Road Tax for Two-Wheeler and Four-Wheeler Vehicles ◦ The road tax rules of various states.₹) Delhi makes circa₹ 2,500 cr yearly XD.

• Land Revenue

• Land Taxes ◦ Nevertheless, under laws that are increasingly minor but are a state subject entertainment taxes, professional tax. Entertainment Tax, Profession Tax”"**”–note this from a little later!

> **Indian Example: Rajasthan's Dependence on Stamp Duty**
>
> Rajasthan's own tax revenue is heavily dependent on stamp duty and registration fees, accounting for nearly 15% of its own tax revenue. In urban areas like Jaipur, rising property values have made stamp duty a buoyant revenue source, while rural areas show lower collection — illustrating inter-district revenue disparities within a state.

5.5.2 State's Own Non-Tax Revenue

Revenue to forests (timber, charges on forest produce)

- Irrigation Charges (water user charges from canals)
- Fees and fines (state judicial, RTO, regulatory agencies)
- Dividends from State PSUs (State Electricity Boards, SRTCs)
- Mining royalties: mineral-rich states like Jharkhand, Odisha and Chhattisgarh rake in huge royalties.

State	Major Own Revenue Source	Approx. Share of SOTR
Maharashtra	SGST, Stamp Duty, State Excise	Largest state tax base — ₹3.15 lakh cr (2023-24)

Uttar Pradesh	SGST, Stamp Duty	Largest state by population; SGST dominant
Goa	State Excise (tourism-linked)	High per capita own revenue
Odisha	Mining Royalties, SGST	Iron ore & coal royalties ~18% of SOTR
Kerala	SGST, State Excise, Lottery	Kerala Lottery contributes ~₹4,000 crore/year

5.6 Shared Taxes and Grants-in-Aid

The fiscal relations between the Union and States in India are based upon vertical fiscal imbalance, as it is the case in other federations: the Union raises more revenues than is required for its own needs and the States find that their decennial collection is not enough to meet their expenditure needs. This disequilibrium is rectified by one or both of the following devices: (i) the sharing of central taxes with the states, and (ii) ploughing back of central revenue to the states by the way of grants-in-aid.

4.6.1 The Finance Commission — Constitutional Basis A Finance Commission is constituted every fifth year under Article 280 of the Constitution. The Commission is also required to suggest a) the distribution between the States and the Union of the net proceeds of the central taxes; b) the grants-in-aid to the States out of the Consolidated Fund of India; and c) the measures that can be taken to increase the Consolidated Fund of a State to enable it to match resources of panchayats and municipalities.

Finance Commission	Period	States' Share in Central Taxes	Key Innovation
10th FC	1995–2000	29%	Introduced normative approach to state finances
11th FC	2000–2005	30.5%	Recommended grants for upgradation of standards
12th FC	2005–2010	30.5%	Emphasised fiscal consolidation by states
13th FC	2010–2015	32%	Performance grants; climate change grants
14th FC	2015–2020	42%	Historic increase — largest ever devolution

15th FC	2020–2026	41%	1% reduction for newly formed UTs of J&K & Ladakh

Key Fact: 14th Finance Commission — The Big Leap

The 14th Finance Commission (Chairman: Y.V. Reddy) recommended increasing the states' share from 32% to 42% — the highest ever vertical devolution. This was justified on the grounds of enhanced fiscal autonomy and cooperative federalism, allowing states to prioritise local needs without Central conditionalities.

5.6.2 Horizontal Devolution — How Taxes are Shared Among States

The Finance Commission also prescribes criteria for distributing the States' share among individual states (horizontal devolution). The 15th Finance Commission used the following criteria:

Criterion	Weight (15th FC)	Logic
Income Distance (per capita GSDP gap)	45%	Equalisation — poorer states get more
Population (2011 Census)	15%	Demand for public services
Area	15%	Cost of providing services in large states
Forest and Ecology	10%	Conservation incentive
Tax Effort	2.5%	Reward for own revenue mobilisation
Demographic Performance	12.5%	Reward for reducing fertility rates

Indian Example: Why Does Bihar Get More Than Maharashtra?

Under horizontal devolution, Bihar (with very low per capita income) receives ~10% of the divisible pool while Maharashtra (a high-income state) receives ~6.3%, despite Maharashtra's much larger economy. This is the equalisation principle at work: the formula deliberately tilts funds towards backward states to reduce inter-state fiscal disparities.

5.6.3 Grants-in-Aid (Article 275)

Apart from tax devolution, the Central also grants the states grants-in-aid. They are two-fold: (a) statutory grants under Article 275 recommended by the Finance Commission and

(b) discretionary grants (which now mainly come in the form of grants for Centrally Sponsored Schemes and Central Sectors Schemes).

• Revenue Deficit Grants: States with a revenue deficit post-devolution are given assistance to fill the gap. The 15th FC has identified 17 states as eligible.

• Sector-Specific Grants: Health, Education, Local Bodies, DM.

• Performance-Based Grants: Related to performance on education outcomes, ease of doing business, and so on.

• Local Body Grants: For Gram Panchayats and Urban Local Bodies — Rs 4.36 lakh crore over 2021-26 (15 th FC). 4.6.4 CSSs and CSs-WTO Compatible Apprcrich to Fully Execute BPSs WTO Sanctioned CFMAS) In addition to Finance Commission grants, Central Government also financially supports programs through CSS (jointly funded by Centre-State) and Central Sector Schemes (fully funded by Centre).These are discretionary transfers with conditionalities.

Category	Funding Pattern	Examples
Core of the Core CSS	Centre: 90%, State: 10% (NE states: 100% Centre)	MGNREGS, PMGSY, National Social Assistance Programme
Core CSS	Centre: 60–75%, State: 25–40%	PM Awas Yojana, Swachh Bharat Mission, Ayushman Bharat
Optional CSS	Centre: 50–60%, State: 40–50%	AMRUT, Smart Cities Mission, HRIDAY
Central Sector Schemes	100% Centre	PM KISAN, PMFBY (Pradhan Mantri Fasal Bima Yojana)

5.6.5 The GST Compensation Mechanism — A Special Case

When GST was rolled out in 2017, there were concerns in states about potential loss of revenue with the ceding of VAT, CST and other taxes. The GST (Compensation to States) Act, 2017 ensured states an annual revenue growth of 14 per cent for five years (2017-22), the shortfall in revenue compensated through a cess on demerit goods.

Indian Example: COVID-19 and GST Compensation Dispute

In 2020-21, GST collections collapsed due to COVID-19. States were owed ~₹2.35 lakh crore in compensation but the cess fund was insufficient. The Centre offered states back-to-back loans. The compensation period ended in June 2022, and the cess (now called GST

Compensation Cess) continues to repay these loans until 2026 — illustrating the complexity of shared-tax mechanisms in federal systems under stress.

Chapter Summary

Dimension	Central Govt	State Govts	Local Govts
Constitutional Basis	Union List (97 subjects)	State List (66) + Concurrent (52)	11th & 12th Schedules (73rd & 74th Amendments)
Key Functions	Defence, Railways, Currency, Foreign Affairs	Health, Agriculture, Police, Education	Water supply, Sanitation, Urban planning
Primary Tax Source	Income tax, Corporate tax, CGST, Customs	SGST, State Excise, Stamp Duty	Property tax, Professional tax
Transfers Received	—	42% of divisible pool + grants	Finance Commission local body grants
Indian Example	ISRO, RBI, Indian Railways	Ayushman Bharat State variants, APMCs	BMC Mumbai, Gram Panchayats under MGNREGS

Review Questions

- Explain the significance of the Seventh Schedule in India's federal fiscal architecture. How does the three-list structure resolve potential conflicts?
- Why did the 14th Finance Commission increase the states' share from 32% to 42%? What arguments support and oppose this decision?
- Distinguish between vertical and horizontal fiscal imbalance. How does the Finance Commission address each?
- Critically evaluate the role of Centrally Sponsored Schemes in India's fiscal federalism. Do they enhance or undermine state autonomy?
- With the introduction of GST in 2017, how did the revenue autonomy of states change? Discuss the GST compensation mechanism and its implications.
- Examine the financial constraints of Urban Local Bodies in India. What reforms would strengthen their fiscal position?

Chapter 6:
Centre–State Financial Relations in India

- Tax Sharing between Centre and States
- Grants-in-Aid
- Loans and Borrowings
- GST and Fiscal Relations
- Role of Intergovernmental Transfers
- Issues in Centre-State Financial Relations**Learning Objectives**
- After studying this chapter, students will be able to:

- • Understand the constitutional provisions governing Centre–State financial relations in India
- • Analyse the mechanism of tax sharing through the Finance Commission and the divisible pool
- • Explain grants-in-aid and their role in reducing vertical fiscal imbalances
- • Evaluate the borrowing powers and constraints of State Governments
- • Examine how GST has restructured fiscal federalism in India
- • Assess the role and adequacy of intergovernmental transfers
- • Critically discuss major issues and reform proposals in Centre–State financial relations

LEARNING OBJECTIVES

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6.1 Introduction

India is a Union of States. What India is under its Constitution is a 'Union of States' – a linguistic formula that "burries the question of federalism" and "bows the federal polity in line behind the centre," said a prominent commentator on Indian politics. While India is certainly a federal state, its federalism is unique — it is asymmetric, quasi-federal and heavily Centre-biased, particularly in financial matters. The founding fathers acknowledged that political cohesion, planning exigencies, and administrative efficiency dictated a strong Centre, and that fairness and grassroots governance required fiscally empowered States. Centre–State financial relations have a pivotal position in Indian fiscal policy. They decide what share of public revenue gathered at the national level is distributed between the Union Government and the 28 States (plus 8 Union Territories), and eventually determines the quality of public services – roads, schools, hospitals, drinking water – accessed by over 1.4 billion citizens. This chapter presents an end to end assessment of the fiscal federalism architecture in India, which includes: the constitutional provisions related to the division of revenues, the system of tax sharing and grants-in-aid, borrowing constraints on States, the transformative GST, the significance of intergovernmental transfers, and the nagging issues that reformers are faced with.

6.2 Constitutional Framework of Centre–State Financial Relations

6.2.1 Seventh Schedule: Division of Legislative Powers

The seventh schedule to the concerning three lists that partition the taxing (and, under the list including Legislations designing within particular class of Laws) powers of the Centre and the States are: The three lists are; Union, State and Concurrent list (Union being the most exclusive list and Concurrent list being the most inclusive of three). It has 97 subjects which are the exclusive domain of the Parliament. Key tax heads include income tax (other than agricultural income), customs duties, central excise duties, corporation tax and taxes on inter-state transactions.

State List (List II) - It contains the subjects that are under the exclusive jurisdiction of the State. The important tax heads are so be revenue to land, stamp duty, state excise (on alcohol), taxes on land and by using on buildings, entertainment tax and tax on professionals. Concurrent List (List III): VERSION 3: (a) Powers to legislate on 52 subjects of activities under the

Concurrent List are conferred upon both Houses of Parliament and the State Legislative Assemblies fo the States; (b) Acts of the Parliament duly made under this List override conflicting laws of the State Council of States. This creates the classic 'vertical fiscal imbalance' picture whereby the vast majority of revenues (income tax, corporate tax and customs) is collected by the Centre, but the States have far greater expenditure responsibilities in education, health, agriculture, policing. Centre-State transfersIdentify the primary way to fill this gap between the two.

6.2.2 Key Constitutional Articles

Article	Provision
268	Duties levied by the Union but collected and appropriated by the States (e.g., stamp duties on bills of exchange).
269	Taxes levied and collected by the Union but assigned to the States (e.g., taxes on inter-state sale of goods before GST).
270	Taxes levied and collected by the Union and distributed between Union and States (income tax, central GST pool).
271	Parliament may levy surcharges on Union taxes; proceeds go to the Consolidated Fund of India (not sharable).
273	Grants in lieu of export duties on jute and jute products to certain States.
275	Grants-in-Aid to States in need of assistance; recommended by Finance Commission.
280	Finance Commission: Constituted every 5 years to recommend distribution of taxes and grants.
282	Union or State may make grants for any public purpose even outside their legislative competence.
293	States may borrow within India only; subject to consent of Centre if previous loans are outstanding.

Table 7.1: Key Constitutional Provisions on Centre–State Financial Relations

6.3 Tax Sharing Between Centre and States

6.3.1 The Divisible Pool

The 'divisible pool' is the total of the Central taxes and duties, which the Central government is obliged under the Constitution to share with states. It is the backbone of vertical fiscal transfers in India. Under Article 270 (as substituted by the Constitution 80th Amendment Act, 2000), all the taxes collected by the Union — but for surcharges and cesses — are included in the divisible pool.

KEY CONCEPT — Divisible Pool Divisible Pool = All Central taxes and duties received by the Union Government minus (a) the surcharges and cesses that are to be used for specific purposes and (b) the taxes that are solely assigned to States under Articles 268 and 269. The Finance Commission is responsible for recommending what proportion of the total pool is transferred to the States in aggregate (vertical share), and the share of each State (horizontal

disaggregation) that they preside over. The size and structure of the divisible pool have undergone significant changes. The inclusion of the entire Union tax net in the pool (post-80th Amendment) was a transformative reform which gave the States a bigger, more stable share of central revenues, it replaced the earlier regime under which only income tax and Union excise duties were pooled and shared.

6.3.2 Finance Commission: Constitutional Mandate

The President is required under Article 280 of the Constitution to constitute the Finance Commission at five year intervals (or sooner if deemed necessary). The Commission is a quasi-judicial body headed by an eminent economist or administrator / jurist comprising five members.

It is also required to recommend:

• The sharing between the Centre and states of the net proceeds of taxes (vertical devolution);
• The distribution among the states of each state's share of the proceeds (horizontal distribution);

• The principles on which grants-in-aid are to be made to the states and

• Any other matter which it considers necessary for being referred to it by the President in the interest of sound finance. The Finance Commission's recommendations have traditionally been accepted by the government in their entirety, which confers de facto power over India's fiscal architecture to the Commission, insane were only the Finance Commission has any legal power to make such recommendations be they then considered advisory.

6.3.3 Evolution of the Devolution Ratio

The vertical devolution ratio — the percentage of the divisible pool allocated to States — has increased progressively over the decades, reflecting greater recognition of States' developmental responsibilities:

Finance Commission	States' Share (%)	Key Recommendation / Context
1st FC (1952–57)	55% (income tax)	Separate formulas for income tax and excise
7th FC (1979–84)	~30% (pool)	Expanded the concept of a pool
10th FC (1995–2000)	29%	First to use a unified pool concept
11th FC (2000–05)	29.5%	Post-80th Amendment unified pool

13th FC (2010–15)	32%	Increase to strengthen State finances
14th FC (2015–20)	42%	Landmark jump; reduced Centrally Sponsored Schemes
15th FC (2021–26)	41%	Slight reduction due to J&K bifurcation

Table 7.2: Evolution of States' Share in the Divisible Pool

The 14th Finance Commission (Chairman: Y.V. Reddy) made the most consequential recommendation in post-Independence fiscal federalism by raising the States' share from 32% to 42% — a 10 percentage point jump in a single award. This was explicitly linked to reducing discretionary, tied grants and enhancing States' 'untied' fiscal space.

6.3.4 Horizontal Distribution Among States

After arriving at the aggregate States' share (vertical devolution), the Finance Commission has to make the decision as to how it is to be distributed among the 28 States. The 15th Finance Commission provided the following norms for horizontal distribution::

Criteria	**Weight (2021–26)**	**Rationale**
Income Distance (State's per capita income vs richest State)	45%	Equity: redistributes to poorer States
Population (2011 Census)	15%	Need-based allocation
Area	15%	Cost of service delivery across geography
Forest and Ecology	10%	Reward for environmental services
Demographic Performance	12.5%	Incentive for States managing population growth
Tax Effort	2.5%	Reward for own revenue mobilisation

Table 7.3: Horizontal Distribution Criteria — 15th Finance Commission

The smaller States such as Bihar, UP, MP, Jharkhand are getting disproportionate share far more than their population because the income-distance criterion heavily biases towards States with low per capita income. On the other hand, wealthier states like Maharashtra, Karnataka and Tamil Nadu have complained that high tax effort, better demographic performance and urbanisation are inadequately rewarded. INDIAN EXAMPLE — Bihar Share Under 15th FC

Bihar, one of the poorest States in the country whose per capita income is barely one-fourth of the national average, gets a whopping 10.06% of devolution under the 15th Finance Commission – far more than its share in the national population (~8.6%). This equity based distribution allows Bihar to provide for basic public services despite the low own-tax revenues. In Bihar, too, 60% of the total revenue receipt was from centre's hands as the State received more than ₹1.7 lakh crore in total central transfers in 2023-24.

6.4 Grants-in-Aid

6.4.1 Constitutional Basis and Rationale

Grants-in-Aid are unconditional or conditional transfers from the Centre to the States that act as supplements to the tax devolution system. These have a base in Articles 275 and 282 of the Constitution. Even as devolution of Article 270 addresses vertical imbalance through sharing of Central tax revenues, grants-in-aid attain some other objectives:

- Compensate for residual vertical fiscal mismatches post-tax devolution;
- Address horizontal fiscal disparities (the poorer States are given higher per capita grants);
- Support specific national priority programmes (health, education, rural development) and
- Encourage States to pursue certain policy objectives (such as performance-linked grants).

6.4.2 Types of Grants

(a) Finance Commission Grants (Article 275)

The grants under the Finance Commission are formula based and substantially non-discretionary in nature. They are advised to to meet special requirements and deficiencies which cannot be addressed by tax devolution. The following types of grants were recommended by the 15th Finance Commission (2021–26):

Type of Grant	Amount (₹ cr, 2021–26)	Purpose
Revenue Deficit Grants	2,94,514	Bridge gap for States in post-devolution revenue deficit
Local Bodies (Rural + Urban)	4,36,361	Funds for Panchayats and Urban Local Bodies
Disaster Risk Management	1,22,601	State Disaster Response Fund + NDRF corpus
Health Grants	70,051	Supplement health infrastructure, especially post-COVID

Sector-specific / Performance	Conditional	Agriculture, judiciary, statistics, power sector reforms

Table 7.4: Grants Recommended by the 15th Finance Commission (2021–26)

Revenue deficit grants need special mention. These are awarded to the States which continue to experience revenue deficit post-devolution — i.e., after taking into account their share of central taxes, their revenues are inadequate to meet their expenditure needs. For the period 2021-26, States like Himachal Pradesh, Uttarakhand, Punjab, Andhra Pradesh, Kerala, along with a number of north eastern States were found to have revenue deficit and were recommended grants.

(b) Centrally Sponsored Schemes (CSS)

A vast portion of grants is distributed under Centrally Sponsored Schemes — development programmes financed by Centre and States on a shared basis. These are granted pursuant to Article 282 (grants for public purpose) and are conditional, for they come with specific sectoral and outcome-based conditions. Major CSSs include MGNREGS (rural employment), PM-KISAN (farm income support), PM Awas Yojana (housing), Ayushman Bharat (health insurance), and Samagra Shiksha (school education). The pattern of financing in CSS has changed. The 14th Finance Commission, in raising tax devolution, implicitly asked States to bear more burden of CSS. Many CSS were restructured post 2015 to require States to contribute 40% (for general category States) and 10% (for north-eastern and special category States), with the Centre providing 60% and 90% respectively.

INDIAN EXAMPLE — PM Awas Yojana (Gramin)

Under PM Awas Yojana – Gramin (PMAY-G), the Centre funds 60% and States fund 40% of the cost of rural housing units. The scheme targets completion of 2.95 crore pucca houses for the rural poor. States like Uttar Pradesh (target: over 50 lakh units) and Madhya Pradesh receive substantial annual grants under this scheme, but must make matching contributions — creating incentives for States to budget accordingly. By 2024, over 2.5 crore houses had been completed under the scheme.

(c) Central Assistance for State Plans (Discretionary Grants)

In the past, the Planning Commission (which was dissolved in 2014 and replaced by the NITI Aayog) used to provide ex-ante plan support to the States. This was broadly categorized into the 'Normal Central Assistance' and the 'Additional Central Assistance'. With the abolition of the Planning Commission and the replacement of Five-Year Plans with rolling annual plans, this category has been dismantled. The Ministry of Finance now disburses the plan assistance under the specific heads of the budget.

6.5 Loans and Borrowings

6.5.1 Constitutional Constraints: Article 293

The State borrowing is regulated by the Article 293 of Indian Constitution. Its key features are as follows: • The States can borrow inside India on their Consolidated Fund as security up to the limit fixed by the legislatures of the States. • No State shall borrow from any outside source (foreign government or multilateral organisation) without prior permission of the Centre. • A state cannot borrow further if it has any outstanding loans from the centre.

Since all States but one have outstanding loans from the Union Government, Article 293(3) grants the Centre sweeping power to control the borrowing of the states. It has been wielded — to impose fiscal discipline, and to apply what critics say is political pressure.

6.5.2 The FRBM Framework

The FRBM Act at the central level laid down targets for the reduction of fiscal deficit and revenue deficit of the Centre. The majority States followed suit to pass their own State FRBM Acts thus establishing a two tier system of fiscal consolidation. The major borrowing limit on states under FRBM is that of fiscal deficit: Limit on FRBM Fiscal Deficit for States The States are entitled to a fiscal deficit of 3% of their Gross State Domestic Product (GSDP) per annum under FRBM guidelines. This limit was raised to 5% of GSDP (with stipulated conditions) during COVID-19 (2020–21). From 2021–22 onwards, the limit has been restored to 3% plus an additional 0.5% allowed for power sector reforms. States implementing prescribed reforms (power distribution, one-nation-one-ration,Â ease of doing business, urban local body revenues) attract additional borrowing space.

6.5.3 Sources of State Borrowings

The states borrow from different sources to meet capital and revenue expenditure and the deficit:

• Market borrowings (Open market borrowings – OMBs): States issue market borrowing instruments such as bonds or a taxable debt security known as State development loans (SDL) in the domestic market which is coordinated by RBI. SDL market has deepened considerably since the late 1990s.

• National Small Savings Fund (NSSF) loans: Central government mobilizes small savings deposits and advances to States. Nssf loans were more costly than market rates of interest. Many states have asked for the replacement of NSSF loans with cheaper market borrowings.

• Borrowings from the Centre: Falling share; mainly for externally aided projects (EAPs) routed through the Centre.

• Multilateral and Bilateral Loans (via Centre) : Centre negotiates and secures WB, ADB, JICA loans and passes it to the states who also take on repayment obligations.

EXAMPLE FROM INDIA— The ‘debt crisis’ in Punjab: Punjab is a warning bell for Indian federalism’s fiscal stress. By 2022–23, the total outstanding debt of Punjab crossed ₹3.27 lakh crore — which was about 45% of its GSDP, much beyond the FRBM-prescribed ceiling of ~25–27%. Annual interest payments consumed more than 22 per cent of State’s revenue receipts. It has repeatedly applied for the special central assistance and the NSSF loan

restructuring. In 2022, the inznewly elected AAP government announced a panel to audit the State's finances, underscoring the need for debt consolidation and expenditure rationalisation.

6.5.4 The Off-Budget Borrowings Issue

A major governance issue in many states lately has been the rise of 'off-budget borrowings' — borrowings by State-run Public Sector Undertakings (PSUs), State Electricity Boards (SEBs), irrigation corporations, and special purpose vehicles (SPVs) that are not included in the State budget but are indirectly guaranteed by the State government. These borrowings don't get factored into FRBM limits, creating fiscal opacity. RBI, Finance Ministry have been raising this issue repeatedly. The 15th Finance Commission has also suggested that all State guarantees and off budget liabilities should be brought to the fore in the State budget and factored in the effective fiscal deficit for the purpose of monitoring.

6.6 GST and Fiscal

6.6.1 Background: Fragmentation of Indirect Taxes Before GST

Before 1 July 2017, when the Goods and Services Tax (GST) was implemented, India's indirect tax system was a baffling mess. There used to be Central Excise Duty in the Centre (on manufacture), the Service Tax (on services) and the Central Sales Tax (on inter-state trade). At the State level, there were VAT/Sales Taxes (on sales within the State), entry taxes, octroi, luxury taxes, and many other levies. Such balkanisation of taxes resulted in: piling up of tax over tax (cascading impact) at various levels of production; burden on enterprises doing business in more than one State; distortionary effects on trade and investment between the States; and a huge fiscal leakage and evasion.

7.6.2 The GST Architecture: A Dual-Structure The GST was notified in the Constitution by the Constitution (101st Amendment) Act, 2016, which added Articles 246A, 269A and 279A to the Constitution.The Indian GST is characterised by a one of a kind dual structure:

Component	Levied By	Goes To
CGST (Central GST)	Central Government	Consolidated Fund of India
SGST (State GST)	State Government	State's Consolidated Fund
IGST (Integrated GST)	Central Government (on inter-State supply)	Apportioned between Centre and Destination State
UTGST (Union Territory GST)	Central Government	Consolidated Fund of India (for UTs without legislature)

Table 7.5: Structure of GST in India

6.6.3 GST Council: A New Intergovernmental Institution

The GST Council (Article 279A) is an intergovernmental body that is constituted under the Constitution comprising the Union Finance Minister (Chairperson), the Union Minister of State for Finance and the Finance Ministers of the States or their representatives. Its decisions on GST rates, exemptions and administration are taken by a three-fourths majority weighted vote: • Centre's vote: One-third of total votes cast .

• States's votes: Two-thirds of total votes cast. This design ensures that States as a bloc have a de facto veto on virtually all GST decisions, rendering the Council a real exercise in cooperative federalism. The practical outcome, at least so far, has been that most decisions have been reached by consensus. The Council has met more than 50 time since 2017, decides on hundreds of rate rationalisation and administrative proposals.

INDIAN EXAMPLE — GST Council and Rate Rationalisation

In October 2021 and August 2023, the GST Council undertook significant rate rationalisation exercises. Items such as packaged food and cereals were brought into the GST net (earlier exempt), while the inverted duty structure (where input tax rates exceeded output rates, leading to accumulation of credits) for several industrial goods was corrected. These decisions, taken by consensus, demonstrate the Council's role as India's apex body for cooperative indirect tax policy.

6.6.4 GST Revenue Compensation to States

One of the hallmarks of GST introduction was the promise made to States: their GST revenues would be made up so that they would see a minimum 14% annual growth over their base year (2015-16) revenues for five years (2017-2022). The Compensation Cess — a special cess levied on 'demerit' goods like tobacco, pan masala, luxury cars, aerated drinks — was designated for this purpose. The COVID-19 pandemic shrank GST revenues and the Compensation Cess fund went into deep deficit in 2020–21. In a politically controversial move, the Centre borrowed from the market on States' behalf and gave it back to them as back-to-back loan to cover for the compensation gap. Punjab, Kerala, Rajasthan, Jharkhand and few other opposition-ruled States alleged that the Centre was burdening them with debt instead of compensating them. The compensation period expired in June 2022. The Council has since been discussing an extension of the compensation cess (to service the borrowings related to the cess) till 2026, which has complicated Centre-State financial relations even more.

6.6.5 Impact of GST on Centre–State Fiscal Relations

Some of the implications of GST for India's fiscal federalism are as follows:

• Concurrent taxation: With the introduction of GST, Centre and States are now equal partners in the taxation of goods and services — a major constitutional novelty.

• Revenue buoyancy: The monthly GST collections, which were about ₹90,000 crore in 2017–18, have climbed up to consistently more than ₹1.6–1.8 lakh crore per month in 2023–24.

• Formalisation dividend: Millions of hitherto informal firms have been drawn into the formal economy and tax base by GST's invoice-matching system.

• Fiscal autonomy diminished: States could no longer set their own rates on most goods and services, and their fiscal flexibility was narrowed due to loss of revenue raising autonomy.

• Destination-based principle: The destination principle is followed for IGST (tax should flow to the consuming State), which benefits the consumer States like Uttar Pradesh, Bihar, and Rajasthan and comparatively hurts the exporting/manufacturing States.

6.7 Role of Intergovernmental Transfers

6.7.1 Rationale: Correcting Fiscal Imbalances

Intergovernmental transfers have been serving four major functions in India which are also recognized in theory of fiscal federalism:

• Vertical Equalisation – Transfers from the central government, which has greater revenue capacity, to the sub-national governments, which have greater expenditure responsibilities).

• Horizontal Equalisation – Redistribution among States to alleviate disparities in per capita fiscal capacity — poorer States get larger transfers on an inverse per capita formula.

• Internalisation of Spillovers: Grants for Public Goods with inter-jurisdictional externalities (highway connectivity, disease control, higher education).

• Merit Goods:

Grants from the Centre for certain goods that the Centre would want to see provided at a higher level than what States would voluntarily provide (nutrition, sanitation, financial inclusion).

6.7.2 Components and Magnitude

Central transfers to States in 2023–24 amounted to approximately ₹22–24 lakh crore, comprising:

Component	Approx. Amount (₹ lakh cr)	Share of Total Transfers
Tax Devolution (Divisible Pool, 41%)	~10.2	~47%
Finance Commission Grants (Article 275)	~1.6	~7%
CSS / Central Schemes (Article 282)	~4.7	~22%
Centrally Sponsored Scheme Matching Funds (Net)	~2.8	~13%
Loans and Advances to States	~1.5	~7%
Special Grants / Disaster / Others	~0.9	~4%

Table 7.6: Estimated Composition of Central Transfers to States, 2023–24

6.7.3 Untied vs. Tied Transfers

There is a long-standing debate in India's fiscal federalism on the delivery of transfers:

• Tax devolution as well as the revenue deficit grants are largely 'unconditional' — in the sense that the States can utilise these funds as per their respective priorities. The increase in devolution by the 14th Finance Commission was aimed at maximising untied transfer.

• CSS grants are 'tied', in other words, are conditional on carrying out specific activities, having lists of beneficiaries, procurement processes, reporting obligations, etc. Critics say this undermines the autonomy of the States.

The growing dominance of CSS (about 130 schemes at present) has been condemned for: disintegrating State budget planning, causing multiple reporting formats to Departments, enforcing uniform national norms on diverse States, and precipitating fiscal crisis when States have to provide matching funds even for schemes with minimal local support.

EXAMPLE — The Centrally Sponsored Scheme Rationalisation In 2015, a Sub-Committee of the National Development Council (headed by Chief Ministers of Arunachal Pradesh, Madhya Pradesh, Manipur, etc.) proposed the thinning out of the CSS from above 160 to about 28 'umbrella schemes'. Subsequently, the number was brought down to about 28 'core' CSS (fully funded by Centre) and 'core of the core' CSS. However, total CSS spending has continued to increase, with States agitating for greater flexibility in using CSS monies to reflect local priorities.

6.7.4 Adequacy of Intergovernmental Transfers

A number of analyses suggest that the entire system of transfers is still inadequate, even with large transfers for resource-poor states:

• The overall transfer (devolution + grants) to States, at around 5–6% of GDP, might be low in light of the expanded roles for States under the framework of the Sustainable Development Goals (SDGs), climate adaptation and digital infrastructure.

• The absorptive capacity of States varies widely; some poorer States fail to make full use of their CSS grants for want of institutional capacity, with occasional lapses.

• The system also leads to anomalous outcomes: States with higher expenditure (whether efficient or not) end up getting larger revenue deficit grants; States with superior tax collection do not necessarily get higher devolution.

6.8 Issues in Centre–State Financial Relations

6.8.1 Vertical Fiscal Imbalance (VFI)

The structural revenue-cost mismatch between the States and Central government in India is still significant. State governments are believed to spend roughly 60 to 65 percent of total government expenditure (on paying the salaries of teachers, health workers, police and public works) but they raise only around 35 to 38 percent of total government revenues. The rest is funded through Central transfers. This structural reliance restricts States' fiscal independence and poses challenges to soft budget constraints — that is, States could over spend on the assumption that the Centre will rescue them.

6**.8.2 Distorted Effect of Cesses and Surcharges** A worrying pattern emerging in India's fiscal federalism is the increasing proportion of Central cesses and surcharges which are not part of the divisible pool and are therefore not shared with States. The multiplication of such levies takes a bigger and bigger slice out of the divisible pool at the same time that nominal tax revenues are rising.

INDIAN EXAMPLE – Cesses Eroding the Divisible Pool In 2022–23, cesses and surcharges had reached ₹6.3 lakh crore, or about 28% of gross Central tax revenues. They include the GST Compensation Cess, The Health and Education Cess (4 per cent surcharge on income tax) and several others. Because all these are outside the divisible pool, States lose about ₹2. 6 lakh crore (41 per cent of ₹6.3 lakh crore) that they would have otherwise received. The issue of increasing share of cesses and surcharges leading to a decreasing share of the devolution received by states was something that the 15th finance commission also raged strongly against.

6.8.3 Declining Share of Untied Resources

Notwithstanding the 14th Finance commission's endeavor to enhance untied devolution, the share of 'tied' grants (CSS) in the total transfers has remained stubbornly high in the post-2014 period. This is in part because the Centre created a number of new CSS (PM Jan Dhan Yojana, PM Mudra Yojana, Ayushman Bharat, PM Kisan etc) that, while of national importance, place obligations on State governments in terms of matching funds, administration and beneficiary management.

6.8.4 The Problem of Incentives in Revenue Deficit Grants The Fiscal Commission's recommendations on revenue deficit grants to States, which are also a source of perverse incentives, can be a source of perverse fiscal incentives. If a State knows that a bigger deficit will mean a bigger grant from the Central government, it may not have much incentive either to rationalise its own expenditure or its tax collection. The Finance Commission has attempted to address this through performance-based conditionalities, but enforcement continues to be problematic.

6.8.5 Bottoms-up Explanation of Asymmetric Special Category States In the past, certain States were accorded a 'special category status' (e.g. north-eastern States, Jammu & Kashmir, Himachal Pradesh, Uttarakhand) which entitled them to higher CSS funding ratio (90:10 Centre:State) and some other relaxations. With regard to special category status the 14th FC did away with it and instead enhanced tax devolution. However, this has remained debatable: the smaller, hilly states with less own-tax capacity feel short-changed in the new arrangement.

6.8.6 Competitive Federalism vs. Cooperative Federalism

India's intergovernmental fiscal system is coming to be characterised increasingly by a contradiction between two different paradigms: competitive federalism (States competing in a race to the bottom to woo investment with tax breaks, land, infrastructure) and cooperative federalism (States working together on common norms, on GST rates, and national plans). In a sense, GST has deepened cooperative federalism in the realm of indirect taxes, while some elements of competition remain in direct incentives and handouts wars (mostly related to electricity, water, and farming).

6.8.7 Local Governments: The Third Tier India's 73rd and 74th Constitutional Order (1992–93) established a third tier of government: Panchayati Raj Institutions and Urban Local Bodies (ULBs). But the devolution of finances to the third tier has been grossly insufficient. Own revenue generation for PRIs and ULBs is still minuscule (around 1% of GDP estimated). Finance Commission grants for local bodies have increased — the 15th FC apportioned ₹4.36 lakh crore for 2021–26 — but bureaucratic capacity to absorb and utilize these finances continues to be a large limitation.

INDIAN EXAMPLE — Gram Panchayats and Fiscal Decentralisation India about 2.55 lakh Gram Panchayats. Until now most Panchayats are entirely dependent on Central and State grants and have little to no meaningful own-revenue sources even constitutional provisions that says otherwise. According to a 2023 data report by RBI, the own revenues of Panchayats in most States are less than ₹30,000 per annum — not enough even to cover the salary of one peon. Finance Commission grants are the bread and butter. The 15th FC put in place 'tied' grants for sanitation and drinking water provision and 'untied' grants for other use, but capacity constraints have meant that a large chunk of grants are being surrendered at the end of the year.

6.8.8 Issues in Borrowing Management

Several issues are raised by the States borrowing arrangement:

• Crowding out: As the States borrow en masse, the yield on SDL rises and this crowds out investment in the private bond market.

• Debt sustainability: Several States (Punjab, Rajasthan, H P, A P) are on fiscally unsustainable debt paths as indicated by the RBI's State Finances reports.

• Off-budget liabilities: The debts (and guarantees) of state-owned PSUs are a hidden risk to the public fisc. The Reserve Bank of India (RBI) has suggested that the off-budget liabilities of States could increase debt-GSDP ratios by 4–5 percentage points.

• NSSF rates: National Small Savings Fund loans are costlier for State Governments as the interest rates on these loans are higher (usually 25 to 50 basis points higher than SDL yields).

6.9 Reform Proposals

6.9.1 Rationalising Cesses and Surcharges

Several Finance Commissions and expert panels have suggested that the Centre limit cesses and surcharges to a certain percentage of gross tax revenues, and, as far as possible, phase out most cesses by integrating them into the main tax system (which contributes to the divisible pool). This would bring about an immediate increase in the effective devolution to States.

6.9.2 Strengthening the GST Council Enhance the dispute resolution procedure of the GST Council, improve the transparency of its decisions, and set up a permanent secretariat equipped with independent analytic capacity (TPS) have been recurrent suggestions. A stronger Council might also mitigate ad hoc rate changes, which have the effect of destabilizing State revenues, and facilitate medium-term rationalization of GST rates.

6.9.3 CSS Rationalisation An extensive revision of CSS — streamlining the number of schemes, providing States with greater flexibility in how funds were used within broad outcomes, and allowing States to withdraw from schemes not in line with their local priorities — would boost public expenditure quality. This was proposed by the Expenditure Management Commission (2014–16) and the three-year action agenda of the NITI Aayog.

6.9. 4 Fiscal Federalism and Climate Finance Given India's NDCs (net zero by 2070, 50% non-fossil electricity capacity by 2030), States will require huge investments in renewable energy, climate adaptation (flood management, drought-proofing), and green urban infrastructure. The Finance Commission mechanism should have an explicit element of climate and environment related parameters in the horizontal share calculation. The 15th Finance Commission did put a weight of 10% for forest and ecology as a beginning, but climate-specific transfers may have to be worked out further.

6.9.5 Third-Tier Empowerment

India mein sachchaa *fiscal federalism* tabhi samposhit hoga jab teesre star ko arthpuran adhikaar diya jaayega. Sujhaw hai ki: Mandatory devolution of at least 5 specified functions with matching funds from State Finance Commission awards; Propety tax reforms to enhance capacity of own-tax revenues of ULBs ; Direct Centre–local transfers (difficult States out) for specific programmes (bypassing State governments) to increase accountability; and Capacity building of Gram Panchayats in financial management and audit.

CHAPTER SUMMARY

1. In India, the Constitution (7th Schedule) creates a vertical fiscal imbalance with the Centre generating the bulk of the revenue and the States performing the bulk of the expenditure;
2. The Finance Commission (Art. 280) is the primary institution for tax sharing (both the vertical split—presently 41% to State—and the horizontal distribution among State).
3. Grants-in-Aid (Art . 275 and 282) supplement devolution and consist of Finance Commission grants and Centrally Sponsored Schemes (CSS).
4. State borrowing is regulated by Art. 293; FRBM ceilings over 3% of GSDP on fiscal deficit; Off budget liabilities are a growing worry.
5. GST (implemented from July 2017) reformed India's indirect tax structure into a dual CGST/SGST regime system, with the GST Council functioning as a cooperative federalism.
6. Intergovernmental transfers have been said to serve vertical equalisation, horizontal equalisation, spillover internalisation and merit goods functions.
7. Major challenges are identified relating to the erosion of the divisible pool by cesses and surcharges, expanding tied CSS, incentive issues in revenue deficit grants and insufficient fiscal empowerment for the third tier.

8. Needed reforms are CSS rationalization, cess phasing out, strengthening the GST Council, integrating climate finance and third-tier empowerment.

Key Terms

Divisible Pool: The aggregate of Central taxes and duties (excluding cesses and surcharges) constitutionally required to be shared with States.

Finance Commission: A Constitutional body (Art. 280) constituted every five years to recommend distribution of taxes and grants between Centre and States.

Vertical Fiscal Imbalance (VFI): The structural mismatch between the Centre's revenue capacity and States' expenditure responsibilities.

Horizontal Fiscal Equalisation: Distribution of transfers across States to reduce per capita fiscal capacity disparities.

Grants-in-Aid: Transfers from Centre to States supplementing tax devolution; may be unconditional (Art. 275) or tied (CSS).

GST Council: Constitutional body (Art. 279A) comprising Union and State Finance Ministers to decide GST rates and policies.

FRBM Act: Fiscal Responsibility and Budget Management Act, 2003; mandates deficit reduction targets; States' fiscal deficit capped at 3% of GSDP.

Centrally Sponsored Scheme (CSS): Central grants under Art. 282, tied to specific national programmes with Centre–State cost-sharing.

Off-Budget Borrowings: Borrowings by State-owned entities backed by State guarantees but not reflected in State budget fiscal deficit.

Revenue Deficit Grant: Finance Commission grant to States that remain in revenue deficit even after receiving their share of Central taxes.

Review Questions

Short Answer Questions

1. Explain the significance of the Seventh Schedule in governing Centre–State financial relations.
2. What is the 'divisible pool'? How is it calculated?
3. Describe the role of the Finance Commission under Article 280.
4. Distinguish between vertical fiscal imbalance and horizontal fiscal disparities.
5. What are Centrally Sponsored Schemes? How do they affect States' fiscal autonomy?
6. Explain the dual GST structure (CGST, SGST, IGST) and its implications.
7. What is the FRBM framework? How does it constrain State borrowing?

Long Answer Questions

1. Critically analyse the evolution of the vertical devolution ratio from the 1st to the 15th Finance Commission. How did the 14th Finance Commission represent a watershed moment?
2. 'The rapid growth of cesses and surcharges has become a threat to cooperative federalism in India.' Evaluate this statement with data and examples.
3. Examine the impact of GST on India's fiscal federalism. To what extent has GST improved revenue buoyancy and cooperative federalism?
4. 'India's third tier of governance is constitutionally empowered but fiscally starved.' Discuss with reference to Gram Panchayats and Urban Local Bodies.
5. Critically evaluate the main issues in Centre–State financial relations and suggest a reform agenda for the 16th Finance Commission.

Chapter 7:
Finance of Local Bodies

- Meaning of Local Body Finance
- Rural Local Bodies (Panchayats)
- Urban Local Bodies (Municipalities)
- Sources of Revenue of Local Bodies
- Problems of Local Finance
- Importance of Fiscal Decentralization

Learning Objectives

After studying this chapter, students will be able to:

• Define local body finance and explain its significance in India's three-tier federal structure

• Distinguish between Rural Local Bodies (Panchayats) and Urban Local Bodies (Municipalities)

• Identify and analyse the diverse revenue sources available to local governments

• Critically evaluate the structural problems plaguing local finance in India

• Understand the economic rationale and importance of fiscal decentralisation

• Examine constitutional and institutional reforms that have shaped local finance since 1992

7.1 Meaning of Local Body Finance

Local body finance is the subsistence system of revenue, expenditure, borrowing and intergovernmental transfer that allows sub-national grassroots institutions to have the means to perform the functions assigned to them. It is concerned with how local governments generate revenue, how they allocate resources, and how they sustain financial viability and remain accountable to citizens.

In India, the term 'local bodies' sums up the following two major segments: Rural Local Bodies (RLBs), which are mainly the Panchayati Raj Institutions (PRIs), and Urban Local Bodies (ULBs), which consist of Municipal Corporations, Municipal Councils, and Nagar Panchayats. Together, these institutions of 1.4 billion people in 6.4 lakh villages and nearly 8,000 urban settlements govern a population 6″m and nearly 8,000 urban settlements.

7.1.1 Constitutional Foundation

Art. 243G	The Legislature of a State may, by law, endow the Panchayats with such powers and authority as may be necessary to enable them to function as institutions of self-government — including preparation of plans for economic development and social justice.

Art. 243W	The Legislature of a State may, by law, endow the Municipalities with such powers and authority as may be necessary to enable them to function as institutions of self-government.

The 73rd and 74th Amendments to the Constitution (both passed in 1992 and coming into force from April 1993) provided for the constitutional recognition of local self-government — thereby converting PRIs and ULBs from statutory bodies into constitutional bodies with assured elections, reserved seats, and financial obligations. Article 243-I and Article 243-Y provide for SFCs every five years to suggest fiscal devolution to local bodies.

7.1.2 Why Local Body Finance Matters

Dimension	Why It Matters	Indian Scale
Service Delivery	Local bodies deliver water, sanitation, roads, markets — daily public goods	~2.5 lakh PRIs + ~4,500 ULBs serve all Indians
Democratic Participation	Fiscal autonomy enables local priorities; dependency creates top-down governance	30 lakh elected representatives in PRIs alone
Economic Efficiency	Local knowledge advantage — decisions closer to beneficiaries are better informed	1% increase in local spending ≈ measurable welfare improvement
Accountability	Own-source revenue creates taxpayer pressure for performance	Property tax payers demand visible services
Equity	Targeted spending on marginalised communities needs local governance	SCs/STs/Women reservation in PRIs
Macroeconomic	Local capital expenditure multiplies — roads, drains, markets stimulate rural economy	MGNREGS: ₹73,000 crore local capital creation (2023-24)

7.2 Rural Local Bodies — Panchayati Raj Institutions

Panchayati Raj (PR) system is the basic instrument of Democratic decentralisation in rural India. It was the Balwantrai Mehta Committee (1957) which proposed the first in the series (though never implemented at the first go) of the three-tier Panchayati Raj system. It was accorded constitutional status under the 73rd Constitutional Amendment Act, 1992. Today, India boasts of the world's largest experiment in local self-governance through PRIs.

7.2.1 Three-Tier Structure of PRIs

Tier	Institution	Level	Average Population	Number (approx.)
Tier I (Base)	Gram Panchayat	Village / Cluster of villages	~5,000–7,000	2,62,000+
Tier II (Intermediate)	Panchayat Samiti / Block Panchayat	Block / Taluka	~1,00,000	6,600+
Tier III (Apex)	Zila Parishad	District	~20,00,000	700+

Note: States with population below 2 million may constitute a two-tier system. Goa (Gram Panchayat + Zila Panchayat) and Sikkim are the cases. The Gram Panchayat is the unit of core fiscal and service delivery.

6.2.2 Role of Gram Panchayats - The Eleventh Schedule The Eleventh Schedule (article 243G) contains a list of 29 items under which the State Legislature may bestow responsibilities to the Panchayats.Major areas include:

Developmental Functions (Eleventh Schedule)	**Social & Welfare Functions (Eleventh Schedule)**
• Agriculture, land improvement, minor irrigation • Animal husbandry, dairy, poultry • Primary & secondary education (implementation) • Primary health, family welfare, sanitation • Drinking water supply • Rural housing (PM Awas Yojana – G) • Village roads, culverts, waterways • Poverty alleviation programmes	• Non-conventional energy sources • Markets and fairs • Maintenance of community assets • Social welfare, women & child development • Public distribution system maintenance • Cultural activities & libraries • Management of common lands • Fisheries

Indian Example: Kerala's Model Gram Panchayat Finance

Kerala's People's Plan Campaign (1996) transferred 35–40% of the State's Plan budget to local bodies — a landmark in fiscal decentralisation. Today, Kerala's 941 Gram Panchayats:

- Prepare their own Gram Panchayat Development Plans (GPDP)
- Have technical capacity through dedicated planning staff
- Collect property tax, profession tax, and service charges independently
- Integrate MGNREGS with local infrastructure planning

Kerala's Thiruvananthapuram Corporation and Panchayats consistently rank among India's top performers in own-source revenue collection, demonstrating that capacity building enables fiscal health.

7.2.3 Finance of Gram Panchayats — Key Characteristics

Financial Aspect	Details	Data Point (2023-24)
Own Tax Revenue	Property tax, profession tax, advertisement tax, water/drainage rates	~₹25,000–35,000 crore combined (all PRIs)
Own Non-Tax Revenue	Fees for certificates, rents on community property, fines	Varies widely — urban fringe GPs earn more
State Government Grants	SFC devolution, state scheme funds	~₹60,000–80,000 crore across all states
Finance Commission Grants	15th FC: ₹2,36,805 crore over 2021–26 for PRIs	~₹43,000 crore per year to Gram Panchayats
MGNREGS Material Component	30% material component for durable assets managed by GPs	₹73,000 crore national allocation (2023-24)
Borrowings	Very limited — GPs rarely access capital markets	Mostly through NABARD schemes

Issue: Own Revenue Paralysis in Rural India

The 15th Finance Commission observed that the total Own Source Revenue (OSR) of Gram Panchayats was under ₹35,000 crore — a mere fraction of what could have been: • Average OSR of Gram Panchayats - ₹13 lakhs in a year (2022-23 data) • 75% of Gram Panchayats rely on grants for more than 90% of their revenues • Property tax — the biggest potential source — is grossly under-assessed; slabs haven't been revised in decades in several states • Rajasthan Gram Panchayats: Average OSR ≈ ₹6 lakhs; Bihar GPs: ₹4 lakhs; Kerala GPs: ₹45 lakhs (exemplifying the 10x gap better and weaker states)

7.3 Urban Local Bodies — Municipalities

Urban India is administered by the Urban Local Bodies (ULB) which are established under State Municipal Acts and empowered by 74th CAA Act, 1992 providing them constitutional recognition. Accounting for a 507 million urban population (2021) in India — expected to go beyond 800 million by 2050 — ULBs are responsible for managing the rapidly growing portion of the population in the country.

7.3.1 Types of Urban Local Bodies

Type of ULB	Population Criteria (Approx.)	Examples	Number (India)
Municipal Corporation (Nagar Nigam)	Above 10 lakh (1 million)	BMC Mumbai, BBMP Bengaluru, NDMC Delhi, GHMC Hyderabad	~200
Municipal Council (Nagar Palika / Parishad)	1 lakh to 10 lakh	Ajmer (Rajasthan), Mangaluru (Karnataka), Puri (Odisha)	~1,800
Nagar Panchayat (Town Panchayat)	11,000 to 1 lakh (transitional areas)	Small towns moving from rural to urban classification	~2,500
Cantonment Board	Military areas — administered by MoD	Pune Cantonment, Delhi Cantonment	~62
Notified Area Committee	Newly formed industrial towns	Jamshedpur NAC (Jharkhand)	~50

7.3.2 Functions of Municipalities — The Twelfth Schedule

The Twelfth Schedule (Article 243W) contains 18 functions for Municipalities.These include the entire gamut of urban public services:

- Urban planning — preparation and execution of Master Plans, zoning norms
- Control over land use and construction of buildings – building permission, OC certificates
- Roads, bridges and flyovers — urban arterial and internal roads
- Water supply – domestic, industrial and commercial •
- Public health and sanitation, conservancy and solid waste management
- Fire Service and Fire Fighting – Engines, fire stations, equipment
- Urban forestry— parks, playgrounds, urban green spaces
- Prevention of environment pollution and ecological promotion
- Welfare of weaker sections- slum dwellers, EWS housing
- Slum development & up gradation
- Urban poverty reduction – Deendayal Antyodaya Yojana – NULM
- Urban amenities — provision of libraries, markets, bus-stands
- Advancement of cultural, educational and aesthetic interests
- Burials and burial grounds, cremations and electric crematoria
- Cattle pounds and prevention of cruelty to animals
- Vital statistics — registration of births and deaths
- Public conveniences — street lighting, parking areas, bus shelters
- Regulation of slaughterhouses and tanneries.

7.3.3 Finance of Municipal Corporations — The BMC Example

Indian Example: Brihanmumbai Municipal Corporation (BMC) — India's Richest ULB

BMC governs Mumbai — India's financial capital — with a budget of ₹59,954 crore (2024-25):

• Property Tax: ₹6,200 crore (10.4% of revenue budget)
• Water & Sewerage Charges: ₹4,200 crore
• Development Charges & Fees: ₹3,800 crore
• State Government Grants: ₹8,500 crore
• Central Grants (Smart Cities, Jal Jeevan): ₹3,100 crore
• Own Non-Tax Revenue (rents, markets, penalties): ₹2,400 crore

BMC's Achievements: Runs 27 hospitals (200,000 OPD/day), maintains 2,100 km of roads, operates 130+ markets.

BMC Challenge: Capital expenditure routinely under-executed — ₹18,000 crore capex budgeted, only ₹10,500 crore actually spent in 2023-24, reflecting procurement and planning bottlenecks.

ULB	City	Annual Budget (Approx.)	Primary Revenue Source	Key Challenge
BMC	Mumbai	₹59,954 crore	Property tax, water charges	Capex under-execution
BBMP	Bengaluru	₹11,400 crore	Property tax, grants	IT sector property undervaluation
GHMC	Hyderabad	₹6,200 crore	Property tax, advertisement tax	Slum population excluded from tax base
NDMC	New Delhi	₹4,900 crore	Property tax, lease income	Covers only Lutyens Delhi — limited jurisdiction
AMC	Ahmedabad	₹7,600 crore	Octroi substitute, property tax	Asset maintenance backlog
PMC	Pune	₹8,200 crore	Property tax, NMT charges	IT corridor infrastructure gap
SDMC / EDMC	Delhi (South / East)	₹3,200 / ₹1,800 crore	Property tax, parking fees	Fragmented jurisdiction limits scale

7.4 Sources of Revenue of Local Bodies

Subnational governments around the world use a mix of own-source revenues (tax and fee-based) and intergovernmental transfers (from upper levels of government). In India, transfers predominate – particularly for rural bodies. The revenue framework can be seen in four pillars: own tax revenue, own non-tax revenue, assigned revenues and shared taxes, and grants and transfers.

7.4.1 OWN TAX REVENUE Under the State Municipal Acts and Panchayati Raj Acts, the local bodies can impose the own taxes which they are empowered to. They are most fiscally autonomous (and politically sensitive) sources. A.

Property Tax It (property tax) is the most important own-tax revenue source for the urban local bodies all over the world, even for Gram Panchayats, its importance is growing. It is a tax based on the assessed value (Annual Rental Value, Capital Value, or Unit Area Value) of land and buildings.

ULB / State	Assessment Method	Rate (Approx.)	Revenue (Approx. 2022-23)
Mumbai (BMC)	Capital Value System (CVS) — introduced 2010	0.316% of ready reckoner value	₹6,200 crore
Delhi (SDMC / EDMC / NDMC)	Unit Area Value (UAV) — colony-based multiplier	₹0.50–7.00 per sq ft per month	₹2,100 crore (all 3 MCDs)
Bengaluru (BBMP)	SAS (Self-Assessment Scheme) — guidance value	0.5% of guidance value	₹3,100 crore
Chennai (GWMC)	Annual Rental Value (ARV) — 1890s base!	Property tax = ARV × rate	₹900 crore
Hyderabad (GHMC)	Annual Rental Value	Based on use and location	₹1,400 crore
Gram Panchayats	Land/House tax under State Panchayat Acts	Variable — ₹100–5,000 per house per year	₹12,000 crore (all GPs)

> ⚠ **Indian Example: Chennai's 130-Year-Old Property Tax Base**
>
> Greater Chennai Corporation used Annual Rental Value based on rent surveys from the 1890s until 2023! Despite multiple revision attempts, political resistance delayed revisions for decades. A Chennai household paying ₹500 per year in property tax in 1990 continued paying the same amount in 2010 — while its market value rose from ₹5 lakh to ₹1 crore.
>
> Impact: Chennai Corporation collects only 17% of its estimated property tax potential. In 2023, the Tamil Nadu government revised rates — triggering protests.
>
> Compare: Ahmedabad revised property tax in 2021 using GIS-based mapping, increasing collections by 34% in one year.

B. Profession Tax / Tax on Trades and Callings

Profession tax is imposed on all individuals who are engaged in any profession, trade or employment. It is a state subject under entry 60, List II of the Seventh Schedule; it involves some sharing with the urban local bodies (ULB) or the ULBs are empowered to collect it. The maximum limit under the Constitution is ₹2,500 per annum per person — such ceiling was fixed in 1988 and has not been revised.

- Maharashtra: The State government collects profession tax and hands it over entirely to local bodies — ₹12,000 crore every year. Large source of income for BMC and ppune.
- Karnataka: BBMP appropriately charges and collects the profession tax – ₹1,800 crore per annum.
- West Bengal: Kolkata Municipal Corporation makes around ~₹800 cr from profession tax.
- The nominal constitutional ceiling of ₹2,500/year has eroded in real terms — a ₹2,500 cap in 1988 is equivalent to over ₹25,000 in 2024 real terms.

C. Advertisement Tax

Advertisement tax is leviable on hoardings, banners, etc. in cities. Significant source of revenues in footfall cities.

• Mumbai: BMC income from advertisement tax is around ₹400 crore — hoardings sizes and location subject to strict regulations.

• Bengaluru: BBMP advertisement tax row — in 2023, BBMP auctioned hoarding rights, fetching ₹450 crore and the move is facing court challenges on illegal hoardings. • Outdoor India Market: ₹4,000 crore p.a; — ULBs can only capture a meager portion. D. Other Local Taxes

• Entertainment Tax: Charged on cinema tickets, amusement parks and functions. Partly as goods and services tax (GST), partly by ULBs.

• Toll Tax / Octroi Substitute: Octroi (tax on goods entering city limits) was abolished with the GST. States compensated it with the Octroi Substitute grants or the Local Body Tax — Maharashtra gives compensatory grants to BMC and other ULBs.

• Fire Tax: Impost against public fire services by larger Municipal Corporations.

• Drainage / Sanitation Tax: For maintenance of sewers in some ULBs a separate tax has been imposed.

7.4.2 Own Non-Tax Revenue

Non-tax revenue comes from fees, charges, rents, and returns on local body assets. This is often the most elastic revenue source for ULBs — and the most underutilised.

Source	Description	Indian Example
Water & Sewerage Charges	User charges for water supply and sewerage connection and consumption	Mumbai: ₹4,200 crore; Delhi Jal Board: ₹1,800 crore
Fees for Building Permissions	Scrutiny fees, building plan approval, occupancy certificates	BBMP: ₹600 crore from building plan fees (2022-23)
Development Charges	One-time charge on new construction for infrastructure augmentation	Mumbai: ₹3,800 crore in development charges
Rents from Local Body Properties	Markets, shops, community halls, bus depots owned by ULBs	Chennai: ₹350 crore from market rents and properties
Parking Fees	On-street and multi-level parking managed by ULBs	Delhi: ₹180 crore; Pune Smart Parking: ₹90 crore
Health Fees	Birth/death certificates, health permits for eateries	Nominal but universal — all ULBs levy
Fines and Penalties	Traffic violations (transferred from police), building violations	Varies — unenforced in many cities
Solid Waste User Charges	Per-household collection charges for municipal solid waste	Indore: ₹150/month; collected ~80% efficiency

Indian Example: Indore — Model for User Charge Collection

Indore (Madhya Pradesh) has won the Swachh Survekshan national award 7 consecutive times (2017–2023). Its solid waste management is funded through:

• Door-to-door collection charges: ₹100–300/month (residential)

• Commercial establishments: ₹500–5,000/month based on waste generated

• Revenue from waste processing: Indore's Devguradia Plant converts 1,100 MT/day of waste into compost and biogas — earning ₹6 crore/month

• Total SWM revenue: ~₹90 crore/year from user charges

Lesson: Visible, efficient service delivery justifies user charges — Indore's experience shows willingness to pay follows quality of service.

7.4.3 Assigned Revenues and Shared Taxes

The State Government assigns certain taxes to local bodies or shares a portion of State tax collections with ULBs. These are more predictable than own-source revenues but reduce local fiscal autonomy.

Revenue Type	Mechanism	Examples
Entertainment Tax (State-collected, locally shared)	State collects and assigns share to ULB in whose area the cinema/venue is located	Tamil Nadu assigns 50% of entertainment tax to Chennai Corporation
Stamp Duty Surcharge	State levies stamp duty; a surcharge is earmarked for local bodies	Maharashtra: 1% stamp duty surcharge goes to municipal bodies
Motor Vehicle Tax (partial)	Some states share road tax with ULBs for road maintenance	Kerala: Portion of motor vehicle tax assigned to municipalities
Profession Tax	Many states collect and fully pass on to local bodies	Maharashtra: ₹12,000 crore profession tax flows to ULBs
State GST (SGST) — Notional Assignment	Some states notionally assign a share of SGST to incentivise local bodies	No formal mechanism yet — policy recommendation of 16th FC

7.4.4 Grants and Transfers from Higher Governments

The largest share of local body revenue urban or rural is transfer from the central and state government, which account for nearly 73% and 71%, respectively for Gram Panchayats. These are received in two forms — Finance Commission grants (statutory) and Scheme-based grants (discretionary). Grants to Locals from the Finance Commission The 15th Finance Commission (2021-26) has given ₹4,36,361 crore to local bodies — the highest ever — divided between PRIs and ULBs.

15th FC Grant Component	Total Allocation (₹ Crore)	Conditions
Gram Panchayat Basic (Untied) Grant	1,40,965	No conditions — GP can use for any priority
Gram Panchayat Tied Grant	95,840	Must spend on: (a) Sanitation & ODF-Plus; (b) Drinking water supply
Urban Local Body Basic (Untied) Grant	66,750	Only for ULBs with audited accounts and published accounts online
Urban Local Body Tied Grant	44,500	Must spend on: (a) Sanitation & sewage; (b) Drinking water supply
Health Grants (to local bodies)	70,051	Strengthening health infrastructure at local level
Total FC Grants to Local Bodies	4,36,361	Combined 2021-26 allocation

Indian Example: Direct-to-Local-Body FC Grant Transfer

A landmark feature of the 15th Finance Commission: For the first time, grants to Urban Local Bodies were made conditional on:

(a) Publication of audited accounts for the last two years on a public portal

(b) Notification of floor rates of property tax by the State

If a ULB fails to meet these conditions, it cannot access its basic grant.

Impact: By 2022-23, over 85% of eligible ULBs had met both conditions — forcing institutional reforms that decades of advisory circulars had failed to achieve.

States like Tamil Nadu, Kerala, and Maharashtra achieved 100% compliance; Uttar Pradesh and Bihar lagged with 60% and 58% respectively, causing grant withholding.

Scheme-Based Transfers to Local Bodies

Scheme	Nature	Key Local Body Component
MGNREGS	Central — 100% wages + 75% material	GPs manage worksite planning, execution, and payment (EFMS)
PM Awas Yojana – Grameen (PMAY-G)	Centre:State 60:40	GPs identify and verify beneficiaries; DRDA routes funds
Jal Jeevan Mission	Centre:State 50:50	Village Water & Sanitation Committees (VWSCs) under GP
Swachh Bharat Mission (Grameen)	Centre:State 60:40	GPs implement ODF and ODF-Plus programmes
AMRUT 2.0 (Urban)	Centre:State:ULB 50:30:20	ULBs implement water, sewerage, parks projects
Smart Cities Mission	100% Centre + ULB share	Special Purpose Vehicle (SPV) — ULB is a 50% shareholder
PM SVANidhi (Street Vendors)	Central micro-credit	ULBs identify and provide LoR to street vendors for loans

7.5 Problems of Local Finance in India

Despite constitutional endorsement and increasing fiscal outlays, the finances of local bodies in India are still in a mess. The problems are multi-dimensional — structural, political, administrative and institutional. To design appropriate reforms one must understand these problems.

7.5.1 Under Provision of Own-Source Revenue The most basic issue is that (a) local bodies raise much less revenue than they are allowed or meant to-collect. India's ULBs raise only 0.5% of country GDP in own-source revenues - rather distant from 6% in Brazil, 6.5% in South Africa, 1.5% in China. PRIs raise even less.

Country	Local Body OSR as % of GDP	Remarks
India (ULBs)	~0.5%	Far below potential — property tax underperforms
India (PRIs)	~0.1%	Negligible — almost entirely grant-dependent

Brazil	~6.0%	Municipal fiscal autonomy — strong own revenues
South Africa	~6.5%	Large municipalities with significant rating power
China	~5.0%	Land-based finance — local governments sell land use rights
OECD Average	~5.0%	Sub-national tax autonomy well-established

⚠ **Problem: Property Tax — The Biggest Missed Opportunity**

India's property tax potential is estimated at ₹1.5–2.0 lakh crore per year.
Actual collection (2022-23): ~₹25,000–30,000 crore — only 15–20% of potential.

Reasons for underperformance:

- Outdated valuation systems — ARV based on 1970s-80s surveys still used in many cities
- Political resistance to rate revision — tax hike is electoral liability
- Rampant exemptions — government properties, religious institutions, slums
- Low coverage — significant share of buildings not in tax net (especially in cities with rapid illegal construction)
- Weak enforcement — few ULBs consistently penalise defaulters
- Manual records — poor databases, absence of GIS-based property mapping

GIS-based reform: Andhra Pradesh's GIS survey of Visakhapatnam in 2022 added 45,000 new properties to the tax roll — increasing assessed properties by 22% in one year.

7.5.2 Excessive Dependence on Grants

There is a grant dependence of local bodies — and more so PRIs — which engenders a 'transfer dependency syndrome' that makes the local bodies more concerned with meeting the grant conditions rather than attending to people. The local delivery of services falls apart when grants become so uncertain or delayed.

• Bihar Gram Panchayats: More than 94 per cent revenue from grants — own tax revenue less than 6 per cent.

• Uttar Pradesh PRIs: 91 per cent grant-dependent — devolution from State Finance Commission continuously delayed.

• National average (all PRIs): Between 87 and 90% of total income of P LIIs comes from grants — this hampers autonomy.

• The grant malaise: Several states disbursing Finance Commission grants to panchayats and municipalities 4-6 months belatedly in 2021-22 has crippled panchayat work and stalled MGNREGS payments of the material kind to rural labour.

7.5.3 Weak State Finance Commissions

SFCs) are the constitutional body (under Articles 243-I and 243-Y) responsible to recommend the intra-state devolution to local bodies. Their functioning has been abysmally poor.

Problem	Manifestation	Indian Example
Delay in Constitution	Many states constitute SFCs years late — no SFC = no updated devolution formula	UP constituted 5th SFC in 2022 — years behind schedule
Report Non-Implementation	State governments accept SFC reports with modifications that reduce devolution	Rajasthan accepted only 40% of 4th SFC recommendations
Weak Secretariat	SFCs lack research staff, data, and independent capacity	Many SFCs have 3–5 staff — producing inadequate reports
No Penal Mechanism	No constitutional penalty if state ignores SFC recommendations	No state has faced consequence for SFC non-compliance
Poor Data Availability	Local body accounts often unaudited — SFC cannot assess fiscal capacity	Only 60% of GPs have audited accounts (CAG estimate)

Indian Example: The Kerala SFC Success Story vs. the National Norm

Kerala constituted its 5th SFC in 2021 — on time. The 5th SFC recommended:

• Devolution of 20% of State's Own Tax Revenue to local bodies

• Population, development index, and performance criteria for distribution

• All 941 Gram Panchayats received updated formula-based grants within 3 months of report acceptance

Contrast: Jharkhand's 2nd SFC report submitted in 2011 was not acted upon for 7 years. Local bodies operated on ad hoc grants based on 2005 recommendations.

The Kerala model shows that SFCs can work when the political will exists — and that they are dysfunctional when it does not.

7.5.4 Functional Devolution Gap — The 3F Problem

But even those local bodies that are accorded constitutional status suffer from a '3F Gap' — lack of adequate devolution of Functions, Funds and Functionaries. The Eleventh and Twelfth Schedules enumerate subjects, but mere listing does not amount to actual delegation.

Dimension	Problem	Impact
Functions (F1)	Activities listed in 11th/12th Schedule not actually transferred — Activity Mapping incomplete	GPs cannot plan for education or health — State Departments retain control
Funds (F2)	Even when functions transferred, budget does not follow — funds remain with State line departments	GP 'manages' primary school but cannot hire staff or buy equipment
Functionaries (F3)	Staff posted to local bodies remain under State control — GPs cannot direct their work	GP Pradhan cannot instruct the Block Development Officer or schoolteacher
Parallel Bodies	State governments create District Rural Development Agencies (DRDAs), State Missions that bypass PRIs	MGNREGS initially implemented through DRDAs — GPs marginalised

7.5.5 Weak Accounting and Audit Systems

- Unaudited Accounts: CAG (2021) observed that more than 40% of Gram Panchayats were due for audit for 3+ years — implicating them in unaccounted public funds.

- Cash accounting: The majority of local bodies practice cash accounting - there is no balance sheet, no register of assets, no tracking of liabilities.
- Reforms in accounting: The National Municipal Accounting Manual (2004) for ULBs prescribes accrual accounting — only ~15% of large ULBs have completed the transformation by 2024.
- Off-balance sheet obligations: Many ULBs have pensions, dues to contractors and utility liabilities that do not show up in their accounts.

7.5.6 Borrowing Constraints and Capital Finance Local bodies in India suffer severe limitations in raising resources from capital markets for long term infrastructure finance. Local bodies in India are severely constrained in raising resources from capital markets for long-term infrastructure finance.

- Municipal bonds: Only around ten Indian urban local bodies (ULBs) have issued municipal bonds so far. The SEBI norms (2015) permit bonds issuance — but most cites suffer from lack of investment-grade credit ratings.
- AMRUT scheme facilitated the issuance of bonds by 10 ULBs aggregating to ₹3,840 crore during 2017-23 — Pune (₹200 crore, 2017 – the first in India), Ahmedabad, Hyderabad, Indore, Bhopal, Vadodara, Ghaziabad, Greater Hyderabad, Lucknow, Patna. • Credit rating gap: Out of 4,500 ULBs, around 100 have credit ratings — the rest are not bankable for capital markets.
- NABARD and NHB: principal financiers in the case of rural and urban local bodies respectively – but only for project loans, not for the general purpose.

Indian Example: Pune Municipal Corporation's Municipal Bond

In June 2017, Pune Municipal Corporation (PMC) issued India's first modern municipal bond in 17 years:

- Amount: ₹200 crore; Coupon: 7.59% per annum
- Tenure: 10 years
- Purpose: Kalyani Nagar-Ahmednagar Road Project
- Credit Rating: AA (stable) by CARE Ratings
- Oversubscribed: 1.96 times — institutional investors bought ₹391 crore worth
- Innovation: Tax-free bond under Section 10(15)(ix) of Income Tax Act

The PMC bond catalysed the SEBI municipal bond framework. However, replication has been slow — most ULBs cannot achieve AA rating required for retail investor access.

7.5.7 Multiplicity of Authorities and Fragmented Jurisdiction

- Bodies under control of the State: State governments have established Water Boards, Development Authorities, House-Building Boards, Industrial Estates etc which functioning parallel to ULBs — leading to a fragmentation of responsibility.

• Sample — Delhi: NDMC, MCD, DCB, DJB, DDA, DMRC, DSIIDC — all have a say in the city the result: no one is responsible for what happens.

• Sample-Bengaluru: BBMP (civic), BWSSB (water), BESCOM (power), BDA (planning), BMTC (transpor t), Bruhat Bengaluru Ring Road Authority — 9 different agencies with overlapping areas.

• Political Fragmentation: Party A rules State ULBs while Party B controls the parliament constituency – leaves no space for governance working in tandem.

7.6 The Need for Fiscal Decentralisation Fiscal decentralization is defined as the degree to which financial powers, revenue-raising capacity, expenditure assignments, and borrowing powers are devolved from central/state governments to local governments. It's both an economic and governance principle – premised on the belief that citizens are best served when decisions are made as near to them as possible

7.6.1 Theoretical Foundations

Theory	Proponent	Core Argument	Indian Application
Tiebout Model	Charles Tiebout (1956)	People 'vote with their feet' — migrate to jurisdictions offering best services at lowest taxes	Urban migration to Bengaluru/Mumbai partly reflects local service quality preferences
Decentralisation Theorem	Wallace Oates (1972)	Decentralised provision of public goods is efficient when preferences vary by location	Rural health spending in Kerala vs. UP reflects local priority differences
Fiscal Federalism (First Gen.)	Musgrave (1959)	Allocative function best decentralised; redistribution and stabilisation should be central	India's Finance Commission assigns redistributive grants to Centre
Second-Generation Fiscal Federalism	Weingast (1995), Qian-Roland	Local governments face hard budget constraints and compete — improving governance	Inter-city competition in Swachh Survekshan ranking spurs civic improvement
Participatory Decentralisation	World Bank (1990s)	Community participation in planning improves project selection and sustainability	Kerala's People's Plan — GP-level participatory planning with ward sabhas

7.6.2 Economic Benefits of Fiscal Decentralisation

A. Efficiency of resource usageLocal governments have better knowledge of their needs, tastes, and costs. A Gram Panchayat in drought-ridden Vidarbha is aware more than Maharashtra (state government) that water conservation work should get precedence over road laying — but that is only if the GP has the fiscal capacity to translate that knowledge into action.

> **Indian Example: Participatory Budgeting in Kerala**
>
> Kerala's Gram Panchayats conduct Gram Sabha meetings before preparing the Annual Plan. Each ward conducts a 'beneficiary committee meeting' where:
>
> • Citizens identify local needs (roads, wells, streetlights, sanitation)
>
> • Ward representatives prioritise using a standardised scoring matrix
>
> • GP approves based on citizen priorities, not politician preferences
>
> Result: Kerala's local body plans show higher alignment between stated citizen needs and actual budget allocation than states without participatory budgeting. The SIRD (State Institute of Rural Development) documents that 78% of Kerala GP projects in 2022-23 were citizen-initiated.

B. Accountability and Reduced Corruption

When local voters know where the money is spent (on a drain, a streetlight, a school toilet), they can make their local officials answerable — much more so than they can a State minister who is far away.

Financial independence with the political accountability provides good incentive for clean administration.

• Social audits under MGNREGS: Gram Sabha social audit on all MGNREGS work — bills are read out, names of contractors and wage payment details made public. This has led to a large decline in asset quality corruption.

• e-Gram Swaraj: The MoPR citizens can log on to a web portal to see GP plans, expenditure, and generation of assets — 2.6 lakh GPs upload plans (2023-24).

• Swachh Survekshan rankings: This annual city-level ranking by MoHUA — with disclosure in public — also created accountability pressure on ULB Commissioners. C. Innovation and Competitive Pressure Across Levels of Government Local governments are given opportunities to test innovative approaches through decentralisation. Innovations that work are diffused ('yardstick competition'), and the failures are contained rather than becoming disasters at the national level.

Innovation	Local Body	What Changed	Scale-up
Swachh Survekshan Ranking	MoHUA / All ULBs	Annual rankings incentivise civic improvement — competitive pressure drives investments	Indore model replicated in Surat, Navi Mumbai, Mysuru

GIS-based Property Tax	Andhra Pradesh ULBs	Satellite mapping of all buildings — added 45,000 new properties in Visakhapatnam	Replicated in Telangana, Karnataka
e-Governance in Local Bodies	Pune PMC	Online building permissions, property tax payment, grievance redressal	PMC model basis for Smart Cities Mission e-governance norms
Solid Waste User Charges	Indore IMC	Door-to-door collection with app-based monitoring and user charges	Indore model in Bhopal, Jabalpur, now national Best Practice
Municipal Bonds	Pune PMC (2017)	First modern muni bond — tax-free, SEBI-compliant	9 more cities issued bonds by 2023 after PMC success

7.6.3 Social and Political Importance

A. Deepening Democracy

There are roughly 3 million elected representatives in the Panchayati Raj Institutions in India — more than the combined democracies of the rest of the world. Fiscal decentralisation is a way of giving effect to these electoral mandates. When a Gram Pradhan doesn't have any money to spend, she is a figurehead and not a leader. Local democracy becomes real democracy through fiscal empowerment.

• Women's empowerment: 33-50% reservation for women in PRIs (more in states like Bihar – 50%) has enabled ~15 lakh women to get elected. With fiscal autonomy, these women can direct resources towards priorities such as women's self-help groups, creches, safe drinking water – informed gender-based knowledge of the local level.

• SC/ST representation: The fiscal power at the grassroots for the constitutionalally reserved, marginalised communities to participate in the decision-making over public resources – the public resources which they have historically been excluded from. B. Responsive and Visible Governance Citizens can see and touch local public goods — a repaired road, a functioning handpump, a clean market. That visibility generates both pride and accountability,prompting motivation to perform (pride) and pressure to perform (sanctions). That kind of dynamics doesn't work with states and the national government; they are far too removed.

Indian Example: MGNREGS Social Audit — Accountability in Action

The MGNREGS Act, 2005 mandates Social Audit of every MGNREGS work by the Gram Sabha. The National Social Audit Standards (2012) govern the process. In Andhra Pradesh:

- The Society for Social Audit, Accountability & Transparency (SSAAT) — an independent body — conducts social audits in 13 districts simultaneously
- In 2022-23: 6,200 works audited; ₹87 crore in financial irregularities detected; ₹23 crore recovered
- District Collectors must attend reading of social audit findings
- SSAAT reports published online within 30 days

This model — local spending + local audit + local accountability — represents fiscal decentralisation at its most powerful. AP's model has been replicated in Telangana, Rajasthan, and Jharkhand.

7.6.4 Macroeconomic Role of Local Finance

Spending Local: Local government expenditure — and capital expenditure in particular — in local economies is known to have significant macroeconomic multiplier effects. Roads link farms to markets; drainage prevents crop losses; street lighting enables after-dark commerce; water supply helps reduce household time poverty (especially for women).

Channel	Mechanism	Indian Evidence
Employment Multiplier	Local construction spending creates direct and indirect employment	MGNREGS: 264 crore person-days in 2023-24 — ₹73,000 crore wage income injected in rural areas
Asset Creation	Durable local infrastructure raises agricultural productivity and reduces logistics costs	PMGSY rural roads: Each 10 km of rural road raises agricultural wages by 4.3% (World Bank study)
Poverty Reduction	Targeted local spending on the poor (housing, water, sanitation) reduces poverty directly	PM Awas Yojana – G: 2.94 crore houses completed (2016–2024) — each house ₹1.20 lakh to GP area economy
Female Labour Force Participation	Water supply reduces women's water-fetching burden — frees time for productive activities	Jal Jeevan Mission: 14.55 crore tap connections — estimated 2 hours/day saved per rural woman

Health Productivity	Clean water, sanitation, waste management reduce morbidity — increase labour productivity	Swachh Bharat: ODF districts showed 8% reduction in child diarrhoea (UNICEF study)

7.6.5 Challenges to Effective Fiscal Decentralisation in India

⚠ The Decentralisation Gap — Between Promise and Reality

India's fiscal decentralisation remains 'incomplete' by global and constitutional standards:

1. Local bodies' share in total government expenditure: ~3% (India) vs. 12% (Brazil), 50% (China)
2. Local bodies' own-source revenue as % of GDP: 0.5% (India) vs. 5–6% (OECD average)
3. Staff autonomy: Most GP and ULB staff are State employees — local bodies cannot hire, fire, or direct them
4. Borrowing access: Fewer than 100 of 4,500 ULBs have credit ratings
5. SFC compliance: Many states delay SFC constitution, ignore recommendations, or reduce devolution below SFC recommendations

The 16th Finance Commission (constituted 2023, Chairman: Arvind Panagariya) has been asked to specifically address local body finance — including whether SGST sharing should extend to local bodies and whether local body grants should be further increased.

7.7 Chapter Summary

Topic	Core Content	Key Indian Example
Local Body Finance	Financial system of PRIs and ULBs; constitutional basis in Art. 243G and 243W	₹4.36 lakh crore FC grants to local bodies (2021-26)
Rural Local Bodies	Three-tier PRIs: GP (2.62 lakh), Block Panchayat, Zila Parishad; 29 functions in 11th Schedule	Kerala GP Finance: ₹45 lakh avg OSR vs. Bihar: ₹4 lakh
Urban Local Bodies	Municipal Corporations, Councils, Nagar Panchayats; 18 functions in 12th Schedule	BMC Budget: ₹59,954 crore (2024-25); Indore SWM model

Revenue Sources	Own tax (property tax, profession tax), own non-tax (user charges, fees), assigned revenues, grants	Chennai property tax — ARV basis; Pune municipal bond
Problems	Low OSR, grant dependency, weak SFCs, 3F gap, poor accounting, borrowing constraints, jurisdictional fragmentation	Delhi — 9 overlapping agencies; 40% GPs with unaudited accounts (CAG)
Fiscal Decentralisation	Efficiency, accountability, innovation, democratic deepening, macroeconomic multipliers	MGNREGS social audit (AP); Kerala People's Plan; Swachh Survekshan

Review Questions

1. Define local body finance. Explain how the 73rd and 74th Constitutional Amendment Acts of 1992 transformed the financial position of local bodies in India.
2. Distinguish between Gram Panchayats and Municipal Corporations in terms of (a) constitutional basis, (b) functions, and (c) revenue sources. Illustrate with Indian examples.
3. 'Property tax is the most important but most underutilised revenue source of urban local bodies in India.' Discuss the reasons for underperformance and suggest reforms, with reference to at least two city-specific examples.
4. Critically examine the functioning of State Finance Commissions in India. Why does the national norm fall far short of the Kerala model?
5. Explain the '3F Problem' in local body finance. How does the functional devolution gap undermine fiscal decentralisation in India?
6. Evaluate the role of Finance Commission grants in strengthening local body finance in India. How did the 15th Finance Commission innovate in its approach to local body grants?
7. Discuss the economic and political importance of fiscal decentralisation. Use Indian examples from MGNREGS, Kerala's People's Plan, and the Swachh Survekshan to support your answer.
8. Write a critical note on municipal bonds as a tool of urban infrastructure finance in India. What are the conditions for success? Illustrate with the Pune Municipal Corporation experience.

Key Terms and Concepts

Term	Definition
Local Body Finance	Financial architecture — revenue, expenditure, transfers, and borrowing — of Panchayati Raj Institutions and Urban Local Bodies
Own-Source Revenue (OSR)	Revenue raised by a local body from its own taxes, fees, and charges — independent of higher government transfers
Property Tax	Annual levy on assessed value of immovable property — largest potential own-tax source for ULBs
Eleventh Schedule	Constitutional schedule listing 29 subjects that may be assigned to Panchayats (Article 243G)
Twelfth Schedule	Constitutional schedule listing 18 subjects that may be assigned to Municipalities (Article 243W)
State Finance Commission	Body constituted under Art. 243-I / 243-Y to recommend intra-state devolution to local bodies every 5 years
3F Gap	Inadequate transfer of Functions, Funds, and Functionaries to local bodies despite constitutional mandate
Fiscal Decentralisation	Transfer of financial powers, revenue authority, expenditure responsibilities, and borrowing capacity to local governments
Municipal Bond	Debt security issued by a Municipal Corporation to fund capital infrastructure; SEBI-regulated in India since 2015
Gram Sabha	Assembly of all registered voters of a village; primary institution of direct democracy and social audit at grass-root level
Tiebout Model	Economic model predicting that citizens will migrate to jurisdictions offering optimal public services — creating inter-jurisdictional competition
Swachh Survekshan	Annual national ranking of cities by MoHUA on sanitation and solid waste management — creates competitive decentralisation incentives

Chapter 8:
Finance Commission of India

- Meaning and Constitutional Status
- Composition of Finance Commission
- Functions of Finance Commission
- Role in Revenue Distribution
- Recommendations of Recent Finance Commissions
- Importance of Finance Commission in Fiscal Federalism

Learning Objectives

After studying this chapter, students will be able to:

• Define the Finance Commission and explain its constitutional basis under Article 280

• Describe the composition and qualifications of Finance Commission members

• Enumerate and analyse the functions of the Finance Commission

• Explain the mechanisms of vertical and horizontal revenue distribution

• Examine the recommendations of the 13th, 14th, and 15th Finance Commissions in detail

• Critically assess the importance of the Finance Commission in maintaining India's fiscal federalism

• Understand current issues and reform proposals relating to the Finance Commission

8.1 Meaning and Constitutional Status

The Indian finance commission is a constitutional body, instituted under the article 280 of the Indian constitution and it is a quasi judicial body. It corresponds to India's fiscal federalism — the agency that defines how Central tax revenue is distributed to States and the terms on which grants flow from the Consolidated Fund of India to States and local government. The Finance Commission of India holds an exceptional position in the Indian polity: it is not a permanent commission and it does not belong to the executive organisation of the government. It is reconstituted by the President every five years (or earlier), carries out its work in 18-24 months, submits a report and is then wound up. While its recommendations are not binding in

law, they are regarded as conventions of the constitutional practice – not a single Government of India has ever let out a Finance Commission's award.

8.1.1 Constitutional Provision — Article 280

\Art. 280(1)	**The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission.**

Art. 280(2)	**Parliament may by law determine the qualifications requisite for appointment as members of the Commission and the manner in which they shall be selected.**

Art. 280(3)	**It shall be the duty of the Commission to make recommendations to the President as to — (a) distribution of net proceeds of taxes between Union and States; (b) principles governing grants-in-aid from the Consolidated Fund of India; (c) measures to augment the Consolidated Fund of a State to supplement the resources of panchayats and municipalities; (d) any other matter referred to the Commission by the President in the interests of sound finance.**

8.1.2 Nature and Status of the Finance Commission

Characteristic	Details
Constitutional Status	**Creature of the Constitution — Article 280; not a statutory or executive body**
Quasi-Judicial Nature	**Functions like a judicial tribunal — receives submissions from Centre and States, hears arguments, awards recommendations**
Temporary Body	**Constituted for each award period; dissolved after submitting report — no permanent secretariat (support from Ministry of Finance)**
Non-Partisan Independence	**Members must be persons of competence in public affairs — convention of appointing eminent economists, civil servants, jurists**

Recommendations Not Binding	**Technically advisory — but politically and constitutionally treated as binding; Parliament's acceptance is convention**
Scope Expandable	**Art. 280(3)(d) allows President to refer 'any other matter' — used to seek views on disaster management, local body reforms, GST transition**
No Permanent Secretariat	**Staff drawn from Ministry of Finance and Planning Commission/NITI Aayog; Commission builds own research capacity during tenure**

Indian Example: Why the Finance Commission is Constitutionally Unique

The Finance Commission is one of only four bodies expressly created by the Constitution to perform specific functions (the others being the CAG, UPSC, and Election Commission). Unlike the Planning Commission or NITI Aayog — which were executive bodies created by Cabinet resolution — the Finance Commission derives its mandate directly from the Constitution. No Parliament Act is needed to create it; the President's order suffices.

This constitutional anchoring gives its recommendations enormous moral authority. When the 14th Finance Commission (2015) recommended 42% devolution to States, no political party in Parliament dared to formally oppose the recommendation — even those in the Centre who might have preferred to retain more for Central schemes.

8.2 Composition of the Finance Commission

The Finance Commission (Miscellaneous Provisions) Act, 1951 lays down the qualification, appointment, and terms and conditions of service of members of the Finance Commission. The Commission is constituted by the President by a notification in which the Chairman and four other members are specified.

8.2.1 Statutory Composition

Position	Number	Qualification Requirement (under FC Act, 1951)
Chairman	**1**	**Must be a person with experience in public affairs — usually an eminent economist, retired judge, or senior administrator**
Members	**4**	**At least one member must be: (a) a judge of a High Court; (b) a person with knowledge of government finances or financial matters; (c) a person with wide experience in administration and financial expertise; (d) a person with special knowledge of economics**

7.2.2 Chairmen of Finance Commissions — A Profile

Finance Commission	Chairman	Background	Notable Attribute
1st FC (1951)	K.C. Neogy	Civil servant, politician	Established foundational principles of tax sharing
5th FC (1968)	Mahavir Tyagi	Freedom fighter, politician	First non-economist chairman — political economy perspective
8th FC (1983)	Y.B. Chavan	Veteran politician, ex-Finance Minister	Strong political weight given to recommendations
10th FC (1992)	K.C. Pant	Senior politician, former minister	Introduced normative approach to state finances
12th FC (2003)	C. Rangarajan	Eminent economist, ex-RBI Governor	Fiscal consolidation framework; debt relief for states
13th FC (2007)	Vijay Kelkar	Economist, ex-Finance Secretary	Performance grants; climate finance grants
14th FC (2012)	Y.V. Reddy	Economist, ex-RBI Governor	Historic 42% devolution; reduced tied transfers
15th FC (2017)	N.K. Singh	IAS officer, ex-Finance Secretary, MP	COVID adjustment; local body accountability grants
16th FC (2023)	Arvind Panagariya	Economist, ex-NITI Aayog Vice Chairman	Focus on local bodies, GST, fiscal consolidation

8.2.3 Terms of Service and Independence

• Security of tenure: a member may be removed only on proven grounds of misbehaviour or incapacity before the Supreme Court — protecting them from executive influence.

• Salary and allowances: Are determined by the President and they don't get voted on in the Parliament – enabling them to remain financially independent.

• Ban on further government service: The Chairman and members cannot be appointed to the government of India once they are past their term — stopping them from indulging in anticipatory compliance with executive priorities.

• Support for research: Each Finance Commission is supported by a Secretariat comprising officers of the IAS and economists from the MoF, RBI, CAG and academia.

> ⚠ **Issue: Is the Finance Commission Truly Independent?**
>
> **Critics raise several concerns about FC independence:**
>
> **1. Executive appointment: Chairman and members are appointed by the President — effectively the Cabinet — raising concerns about bias in appointment**
>
> **2. Terms of Reference: The ToR given to each FC by the Cabinet can constrain recommendations — the 15th FC's ToR directing it to use 2011 Census population was seen as politically motivated (benefiting states with higher population growth)**
>
> **3. Acceptance cherry-picking: While no FC award has been formally rejected, Governments have sometimes delayed implementation or modified grant conditions**
>
> **4. Centre's structural advantage: The Finance Commission Secretariat is funded by the Ministry of Finance (Centre) — States argue the FC depends financially on one of the parties it arbitrates between**
>
> **Despite these concerns, the Finance Commission remains India's most credible federal arbitration institution — far more independent than executive bodies like NITI Aayog.**

8.3 Functions of the Finance Commission

The Finance Commission carries out both its mandatory functions — which are those laid down in Article 280(3)(a), (b) and (c) — and the referred functions that the President may add in terms of Article 280(3)(d). The Finance Commission has become a broader fiscal policy institution as a result of the substantial expansion in the scope of its referred functions over the decades.

8.3.1 Mandatory Functions

8.3.1 Responsibilities that Must be Performed A. Distribution of the Tax Revenue – Article 280(3)(a) The most important part: what share of net Central taxes should be given to States as a whole (vertical devolution), and the formula to distribute that share among individual States (horizontal devolution).

Sub-Function	What the FC Determines	Output
Vertical Devolution	**What % of the divisible pool goes to States collectively**	**e.g., 41% under 15th FC**
Horizontal Distribution	**By what formula is the states' share divided among 28 states**	**Weighted criteria: income distance, population, area, forests, tax effort**

Divisible Pool Definition	**Which taxes enter the shareable pool — cesses and surcharges excluded**	**Net Central taxes after refunds, net of cesses**
Tax-specific Recommendations	**Separate treatment of income tax, corporate tax, CGST, customs if needed**	**Usually a combined pool approach since the 10th FC**

B. Grants-in-Aid — Article 280(3)(b)

The Finance Commission disburses grants-in-aid to States from the Consolidated Fund of India under Article 275. These are statutory grants were not subject to annual Parliamentary approval and they helped States cover residual fiscal gaps after tax devolution.

Type of Grant	Purpose	15th FC Amount (₹ Crore, 2021-26)
Revenue Deficit Grants	**Bridge post-devolution revenue deficit of specific States**	**2,94,514**
Sector-Specific Grants	**Health, education, judiciary, statistics upgradation**	**1,28,860**
Performance-Based Grants	**Agriculture reforms, power sector, ease of business, urban development**	**1,15,848**
Local Body Grants (Gram Panchayats)	**Untied + tied grants for rural local bodies**	**2,36,805**
Local Body Grants (Urban Local Bodies)	**Untied + tied grants for municipalities**	**1,11,250**
Disaster Risk Management	**Contribution to State Disaster Response Funds**	**1,60,153**
Total Grants Recommended	**Combined statutory grants 2021-26**	**10,33,430**

C. Augmenting State Consolidated Funds for Local Bodies — Article 280(3)(c)

Touted by the 73rd and 74th Amendments (1992), the clause obliges the Finance Commission to take into account the need to increase the resources of the Panchayats and the Municipalities. This has turned the FC into a direct funder of grassroots democracy.

Indian Example: Evolution of Local Body Grants Across Finance Commissions

The journey of Finance Commission local body grants reflects India's deepening commitment to the third tier:

• 10th FC (1995): First local body grants — ₹4,381 crore (rudimentary, lump-sum)

• 11th FC (2000): ₹8,000 crore — introduced panchayat and municipality distinction

• 12th FC (2005): ₹25,000 crore — first tied grants for basic services

• 13th FC (2010): ₹87,519 crore — general and specific purpose grants; performance incentives

• 14th FC (2015): ₹2,87,436 crore — massive 3x increase; basic and performance criteria

• 15th FC (2021): ₹4,36,361 crore — highest ever; conditions on audited accounts and property tax notification

Each successive FC has increased both the quantum and the conditions attached to local body grants — using fiscal incentives to drive institutional reforms in governance.

8.3.2 Referred Functions — Article 280(3)(d)

The President's order constituting each Finance Commission contains certain additional specific questions (Terms of References) which the Commission is required to address. Over time these have transformed the role of the FC from fiscal arbitrator to general fiscal policy adviser.

Finance Commission	Key Referred Functions	Significance
12th FC (2004-10)	Review of state fiscal consolidation plans; restructuring of public finances	Led to FRBM legislation in most states
13th FC (2010-15)	Principles for equitable distribution; climate change financing; public sector plan financing	First FC to address climate grants — ₹61,000 crore for environment
14th FC (2015-20)	Evaluation of CSS performance; local body finance; disaster management financing	Prompted massive reduction in CSS tied grants

15th FC (2020-26 extended)	**Impact of GST on state finances; defence expenditure financing; performance incentives**	**COVID-19 adjustments; two-year transitional report (2020-21) + full report (2021-26)**
16th FC (2026-31)	**Local body taxation reforms; sub-national climate finance; post-COVID fiscal consolidation**	**Expected to address SGST sharing with local bodies**

8.3.3 Process of the Finance Commission

Constitution: The President promulgates a Constitution Order — normally 18–24 months before the term of award starts.

- Terms of Reference: Accompanying the Constitution Order — defines the specific issues the FC has to deal with.
- Data collection: FC dispatches a comprehensive questionnaire to all State governments, Ministries, RBI, CAG and NITI Aayog.
- State visits: FC members themselves travel to every state capital and meet Finance Ministers, bureaucrats and subject experts.
- Stakeholder consultations: From academic economists to civil society, local government associations, industry chambers.
- Interim / transition report: FC can first submit a one-year transition report for new award periods (as 15th FC did for 2020-21).
- Final report: To the President; laid on the Table of the Parliament within a month along with a Government of the Action Taken Report.

8.4 Role in Revenue Distribution

Equitable distribution of resources is the fundamental charge to the Finance Commission. It is a two-stage decision making process: (i) how much of the Central tax revenue is to be assigned to the States as a group — this is the vertical devolution — and (ii) how the States sues the tax pie, in other words, how the States are allocated the pool of revenues raised along the horizontal dimension. Both choices are significant for the coherence of inter-state equalization and growth in the nation.

8.4.1 The Divisible Pool - What Is Distributed After deduction of the cost of collection and refunds, the net revenue of all Central taxes and duties forms the divisible pool. Some levies are not part of the pool:

Included in Divisible Pool	Excluded from Divisible Pool
Income Tax (personal and HUF)	Health and Education Cess (4% surcharge)
Corporate Tax	PM CARES contributions (not a tax)
Central GST (CGST)	National Calamity Contingency Duty (historical)
Customs Duty (import & export)	Surcharges on income tax and corporate tax
Union Excise Duties (petroleum, tobacco)	Goods imported under specific exemptions
Central component of IGST (unsettled portion)	Interest on Central loans to States

⚠ **Critical Issue: Growing Cesses Erode States' Revenue**

The exclusion of cesses and surcharges from the divisible pool has become a major federal grievance:

Year | Cesses as % of Gross Central Tax Revenue

2011-12 | 8.4%

2015-16 | 11.6%

2019-20 | 15.7%

2022-23 | 20.8%

2023-24 | 21.5% (Budget Estimate)

Annual loss to states (2023-24): Approximately ₹3.8–4.2 lakh crore not shared, despite states having a 41% constitutional claim on Central taxes.

The 15th Finance Commission flagged this as a "matter of serious concern" but could not recommend inclusion of cesses in the divisible pool — that requires a Constitutional amendment or Parliamentary legislation.

8.4.2 Vertical Devolution — Historical Trend

Period	States' Share	Change	Context
Pre-10th FC	**~28–29%**	**Gradual increase**	**States' needs growing with developmental responsibilities**
10th FC (1995–2000)	**29.0%**	**+0%**	**Stabilisation; normative approach introduced**
11th FC (2000–2005)	**30.5%**	**+1.5%**	**GST preparation; local body grants begin**
12th FC (2005–2010)	**30.5%**	**0%**	**Fiscal consolidation priority; debt relief to states**
13th FC (2010–2015)	**32.0%**	**+1.5%**	**Performance grants introduced; first climate grants**
14th FC (2015–2020)	**42.0%**	**+10%**	**Historic 10-point jump — cooperative federalism**
15th FC (2020–2026)	**41.0%**	**-1%**	**1% reduction for J&K & Ladakh UTs (bifurcation 2019)**
16th FC (2026–2031)	**TBD**	**Pending**	**Expected to address cess issue and local body SGST**

8.4.3 Horizontal Devolution — Criteria and Weights

Horizontal devolution defines how the States' aggregate share is apportioned among the 28 States.

The various Finance Commissions that have been constituted have used criteria that reflect changing policy priorities — a trade off between equalisation (supporting the needs of poor states) versus efficiency (rewarding better fiscal performance) and equity (recognizing geography and demographic considerations).

Criterion	13th FC Weight	14th FC Weight	15th FC Weight	Purpose
Population	**25%**	**17.5%**	**15%**	**Demand for public services; service-level requirements**

Area	**10%**	**15%**	**15%**	**Cost of delivering services across large geographies**
Income Distance (GSDP gap)	**47.5%**	**50%**	**45%**	**Equalisation — poorer states receive proportionally more**
Fiscal Capacity Distance	**—**	**—**	**—**	**Merged into income distance in recent FCs**
Fiscal Discipline / Tax Effort	**17.5%**	**—**	**2.5%**	**Reward states that mobilise own revenues effectively**
Forest Cover	**—**	**7.5%**	**10%**	**Environmental services; compensation for land use restrictions**
Demographic Performance	**—**	**—**	**12.5%**	**Incentivise states that reduced fertility rates (TFR)**
Human Development Index	**—**	**10%**	**—**	**Dropped in 15th FC; income distance considered sufficient**
TOTAL	**100%**	**100%**	**100%**	

Indian Example: How the Formula Works — Maharashtra vs. Bihar

15th Finance Commission horizontal devolution — illustrative calculation for 2023-24:

States' collective share = 41% of ₹24.9 lakh crore gross Central taxes = ₹10.2 lakh crore

Bihar's share (10.06% of states' pool):

- **Large Income Distance weight (very low per capita GSDP vs. Haryana benchmark)**
- **High population (130+ million — 2011 Census)**
- **Low Demographic Performance score (TFR still above replacement)**
- **Bihar receives: ~₹1.03 lakh crore from central tax devolution alone**

Maharashtra's share (6.31% of states' pool):
- **Small Income Distance weight (near Haryana-level GSDP)**
- **Lower relative population weight**
- **Better Demographic Performance (TFR near replacement)**
- **Maharashtra receives: ~₹0.64 lakh crore from devolution**

Despite Maharashtra having a GDP 3x Bihar's, Bihar receives 60% MORE in devolution — the equalisation principle at work.

8.4.4 Grants vs. Devolution — A Key Distinction

Feature	Tax Devolution	Grants-in-Aid
Constitutional Basis	Article 270 — sharing of Central taxes	Article 275 — grants from Consolidated Fund
Nature	State's right — not at Centre's discretion	Discretionary in terms of amounts (FC recommends)
Conditionality	None — completely untied	Some grants are tied to specific expenditures or reforms
Predictability	Formula-based — predictable monthly releases	Assessed based on fiscal gap and performance; can vary
Who Benefits	All States get a share (formula-based)	Only States with revenue deficits or specific needs
Equalisation Role	Partially equalising through income distance criteria	More targeted equalisation for revenue-deficit States
Quantum (15th FC)	₹43.2 lakh crore over 2021-26	₹10.3 lakh crore over 2021-26

8.5 Recommendations of Recent Finance Commissions

This part elaborates on the 13th, 14th and 15th Finance Commissions - the three latest finalised award periods. Together they cover the period 2010–2026 and they hold the record for shaping the most transformative times in India's fiscal federalism history, both before and after the GST (2017); the COVID-19 pandemic (2020-21); and the bifurcation of the Union State of Jammu & Kashmir (2019).

8.5.1 Thirteenth Finance Commission (2010–2015) The 13th Finance Commission was formed in 2007 chaired by Vijay Kelkar. It extended from 1st April 2010 to 31st March 2015. It submitted its report in 2009.

Parameter	13th Finance Commission Recommendation
Chairman	**Dr. Vijay Kelkar (Economist, former Finance Secretary)**
Award Period	**2010–2015**
States' Share in Divisible Pool	**32% (up from 30.5%)**
Total Transfers to States	**₹14.48 lakh crore (devolution + grants) over 5 years**
Revenue Deficit Grants	**₹51,800 crore to 13 revenue-deficit states**
Local Body Grants	**₹87,519 crore (general + specific purpose)**
Disaster Management	**Recommended unified National Disaster Response Fund (NDRF) + State Disaster Response Fund (SDRF)**
Fiscal Consolidation Target	**Revenue deficit to be eliminated by 2014-15; fiscal deficit 3% of GDP**

Key Innovations of the 13th Finance Commission

Performance Grants: This FC was also the first FC to introduce performance-based grants — linked to quantifiable outcomes in education enrolment, immunisation, power sector reforms, and enhancement in own-tax collection.

• Climate Change Grants: Suggested ₹61,000 crore for 'green accounting' and environmental services — acknowledging that states with large forest cover sacrifice development revenue; path-breaking in India's fiscal policy.

• GST Transition Grant: Proposed an implementation grant for GST of ₹50,000 crore to help states to go along with GST — it recognises revenue loss in the process of removing multiple state levies.

• Fiscal Roadmap: Lays down an elaborate 'roadmap' for Centre and State fiscal consolidation — effectively a medium term fiscal strategy, which is above the traditional FC mandate.

Indian Example: 13th FC Performance Grants in Action

The 13th FC's Elementary Education Performance Grant required states to:

(a) Increase enrolment in Classes I-VIII by 5% over baseline

(b) Reduce dropout rate to below 5%

(c) Complete schools under SSA (Sarva Shiksha Abhiyan) construction norms

States earning maximum education grants (2010-14): Kerala, Tamil Nadu, Himachal Pradesh — states with already strong education systems, reinforcing their advantage.

States earning minimum: Bihar, Uttarakhand, Manipur — states with weak institutional capacity, illustrating the limitation of purely performance-linked grants in improving equity.

This tension — between incentive efficiency and equalisation — has shaped the design of performance grants in subsequent Finance Commissions.

8.5.2 Fourteenth Finance Commission (2015–2020)

The report of 14th Finance Commission was submitted in 2015 by its Chairman Dr. Y.V. Reddy (former Governor, Reserve Bank of India). It has issued the most radical set of recommendations in the history of the Finance Commission — altering Centre-State fiscal relations to a dramatic extent.

Parameter	14th Finance Commission Recommendation
Chairman	Dr. Y.V. Reddy (Economist, ex-RBI Governor, ex-IAS)
Award Period	2015–2020
States' Share in Divisible Pool	42% — largest single increase in FC history (+10 percentage points)
Total Transfers to States	₹39.49 lakh crore (devolution + grants) over 5 years
Revenue Deficit Grants	₹1,94,821 crore to 11 revenue-deficit states
Local Body Grants	₹2,87,436 crore (basic + performance)
Disaster Management	Restructured SDRF — Centre:State 75:25 for general states; 90:10 for special category
Fiscal Deficit Target	3% of GSDP for States; escape clause for capital expenditure

Post-Devolution Revenue Surplus	**Projected all 29 states would have post-devolution revenue surplus**

Why the 14th FC Was a Landmark

The 14th Finance Commission — Cooperative Federalism's Highpoint

Y.V. Reddy's 14th FC made three interlinked arguments for the 42% devolution:

1. Untied vs. tied: Centrally Sponsored Schemes came with conditions and uniform design — inefficient. Giving States more untied money via devolution lets them address local needs better.

2. Fiscal autonomy: States were emerging from fiscal consolidation (post-FRBM) and needed space to invest in infrastructure without Central permission or conditionality.

3. Cooperative federalism: In a mature federation, the Centre should trust States to allocate resources according to local priorities. The jump from 32% to 42% was an act of institutional trust.

The Government accepted the recommendation — BUT compensated by sharply reducing its own discretionary grants (CSS funding). The net transfer increase was therefore more modest than the headline 42% suggested.

State Finance Minister reactions (2015): Revenue-deficit states (Himachal, Uttarakhand, J&K) welcomed unconditional devolution. Revenue-surplus states (Maharashtra, Gujarat, Tamil Nadu) received more but complained about losing predictable CSS funding for specific projects.

14th FC Horizontal Devolution Criteria

Criterion	Weight	Indian Impact
Population (2011 Census)	**17.5%**	**Replaced 1971 Census — benefited states with higher population growth (UP, Bihar, MP, Rajasthan)**
Area	**15%**	**Benefited large states: Rajasthan, MP, Maharashtra, Uttar Pradesh**
Income Distance (GSDP gap from Haryana)	**50%**	**Strong equalisation; heavily favoured Bihar, UP, Jharkhand, Odisha**

Forest Cover	**7.5%**	**Benefited Chhattisgarh, Jharkhand, Odisha, MP, Assam**
Human Development Index	**10%**	**Benefited states with lower HDI — converges with income distance for most**
Total	**100%**	

⚠ Controversy: 2011 vs. 1971 Census Population in Horizontal Devolution

The 14th FC's shift from 1971 to 2011 Census population triggered a major political controversy:

• Southern states (Tamil Nadu, Kerala, Karnataka, AP, Telangana) argued they had controlled population growth since the 1970s in response to national policy

• Using 2011 Census effectively penalised states for complying with the government's own family planning recommendations

• Bihar, UP, MP, Rajasthan — which had higher population growth — benefited from the shift to 2011 data

• Tamil Nadu Finance Minister (2015): "Using 2011 Census is anti-federal — it penalises good governance"

The 15th FC attempted to balance this by introducing the Demographic Performance criterion (12.5% weight) — rewarding states that achieved below-replacement fertility rates. However, the Population criterion still uses 2011 Census, keeping the structural advantage for high-population states.

8.5.3 Fifteenth Finance Commission (2020–2026)

The 15th Finance Commission was constituted in November 2017 under Chairman N.K. Singh (former IAS officer and Finance Secretary and presently Rajya Sabha MP). It has submitted a report for a duration of one year, 2020-21 in February 2020, which is called the 'interim report' and the 'final report' for the remaining period of 2021-26 in October, 2020 — just as India was grappling with the COVID-19 pandemic.

Parameter	15th Finance Commission Recommendation
Chairman	**Shri N.K. Singh (IAS, ex-Finance Secretary, ex-MP)**
Award Period	**2020-21 (transition) + 2021-26 (full period)**
States' Share in Divisible Pool	**41% (reduced from 42% by 1% due to J&K bifurcation into two UTs)**

Total Devolution to States	**₹43.20 lakh crore over 2021-26**
Revenue Deficit Grants	**₹2,94,514 crore to 17 revenue-deficit states**
Local Body Grants	**₹4,36,361 crore (largest ever to local bodies)**
Sector-Specific Grants	**₹1,28,860 crore (health, education, judiciary, statistics)**
Performance-Based Grants	**₹1,15,848 crore (agriculture, power, ease of business, urban, judiciary)**
Disaster Risk Management	**₹1,60,153 crore (SDRF contributions)**
Total Recommended Transfers	**₹53.35 lakh crore over 2021-26 (devolution + all grants)**

Key Innovations of the 15th Finance Commission

New Demographic Performance Criterion (12.5 percent weight): States with fertility rates below replacement level (TFR < 2.1) — primarily southern states and Kerala — are awarded extra share to partly compensate for their disadvantage under the population criterion.

- Conditionality on Local Body Grants: ULBs are required to publish audited accounts for the last two years and notify floor property tax rates, to be eligible for untied grants — employing fiscal incentives to stimulate reforms in urban governance.
- Health Sector Grants: ₹70,051 crore specifically for health — on the condition that states ramp up health spending to 8 percent of their budget — in response to gaps in health infrastructure revealed by COVID-19.
- Two-Phase Report: Unprecedented two-part disclose — a one-year transition report for 2020-21 (due to acknowledge the COVID uncertainty) followed by the full five-year report for 2021-26.
- Performance Grants for Power Sector: States have to bring down aggregate technical and commercial (AT&C) losses, and cross-subsidy they are to be faced with a mandatory reduction in cross-subsidy! - dealing with DISCOM's chronic crisis.
- Macro-Fiscal Framework: 15th FC suggested that the Centre should aim for a fiscal deficit of 3.5%; the states as a group, 3 per cent; with an additional 0.5 per cent allowed for capital expenditure..

15th FC Revenue Deficit Grants — State-wise (Selected)

State	Total Revenue Deficit Grant 2021-26 (₹ Crore)	Reason
Andhra Pradesh	14,613	Post-bifurcation revenue loss and committed expenditure
West Bengal	10,526	Underperformance in own tax revenue; high committed expenditure
Himachal Pradesh	10,281	Small tax base; high per-unit service delivery cost in hills
Kerala	6,362	High social sector committed expenditure; post-flood rebuilding
Uttarakhand	5,709	Hilly terrain; small economy; high maintenance costs
Manipur	4,204	Small state; conflict-affected; limited revenue base
Nagaland	3,692	Special category; minimal own revenues
Meghalaya	3,642	Tribal areas; land use restrictions limit revenue base
Tripura	2,586	Small economy; post-insurgency developmental gap
17 States Total	2,94,514	Post-devolution revenue deficit bridged

Indian Example: 15th FC Health Grants — COVID's Impact on Fiscal Policy

The 15th FC's ₹70,051 crore health sector grant was a direct response to COVID-19:

Condition: States must increase health expenditure to at least 8% of their total budget

Baseline (2018-19): National average health spending = 5.8% of state budgets

Progress (2022-23 estimates):

- **Kerala: 8.4% — already met; benchmark state**
- **Tamil Nadu: 7.2% — close to target**
- **Bihar: 4.1% — far below target; but FC grants compensate for capacity**
- **Rajasthan: 6.8% — improving; Rajasthan increased health budget by 34% in 2022-23**
- **UP: 3.9% — lowest among large states; significantly below target**

Lesson: Conditional grants work when states have capacity to comply; for the most backward states, conditions may need to be relaxed or accompanied by capacity-building grants — a fundamental tension in fiscal federalism design.

7.5.4 Sixteenth Finance Commission — Preview

The 16th Finance Commission was constituted in December 2023 under Dr. Arvind Panagariya (economist, former Vice Chairman of NITI Aayog) as the Chairperson. Its term will be from 1st April, 2026 to 31st March, 2031. Reporting is scheduled for October 2025.

Key Issue Before 16th FC	Context	Significance
Cess and Surcharge Exclusion	**States losing ₹4+ lakh crore annually due to cess exclusion from divisible pool**	**Could recommend legislation to partially include cesses**
Local Body GST Sharing	**Whether SGST should be directly shared with ULBs as recommended by various committees**	**Would fundamentally empower urban local finance**
Vertical Share (42% vs. 41%)	**Whether to restore 14th FC's 42% or reduce further for defence/national security**	**Political economy most contested question**
Population Criterion	**Pressure from southern states to use TFR-adjusted population or 1971 Census**	**Demographic fairness vs. representation equity**
Post-COVID Fiscal Consolidation	**States accumulated debt during COVID; how to set realistic FRBM targets**	**Medium-term fiscal path for states**

Climate Finance	**Sub-national financing for India's NDC commitments; green transition**	**New expenditure mandate for states and local bodies**

8.6 Importance of the Finance Commission in Fiscal Federalism

The Finance Commission is the backbone of India's fiscal federalism — the link between the tax raising capacity of the Union and the spending responsibilities of the States. Its significance has economic, political, developmental and constitutional overtones.

8.6.1 Correcting Vertical Fiscal Imbalance The Indian Constitution confers the revenue-elastic taxes (income tax, corporate tax, customs, CGST) on the Centre, while it assigns the States the service-intensive expenditure obligations (health, education, agriculture, police, local government). This intrinsic vertical fiscal imbalance would have crippling effect on State finances in the absence of systematic redistribution – which the Finance Commission provides.

Fiscal Dimension	Centre	States	FC's Role
Share in Tax Collection (2023-24)	**~63%**	**~37%**	**Transfers 41% of Central taxes to correct imbalance**
Share in Expenditure (2023-24)	**~40%**	**~60%**	**Finance Commission transfers bridge the 23% gap**
Revenue Buoyancy	**High — income, corporate taxes grow faster than GDP**	**Lower — State taxes less elastic to growth**	**FC devolution grows automatically with Central tax growth**
Infrastructure Mandate	**National highways, defence, railways**	**State highways, irrigation, rural roads, urban services**	**FC grants support state capital investment**

8.6.2 Promoting Horizontal Equity — Equalisation

The states of India differ widely in levels of economic development, and fiscal capacity and needs. In the absence of equalisation transfers, the richer states would have delivered a much better public services than the poorer states — reproducing inter-state inequalities across generations. The horizontal devolution formula of the Finance Commission is the major instrument of equalisation in India.

State	GSDP per Capita (2022-23, ₹ lakh)	15th FC Share	Equalisation Outcome
Goa	5.68	0.38%	Tiny share despite high income — receives less
Haryana	3.32	1.07%	Income distance benchmark state — moderate share
Maharashtra	2.86	6.31%	High income but large population — moderate share
Madhya Pradesh	1.36	7.85%	Low income, large area — above-average share
Odisha	1.30	4.63%	Low income + large forest cover — equalised upward
Uttar Pradesh	0.87	17.93%	Largest population + very low income — largest share
Bihar	0.52	10.06%	Lowest income + second largest population — massive equalisation

Indian Example: Has Equalisation Worked? — Evidence from Development Indicators

Finance Commission equalisation transfers have contributed to measurable convergence in state-level development indicators since 1991:

Infant Mortality Rate (IMR) — convergence story:

• 1991: Bihar IMR = 72; Kerala IMR = 17 (gap: 55)

• 2021: Bihar IMR = 46; Kerala IMR = 7 (gap: 39)

• Gap reduced by 29% over 30 years — partially attributable to FC transfers enabling Bihar to expand health infrastructure

Per Capita State Expenditure:

• 2001-02: Bihar per capita expenditure = ₹2,100; Maharashtra = ₹5,200 (ratio: 1:2.5)

• 2022-23: Bihar per capita expenditure = ₹21,000; Maharashtra = ₹32,000 (ratio: 1:1.5)

• Significant convergence in public spending per person — FC devolution key factor

However, full equalisation remains elusive: Bihar's per capita GSDP is still only 18% of Goa's — suggesting that fiscal transfers alone cannot overcome structural economic disadvantages.

8.6.3 Fiscal Discipline and Macroeconomic Stability

In fact, besides redistribution the FC functions as a macroeconomic stabilizer by setting fiscal targets, recommending FRBM-like frameworks for states, and serving as a medium-term fiscal anchor. States that comply with the fiscal roadmaps laid out by the FC are likely to enjoy lower deficits and more sustainable public finances.

• FRBM implementation: The 12th Finance Commission (2004) made debt write-off of ₹1,06,551 crore conditional on States passing their own FRBM legislation — leading to passage of state-level fiscal consolidation laws in 25 states within three years.

• Controlling fiscal deficit: The average fiscal deficit of States declined from 4.2% of GSDP (2001-02) to 2.4% (2007-08) — a time period that also matches the FC fiscal roadmaps.

• COVID recalibration: The 15th FC's dual phase strategy enabled relaxation of fiscal consolidation targets at the height of the COVID (2020-22) and phased them out at the end of the decade – an evolving approach to fiscal management.

• Debt sustainability: In recommending state debt-GSDP targets (20% for most states), the FC offers a fiscal anchor that wards off reckless borrowing.

8.6.4 Strengthening the Third Tier

From the 11th Finance Commission (2000), local body grants have increased from a marginal term to a significant term in FC transfers. The Finance Commission emerged as the chief instrument to channel fiscal resources to Panchayats and Municipalities — turning grassroots democracy from paper to practice.

Finance Commission	Local Body Grants (₹ Crore)	As % of Total FC Transfers	Key Condition
10th FC (1995-2000)	**4,381**	**~1.0%**	**No conditions — first such grants**
11th FC (2000-05)	**8,000**	**~2.3%**	**Auditing and accounting requirements**

12th FC (2005-10)	**25,000**	**~4.7%**	**Separate panchayat and municipality grants**
13th FC (2010-15)	**87,519**	**~8.6%**	**General purpose + specific purpose grants**
14th FC (2015-20)	**2,87,436**	**~17.5%**	**Basic (untied) + performance-based grants**
15th FC (2021-26)	**4,36,361**	**~18.4%**	**Audited accounts; property tax notification; tied grants for water and sanitation**

8.6.5 Providing a Federal Forum

The process of deciding the Finance Commission itself is a demonstration of co-operative federalism. For a period of 18-24 months every half decade, Centre and States put forth their financial cases, negotiate parameters, and accept a constitutionally mandated award. This routine, institutionalised consultation serves to preclude the kinds of fiscal grudges that might otherwise ferment in a heterogeneous federal system.

Indian Example: States' Pre-Submission Lobbying — The Federal Negotiation in Practice

Before each Finance Commission submits its report, State governments engage in intensive advocacy:

• Southern states (Tamil Nadu, Kerala, Karnataka) typically form informal coalitions to argue for demographic performance weights and against 2011 Census population

• Hindi belt states (UP, Bihar, MP, Rajasthan) advocate for higher income-distance weights and continued use of 2011 Census

• Forest-rich states (Chhattisgarh, Jharkhand, Odisha, Northeast) lobby for higher forest cover weights

• Fiscal prudence champions (Gujarat, Maharashtra, Odisha since 2015) advocate for tax effort and fiscal discipline weights

This negotiation — transparent, institutionalised, and mediated by an independent body — is remarkably civilised compared to the fiscal conflicts in federal systems without such institutions (e.g., Argentina's provincial fiscal wars, Nigeria's FAAC disputes).

The Finance Commission is, in essence, India's periodic federal fiscal constitution — rewritten every five years.

8.6.6 Limitations and Reform Proposals

Limitation	Explanation	Reform Proposal
Recommendations Not Binding	**Government can theoretically reject — weakens authority**	**Constitutional amendment to make FC awards legally binding (like election results)**
Growing Cess Exclusion	**Cesses bypass divisible pool — states lose ₹4+ lakh crore/year**	**Finance Commission should recommend phasing out or sharing cesses**
CSS Parallel Transfers	**Centrally Sponsored Schemes create a parallel discretionary transfer stream outside FC control**	**All Central transfers to States should route through FC framework**
Temporary Nature	**Dissolved after each report — no institutional continuity or learning**	**Create a permanent Fiscal Federal Secretariat to serve successive FCs**
Weak Data Base	**Absence of timely State Finance Accounts; CAG audit delays hamper FC analysis**	**Mandatory real-time State financial reporting to a centralised database**
No Local Body SFCs Oversight	**State Finance Commissions — responsible for intra-state devolution — are chronically weak; FC cannot enforce SFC implementation**	**FC should condition State grants on timely SFC constitution and action taken reports**
Centre vs. State Asymmetry	**FC Secretariat funded by Centre; States argue structural bias**	**Independent funding from a neutral source; states get research grant to prepare submissions**

8.7 Finance Commissions of India — Complete Timeline

The following table provides a comprehensive overview of all sixteen Finance Commissions, from 1951 to the forthcoming 16th Commission:

Finance Commission	Award Period	Chairman	States' Share	Key Feature
1st FC	**1952–57**	**K.C. Neogy**	**—**	***Established sharing framework; income tax devolution***
2nd FC	**1957–62**	**K. Santhanam**	**—**	***Expanded scope; deficit grants introduced***
3rd FC	**1962–66**	**A.K. Chanda**	**—**	***Share of income tax raised to 66.66%***
4th FC	**1966–69**	**P.V. Rajamannar**	**—**	***Recommended new criteria for horizontal sharing***
5th FC	**1969–74**	**Mahavir Tyagi**	**—**	***Included grants for backward areas***
6th FC	**1974–79**	**K. Brahmananda Reddi**	**—**	***Estate duty shareable; new non-plan grants***
7th FC	**1979–84**	**J.M. Shelat**	**—**	***Devolution linked to State plans***
8th FC	**1984–89**	**Y.B. Chavan**	**—**	***Area and backwardness added as criteria***
9th FC	**1989–95**	**N.K.P. Salve**	**—**	***Two-part report; expanded grants***
10th FC	**1995–2000**	**K.C. Pant**	**29%**	***Normative approach to state finances***
11th FC	**2000–05**	**A.M. Khusro**	**30.5%**	***First FC to address local body grants***
12th FC	**2005–10**	**C. Rangarajan**	**30.5%**	***State fiscal consolidation; debt relief***
13th FC	**2010–15**	**Vijay Kelkar**	**32%**	***Performance grants; climate change grants***

14th FC	**2015–20**	**Y.V. Reddy**	**42%**	***Historic jump; untied devolution landmark***
15th FC	**2020–26**	**N.K. Singh**	**41%**	***Local body grants; performance incentives***
16th FC	**2026–31**	**Arvind Panagariya**	**TBD**	***Constituted 2023; award expected 2025***

8.8 Chapter Summary

Section	Core Theme	Key Indian Data / Example
7.1 Constitutional Status	**Art. 280 — FC is a constitutional, quasi-judicial body; constituted every 5 years by President**	**16 FCs constituted since 1951; no FC award ever formally rejected**
7.2 Composition	**Chairman + 4 Members; FC (Misc. Provisions) Act 1951; tenure security; post-tenure employment ban**	**Chairmen range from economists (Y.V. Reddy, Kelkar) to civil servants (N.K. Singh)**
7.3 Functions	**Mandatory: tax sharing (Art. 270), grants (Art. 275), local body finance (Art. 243); Referred: fiscal roadmap, climate, GST**	**15th FC scope included COVID impact, defence expenditure, local body reforms**
7.4 Revenue Distribution	**Divisible pool (41% to states); vertical + horizontal devolution; grants vs. devolution distinction**	**Bihar gets 10.06%; Maharashtra 6.31%; cess exclusion costs states ₹4 lakh crore/year**
7.5 Recent FCs	**13th: Performance grants, climate; 14th: Historic 42%, cooperative federalism; 15th: COVID, local body conditions, health grants**	**14th FC: 42% was landmark; 15th FC: ₹4.36 lakh crore to local bodies**
7.6 Importance	**VFI correction, horizontal equity, fiscal discipline, third-tier empowerment, federal forum**	**IMR gap India Bihar-Kerala reduced 29% (1991-2021); ₹53.35 lakh crore 15th FC transfers**

Review Questions

1. What is the Finance Commission of India? Explain its constitutional basis under Article 280 and distinguish it from the Planning Commission and NITI Aayog.
2. Describe the composition of the Finance Commission. What provisions ensure its independence from executive interference?
3. Enumerate the mandatory and referred functions of the Finance Commission. How has the scope of referred functions evolved from the 10th to the 15th Finance Commission?
4. Explain the concept of the 'divisible pool'. Why are cesses and surcharges excluded? What are the fiscal implications for States of the growing cess component in Central tax revenue?
5. Compare and contrast the horizontal devolution criteria used by the 13th, 14th, and 15th Finance Commissions. How did the shift from 1971 to 2011 Census population affect different categories of states?
6. Write a detailed note on the recommendations of the 14th Finance Commission. Why is it considered a landmark in India's fiscal federal history? Were its benefits as large as the headline 42% devolution figure suggested?
7. 'The Finance Commission is India's periodic federal fiscal constitution.' Critically evaluate this statement with reference to the FC's role in vertical imbalance correction, horizontal equalisation, fiscal discipline, and local body finance.
8. Identify any three major limitations of the Finance Commission and suggest constitutional or legislative reforms to address them.

Key Terms and Concepts

Term	Definition
Finance Commission	**Constitutional body (Article 280) constituted every 5 years to recommend distribution of Central tax revenues between Centre and States and grants-in-aid**
Divisible Pool	**Net proceeds of Central taxes and duties that are constitutionally required to be shared with States — excludes cesses, surcharges, and collection costs**
Vertical Devolution	**The share of the divisible pool that goes to States collectively — currently 41% (15th FC)**
Horizontal Devolution	**The formula by which States' collective share is distributed among individual States — based on income distance, population, area, forests, and demographic performance**

Revenue Deficit Grant	**Article 275 grant to States whose post-devolution revenues fall short of their assessed expenditure needs**
Performance Grant	**Finance Commission grant conditional on achieving specific measurable outcomes — e.g., improving education enrolment, reducing power losses, ease of doing business**
Terms of Reference (ToR)	**Specific questions the President directs the Finance Commission to address — determines the scope of each FC's mandate**
Income Distance Criterion	**Horizontal devolution criterion measuring gap between a state's per capita GSDP and that of the highest-income state (Haryana) — highest weight in 15th FC at 45%**
Fiscal Equalisation	**Process of redistributing fiscal resources to reduce disparities in fiscal capacity and expenditure needs across States**
Demographic Performance Criterion	**15th FC innovation — rewards states with below-replacement fertility rates (TFR < 2.1) with additional devolution share**
FRBM	**Fiscal Responsibility and Budget Management Act — targets for fiscal deficit, revenue deficit, and debt; recommended by Finance Commissions for Centre and States**
State Finance Commission	**Sub-national body (Art. 243-I/243-Y) for intra-state devolution to local bodies — mirrors FC at State level**

Unit 5:

Artificial Intelligence and the Economics of Public Finance

Unit Overview In this chapter we discuss the ways in which artificial intelligence (AI) is changing the economics of public finance — the manner in which governments collect revenue, use expenditure, issue debt, and formulate fiscal policy. It is structured into four chapters that cover conceptual foundations and policy applications as well as governance and risk.

Learning Outcomes By the end of this unit, learners should be able to:

1. Explain how AI changes the production function of government and the economy it taxes.
2. Analyze AI's effects on tax revenue systems and compliance.
3. Evaluate AI's role in public expenditure, budgeting, and social welfare delivery.
4. Assess the macro-fiscal risks, regulatory needs, and governance challenges AI poses for public finance.

Foundations — AI and the Changing Economic Landscape

1.1 Introduction

Public finance describes the study of the processes by which governments raise and expend resources. In the past, this discipline has adapted to structural changes in the economy, including industrialization, globalization and digitalization. AI is a new structural shift: a general-purpose technology that changes productivity, labor markets, and even the tax base it considers in its own terms prior to being applied directly to government functions.

1.2 What Makes AI Economically Distinct

- General-purpose technology (GPT) features:: as with electricity or internet, AI permeates almost all industries and drives complementary innovations as opposed to being a one-use vollstet tool.
- Capital-labour substitution: AI is a replacement for cognitive and certain physical labour, rather than just routine manual labour like previous automation.
- Scalability and non-zero marginal cost: AI services built using software can scale their output otherwise proportionally at costs increases, finding tax and value, and taxes and profits, altering.
- Data as a production factor: AI models rely on data, which is unlike traditional capital or labor (non-rival, potentially monopolizable).

1.3 Macroeconomic Channels Relevant to Public Finance

Channel	Effect	Public Finance Relevance
Productivity growth	Higher potential GDP growth	Expands long-run tax base
Labor market displacement	Wage and employment shifts	Alters income tax and payroll tax revenue
Capital income share	Returns may shift toward capital owners	Raises questions about capital vs. labor tax mix
Market concentration	Winner-take-most dynamics in AI-driven markets	Affects corporate tax base and competition policy

1.4 Government as Both Regulator and Adopter

The government plays two roles at once:

- Regulator and collector of taxes from an AI-transformed private economy.
- As adopter and user of AI in its own operations and services.N This two-act play is the organizing metaphor for the rest of the unit:

Revenue (government as regulator/taxer of an AI economy), Chapter 3 is about expenditure (government as adopter/user of AI), and Chapter 4 brings the two together in fiscal policy and governance..

AI and Public Revenue

2.1 The Shrinking Labor Tax Base Problem

A large part of public revenue systems is generated through taxation of labor income (personal income tax, payroll/social security contributions). If AI displaces labor income in favor of capital income or decreases the aggregate labor income share, this undermines a conventional source of revenue and generates policy discussion on substitutes.

2.2 Policy Proposals Under Discussion

- Robot/automation taxes: charges on capital that replaces labor, aimed at slowing displacement or compensating for lost payroll revenue. Debated on efficiency costs (could impede productivity-enhancing investment).
- Digital services taxes (DSTs): tax on revenue derived from digital platforms, in part a response to AI-and-data-fuelled business models that operate across borders with minimal physical presence. • Data value taxation: proposals to tax the value generated by user data, although the valuation methodology is still work in progress.
- More general consumption or value-added taxes: a tax mix shift towards consumption taxes, which are less sensitive to the source of income production (labor vs. capital vs. AI).
- Reforms of the corporate tax base: tackling profit-shifting by highly automated, intangible asset–intensive firms (in connection with international efforts on minimum corporate taxation).

2.3 AI as a Tool for Tax Administration

Besides the possibility of taxing the AI economy, tax authorities are also employing AI to themselves to administer taxes:

- Compliance risk-scoring: machine learning algorithms predict which returns are likely to be erroneous or fraudulent, enabling better selection for audit.
- Automated matching and pre-filled returns: using AI to compare third-party information (employer records, bank information) to ease the burden on filers and minimize errors.

- • Fraud and evasion detection: applying pattern recognition to VAT chains, invoice networks and transfer pricing to identify irregularities.
- Taxpayers service chatbots: streamlining the cost of administrative burden for routine enquiries. 2.4 Efficiency and Fairness Trade-offs
- AI-based administration can yield a greater compliance and revenue without any increases in statutory rates — a pure efficiency gain.
- But algorithmic targeting raises equity and due-process concerns: a suggestion of biased audit selection, opaqueness as to why a taxpayer was flagged, and asymmetric ability to appeal. • AI services provided cross-border may further confuse the concepts of nexus and source of income that form the basis of international tax law.

2.5 Case Illustration (Illustrative, Not Prescriptive)

A tax authority uses a machine-learning model to select VAT audits for investigation. The audit results from the selection model increase, but a review inside finds the model is overfiring at small vendors in the informal sector — hard-pressed to keep formal records, a kind of demonstration effect showing how a technically effective tool can bring distributional outcomes that can be bias if not tempered with fairness criteria.

2.6 Discussion Questions

1. What are the trade-offs between a robot tax and a broad-based consumption tax as responses to the erosion of the labor tax base?
2. To what extent should governments trade off potential compliance gains from more precise AI-driven audit targeting with concerns about fairness?
3. How does the "digital/AI nexus" problem challenge traditional definitions of taxable presence?

AI and Public Expenditure

3.1 AI in Budgeting and Forecasting

Forecasting revenue and spending: Machine learning models have been shown to outperform classical time-series models in short-term forecasting, which can aid in cash management and deficit projections. · Spending review and efficiency analysis: anomalous, or potentially wasteful, spending patterns across massive procurement or grant datasets can be flagged by AI tools. · Scenario simulation: AI-enabled models provide finance ministries with the ability to run simulations of policy impacts on the fiscal position at higher speed than traditional structural models, although with certain reservations about model transparency ("black box" risk in policy-critical forecasts).

3.2 AI in Public Service Delivery · Targeting of social transfers: predictive models can assist in targeting of social program beneficiaries (e.g., poverty-targeting algorithms), potentially enhancing coverage and minimizing leakage. · Efficient spending on health care and education: AI-enhanced diagnostics, resource management, and personalized learning have the potential to generate better outcomes for the money spent. · Procurement and infrastructure management: predictive maintenance and AI-enabled procurement scoring can decrease long-run capital expenditure.

3.3 Risks in Expenditure-Side Applications

Errors of exclusion: eligibility can be automatically and incorrectly denied to citizens who do qualify, and real cases are documented in which algorithm-driven welfare fraud detection systems said to have generated false accusations. • Opaqueness and liability: when an

algorithm denies a benefit or flags a citizen, due process rights (the right to know and challenge a determination) become more difficult to guarantee. • Capital cost of AI adoption itself: The upfront costs for acquiring an AI system, coupled with the investment in infrastructure and skilled personnel necessary to operate the technology, also represent an expenditure that must be justified through a cost-benefit analysis.

3.4 Fiscal Multiplier Considerations Public investment in AI infrastructure (compute, data systems, digital public infrastructure) poses questions familiar to public finance: what is the fiscal multiplier on AI-related public investment relative to more traditional infrastructure? Early evidence is scant and this remains an open empirical question rather than one that is conclusively answered.

AI, Fiscal Policy, and Governance Challenges

4.1 Macro-Fiscal Risk Channels

TAX BASE VOLATILITY: if AI leads to a faster tempo of business-cycle dynamics (faster market concentration, faster displacement) and revenue volatility increase, volatile revenue could complicate fiscal planning.

• Contingent liabilities: government guarantees, bailouts, or support linked to AI-led industries (such as critical AI infrastructure companies) may turn into contingent fiscal liabilities like financial-sector guarantees.

• International tax competition — jurisdictions may compete to attract AI firms with tax breaks, leading to a race-to-the-bottom that undermines collective revenue raising capacity – a dynamic public finance scholars liken to earlier rounds of competition for mobile capital.

4.2 Issues of Institution and Go ernance

• Algorithmic accountability in government: what rules apply when public agencies employ AI in decisions about taxes or benefits (transparency, explainability, appeal rights)?

• Data governance: Government's ability to access and use private-sector data (for tax enforcement or spending targeting) brings up privacy and civil liberties questions that cross fiscal administration.

• Capacity and Skills Gap: Public sector implementation of AI is constrained by administrative capacity; under-equipped tax and finance ministries may lag further behind well-funded private entities, thereby weakening the state's negotiating power (e.g. in transfer pricing disputes with AI-driven multinationals).

4.3 International and Comparative Dimensions

Initiatives including the OECD/G20 discussions on the taxation of the digital economy demonstrate how international cooperation is being sought to combat tax base erosion in highly digitalized, AI-based business models.

• Developing countries have unique challenges: they tend to be less diversified and more reliant on trade and consumption taxes, have less capacity to administer AI-based compliance applications, and may experience a widening "gap in fiscal capacity" between advanced and developing countries.

4.4 Synthesis:

A Facilitating Framework for Policy Analysis When considering any public finance proposal related to AI, students should ask themselves:

1. Effect on revenues — Does it broaden, protect, or erode the tax base?
2. Expenditure effects: Does it increase the efficiency of expenditure, or the efficacy of expenditure, and at what adoption cost?
3. Equity effects: Who benefits and who bears risk (taxpayers, beneficiaries, or firms)?
4. Governance Effects: Does that strengthen or weaken accountability and due process?
5. Macro-fiscal risk: does this amplify or dampen exposure to volatility and contingent liabilities?
6. How does AI's status as a general-purpose technology change the assumptions behind traditional tax theory?
7. If capital's share of income rises due to automation, what are the implications for tax equity?
8. In what ways is data a new, distinct factor of production for fiscal analysis?
9. What safeguards should accompany AI-driven welfare eligibility systems to protect due process?
10. How should a finance ministry evaluate the cost-effectiveness of adopting an AI forecasting tool versus maintaining existing methods?
11. Should AI infrastructure be treated as public capital investment in national accounts and budget planning? Why or why not?
12. Design a policy brief: should your government adopt an AI-driven risk-scoring system for tax audits? Address revenue, distributional, and governance effects.
13. Compare a robot tax, a digital services tax, and a VAT-rate increase as responses to AI-driven labor-base erosion. Which best balances efficiency and equity, and why?
14. Debate: "AI in public service delivery primarily benefits fiscal efficiency, but at the cost of due process." Argue both sides.
15. How might international tax coordination evolve to address AI-driven profit shifting over the next decade?

Case Study 1: AI-Based Tax Audit System and Small Vendor Bias

Background

The State Revenue Department introduced an AI-based risk-scoring system to identify suspicious GST/VAT returns. The machine-learning model analyzed invoice patterns, transaction frequency, and historical audit data.

Problem

Within one year:

- Tax collection increased by 18%.
- Fraudulent invoice networks were detected successfully.
- However, 62% of audit notices were issued to small vendors operating in semi-formal markets.

Many small businesses lacked digital records and accounting support, while large firms with sophisticated tax systems were less frequently flagged.

Public Finance Issue

The government achieved higher revenue efficiency, but concerns emerged regarding:

- Equity in tax administration
- Algorithmic bias
- Due process rights
- Administrative burden on small taxpayers

Analysis Questions

1. Was the AI system economically efficient?
2. Did it violate principles of horizontal equity?
3. How should fairness criteria be incorporated into audit algorithms?
4. Should taxpayers have a right to know why they were flagged?

Case Study 2: AI Welfare Eligibility System and Exclusion Errors

Background

A national government implemented an AI-powered welfare eligibility platform to identify households eligible for food subsidies and cash transfers. The system used income data, utility consumption, mobile usage patterns, and demographic indicators.

Problem

After implementation:

- Administrative costs fell by 25%.
- Duplicate beneficiaries were reduced significantly.
- But thousands of genuinely poor households were automatically rejected because their digital records appeared inconsistent.

Citizens struggled to appeal the decisions because the algorithm's reasoning was not transparent.

Public Finance Issue

The government improved expenditure efficiency, but:

- Exclusion errors increased.
- Public trust declined.
- Legal challenges were filed against the welfare department.

Analysis Questions

1. Should fiscal efficiency be prioritized over inclusion?
2. What safeguards should accompany AI-based welfare systems?
3. How can governments ensure transparency and appeal rights?
4. What is the fiscal cost of correcting exclusion errors?

Case Study 3: Automation, Employment, and the

Shrinking Labor Tax Base

Background

A manufacturing-intensive country experienced rapid adoption of AI-driven robotics. Over five years:

- Industrial productivity increased by 22%.
- Corporate profits rose sharply.
- Employment in routine production jobs declined by 14%.

Personal income tax and payroll tax revenues began to stagnate despite economic growth.

Policy Debate

The Ministry of Finance considered three options:

1. Introduce a robot tax.
2. Increase the VAT rate by 1%.
3. Impose a digital services tax on AI-enabled platforms.

Public Finance Issue

The government faced a classic fiscal dilemma:

- Protect employment?
- Maintain tax revenue?
- Preserve productivity growth?

Analysis Questions

1. Which tax option best balances efficiency and equity?
2. Would a robot tax discourage technological progress?
3. Is a VAT increase regressive for low-income households?
4. How should the tax mix change when capital income rises relative to labor income?

Case Study 4: AI Forecasting Tool for National Budget Planning

Background

The Finance Ministry adopted an AI forecasting platform to predict tax revenue, expenditure trends, and fiscal deficits. The system processed real-time economic indicators and social data.

Results

- Short-term revenue forecasts became more accurate.
- Cash management improved.
- Budget preparation time was reduced by 40%.

However, during an unexpected economic shock, the AI model failed to predict the sudden collapse in consumption spending, leading to a large forecasting error.

Public Finance Issue

Officials questioned whether:

- AI forecasts were reliable for policy decisions.
- Human judgment should remain central.
- The "black box" nature of the model reduced accountability.

Analysis Questions

1. Why did the AI model fail during the shock?
2. Should AI replace traditional forecasting models?
3. How can governments combine AI with expert judgment?
4. What governance mechanisms are needed for policy-critical AI systems?

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Summary:

Artificial Intelligence and the Economics of Public Finance

The Economy of Public Finance and Artificial Intelligence The Distinct Factors of Artificial Intelligence that Impact Public Finance include that AI disrupts the public finance system by shifting how governments generate income and how they spend funds on public services, prepare budgets, formulate fiscal policy, and deliver public services. AI is a general-purpose technology which enhances productivity, enables automation of economic activities, and shifts the composition of labor, business models, and taxation. These trends present the governments with both possibilities and challenges. On the revenue side, AI also influences traditional taxation systems with a shrinking labor income base as automation displaces labor and expanding capital income and profits in the corporate sector. This erodes the traditional labour tax base and leads policy makers towards consideration of the use of other sources of revenue such as robot taxes, digital services taxes, taxation of data, consumption taxes and reforms to corporate tax. At the same time, governments are using AI to enhance tax administration, through fraud detection, compliance risk scoring, automated tax returns, revenue forecasting, and taxpayer service chatbots, among other applications, with the result being enhanced efficiency and tax collection. On the expenditure side, AI improves public expenditure by enhancing budget prediction, expenditure analysis, procurement, infrastructure management, health care, education, and welfare provision. AI enables governments more precisely to identify those eligible for benefits, to reduce fraud and leakages, to optimize public procurement and to forecast maintenance needs for public utilities. Nonetheless, AI entails risks such as exclusion errors, automatized decisions opacity and high implementation costs, which can be mitigated through robust governance and human supervision.

AI affects fiscal policy and macroeconomic stability, as well. Governments face new fiscal risks to manage, such as volatility in the tax base, contingent liabilities linked to support for AI-related industries, and international tax competition that might drain public revenue. Investment into AI infrastructure could lead to longer-term productivity increases and economic growth, but the fiscal multiplier of investment in AI is still uncertain given the very limited empirical evidence. That more and more AI is being used raises some important questions of governance and ethics. Governments have to provide for algorithmic accountability, transparency, explainability, protection of privacy, responsible data governance and citizens' right to appeal decisions based on AI. Developing digital infrastructure and nurturing AI- related skills within the public sector is critical for delivery.

At the multilateral level, cooperation is being encouraged by institutions such as the OECD and G20 to tackle the challenges to taxation posed by AI-driven multinational entreprises and the digital economy. Developing countries are confronted with additional barriers, including

weaker digital infrastructure, limited financial resources, a scarcity of skilled personnel, and lower administrative capacity, and these challenges could further exacerbate the fiscal capacity divide between developed and developing nations. In general, AI could contribute to greater efficiency and transparency in public finance and provide a stronger data-driven underpinning for tax administration and delivery of public services. But to harness these benefits will take proportionate regulation, ethical governance, global collaboration, and sustained investment in digital infrastructure and human capital to ensure that AI-enabled public financial management is sustainable, equitable, and accountable.