BUSINESS ECONOMICS SEM V

(As per the Mumbai University Syllabus) 2017-18

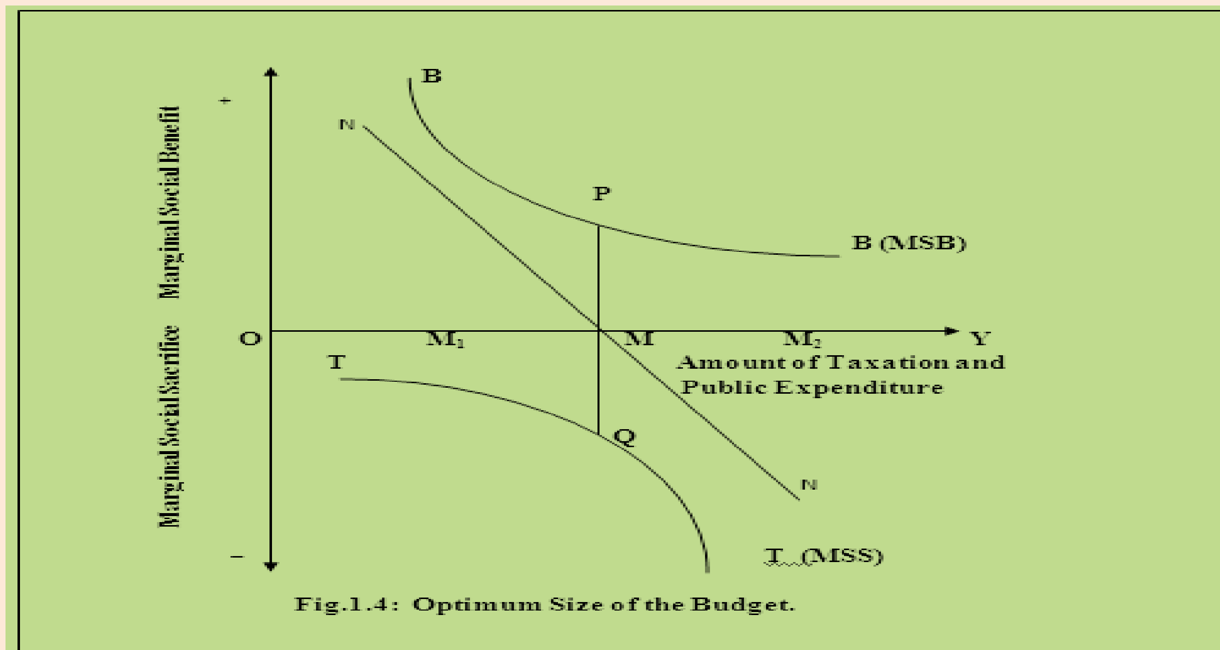
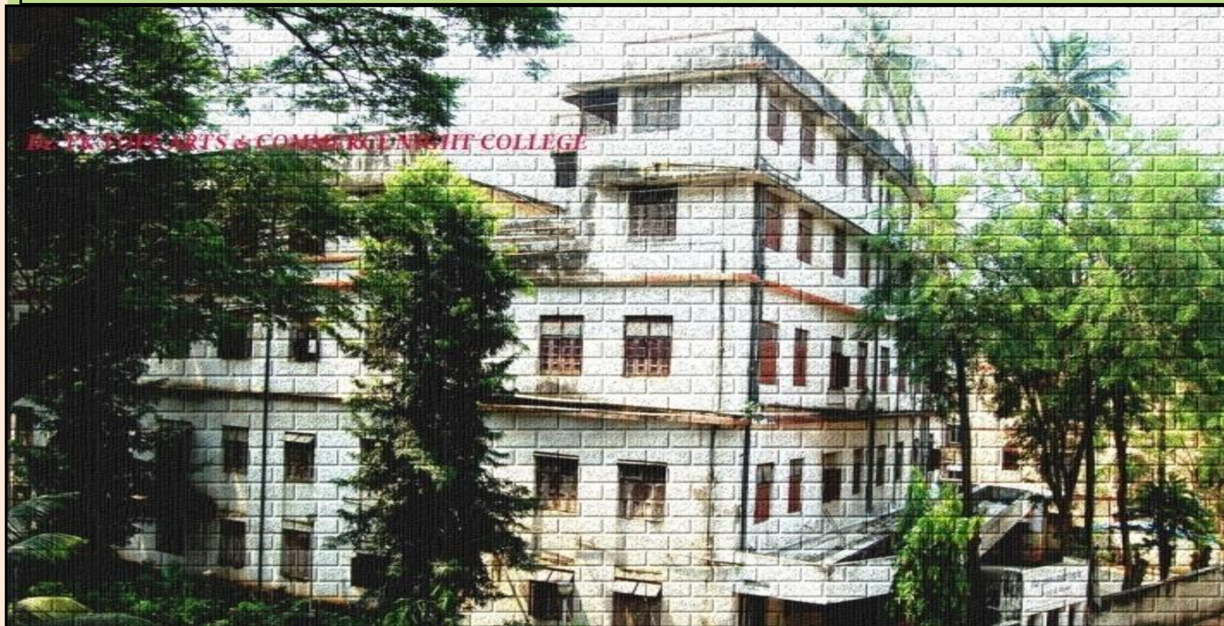


Fig.1.4: Optimum Size of the Budget.



By Krishnan Gopal, Associate Professor & Head, Department of Economics, Dr. TK Tope Arts & Commerce Night Senior College, Parel, Mumbai – 400 012.

2017-18

C O N T E N T S

SNO	CHAPTER	PNO.
	Module - I: INTRODUCTION TO PUBLIC FINANCE	
1.	Public Finance.	**03**
	Module - II: PUBLIC REVENUE.	
2.	Public Revenue.	**15**
	MODULE-III: PUBLIC EXPENDITURE AND PUBLIC DEBT.	
3.	Public Expenditure.	**25**
4.	Public Debt.	**36**
5.	Concept of Fiscal Deficit.	**44**
	Module IV - FINANCIAL MARKETS.	
6.	Money Market.	**56**
7.	Capital Market.	**65**
	Annexure (Objectives, Paper Pattern, Syllabus & Model Question Papers).	**73-101**

Module I

CHAPTER ONE

INTRODUCTION TO PUBLIC FINANCE

PREVIEW.

- Meaning and scope of Public Finance.
- Functions of Public Finance.
- Distinction between Public and Private Finance.
- Sound Finance v/s Functional Finance.
- Redistributive Taxation.
- Anti Inflationary Taxation.
- Principles of Maximum Social Advantage – Dalton & Musgrave.

MEANING AND DEFINITION OF PUBLIC FINANCE

Public finance is known as fiscal science. The word 'public' refers to the government of the day. Public Finance lies on the border line between economics and politics. It deals with problems relating to the raising and spending of money by public authorities. Public authorities include the Central Government, State Government and local bodies. Different definitions by different economists offer a broad idea about the meaning of public finance. This can be understood by studying some leading definitions. H. Dalton: "Public **finance is concerned with the income and expenditure of public authorities, and with the adjustment of the one to the other**".

Philip Taylor: "Public **finance is the fiscal science, its policies are fiscal policies, and its problems are fiscal problems".** R. Musgrave: "**The complex problems that centre around the income and expenditure process of the government are referred to as public finance.**" J. Buchanan: "**Public finance studies the economic activity of the government as a unit**.' Findlay Shirras: "**Public finance is the study of the principles underlying the spending and raising of funds by public authorities**."

These definitions show that public finance is a systematic analytical study of the economic behavior of the government as a relationship between multiple social wants and scarce productive resources having alternative uses, aiming at the attainment of the general wellbeing of the citizens.

SCOPE AND SUBJECT MATTER OF PUBLIC FINANCE.

The study of public finance is divided into five parts.

1. **Public Revenue:** Public revenue deals with the methods of raising funds through both tax and non-tax sources. Public revenue includes the classification of public revenue, the canons or principles of taxation, incidence and effects of taxations, etc.

2. **Public expenditure:** Here we deal with the principle and problem relating to the allocation of public expenditure. It involves the study of principles, justification and effects of public expenditure.

3. **Public debt:** Here we are concerned with the public debts created by public borrowing, methods of public borrowing, methods of public borrowing, impact or effects of public debt and retirement and management of public debt.

4. **Financial Administration:** This deals with the organization of financial machinery to raise and spend funds, preparation and sanction of budget, evaluation of budget, etc.

5. **Fiscal Policy:** This refers to measures to avoid economic fluctuations and promote economic stability. It is also concerned with measures to promote growth and development.

FUNCTIONS OF PUBLIC FINANCE.

In addition to the income and expenditure of the government, the scope of public finance includes the following functions of the budgetary policy of a government. According to Musgrave, the three functions of budget policy are:

The Allocation Function: is the adjustment in the allocation of resources in an economy by means of revenue and expenditure policies to achieve certain objectives.

The Distribution Function: is concerned with the measures to be taken for bringing about an equitable distribution of income in an economy.

The Stabilization Function: is concerned with the measures to be taken to maintain price stability and full employment.

Thus, public finance plays a very great role in the modern economics to promote maximum social welfare. It deals with various aspects of financial operations of the government.

PUBLIC FINANCE VS PRIVATE FINANCE

Public Finance refers to the financial operations of the government, while private finance refers to the financial operations of an individual economic unit such as a firm or a house. In some respects, public finance is similar to private finance, while, in other respects, they differ from each other.

The similarities between public and private finance can be stated as follows:

1. **Satisfaction of want.** Both the private and public sectors are engaged in satisfaction of wants of the society.

2. **Maximum return.** Since both public and private sectors have limited resources they try to obtain maximum return by making optimum use of their limited resources.

3. **Borrowing**. Both the public and private finance resort to borrowing from different sources, when the revenue falls short of expenditure.

4. **Financial Activities**. Both private and public sectors are engaged in similar activities like production, saving, investment, capital accumulation, etc. In order to finance these operations they attempt to increase the size of resources.

The differences between Public Finance and Private Finance are as follows:

1. **Income-expenditure adjustment.** In case of private finance, expenditure is within the limits of income. An individual plans his expenditure pattern on the basis of the income he expects to receive. But in case of public finance, income is adjusted to expenditure. The government first decides the expenditure and then arranges for collecting the necessary revenue.

2. **Objective:** The motive of the government is to maximize the welfare of the community. That is government is interested in promotion of 'social welfare', whereas the motive of private finance is to maximize individual welfare. That is private individual is guided by 'profit motive'.

3. **Nature of resources:** The government has many sources to raise revenue, while private individual has limited sources. The government can raise revenue through tax and non-tax sources. Moreover, whenever necessary government can issue currency to meet additional expenditure. The government can borrow, at more liberal terms, both internally and externally, whereas individual earn his income from work and property. Thus the capacity of the government to raise revenue is much larger than that of the individual.

4. **Methods of collecting revenue:** Government can raise revenue by using force. It can compel people to pay taxes and even lend money during war. But individual can earn his revenue only voluntarily. He cannot use force to get income.

5. **Foresightedness** Government is far sighted. It is a permanent institution and has a long term perspective. The government is the custodian of the interest of future generations. Through the budget, government makes provision for long term projects like social and economic infrastructure. But while planning the budget, individual is short sighted in his perspective. He thinks only for the present or near future.

6. **Secrecy versus publicity.** Private finance is a secret affair. Individual maintains secrecy with regard to sources of income and expenditure. But public finance is an open and public affair. Government budget is given widest publicity. It is widely discussed, appreciated and criticized.

In short public finance is a wider affair. The rules of private finance cannot be applied to public finance. Dalton said that, due to these differences. Public finance and private finance are studied as separate branches of economics

SOUND FINANCE.

The classical economists determined a limited scope to public finance by advocating a balanced budget approach or sound finance approach. They believed that the budget of the government should be balanced annually and governmental functions should be limited to maintenance of internal law and order, protection from foreign aggression and public works. The government had no economic role to perform and all economic activities were best left to the individual. Full employment, optimal allocation of resources and equitable distribution of income is achieved through the operation of the market forces of demand and supply. Deficit budget or public borrowing would lead to inflation and crowding out of private investment. Inflation is an undesirable economic phenomena and the market mechanism ensures optimal allocation of resources. Hence, governments should not follow deficit budget or borrow money to fund the deficit. The classical economists therefore advocated a balanced budget approach and wanted governments to maintain a balance between public revenue and public expenditure. The reasons given for a balanced budget by the classical economists were as follows:

1. Deficit budget means public borrowing. Public borrowing leads to crowding out of private investment, higher interest rates and higher cost of production.
2. Deficit budget leads to expansion in government functions and activities. It increases the role of the government beyond the minimum.
3. Deficit budget leads to inflation due to the unproductive use of resources.
4. Deficit budget leads to economic uncertainty and instability.
5. Regular deficit budgets lead to increase in the burden of public debt.

Thus according to the principle of sound finance, a budget must be balanced annually and the excess of expenditure over revenue should be limited to minimum. The classical economists believed in the policy of laissez-faire or free market economy with a minimum role for the government.

FUNCTIONAL FINANCE.

The functional finance approach to public finance is also known as the unbalanced budget approach. The Keynesian revolution advocated compensatory public spending as a measure to recover from recession. Keynesian economics also led to the establishment of Welfare State Capitalism in the aftermath of the Second World War. Prof. AP Lerner developed the concept of functional finance. He believed that the fiscal operations of the government consisting of taxing, borrowing, public spending, management of public debt, deficit financing etc should be designed with the objective of fulfilling certain functions which have an immediate and far reaching consequences for the economic system. Functional finance involves fiscal instruments like public expenditure, public revenue and public debt management. These instruments are used to achieve macro-economic objectives like economic growth, full employment and price stability.

According to Raja Chelliah, the functional concept of fiscal policy implies that the fiscal operations of the government should be conducted on a functional basis and public finance should not be considered solely for the purpose of producing social goods and that the budget need not be always balanced. The functional finance approach advocates large budgets with a wider functional coverage of government spending to promote basic economic goals such as optimal allocation and efficient use of scarce resources at full employment level, economic stability and equitable distribution of income and wealth. Taxation is considered as an important tool to promote economic growth and stability. Prof. AP Lerner has suggested the following rules for the government under functional finance:

1. The government budget should be directed to achieve full employment and price stability.
2. The government should incur public debt by borrowing from the private sector only during inflation.
3. During recession, public expenditure in excess of public revenue may be met by deficit financing i.e. by printing additional currency notes.

Functional finance thus looks at fiscal policy as a counter-cyclical measure. A surplus budget is recommended during inflation and a deficit budget in recession.

REDISTRIBUTIVE TAXATION.

A socially just income distribution can be ensured only if the principle of equity is borne in mind while determining the pattern of income distribution. The concept of equity has two dimensions, namely the horizontal and vertical. When equal people are compensated or taxed equally, horizontal equity is said to be established. When unequal people are compensated and taxed unequally, vertical equity is said to be established. However, the objective of vertical equity is to reduce the extent of income inequality between unequal people so that the undesirable consequences of unequal incomes are reduced to the minimum. The per capita consumption of an Alsatian dog in a rich family may be equal to that of the food consumption of a poor wage earning family of four. Market mechanism is inherently incapable to address the polarity of income distribution or consumption. Hence, State intervention is the only possible solution to

reduce the extent of inequalities in income, eliminate abject or absolute poverty. Redistributive taxation is effective to address the problem of income redistribution and income inequalities.

The rate of investment and capital formation can be increased by increasing the saving- GDP ratio and by restricting actual and potential consumption. Consumption can be controlled by imposing quantitative restriction on the availability of non-essential consumption goods. Savings can be mobilized by public borrowing programs and supplementary taxes. The government can use fiscal policy measures to redirect investment in a socially desirable manner. Investment in economic overheads such as infra-structure, basic and capital goods industries and social overheads such as health, education and welfare will not only generate huge employment opportunities but also uplift the health, hygienic and economic conditions of the masses. Income inequalities can be reduced by a system of progressive taxation based on the principle of ability to pay. Thus the lowest income brackets must be excluded from the tax net and higher income groups must be taxed higher and in a progressive manner. In this way, the government can mobilize tax revenue and redistribute the income in favor of the poor by implementing poverty eradication, health improvement and employment generation programs. Inflationary forces in the economy tend to widen income inequalities. Firstly, there is a time gap between price rise and compensation of the price rise. Secondly, price rise compensation in the form of dearness allowance is available only to organized labor. For instance, in a country like India, only eight per cent of the labor force is organized, the vast majority of the labor-force experiences a progressive fall in their purchasing power during the times of persistent inflation. Inflation thus becomes an unjust tax on the poor. Fiscal policy must therefore control inflationary tendencies and keep at the moderate levels of less than three per cent per annum.

ANTI-INFLATIONARY TAXATION.

Expansion in income and employment can be realized in an inflationary situation by increasing the tax levels. Obviously, an increase in taxes will decrease the disposable income of the people and lead to a decrease in the aggregate demand. The possible contraction in aggregate demand as a result of increase in tax depends upon two objective factors, namely: the value of tax increase and the marginal propensity to consume. For instance, if the net result of changes in the tax structure is a gain of revenue to the government of the order of Rs. One Trillion and assuming the MPC to be 80% or that the value of MPC being 0.8, consumption demand in the economy will fall by Rs.80,000 Crores. The decrease in consumption demand will have a reverse multiplier effect through the tax multiplier given by the formula:

$$\Delta T \times \frac{MPC}{1 - MPC}$$

$$Rs. 1T \times \frac{0.8}{1 - 0.8} = Rs. 1\ T \times 4 = Rs. 4\ Trillion$$

Thus increase in taxes will lead to decrease in consumption demand until the tax multiplier process exhausts itself and in the process will also lead to decrease in income and employment.

Decrease in income and employment will reduce the level of aggregate demand and hence the rate of inflation.

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE.

The basic principle of public finance is the principle of maximum social advantage. According to Hugh Dalton the principle of Maximum Social Advantage can be stated as follows:

"All the operations of public finance resolve themselves into a series of transfers of purchasing power, by taxation or otherwise, from certain individuals to public authorities and back again from these authorities by way of public expenditure to other individuals. As a result of all these operations of public finance, changes take place in the amount and in the nature of the wealth which is produced and in the distribution of that wealth among individuals and classes. The best system of public finance is that which secures the maximum social advantages from the operations which it conducts."

The Concepts of Marginal Social Sacrifice and Marginal Social Benefits.

The sacrifice that the society is forced to make in the form of payment of taxes is the aggregate social sacrifice. An additional unit of tax paid by the society due to the imposition of an additional unit of tax is the marginal social sacrifice. As more and more units of tax are imposed on the society, the marginal social sacrifice rises. Additional taxes means less savings or less consumption. Further taxes are a payment made by the people to the Government without a quid pro quo. The Marginal Social Sacrifice curve slope upwards from left to right as shown in Fig.1.1 below. It shows that when the amount of Tax is T_1, the marginal social sacrifice is S_1 and as the amount of tax rises, the MSS also rises. Thus there is a positive and direct relationship between the amount of tax paid by the society and the marginal social sacrifice by the society. The tax revenue collected by the Government is spent by the Government on itself and on the welfare of the people.

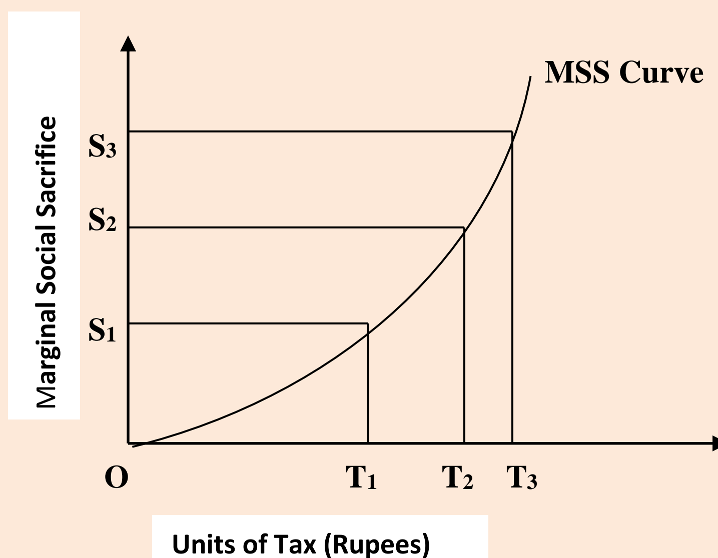


Fig.1.1: The Marginal Social Sacrifice Curve.

The benefit enjoyed by the society on account of an additional unit of public expenditure is known as the Marginal Social Benefit. However, the social benefit from each additional of public expenditure declines as the expenditure increases. Initially, the units of public expenditure are made on the most essential social activities. Later on, public expenditure is made on less important social activities. Hence, the Marginal Social Benefit curve slopes downward from left to right as shown in Fig.1.2 below:

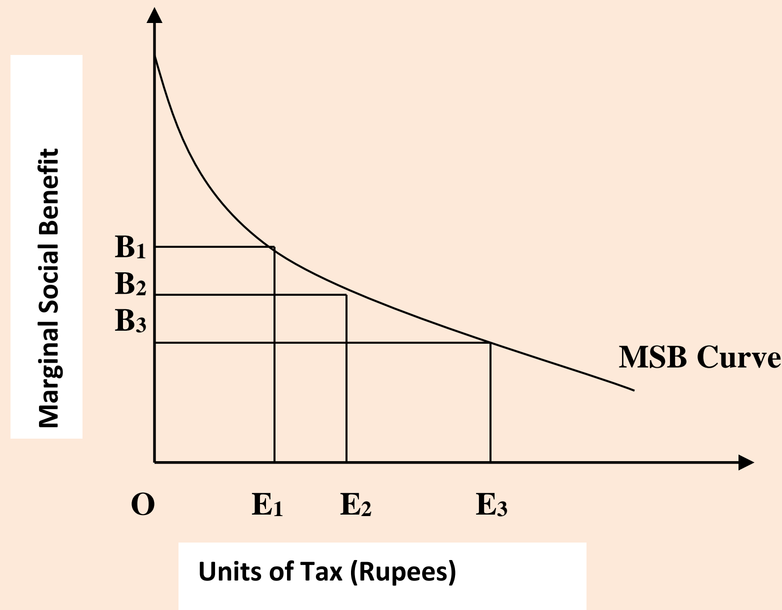


Fig.1.2: The Marginal Social Benefit Curve.

In Fig. 1.2 above, the MSB curve slopes downwards from left to right indicating diminishing marginal social benefit from each additional unit of public expenditure. When the public expenditure is E_1, the MSB is B_1 and when the public expenditure increases to E_2, the marginal social benefit falls to B_2 and so on.

The Point of Maximum Social Advantage.

Social advantage is maximized at the point of equality between Marginal Social Sacrifice and Marginal Social Benefit. Such a point is point B in Fig.1.3 below. At point B_1, the Marginal Social Benefit is B_1Q_1 which is greater than the Marginal Social Sacrifice S_1Q_1. Since the marginal social benefit is greater than the marginal social sacrifice, it makes sense to increase the level of public expenditure and taxation as each additional unit of revenue raised and spent by the Government leads to an increase in the social advantage. The social benefit enjoyed by the society continues to be higher than the taxes paid until point B is reached. At point B, MSB is equal to MSS and thus Maximum Social Advantage is achieved. Further increases in the level of taxation will only reduce the marginal social benefit. For instance, point B_2 indicates that the Marginal Social Benefit is B_2Q_2 whereas the marginal social sacrifice is S_2Q_2 which is higher

than the social benefit. The gap between marginal social sacrifice and the social benefit increases after the point of equality and the society is put to increasing social disadvantage. Hence it makes sense for the Government to stop raising both taxes and expenditure beyond point B so that both taxes and expenditures and sacrifices and benefits are optimized.

It can therefore be concluded that maximum social advantage is achieved at the point of equality between Marginal Social Sacrifice and Marginal Social Benefit i.e. when MSB = MSS and the society as a whole enjoys net benefit equal to the area above the MSS and below the MSB curve. The net benefit area is obtained by subtracting the area covered under the MSS curve from the area covered under the MSB curve.

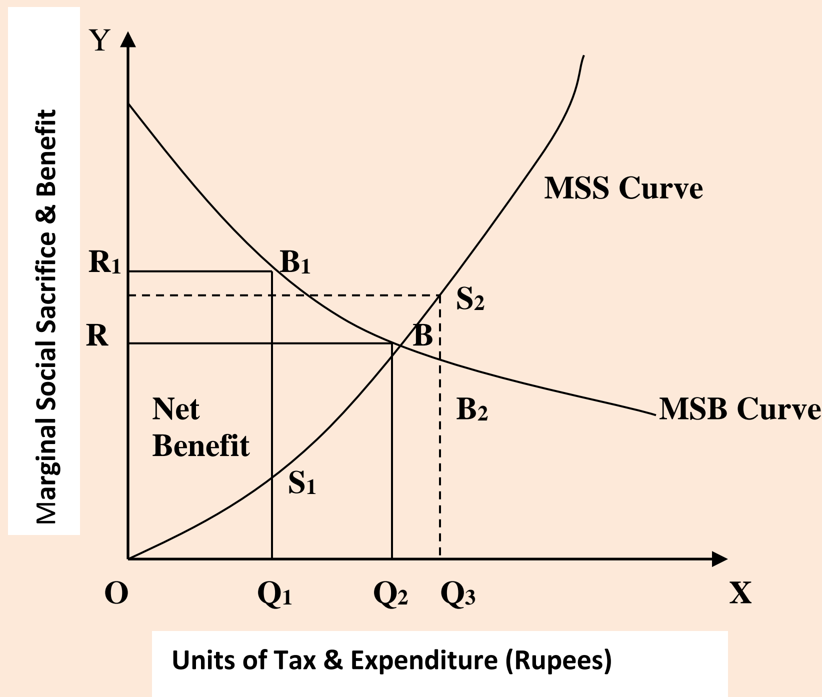


Fig.1.3: The Point of Maximum Social Advantage.

MUSGAVE’S APPROACH: MAXIMUM WELFARE PRINCIPLE OF BUDGET DETERMINATION.

According to Musgrave, Dalton’s principle of maximum social advantage is the maximum welfare principle of budget determination. Dalton put forward two principles of budget policy. These two principles are as follows:

1. Resources should be distributed and allocated to the production of public goods and services in such a manner that the marginal utility derived from each of the goods and services are equal to the expenditure made on these goods and services.
2. Public expenditure should be made up to the point where the satisfaction obtained from the last rupee spent is equal to the dissatisfaction experienced from the last unit of tax imposed on the society.

The maximum welfare principle of budget determination is shown in Fig.1.4. In this figure, the amount of tax and public expenditure is measured along the X axis and marginal social sacrifice along with marginal social benefit is measured along the Y axis. The MSB curve is downward sloping and shown above the X axis in the positive quadrant. The MSB curve is downward sloping because of the operation of the law of diminishing marginal utility and the fact that initially public expenditure would be made on more important public goods and services and later on it will be made on less important public goods and services. The MSS curve is upward sloping and is shown below the X axis in the negative quadrant. The MSS curve is upward sloping because as the level of taxation increases, marginal social sacrifice also increases. The NN curve measures the net benefits derived from additional public expenditure and taxes or public budget. The NN curve is derived by deducting MSS from MSB. The optimum size of the budget is determined at OM where marginal net benefits are zero. Thus the government must determine OM as the amount of taxation and public expenditure. In this manner, the maximum sacrifice approach to the allocation of taxes is equalized by a maximum benefit approach to the determination of public expenditure.

Optimum Size of the Budget.

OM is the optimum size of the budget because at point M, the marginal social benefit MP is equal to the marginal social sacrifice MQ (MSB = MSS). Since MSB and MSS are measured in opposite directions, the marginal net benefit is zero (MSB – MSS = Zero) and hence the NN curve intersects the X axis at point M. At point M_1, marginal social benefit is greater than marginal social sacrifice and the marginal net benefits are positive. It therefore makes sense to increase the level of taxation and public expenditure until point M is reached. Similarly, at point M_2, the marginal social sacrifice is greater than marginal social benefit and hence the marginal net benefits are negative. It therefore makes sense to reduce the level of taxes and public expenditure until point M is reached. Thus the equilibrium point is M where the marginal net benefit is zero. At point M, the level of public expenditure and taxes will be OM. According to Musgrave, the optimum size of the budget is given by the point where the marginal net benefit is zero. This point corresponds to the point of maximum social advantage as at this point MSB = MSS.

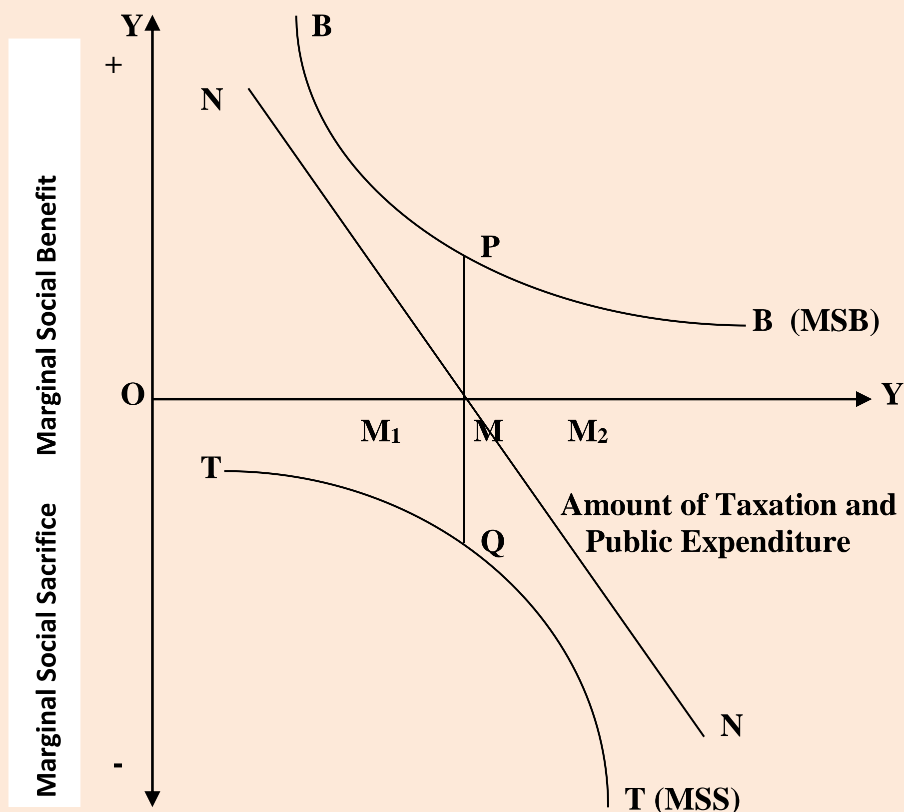


Fig.1.4: Optimum Size of the Budget.

LIMITATIONS OF THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE.

1. **Social Benefits and Sacrifices are Subjective.** Benefits are subjective in nature and therefore they cannot be measured. Similarly, sacrifices are also subjective and hence they also cannot be measured. Since benefits and sacrifices are not measurable, the equality between MSB and MSS cannot be established. The estimates of social benefits and social sacrifices are arbitrary and qualitative. Therefore fiscal policy cannot be determined according to the principle of maximum social advantage.

2. **Future Impact of the Budgetary Policy.** The impact of the budgetary policy takes place overtime. Estimates of future benefits and sacrifices cannot be accurately made in the present. Public projects are executed over a long period of time. Normally, the beneficiaries of the public projects are not the one who pays taxes. Future generations may enjoy social benefits without making social sacrifices or one generation may make relatively less sacrifice and yet enjoy more benefits. The estimates of sacrifices and benefits enjoyed by the society over different time periods cannot be measured accurately.

3. **Indivisibility of Public Expenditure.** Public expenditure is indivisible in nature. Marginal benefits from marginal public expenditure cannot be equalized because public expenditure cannot be divided in small units. The ratio of marginal benefits to marginal expenditure can be equalized only if public expenditure is substitutable between different uses in small units.

4. **Sacrifice and Benefits are not inherent in Taxes and Expenditures.** According to Dalton, not every tax is an evil. For instance, taxes on alcohol, cigarettes and other harmful products which are actually demerit goods will increase social benefit. Under-consumption of demerit goods will increase social welfare. Similarly all public expenditure is not good. Expenditure on war is definitely an evil and reduces social benefit.

5. **Non-tax Revenue Sources are Ignored.** The principle of maximum social advantage considers marginal sacrifice of taxation alone. However, there are non-tax revenue sources also. These non-tax revenue sources are fees, fines, profits of State owned enterprises, market borrowing and deficit financing. In case of market borrowings and profits of State owned enterprises, no social sacrifice is involved.

6. **The Principle Maximum Social Advantage is not suited for Contra-cyclical Fiscal Policy.** When public expenditure is increased to raise the level of effective demand and reduce the levels of unemployment in the economy, the principle of maximum social advantage cannot be followed. Further, developing countries generally follow a deficit budget and continuously increase the level of public expenditure in order to achieve the macroeconomic objective of economic growth and full employment.

7. **The Effects of Public Finance Operations are Complex and Varied.** The effects of public finance operations are widespread affecting a large number of people and various sectors of the economy. It is therefore difficult to identify land measure their impact. For example, taxes on commodities can affect the pattern of production and consumption in the economy and at a later stage the investment pattern in the economy. Therefore the amounts of public expenditure and taxation are very imperfect measures of the welfare and growth aspects of public finance operations.

Questions.

1. Explain the meaning and scope and functions of Public Finance.
2. Distinguish between Public and Private Finance.
3. Write a note on Sound Finance v/s Functional Finance.
4. Write a note on redistributive taxation.
5. Write a note on anti-inflationary taxation.
6. Explain Dalton's principles of Maximum Social Advantage.
7. Explain Musgrave's principle of maximum social advantage.
8. Explain the limitations of the principle of maximum social advantage.

Module II - PUBLIC REVENUE.

CHAPTER – 02

PUBLIC REVENUE

PREVIEW.

- **Meaning of Public Revenue.**
- **Sources of Public Revenue.**
- **Merits and Demerits of Direct & Indirect Taxes.**
- **Impact and Incidence of Taxation.**

MEANING OF PUBLIC REVENUE.

Public revenue refers to the income of the government obtained through tax and non-tax sources. **In a broad sense**, it includes all the incomes and receipts of the government irrespective of their nature and sources. It means that public revenue would include public borrowings, disinvestment receipts, revenue obtained by privatizing public enterprises and issue of new paper money. **In the narrow sense**, public revenue would include only the revenue receipts of the government consisting of tax revenue, interest receipts, dividends and profits from public enterprises, fees, gifts, fines, forfeitures, escheats and grants. Thus capital receipts are not included in the scope of public revenue when viewed in the narrow sense of the term. However, the operational meaning of public revenue would only refer to the revenue receipts of the government. It also means that the operational meaning of public revenue is limited to the narrow view.

SOURCES OF PUBLIC REVENUE.

The sources of public revenue can be classified into two categories. They are: tax revenue and non-tax revenue.

Tax Revenue. The revenue from taxes is called tax revenue. The sources of tax revenue would be direct and indirect taxes. Direct taxes may include taxes such as income tax, property tax, corporation tax, gift tax etc. Indirect taxes may include taxes such as custom duties, excise duties, sales tax, service tax, interest tax etc. The sources of non-tax revenue would include dividends and profits from public enterprises, external grants, interest receipts, administrative revenue and gifts and grants.

A tax is a compulsory contribution made by the residents and citizens of a country to the Government. Government collects tax revenue for its own survival and to carry out the various functions of the State. In order to carry out the various functions of the State, the Government spends the revenue collected in such a manner that it does not generate a corresponding benefit to the tax payers. In this context, it would be pertinent to mention the definition of tax given by **Prof. Seligman**. According to him, **"a tax is a compulsory contribution from the person to**

the government to defray the expenses incurred in the common interest of all without reference to special benefits conferred." Taxes imposed by the Government have the following characteristics:

1. A tax is a compulsory payment made to the Government. All tax payers must pay taxes to the Government. Non-payment of taxes by persons who are liable to pay is a punishable offence.
2. According to **FW Taussig,** there is no direct quid pro quo between the tax payer and the Government. It means that tax payers cannot claim a corresponding benefit from the Government for having paid the taxes. The return obligation of the Government is not toward the individual but to the community of people constituting the Nation.
3. Tax is a contribution made by the citizens and residents to the Government for meeting the expenses incurred in the common good of the Nation.
4. A tax is required to be paid regularly and periodically according to the amount and rate determined by the Government.

In addition to the aforesaid features of tax, it is also used as an instrument of fiscal policy. Changes in the types of taxes and the rates of taxes are made to achieve the macroeconomic objectives of full employment, economic growth, equitable distribution of income and price stability.

Non-tax Revenue. The sources of non-tax revenue are profits from public enterprises, administrative revenue and gifts and grants.

1. **Profits from Public Enterprises.** Public goods like public transport consisting of railways, roadways and airways, water supply, electricity generation and distribution etc are supplied by the Government. Prices paid by the consumers for these goods become the non-tax or commercial revenue of the Government. Further, a Government may also invest and compete with the private sector in certain areas of production goods and services. For instance, India being a mixed economy, the Government has made huge investments in the basic and heavy industries, oil and gas exploration and distribution, banking and insurance services etc. The Government of India earns a dividend on the profits made by the public enterprises. These dividends become a source of non-tax revenue to the Government. In free market economies like the United States of America, profits from public enterprises may be insignificant but in mixed economies like India, profits from government enterprises may constitute a significant source of public revenue.

2. **Administrative Revenue.** The Government performs a number of administrative functions. While performing these functions, the beneficiaries may be charged a fee. Governments may also impose fines, forfeitures and penalties on the offenders. Governments may also acquire wealth and property through escheats. Escheat refers to reversion of property to the State on account of absence of legal heirs to the wealth and property left behind by a dead person.

a) **Fee.** Fees are levied by the Government for giving services to the people. According to Seligman, **"a fee is a payment made by a person to the government to provide for the cost of each recurring service provided by the Government, primarily in the public interest but conferring a measurable advantage to the payer."** For example, Court fee, fee for issuing passport etc.

b) **License Fee.** License fee is charged by the Government to give permission to the license fee payer to obtain the use of certain articles or to begin certain productive activity. For example, license fee charged for the registration of firms, cars, liquor license, driving license, gun license etc. License fee is therefore charged to regulate the conduct of persons obtaining licenses.

c) **Special Assessment.** According to Seligman, **"a special assessment is a compulsory contribution levied in proportion to the special benefits derived to provide for the cost of a specific improvement to property under taken in public interest".** For example, the Government may impose an additional charge on the users of public goods like flyovers, rail transport, road transport etc in order to recover the cost of providing these goods to the people.

d) **Fines and Penalties.** A fine is a deterrent to crime and therefore not designed to earn revenue. A fine is arbitrarily determined and therefore may not be in proportion to the cost of maintaining law and order. Fines and penalties do not become a significant source of revenue. **A fine is a penalty imposed on the offender for the infringement of a law.**

e) **Forfeiture.** Forfeitures are penalties imposed by courts for the failure of individuals to appear before the courts, failure to abide by the terms of the contract or failure to protect valuable assets. Forfeitures therefore do not become a significant source of revenue to the Government.

f) **Escheat.** Escheat refers to reversion of property to the State on account of absence of legal heirs or due to the absence of a Will in respect of the wealth and property left behind by a dead person. Escheats do not constitute an important source of revenue to the Government.

g) **Gifts and Grants.** Gifts are voluntary contributions by individuals, private bodies such as institutions and organizations and other governments to the Government. Grants refer to the funds provided by a Government at a higher level to a government at a lower level in a federal set up. For instance, in India the State Governments receive grants for performing various functions from the Central Government. The State Governments may also give grants to local bodies such as municipal corporations and village panchayats. These are unilateral payments and hence there is no obligation to repay the sums received on account of gifts and grants.

In a broader sense, public revenue also consists of public receipts. Public receipts consist of public borrowings, deficit financing and income from public assets and the sale of public assets.

h) **Public Borrowing.** Modern governments generally follow a deficit budget. Governments therefore borrow from individuals and financial institutions within the country to finance the deficit. Loans obtained by the Government from internal sources constitute public borrowing. Public borrowing is a significant source of public receipts.

i) **Deficit Financing.** When public borrowing fails to bridge the deficit in government budgets, they may resort to deficit financing by printing of currency notes. However, deficit financing is inflationary in nature and therefore not a desirable method of financing government expenditure. Deficit financing is also a significant source of public receipts.

j) **Income from Public Assets and Sale of Public Assets.** Governments obtain income in the form of rent on assets leased to individuals and private bodies, income from the sale of government buildings, government land etc. Such income does not become a significant source of public receipts.

DIRECT AND INDIRECT TAXES.

A direct is paid by the person on whom it is imposed. In this case, the incidence and impact of the imposition of tax is on the same person. For instance, the incidence and impact of income tax is on the tax payer on whom the income tax is imposed. The income tax payer cannot shift the burden of his or her tax liability, either in full or in part on any other person. Personal income tax, corporation tax, property tax, capital gains tax etc are examples of direct taxes. The incidence and impact of indirect taxes can be distributed between the buyers and sellers of goods and services. For instance, the imposition of sales tax gets distributed between the buyer and seller. In this case, the seller can shift the burden of indirect taxes on to the buyer either in whole or in part, depending upon the elasticity of demand for the product. If the demand for the product is perfectly inelastic, the entire burden of indirect tax can be shifted on to the buyer and if the demand is perfectly elastic, the entire burden of indirect taxes has to be borne by the seller. If the demand is relatively elastic, a greater proportion of the tax burden will be shouldered by the seller and if the demand is relatively inelastic, a much lesser burden will be shouldered by the seller. Other examples of indirect taxes could be custom duty, excise duty, securities transaction tax and service tax. Thus, in the case of direct taxes, the impact or the initial tax burden and the incidence or the final tax burden falls on the same person on whom the tax is imposed. However, in case of indirect taxes, the burden can be distributed between the buyers and the sellers in proportions determined by the elasticity of demand for the product.

According to **JS Mill,** when it is the intention of the government that a person who legally pays the tax must bear its burden, it is a direct tax and when the government intends that a tax collected from one should be shifted to others, it should be called an indirect tax. Thus a tax which cannot be shifted is a direct tax and one which can be shifted is an indirect tax. Another way of looking at direct and indirect taxes is like this. Taxes imposed on income earned or received are direct taxes and taxes imposed on expenditures are indirect taxes.

Merits of Direct Taxes.

The merits of direct taxes are as follows:

1. **Equity.** Direct taxes are just and equitable. The burden of direct taxes is equitably distributed among different classes in the society on the basis of the principle of 'Ability to Pay'. For instance, a progressive tax system is known to be just and equitable because the amount of tax liability is determined by the size of the income earned or received. Thus low income persons either pay the minimum amount of tax or are exempted from paying income taxes and middle and high income persons are required to pay high and higher levels of taxes. For instance, in India, annual income up to Rs.2, 00,000 is exempt from income tax. For income between Rs.2, 00,000 and 500, 000, the income tax rate is 10 percent, between Rs.5 and 10 lakh, the income tax rate is 20 per cent and above Rs.10 lakh, the income tax rate is 30 per cent.

2. **Elasticity and Productivity.** Revenue earned through direct taxes is elastic in nature. It changes directly with changes in the level of national income. Direct taxes have therefore built-in flexibility.

3. **Economy.** The administrative cost of collecting direct taxes is low as compared to indirect taxes. Direct taxes are collected at source and therefore the chances of tax evasion are minimized. In contrast, indirect taxes need expansive tax collection machinery which raises the cost of collection.

4. **Certainty.** Future tax receipts can be accurately estimated by the government because of the certainty in direct tax receipts. Further, the tax payers can also estimate their tax liability.

5. **Reduction in Income Inequalities.** Progressive nature of direct taxes reduces income inequalities in a society because the tax imposed is based on the principle of 'Ability to Pay'.

6. **Creates Civic Consciousness.** The persons who pay direct taxes to the government develop civic consciousness. He feels involved in the governance of the country and hence would want to know as to how the tax collected by the government is spent. Tax payers may therefore act as conscience keepers of the government.

7. **Anti-cyclical.** Taxes are an instrument of fiscal policy and are used as instruments of anti-cyclical fiscal policy. Thus during an inflationary period, the rates of direct taxes may be raised so as to reduce aggregate demand and control the price rise. Similarly, during a period of recession, tax rates may be reduced to raise the level of aggregate demand and promote investment, employment, output, income, demand and prices in the economy. Direct taxes can therefore be used to achieve the macroeconomic goal of stable prices.

Demerits of Direct Taxes.

The demerits of direct taxes are as follows:

1. **Tax Evasion.** In developing countries, the unorganized sector of the economy is the predominant sector. Financial and other records are not honestly maintained by the business units in the unorganized sector. For instance, tiny and small enterprises, unregistered manufacturing units, private hospitals, nursing homes, dispensaries, hotels, restaurants and various types of shops selling both goods and services do not maintain proper record of their income and expenditure.

Under-reporting of incomes and exaggeration of expenses is done to either evade paying any income tax or to reduce tax liability. However, salaried personnel have to pay their income taxes because salaries are properly documented and business units have no incentive to hide salary expenses.

2. **Arbitrary in Nature.** The direct tax structure is arbitrary in nature. There is no scientific basis to the direct tax structure. The rates of direct taxes for various income slabs are arbitrarily fixed. For instance, in India the marginal rate of personal income tax is 30 per cent and is applicable to income over Rs.10 lakhs per annum. Further, income tax slabs are not indexed to the changing price level and revisions made in the tax slabs are not according to rising price level. Thus, more and more tax payers are added from the bottom of the income pyramid. [1]**According to a study conducted by the Federation of Indian Chamber of Commerce and Industry (FICCI) in 2005-06, in China, such a rate is applicable to income over Rs.40 lakhs. Similarly, corporation tax rate is 30 per cent in India and if we add other direct tax liabilities such as dividend distribution tax, fringe benefit tax and surcharge, the corporation tax liability goes up to 40 per cent. However, in Honkong, the corporation tax rate is only 17.5 per cent, Singapore and Canada has 22 per cent, Germany, Mauritius, Nepal, Romania and Taiwan has 25 per cent[1].**

3. **Complexity and Corruption.** If the direct taxes have a very complex structure containing numerous exemptions on various accounts, it creates corrupt tax administration machinery. If the exemptions are numerous, it creates a breeding ground for corrupt tax administrators. As a result, the tax potential of the country is never realized and vested interests develop to keep the tax system complicated and archaic. [2]**According to the India Corruption Study 2005 conducted by Transparency International India, about 24 lakh income tax paying households in India paid petty bribes amounting to Rs.496 crore to the income tax personnel. This amount excludes bribes paid by companies and business units[2].**

4. **Unpopular and Inconvenient.** Direct taxes become unpopular particularly when the rates of taxation are perceived by the tax payers to be high and therefore unjust. They become inconvenient when detailed and copious accounts are required to be maintained and filing of income tax returns is tedious. For instance, 55% of the respondents in a study conducted by Transparency International, India reported that they had to make four visits in a year to the income tax department in connection with filing of returns whereas only 15 per cent of the respondents could finish their work in their first visit to the income tax department. Further, 60 per cent of the respondents perceived the income tax department to be corrupt.

5. **Narrow Based in Poor Countries.** The direct tax-GDP ratio and the ratio of direct to indirect taxes are very high developed countries. However, in developing countries, these ratios are very low. For instance, in India, the number of income tax payers are only about three crore which is less than three per cent of the population. This is because of the predominance of the unorganized sector and rampant tax evasion in developing economies.

Merits of Indirect Taxes.

The merits of indirect taxes are as follows:

1. **Convenience.** Indirect taxes are collected in a lump sum by the government from importers, producers and sellers who in turn collect it from the buyers in small amounts. Since the indirect taxes are included in the price, the impact is not felt by

the consumers. Sellers find it convenient because the burden is entirely shifted on to the consumers in most of the cases.

2. **Wider Tax Base.** Theoretically, indirect taxes are paid by all those who buy and therefore the entire society constitutes the tax base as far as indirect taxes are concerned. However, in developing countries, the unorganized sector of the economy is predominant and hence the output produced may not be entirely accounted for indirect taxes.

3. **Absence of Tax Evasion.** It is argued that since the incidence of indirect taxes is on the consumers, producers and sellers would have no incentive in evading payment of indirect taxes. They would therefore diligently collect indirect taxes from the consumers and pay it to the government. However, if substantial economic activity is unreported or under-reported, tax evasion becomes a reality even in the case of indirect taxes. Further, it is possible that producers may collect indirect taxes and end up not paying to the government.

4. **Social Welfare.** Alcoholic and narcotic products reduce both individual and social welfare because they not only have negative externalities but are also harmful to the individual who consumes these products. Heavy indirect taxes on such products would definitely reduce both the demand for such products and their output, thereby improving social welfare. Further, heavy taxation on such products would not be unpopular and the government would be able to collect substantial revenue.

5. **Elasticity.** When the national income increases, the revenue collected through indirect taxes also increases because consumption demand increases. Increasing incomes and rise in population imparts elasticity to indirect taxes.

Demerits of Indirect Taxes.

The demerits of indirect taxes are as follows:

1. **Unjust and Inequitable.** All economic classes are included in the indirect tax net. There is no discrimination between economic classes and principle of 'Ability to Pay' is given a silent burial. The rich and the poor have to proportionately bear the burden of indirect taxes. Indirect taxes are therefore unjust and inequitable.

2. **Uncertainty.** Demand for various goods and services depend upon the tastes and preferences of the people. The tastes and preferences of people keep changing and hence the elasticity of demand for various goods and services also change. Changing elasticity of demand and supply will influence indirect tax revenue. Consumer behavior cannot be accurately predicted and therefore it imparts uncertainty to revenue generated through indirect taxes.

3. **Uneconomic.** The administrative cost of indirect taxes is higher in comparison to direct taxes. Indirect taxes therefore do not satisfy the canon of economy.

4. **Does not create Civic Consciousness.** Since the incidence of indirect taxes is not felt by the tax payers, they do not create any sense of civic consciousness. The desire to hold the government accountable for the revenue receipts and expenditures is therefore absent amongst the indirect tax payers.

5. **Inflationary.** Indirect taxes have inflationary potential, particularly when they are imposed and increased on basic goods such as fuel and transportation. The government in an effort to increase tax revenues may increase the rate of indirect taxes on goods and services having relatively inelastic demand. But such increases may translate into a higher general price level in the economy.

Conclusion.

From the study of merits and demerits of direct and indirect taxes, it can be concluded that direct taxes can be made progressive whereas indirect taxes cannot be made progressive. Indirect taxes are in fact regressive when they are imposed on all goods and services consumed by one and all in the society. However, both the types of taxes have their own utility and they are found to be complementary to each other. A taxation system, purely dependent upon direct taxes would be inefficient and irrational and hence a judicious and thoughtful mix of direct and indirect taxes is essential to ensure revenue and welfare maximization.

IMPACT AND INCIDENCE OF TAXATION.

When a tax is imposed by the government on a person and he pays the tax to the government, the impact and incidence of the tax is on the same person. Here impact refers to the person who appears to be paying and incidence refers to the person who is actually paying. For instance, the impact and incidence of direct taxes like income and corporation tax is on the same person (the corporation is a person or entity). However, when a tax is imposed by the government on one person and the tax is actually paid by other persons, then the impact is on the person who appears to be paying the tax and the incidence is on the persons who actually pay tax. For instance, the impact of indirect taxes like import duty, excise duty, sales tax and service tax is on the seller whereas the incidence is on the consumer. However, the extent of incidence will be determined by the elasticity of demand and supply for goods and services.

Between the impact and the incidence of taxation, **shifting** of taxation takes place. Shifting of tax is a process in which the money burden of a tax is transferred from one person to another. For example, when excise duty is imposed on a producer, he shifts it to the wholesaler who in turn shifts to the retailer and the retailer shifts it to the consumer. Here the tax is shifted forward and each person passes the burden to the next in the chain. In this example, the incidence of taxation is ultimately on the consumer. The producer, the wholesaler and the retailer are in a position to shift the tax whereas the ultimate consumer cannot. He or she bears the burden and the incidence of taxation. A tax may be shifted backwards on the suppliers of intermediate goods by forcing the suppliers to reduce the prices of their goods by the extent of a tax. Thus the

impact of taxation is in the initial stages of the imposition of the tax, shifting takes place in the intermediate stage and the incidence is at the final stage. **The factors that influence shifting and incidence of taxation are as follows.**

Elasticity of Demand and the Incidence of Taxation.

The burden of taxation will be more on the seller and less on the buyer if the demand for the commodity is relatively elastic. The opposite will be the case if the demand for the commodity is relatively inelastic. If the demand for the product is perfectly elastic, the entire burden or the incidence of taxation will be on the seller and the buyers will have zero burden. However, if the demand for the product is perfectly inelastic the entire burden of taxation will be on the buyers. The elasticity of demand and burden of taxation is shown in Table 2.1.

Table 2.1 – Elasticity of Demand and Incidence of Taxation.

SNO	Elasticity of Demand	Incidence of Taxation	
		Seller	Buyer
1.	Perfectly Elastic.	Bears full burden.	Bears no burden.
2.	Perfectly Inelastic.	Bears no burden.	Bears full burden.
3.	Relatively Elastic.	Bears the major burden.	Bears the minor burden.
4.	Relatively Inelastic.	Bears the minor burden.	Bears the major burden.
5.	Unitary Elastic.	Bears half the burden.	Bears half the burden.

Elasticity of Supply and the Incidence of Taxation.

If the supply of a product is relatively elastic, a greater burden of taxation will be on the buyer and vice versa. When the supply is relatively elastic, the supplier will be able to change the quantity supplied in accordance to the changes in price resulting from an imposition of tax. For instance, when a tax is imposed on the product, the supplier can reduce the supply and shift the burden of taxation on the buyer. Thus when the supply is perfectly elastic, the entire burden of taxation can be shifted to the buyer and vice versa. In case of unitary elastic supply, the burden of taxation will be shared equally by the supplier and the buyer. The elasticity of supply and burden of taxation is shown in Table 2.2.

Table 2.2 – Elasticity of Supply and Incidence of Taxation.

SNO	Elasticity of Supply	Incidence of Taxation	
		Seller	Buyer
1.	Perfectly Elastic.	Bears no burden.	Bears full burden.
2.	Perfectly Inelastic.	Bears full burden.	Bears no burden.
3.	Relatively Elastic.	Bears the minor burden.	Bears the major burden.
4.	Relatively Inelastic.	Bears the major burden.	Bears the minor burden.
5.	Unitary Elastic.	Bears half the burden.	Bears half the burden.

Elasticity of Demand and Supply and the Incidence of Taxation.

In reality, the elasticity of demand and supply determines the incidence of taxation. According to Hugh Dalton, the direct money burden of a tax on any commodity is divided between the buyers and sellers according to the ratio of elasticity of supply to the elasticity of demand of the taxed commodity. According to Dalton, the incidence or the direct money burden of tax can be measured with the following equation:

$$Incidence\ of\ Taxation = \frac{e_s}{e_d}$$

Where, e_s and e_d are elasticity of supply and demand respectively.

The incidence of taxation on the basis of elasticity of supply and demand is shown in Table 2.3.

Table 2.3 – Elasticity of Demand and Supply and Incidence of Taxation.

SNO	Elasticity of Demand and Supply	Incidence of Taxation on Seller and Buyer	Impact on Price
1.	Es = Ed	Incidence will be equal.	Price will go up by 50% of the tax.
2.	Es > Ed	Incidence on the buyer will be greater than the seller.	Price will go up by > 50% of the tax.
3.	Es < Ed	Incidence on the seller will be greater than the buyer.	Price will go up by < 50% of the tax.
4.	Ed = α and Es < 1	Full incidence on the seller.	No change in price.
5.	Ed = 0 and Es = α	Full incidence on the buyer.	Price will go up by 100% of the tax.
6.	Es = α and Ed < 1	Full incidence on the buyer.	Price will go up by 100% of the tax.
7.	Es = 0 and Ed > 1	Full incidence on the seller.	No change in price.

Questions.

1. **Explain the meaning and sources of public revenue.**
2. **Explain the merits and demerits of direct taxes.**
3. **Explain the merits and demerits of indirect taxes.**
4. **Explain the impact and incidence of taxation with reference to elasticity of demand and supply Or Explain the factors affecting shifting of a tax.**

Module III – PUBLIC FINANCE.

CHAPTER – 03

PUBLIC EXPENDITURE

PREVIEW.

- **Meaning of Public Expenditure.**
- **Classification of Public Expenditure.**
- **Causes of Increase in Public Expenditure.**
- **Budget and Types of Budget.**

MEANING AND IMPORTANCE OF PUBLIC EXPENDITURE.

Public expenditure is the expenditure incurred by the government at various levels. These levels may be the Federal or the Central level, the State level and the Local level. The government receives income from tax and non-tax sources of revenue and spends the revenue received on various heads of expenditure. Today, the main function of the State is to provide public and merit goods. Most of the economic and social infrastructure consisting of roads, bridges, dams, canals, transport and communication, public lighting, public parks, public hospitals, government funded education at all levels are provided by the Government in modern economies. The free market economy fails to produce public goods. Similarly, the free market economy would not produce merit goods in sufficient quantity. Thus there is a problem of under-production of merit goods and over-production of demerit goods. The governments therefore need to either subsidize the production of merit goods or supply them in their entirety. In modern economies, public expenditure is directed to achieve the macro-economic, macro-political and macro-social objectives of the State.

CLASSIFICATION OF PUBLIC EXPENDITURE.

Public expenditure is classified into the following three categories:

1. Capital and revenue expenditure.
2. Productive and unproductive expenditure.
3. Transfer and non-transfer expenditure.

CAPITAL AND REVENUE EXPENDITURE.

Capital expenditure is the money spent by the government to create fixed assets. The government has to incur capital expenditure because the mixed nature of modern economies and development of social and economic infrastructure has become the responsibility of the State. Creation of economic and social infrastructure which includes construction of dams, canals, roads and highways, flyovers and bridges, public transport, water supply, schools, colleges and universities, hospitals etc needs heavy investment of capital. The rate of return on such investment is either low or external to the investor. Thus private capital shies away from such investment. The government therefore takes the greater part of the responsibility in creating economic and social infrastructure, particularly in the developing countries. Capital expenditure is productive in nature and the social benefits of public capital expenditure far outweigh its costs and hence it makes eminent sense to incur capital expenditure by the government.

Capital expenditure can also be **non-developmental** in character. For instance, enormous amount of money spent on defense is clear example of non-developmental capital expenditure. Defense expenditure is non-developmental because in no way it is productive and leads to the economic development of the country. Governments should therefore spend more time and efforts in establishing international peace and friendship to bring about more economic development. War mongering and grandstanding by nation States is clearly an indication of political immaturity and lack of statesmanship. Defense expenditure is an avoidable burden on the State. Keeping defense expenditure to the bare minimum would reduce debt and interest burden on the society and also free scarce resources for productive purposes. Since capital expenditure is largely financed through public borrowings, care should be taken that it is used for productive purposes and helps in generating sufficient revenue receipts to retire public debt.

Revenue Expenditure.

Modern governments incur large revenue expenditure. Huge amount of money is spent by the government on maintaining and running the public administrative apparatus. The government also spends large amounts of money on social, economic and community services. Revenue expenditure is classified into developmental and non-developmental expenditures.

Revenue expenditure that contributes to the development of the country is called developmental revenue expenditure. Expenditure on social and community services which includes health, education and welfare contributes to the development of the society. Revenue expenditure made by the government on economic services such as agriculture, industries and minerals, foreign trade and export promotion, energy, transport and communications and science, technology and environment directly contributes to national income and hence it is categorized as developmental revenue expenditure.

Governments also incur non-developmental revenue expenditure. Revenue expenditure on defense, administrative services and interest payments is non-developmental in nature.

Productive and Unproductive Expenditure.

Public expenditure incurred in creating and maintaining the productive capacity of the economy is considered as productive. Therefore, all developmental expenditure consisting of expenditure on creating economic and social infrastructure which includes construction of dams, canals, roads and highways, flyovers and bridges, public transport, water supply, schools, colleges and universities, hospitals etc is productive in nature. Productive expenditure leads to creating, maintaining and increasing the productive capacity of the economy. Conversely, all non-developmental expenditure consisting of defense, administrative services and interest payments is considered unproductive in nature. Expenditure on these activities does not contribute to the productive capacity of the economy.

Transfer and Non-transfer Expenditure.

AC Pigou, the British economist classified public expenditure into transfer and non-transfer expenditure. All income creating expenditure is considered as non-transfer expenditure. Thus both developmental and non-developmental expenditures which create income will be considered as non-transfer expenditure. Developmental expenditure on creation of economic and social overhead capital consisting of construction of transport and communication system, generation of electricity, provision of water supply, public health, education at various levels and non-developmental expenditure on defense, public administration, justice, maintenance of law and order etc would be considered as non-transfer expenditure.

Expenditure on interest payments, subsidies, social security benefits like unemployment allowance, old age pension, compensating the dependents of the dead in disasters etc would be considered as transfer expenditure.

CAUSES OF INCREASE IN PUBLIC EXPENDITURE IN INDIA.

The Marxian and Keynesian revolutions contributed to the emergence of the Welfare State in the second half of the 20th century. With the emergence of the Welfare State, mixed economies also came into existence. With extensive and intensive increase in the welfare functions of the State, growth and developmental functions were also added to the list of functions performed by the State. The interventionist role of the State expanded to include maintain price stability and encourage economic growth, reduce inequalities of income and eradicate poverty and most importantly ensure human development in terms of improved life expectancy, literacy and education and reduced mortality rates. Public expenditure as a ratio of national income has been increasing in a sustained manner in all economies. In India, public expenditure as a percentage of GDP has increased from 9.1% in 1950-51 to 26.7% in 2008-09.

The causes of increase in public expenditure can be stated as follows:

1. **Growing GDP, GDP per Capita & Income Elasticity of Demand for Public Goods.** According to RA Musgrave and PB Musgrave, when GDP per capita increases overtime, public expenditure also increases because the demand for public goods increases. The income elasticity of demand for public goods is greater than one and hence as the national income increases, percentage change in public expenditure is greater than the percentage change in national income. In India, the national income has increased at the rate of 5.7 % per annum over the period 1980-81 to 2009-10 and the per capita income also increased at the rate of 3.9 % per annum during this period. The rate of growth of public expenditure during this period has been higher than the rate of growth of national and per capita income.

2. **The Emergence of Welfare State.** The modern Welfare State came into existence during the second half of the 20th century. The market economies performed interventionist role i.e. they intervened in those areas where the market fails to perform. Thus provision of merit and public goods and economic welfare of the people was the responsibility of the State in market economies. In the modern economies of the world which are generally market economies with a few exceptions like Cuba, Vietnam and Laos, the State is gradually withdrawing from the economic front and concentrating on the provision of public and merit goods. However, with increasing demand for merit and public goods, the public expenditure is also growing in the market economies.

3. **Expansion in Defense Expenditure.** The threat of war and the need for defense continues to be felt by all modern States. The age of tribalism is far from over and hence nation States continue to spend a substantial part of their incomes on strengthening their defense systems and war preparedness. While the absolute size of defense expenditure has increased in India since independence, the percentage of total public outlay spent on defense has remained below the 10 per cent mark since the 1980s. This is shown in Table 3.1 below.

   In fact, in percentage terms, the defense expenditure as a percentage of total budgetary resources has fallen from 9.77% in 1980-81 to 5.57 in 2013-14. Although in percentage terms the expenditure has declined overtime, the absolute size has increased by over 56 times and defense expenditure in itself is taking away the largest slice of public outlay in India while there are other more important items of developmental expenditure like health and education.

Table 3.1 – Public Expenditure and Defense Expenditure.
(in Rs. Crore at Current Prices).

Year	Total Budgetary Outlay (Rs. Crore)	Net Defense Expenditure (Rs.Crore)	Net Defense Expenditure as percentage of total Budgetary Outlay (%)
1980-81	36,845	3,600	9.77
1990-91	1,76,548	15,427	8.74
2000-01	6,15,658	49,622	8.06
2009-10	20,70,959	1,41,781	6.85
2010-11	23,96,419	1,54,117	6.43
2011-12	27,25,009	1,70,913	6.27
2012-13 RE	31,172,62	1,78,504	5.72
2013-14 BE	36,55,506	2,03,672	5.57

Source: Table 2.1, Page A-43 of IES 2014-15. Column No.4 is computed by me.

4. **Growth of Population.** The government needs to take care of the growing requirements of a growing population. Population in all the countries of the world with a few exceptions has been growing. The growth of population has been rapid in the less developed countries. With growing population, the demand for public services has increased. The governments therefore have to spend more money on health, education and welfare of an increasing population. In 1951, the population of India was 36 crore and in 2011, the population of India is 121 crore. During this 74 year period, the population has increased by 236%.

5. **Rural Development and Urbanization.** The governments of less developed countries with overwhelming rural population have to spend money on rural and urban development. Thus huge amount of money is spent on urban and rural infrastructure. The need for efficient urban and rural infrastructure is felt by the less developed countries owing rising urban and rural populations. In 1951, the percentage of urban population in India was 17.3 and in 2014, the percentage of urban population to total population has crossed 30%.

6. **Planned Economic Growth & Development.** Countries like India who has adopted planned economic growth and development has been increasing their public outlays on investment in industrial growth and development from one plan to another plan. Further, in mixed economies, owing to the existence of a large public sector, government expenditure has been increasing on both the maintenance and expansion of public sector.

7. **Democratic Forms of Government.** In democratic forms of government, periodic elections are held to constitute representative governments. Political parties may therefore declare populist programs to attract votes from the citizens and also implement them after assuming political power. This leads to competitive populism and rise in non-developmental expenditure. India is a democratic country with a parliamentary system of governance. Elections are held periodically at various levels.

8. **Public Debt.** In order to finance budgetary expenditure, governments are increasingly depending on public borrowings. Heavy public borrowing also necessitates heavy interest payments and principal repayment. In order to make interest payments, governments are found to be increasing their public borrowings year after year. In 2007-08, public debt as a percentage of GDP of India was 61.3 per cent.

9. **Rising Price Level.** With sustained rise in prices over a long period of time, the nominal expenditure has been rising continuously along with rise in real public expenditure.

10. **The Concept of Functional Finance.** The interventionist role of the government had come into prominence after the Keynesian revolution. The fiscal policy of the government is directed to ensure price stability and economic growth. The government's role particularly becomes important during the times of recession. In order to lift the economy out of recession, governments need to make heavy expenditure on public works. Government expenditure as a percentage of national income has increased from 9.1% to 26.7 % during the period 1950-51 to 2009-10.

MEANING OF BUDGET.

The government budget is a financial statement which describes its revenues and expenditures. Programs and policies of the government planned for the financial year are described in the budget statement. The term 'budget' is derived from the French word 'Bougette' which means a leather bag or a wallet. The term 'budget' was used for the first time in 1733 by a member of the House of Commons in England.

The Government of India budget consists of the following data:

1. The actual figures for the year before and the current year.
2. The budget estimates and the revised estimates of the current year.
3. The budget estimates of receipts and expenditure for the year ahead.

The estimates for the year ahead are given in two parts. In the first part, it is assumed that the current year's taxes and their rates would continue and accordingly the estimates are made. In the second part, estimates of revenue and expenditures are given on the basis of proposed changes in the budget. The government budget therefore becomes a financial statement

describing its financial plans and fiscal policy. The government budget is generally classified into two, namely: the revenue account and the capital account.

The Revenue Account.

The revenue account shows revenue receipts and revenue expenditure. The revenue receipts are classified into tax and non-tax revenue. The tax revenue consists of revenue receipts from direct taxes such as personal income tax and corporation tax and revenue receipts from indirect taxes, such as excise and customs duties. Non-tax revenue includes interest receipts and surpluses from public enterprises. Revenue expenditure is divided into developmental and non-developmental expenditure. For instance, the important heads of revenue expenditure of Government of India are defense expenditure, interest payments and subsidies.

The Capital Account.

The capital account shows capital receipts and capital expenditure. Capital receipts consist of market borrowings, small savings, special deposits, recoveries of loans, provident funds, external loans disinvestment receipts etc. Capital expenditure consists of debt repayment and expenses incurred on construction of capital assets.

The Government Budget shows deficit or surplus incurred in these accounts. Deficit incurred in one account is made good by showing a surplus on the other account. For instance, since 1997-98 the government of India has been showing a zero budget deficit. A zero budget deficit is shown by a surplus on the capital account which is equivalent to a deficit on the revenue account. Thus by reducing capital expenditure, the government has been making good the deficit on the revenue account. The budget deficit is the difference between receipts and expenditure of the government.

The Budget Statement.

In India, the financial statement of the government is called the Budget Statement. The Central Government places its financial statement before the Parliament and the State governments place their financial statements before their respective State legislatures. **The government accounts are kept in three parts, namely: the consolidated fund, the contingency fund and the public account.**

The Consolidated Fund.

The government receipts are kept in the consolidated fund. The receipts going to the consolidated fund and the expenses incurred from it become a part of the budget statement. Expenditure from the consolidated fund requires prior sanction of the Parliament. All revenues going to the Consolidated Fund and expenditures to be incurred from this fund are a part of the Budget Statement.

The Contingency Fund.

The contingency fund is maintained for incurring non-postponable expenses. The operations of the contingency fund are also described in the budget statement. In order to incur expenditure from this fund, prior sanction is not required from the Parliament or the State legislature, as the case may be.

The Public Account.

Non-government funds go to the public account. Provident funds, small savings, deposits and advances go to the Public account. Here again, no sanction is required from the Parliament or the State legislatures for incurring expenditure from this account.

In India, the receipts and payments under all the three Accounts are shown separately in the Budget Statements of both the Central and State Governments.

TYPES OF BUDGET.

Government budgets can be classified into balanced and unbalanced budget. Unbalanced budget can be further classified into surplus and deficit budget.

Balanced Budget.

In the case of a balanced budget, the anticipated expenditure of the government is equal to the estimated revenue. **The classical economists advocated a balanced budget approach to public finance.** They believed that the budget of the government should be balanced annually and governmental functions should be limited to maintenance of internal law and order, protection from foreign aggression and public works. The government had no economic role to perform and all economic activities were best left to the individual. Deficit budget or public borrowing would lead to inflation and crowding out of private investment. Inflation is an undesirable economic phenomena and the market mechanism ensures optimal allocation of resources. Hence, governments should not follow deficit budget or borrow money to fund the deficit. The classical economists therefore advocated a balanced budget approach and wanted governments to maintain a balance between public revenue and public expenditure.

Unbalanced Budget.

In an unbalanced budget, the anticipated expenditure of the government is not equal to the estimated revenue. There are two types of unbalanced budget: surplus budget and deficit budget. In a **surplus budget**, the anticipated expenditure of the government is less than the estimated revenue. Under inflationary conditions, the government may adopt a surplus budget to control inflation. Surplus budget leads to fall in aggregate demand and thereby reduce the rate of inflation in the economy. However, in the modern times, the governments are loaded with a wide range of responsibilities and hence the idea of surplus budget is found to be impractical. Further, deficit budgets are found to be more functional than surplus budgets.

In the case of a **deficit budget**, the anticipated expenditure of the government is more than the estimated revenue. According to Prof. Hugh Dalton, if the government expenditure exceeds government revenue over a period of time, then the budget is an unbalanced budget. The deficit is covered through public borrowings and drawing upon the accumulated reserves of the government. A deficit budget generates liabilities for the government and contributes to public debt. The government borrows from the people by issuing government bonds. In underdeveloped countries like India, deficit budget is used to finance planned development and in developed countries like USA, it is used to control business cycles.

The balanced and unbalanced budgets are diagrammatically represented in Figure 3.1 below. In this Figure, point 'E' denotes balanced budget. To the left of point 'E', the government budget is a deficit budget whereas to the right of point 'E', it is a surplus budget.

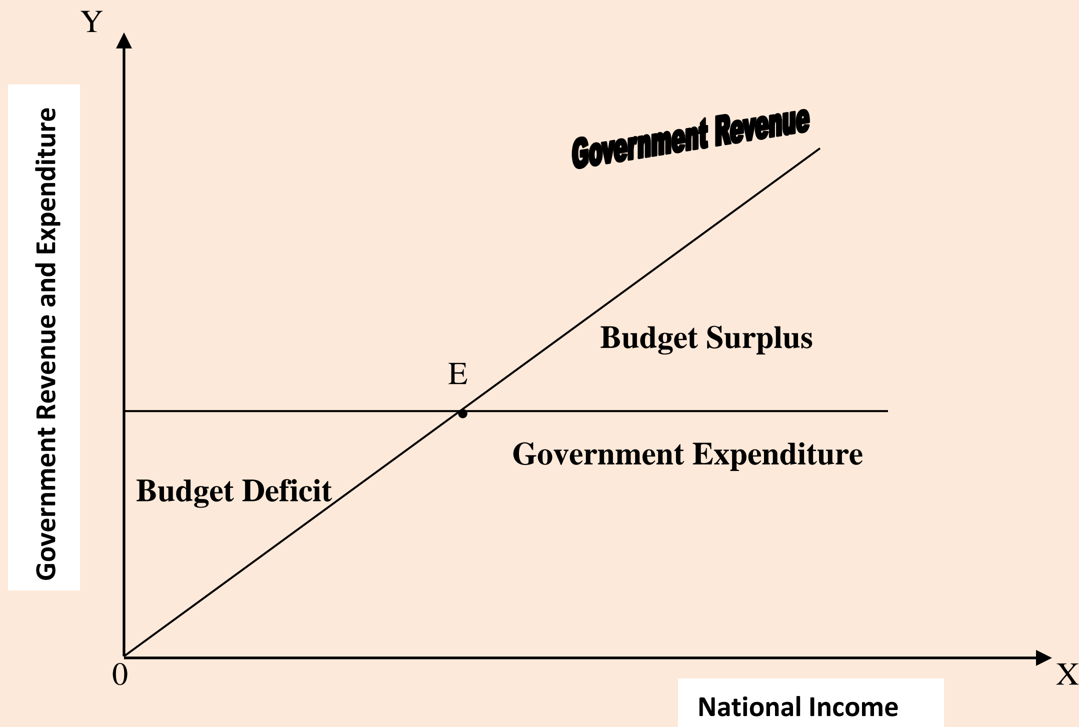


Figure 3.1 – Balanced and Unbalanced Budget.

OTHER TYPES OF BUDGET.

Other types of budget include: revenue and capital budget, legislative and executive budget and zero-based budget.

1. **Revenue and Capital Budget.**

The Revenue Budget.

The revenue budget includes recurring items of expenditure. It shows revenue receipts and revenue expenditure. The revenue receipts are classified into tax and non-tax revenue. The tax revenue consists of revenue receipts from direct taxes such as personal income tax and corporation tax and revenue receipts from indirect taxes, such as excise and customs duties. Non-tax revenue includes interest receipts and surpluses from public enterprises. Revenue expenditure is divided into developmental and non-developmental expenditure. For instance, the important heads of revenue expenditure of Government of India are defense expenditure, interest payments and subsidies. The Revenue budget may be either in surplus or in deficit. In India, the revenue budget is always in deficit and the deficit on the revenue account is made good by a surplus on the capital account.

The Capital Budget.

The capital budget includes non-recurring items of expenditure. It shows capital receipts and capital expenditure. Capital receipts consist of market borrowings, small savings, special deposits, recoveries of loans, provident funds, external loans disinvestment receipts etc. Capital expenditure consists of debt repayment and expenses incurred on construction of capital assets.

The Government Budget shows deficit or surplus incurred in these accounts. Deficit incurred in one account is made good by showing a surplus on the other account. For instance, since 1997-98 the government of India has been showing a zero budget deficit. A zero budget deficit is shown by a surplus on the capital account which is equivalent to a deficit on the revenue account. Thus by reducing capital expenditure, the government has been making good the deficit on the revenue account. The budget deficit is the difference between receipts and expenditure of the government.

2. **Legislative and Executive Budget.**

A legislative budget is made by the legislature: Union or State. An executive budget is made by the government executive. In either case, the budget needs to be passed by the legislature. If the budget is made by the Union Government, it is called as ‘Union Budget’ as in the case of India. The Union Budget is the budget statement of the Central Government whereas every State Government passes its own State Budget.

3. Zero-based Budget.

Zero-based budgeting is an approach to planning and decision-making that reverses the working process of traditional budgeting. In traditional incremental budgeting, the government justifies only variances over the previous years, based on the assumption that the "baseline" is given. In zero-based budgeting, every item of the budget must be approved, rather than only changes. During the review process, no reference is made to the previous level of expenditure. Zero-based budgeting requires the budget request be re-evaluated thoroughly, starting from the zero-base. This process is independent of whether the total budget or specific items are increasing or decreasing.

Questions.

1. **What is public expenditure and explain the causes of increase in public expenditure in India?**
2. **Write a note on classification of public expenditure.**
3. **Explain the meaning and types of budget.**

Module III – PUBLIC EXPENDITURE AND PUBLIC DEBT.

CHAPTER – 4

PUBLIC DEBT

PREVIEW.

- **Meaning of Public Debt.**
- **Classification of Public Debt.**
- **Debt Burden: Internal and External.**
- **Management of Public Debt.**

MEANING OF PUBLIC DEBT.

Public debt is an important source of revenue for the government. In the modern times, governments have time and again used public borrowings to finance their budgeted expenditures. Public debt represents government borrowing from the public. Public debt raised within the country is called internal debt and debt that is raised without the country is called external debt. Countries may raise external debt from other countries and international financial institutions. Governments raise public debt because the public revenue is not adequate to finance huge government expenditures. Governments raise public debt by selling different types of government bonds and securities. The public debt of the Government of India consists of bonds and securities, ad-hoc treasury bills issued to the Reserve Bank, State Governments, State Bank of India and other financial institutions, treasury bills issued to general public, non-negotiable and non-interest bearing securities issued to international financial institutions for raising external loans and direct loans from foreign governments, unfunded liabilities of the Government of India consisting of deposits under small savings, post office savings, post office cash certificates, national savings certificates, income tax annuity certificates, State provident funds, public provident funds etc. The objectives of public debt are as follows:

1. To finance the gap between anticipated public expenditure and current public revenue.
2. To use public debt as an anti-cyclical instrument of fiscal policy.
3. To finance development plans of the government.
4. To fight emergencies like war and natural disasters.

The scale and magnitude of public debt has increased enormously over the years. **For example, total public debt (sum of internal and external debt) in 1990-91 was Rs.3, 14,558 crore. In 2006-07, this figure rose to Rs.24, 73,562 crore. Thus public debt as a percentage of GDP has gone up from 55.3% in 1990-91 to 60.3 percent in 2006-07.** Thereafter, public debt has come down to 49.8% of GDP or Rs. 44,68,714 crore in the year 2011-12. In 2012-13, the public debt GDP ratio went up marginally to 50.1 %. The total outstanding liabilities of the Central

Government were Rs.55.87 lakh crore i.e. 49.2% of the GDP in 2013-14 (RE) and further to 48.3 (BE) in 2014-15. The enormity of public debt necessitates its efficient management.

CLASSIFICATION OF PUBLIC DEBT.

Public debt can be classified in the following types:

1. Internal and external debt.
2. Productive and unproductive debt.
3. Redeemable and irredeemable debt.
4. Short term, medium term and long term debt.
5. Funded and unfunded debt.
6. Voluntary and compulsory debt.
7. Marketable and Non-marketable debt.

Internal and External Debt.

Internal debt is raised from the public and financial institutions within the country. While internal borrowings take place, the resources are transferred from individuals and financial institutions to the government. The total resources available in a country do not increase as a result of internal debt. The repayment of internal debt which is inclusive of interest thus also indicates transfer of resources from the government to the bond holders. If the internal borrowings are used by the government in financing developmental programs such as poverty eradication, health, education and welfare, the revenue spent by the government will result in redistribution of income and wealth in the country and lead to reduced inequalities of income.

External debt is raised from the public and financial institutions of foreign countries. It leads to increase in the availability of resources to the borrowing country. External debt is raised in foreign currencies and hence the foreign exchange reserves of a borrowing country increases and repayment of external debt leads to fall in foreign exchange reserves. External debt is raised to finance a deficit on the current account. When a country's imports are greater than exports, the balance on current account will show a deficit. Developing countries generally faces the problem of deficit on current account because of their dependence on developed countries in terms of capital goods consisting of industrial raw materials, machinery and technology.

Internal and external debts are mutually convertible. According to Dalton, an external loan is converted into an internal loan when government securities of the debtor country are purchased by their citizens and financial institutions. Similarly, an internal loan is converted into an external loan when foreign citizens and international financial institutions purchase government securities of the debtor country.

Productive and Unproductive Debt.

When public borrowings are invested in productive assets, public debt is known as Productive debt. Productive assets are those assets which increase the productive capacity of the economy. According to **Dalton,** productive debts are those which are fully covered by assets of equal or

greater value. Thus investment by the government in creating economic and social infrastructure would result in the creation of productive assets. Construction of dams and canals, roads of all types, communication systems, railways, airways and waterways, hospitals, schools and colleges constitute productive physical infrastructure. Similarly, the money spent by the government on public health, general education and welfare of the people leads to the creation of social infrastructure. Both social and economic infrastructure improves the quality of life and productivity of human resources. When the productive capacity of the economy increases, public revenue also increases and the government is able to repay the principal and interest on public debt. **Thus productive public debt is self-liquidating in nature. The net burden of productive debt is zero.**

When public borrowings are used for unproductive purposes such as financing defense expenditure, interest payments, public administration etc, it is known as unproductive debt. Such debt does not increase the productive capacity of the economy and hence it is not self liquidating in nature. Unproductive debt is also known as deadweight debt. According to Findlay Shirras, "dead weight or unproductive debts are those which have no existing assets". Unproductive debt increases net burden on the society as governments may resort to additional taxation for repaying such debt.

Redeemable and Irredeemable Debt.

Redeemable debts are terminable debts i.e. the principal amount along with interest must be paid back to the lenders on maturity. In order to repay the debt, the government may create a fund or impose additional taxes. Debts raised by the government with indefinite maturity periods are irredeemable debts. The government is obliged to pay only interest on such debt to the lenders. Generally public debt is redeemable in nature and the burden of redeemable debt can be eliminated on maturity. However, irredeemable debt continues in eternity and therefore the burden of irredeemable debt may grow overtime if the government fails to make interest payments.

Short term, Medium term and Long term Debt.

According to the time period of the debt, public debt may be classified into short, medium and long term debt. Short term debts mature within a period of one year. The government issues treasury bills of various maturity periods beginning from 45 days to 364 days to finance temporary deficits in the budget. Medium term debt has a maturity period between one year and five years and long term debt has a maturity period of five years and above. The rate of interest paid on short term debt is the lowest and the highest interest rate is paid on long term debt.

Funded and Unfunded Debt.

Funded debt is long term debt. The maturity period is more than one year and may extend up to a period of 30 years. The government is obliged to pay a fixed rate of interest on funded debt. In order to repay the debt, a debt fund is created in which money is deposited annually by the government. The debt is repaid out of this fund on maturity. According to Findlay Shirras, "funded debt is a debt which is repayable at a distant date and for the payment of interest on

which regular provision is made". Unfunded debt has a definite maturity period of one or less than one year and must be paid back to the lenders on maturity. Unfunded debts are raised to finance temporary deficits and the rate of interest is low. Unfunded debts are repaid out of the current receipts of the government and the government does not create a separate fund for repayment. Unfunded debt is also known as floating debt because the government may issue additional bonds in the market in order to repay unfunded debts.

Voluntary and Compulsory Debt.

When individuals and financial institutions buy government bonds voluntarily, the debt so raised is called voluntary debt. When individuals and financial institutions are forced to buy government bonds, the debt so raised is called compulsory debt. The government may resort to compulsory debt in times of national emergency like war and natural calamities. In modern democracies, only voluntary debt is raised by the government as individuals and financial institutions have freedom of investment and forcing them to subscribe to government bonds would be amounting to infringement of fundamental rights.

Marketable and Non-marketable Debts:

The government securities (short-term and long-term) which can be purchased and sold at stock exchanges by investors constitute marketable debts. Those debts such as saving bonds which cannot be traded on stock exchanges are called non-marketable debts. These are non-negotiable debt instruments. They may be redeemed into cash or converted into another issue. Besides there are other forms or classification of debts such as interest-bearing and non-interest bearing debts etc.

BURDEN OF INTERNAL AND EXTERNAL DEBT.

The burden of public debt can be explained in terms of the sacrifice that the present or future generations will have to make to honor the debt. The burden may be direct or indirect, monetary or real and it may fall either on the present or future generations. The imposition of fresh taxes or increase in the rates of existing taxes in order to repay the debt measures the direct burden of public debt. Direct burden leads to loss of economic welfare. The people who pay additional taxes in order to retire debt raised in the past suffer loss of economic welfare. The indirect burden is felt in terms of effect of fresh and higher rates of taxes on production and consumption. Additional tax burden will definitely reduce aggregate demand and therefore investment, employment, output and income will fall. If the repayment is made in a period of very low inflation rate, the real interest rate would be high and hence the burden will be higher.

Burden of Internal Debt.

The **direct money burden** of internal debt on the nation is zero because the payment of principal and interest amount involves only a transfer of purchasing power from one set of people to another set of people within the country. However, there is a **real burden** on the society because the redistribution of income takes place in favor of the bond holders. The bond holders receive interest payments and the interest burden is imposed on the society as a whole. While the

affluent sections of the society buy government bonds and earn interest, the entire society pays taxes to the government, particularly indirect taxes. The interest burden is on the poor is particularly true in case of developing countries, where the share of indirect taxes in the tax revenue is higher than that of direct taxes. According to **Dalton**, internal debt is more likely to impose a direct real burden on the poorer sections of the society. Further, it is the older generations which save and earn interest and hence income is transferred from the young persons to the old persons in the society.

The government retires public debt by imposing fresh taxes or by increasing the existing rates of taxes. Additional taxation on the young population would reduce their desire to work and production will be adversely affected. According to Dalton, there would be a net loss in terms of ability to work and the ability to save would not be affected by the transfer of income.

The Burden of External Debt.

The **direct money burden** of external debt is measured by the sum of money payments in terms of interest and principal amount to external creditors. The repayment of external debt is made in foreign currency and hence countries incurring external debt must generate an export surplus to provide for repayments. In order to generate an export surplus, debtor countries will have to export more at the cost of reduced domestic consumption. Domestic consumption is reduced by imposing additional taxes on the society. Additional taxes reduce the disposable incomes of the people and demand for goods and services fall. The surplus of goods and services generated as a result of fall in disposable incomes is made available for exports to generate an export surplus. This surplus is used to repay external debt. Repayment of external debt involves transfer of real resources from the debtor country to the creditor country. Countries who fail to generate an export surplus to provide for repayments have to borrow more from external sources to make provision of interest and principal repayment. Such countries fall into an external debt trap.

The **direct real burden** is measured by the loss of economic welfare experienced on account of payment in terms of interest and principal amount by the citizens of the debtor country. According to **Dalton,** if the direct money burden is given, the direct real burden will vary according to the proportions in which various members of the community contribute to the required money payments. If these payments are made mainly by the rich, the direct real burden will be less than when these payments are made mainly by the poor.

The **indirect burden** of external debt is measured by its impact on production as a result of its adverse effect on the tax payers' ability and desire to work and save. With regard to external debt, the adverse impact is irredeemable because the negative impact is felt by the debtor country and the positive impact is felt by the creditor country.

Conclusion.

External debt is raised to finance essential imports. Countries resort to external debt due to shortage of resources i.e. when the export income is not sufficient to finance imports, the need for external debt is felt. However, if the resources raised from foreign countries are used for productive purposes, they will not only lead to rise in national income and greater economic

welfare but also enable the country to liquidate its external debt. Internal debts are raised by the government when the tax revenue is not adequate to finance the developmental requirements of the country. Here again, the debt so raised should be used for productive purposes only so that repayment is made through higher incomes earned. Thus both internal and external debt need not cause any burden on the society, if the debt is used for generating more real income.

MANAGEMENT OF PUBLIC DEBT.

Public debt management refers to measures which affect the composition of public debt. Public debt management consists of the following:

1. The size and forms of public debt.
2. Terms and conditions of sale of bonds.
3. Maturity period of debt.
4. The pattern of ownership of public debt.
5. The ratio of external to internal debt.
6. Retirement of public debt.

In the context of public debt management, **AR Prest** observes that the interest rate on public borrowings should be minimized so that the burden of debt is kept low. Further, the administrative cost should be kept as low as possible.

In developing countries, public debt management must have the following objectives:

1. Growth of government securities market.
2. Mobilization of adequate funds at minimum cost.
3. Optimizing debt maturity.
4. Promoting economic growth with price stability.

Public debt policy may be used to stabilize economic growth. During inflationary situation, the government must borrow from the public and reduce the supply of money. At the same time, the government should not borrow money from the Central Bank as that would increase the supply of money. The size and forms of public debt will be determined by the budgetary decisions taken by the government. A deficit budget will always increase the public debt. When the fiscal deficit as a percentage of GDP increases, public debt also increases. Public debt is therefore directly proportional to the debt GDP ratio.

Public debt management is concerned with the distribution of old and new debt under different maturity periods. When the government increases long term debt and decreases short term debt, the holdings of the liquid assets base of the commercial banks are reduced and vice-versa. The level and structure of interest rates can be changed by changing the composition of public debt.

Public debt has a crowding out effect on the private sector. To the extent that the public debt is raised, investible resources are not made available to the private sector thereby raising the cost of borrowing to the private sector.

The government needs to decide on the types of securities to be sold to the public for raising funds. It also needs to decide on the types of securities for retiring public debt, the timing of public borrowing program, refunding of public debt on maturity and the rate of interest to be given to the public. The maturity period and the rate of interest are the two important decisions to be taken by the government.

The economic impact of public debt depends on the types of securities and the ownership of public debt. Government securities may be short term or long term. Government securities are owned or held by the Central bank, commercial banks and the public. The amount of government securities held by the public reduces the spending power of the public. Government securities held by the commercial banks will reduce their ability to lend. When the government borrows money from the Central bank, the monetary base increases thereby increasing the supply of money. Under inflationary conditions borrowings from the Central bank must be avoided and the government should raise long term debt and vice versa.

Public debt management must lead to price stability and economic growth. In order to achieve price stability and economic growth, public debt management must be integrated with monetary policy. Expansion in public debt will reduce the effectiveness of the monetary policy and will have a destabilizing effect on the national economy. Retirement or redemption of public debt may assume several forms. The methods used to retire public debt are: refunding, conversion, surplus budgets, sinking fund, terminable annuities, additional taxation, capital levy and surplus in the balance of payments. The government may refund public debt by issuing new bonds and securities. The government may replace short term securities by long term securities and thus postpone the redemption of public debt. In case of conversion, the government may convert old loans into new loans and offer a lower rate of interest on new loans. In this way, the interest burden of public is reduced. Surplus budgets may be used to retire public debt and thereby reducing the debt-GDP ratio. A sinking fund is created by the government by setting aside a part of current public revenue to pay off the funded debt at the time of maturity. The government may issue terminable annuities to the bond holders which mature annually. They help to reduce public debt in installments. The debt burden is reduced annually and is fully redeemed on maturity. The government may also resort to additional taxation to pay of public debt. Capital levy is a tax on wealth. Surpluses on the balance of payment account may be used to retire external debt.

METHODS OF PUBLIC DEBT MANAGEMENT.

In order to achieve the objectives of public debt management, the following methods or techniques are used:

1. **Reducing the Interest Cost.** During a recession, the government should exchange its maturing securities with new long term securities carrying low interest rates. Conversely, during expansion, the government should exchange its maturing securities with short term securities which carry low interest rates.

2. **Changing the Maturity Structure.** Maturity structure of government debt can be done by swap operations by the Central bank. During expansion, the Central bank may sell long term government securities in the open market and purchase an equal amount of short term government securities with the same amount of money. The rise in the long term interest rate would curb private spending by reducing the availability of credit. The value of outstanding assets of financial institutions gets reduced with the increase in interest rate. Reduction in the availability of credit and holding of more short term securities will have a tendency to control a boom. During recession, the Central Bank will sell short term government securities and purchase long term government securities. This will reduce the long term interest rate and bring about a small fall in the short term interest rate. Fall in interest rate would increase investment expenditure. Debt management therefore requires manipulation of the term structure of the debt to establish economic stability.

3. **Advance Refunding.** The Central bank may offer the holders of long term government security a much longer term security and thereby restructure the debt without actually refunding the debt.

4. **Coordination with Monetary and Fiscal Policies.** The Central bank should be ready to buy or sell securities in the open market in order to change interest rates and bring about economic stability thereby minimizing the interest cost on government debt. At the same time, the government should a surplus budget during a boom and a deficit budget during a recession. When the Government securities mature, the Central bank is required to refund them. If the government decides to present a surplus budget in order to retire public debt, it will have a deflationary impact on the economy and the Central bank will have to pursue to an expansionary monetary policy. Conversely, if the government decides to present a deficit budget i.e. raising new debt to retire old debt, it will have an inflationary impact on the economy and the Central bank will have to pursue an anti-inflationary monetary policy. In order to manage public debt, there should be a close coordination between fiscal and monetary policies of the government and the central bank respectively.

Questions.

1. **Explain the meaning and classification of public debt.**
2. **Explain the burden of internal and external debt.**
3. **Write a note on management of public debt.**
4. **Explain the methods of managing public debt.**

Module II – PUBLIC FINANCE.

CHAPTER – 05

CONCEPTS OF FISCAL DEFICIT & FISCAL FEDARALISM.

PREVIEW.

- **Concept of Fiscal Deficit.**
- **Fiscal Imbalance and FRBM Act 2003.**
- **Fiscal Federalism – Concept and Key Issues.**

CONCEPTS OF FISCAL DEFICIT.

The basic fiscal concepts such as the budget deficit, revenue deficit, fiscal deficit, primary deficit and monetized deficit are explained based on the budget data of the Central Government of India for various years in Table 5.1.

Budget Deficit. Budget deficit is the differences between total expenditure and total receipts of the central government. Both receipts and expenditures are divided into categories i.e., revenue receipts and capital receipts and correspondingly we have revenue expenditure and capital expenditure. The budget deficit in the year 1990-91 was Rs.11,347 crore. From 1997-98 onwards, the government began to show nil budget deficit. This was done by cleaning up the revenue deficit entirely with a matching surplus on the capital account. The difference between capital receipts and capital expenditure (4-5) has been equal to the revenue deficit from 1997-98 onwards. The government has discontinued showing budgetary deficit in their income and expenditure accounts and hence budgetary deficit does not appear in the aforesaid table.

Revenue Deficit. Revenue deficit is the difference between revenue receipts and revenue expenditure of the government. It indicates the excess of revenue expenditure over revenue receipts or dis-savings by the government. It shows an increase in the liabilities of the Central Government without corresponding increase in its assets. In 1990-91, the revenue deficit was Rs.18, 562 crore. In 2001-02, the revenue deficit rose to Rs.100, 162 crore. According to budget estimates for the year 2011-12, the revenue deficit is estimated to be Rs.3,07,270 crore. The government has been using capital account receipts to clean up the revenue deficit i.e. capital receipts are being used by the government to finance revenue expenditure. The revenue deficit as a percentage of GDP had declined from 3.3 per cent in 1990-91 to 1.0 per cent in 2008-09. However, 2009-10, the revenue deficit went up to 5.2 per cent of the GDP. This was on account of the fiscal stimulus package that was announced in the wake of the Global Financial Crisis of 2008-09. According to the revised estimates for the year 2013-14, the revenue deficit was 3.3 % and for the year 2014-15, the budget estimate of revenue deficit was 2.9 %. **According to the golden rule of public finance, all borrowings by the government must be used for public investment.** Unfortunately, in India's case, a great part of the capital receipts have been used to

finance revenue or current expenditure. The burden of fiscal correction has fallen on capital account whereas it should have fallen on the revenue account.

Fiscal Deficit. The fiscal deficit is obtained by subtracting total receipts (excluding government borrowings) from the total expenditure. The fiscal deficit was Rs.37, 606 crore in 1990-91. In the year 2001-02, the fiscal deficit rose to Rs.140, 955 crore and since then there has not been much of an absolute growth in the fiscal deficit. The fiscal deficit as a percentage of GDP had declined from 6.6 per cent in 1990-91 to 2.6 % in 2007-08 and it increased to 7.8 per cent (revised estimates) in 2008-09. However, the decline in fiscal deficit has been achieved by increasingly drawing upon the capital account which is an indicator of poor fiscal management. In 2010-11, the fiscal deficit came down to 4.8% of GDP. The revised estimate of fiscal deficit for the year 2013-14 was 4.6% of GDP and the budget estimates for the year 2014-15 is 4.1 per cent.

Primary Deficit. The primary deficit is obtained by deducting interest payments from the fiscal deficit. It is therefore also known as non-interest deficit. Primary deficit is also calculated by deducting net interest payments (interest payments – interest receipts) from the fiscal deficit. The net primary deficit is considered as a relevant measure to determine the stability of debt to GDP ratio. The net fiscal deficit is obtained by excluding governments net lending (loans and advances of government less recoveries of loans) from the fiscal deficit. The primary deficit in the year 1990-91 was Rs.16, 108 crore and for 2009-10 it is estimated to be Rs.1,75,485 crore. It only indicates that interest payments have increased over the years. As a percentage of GDP, primary deficit declined from 2.8% in 1990-91 to 2.6 % in 2008-09. However, in 2009-10, it went up once again to 3.2%. The primary deficit for 2013-14 was 1.3 % and the budget estimate for the year 2014-15 was 0.8 per cent of GDP.

Monetized Deficit. Monetized deficit is the increase in net RBI credit to the Central government. It constitutes the net increase in the holdings of treasury bills of the RBI and its contribution to the market borrowings of the government. It indicates the amount of fiscal deficit that is monetized or release of additional money supply into the economy. However, the practice of monetization of government's deficits was discontinued from 01st April, 1997 and was replaced by a new scheme called Ways and Means Advances (WMA). The WMA is a mechanism to fill the temporary gap between the government's receipts and expenditure. The government of India is obliged to clear the WMA by the end of every financial year. According to the agreement between the RBI and the Central government on 26th March, 1997, the limit or the ceiling on WMA was kept at Rs.12,000 crore for the first half (April to September) and Rs.8,000 crore for the second half (October to March) of the year 1997-98. The government has also been given an

Table 5.1
Receipts and Expenditures of the Central Government of India.

(in Rs. Crore)

		1990-91	2010-11	2011-12	2012-13	2013-14 RE	2014-15 BE
01.	**Rev Receipts of which:**	**54,954**	7,88,471	7,51,437	877613	1029251	1189763
	a) Tax revenue (Net of States share)	42,978	569869	629765	740256	836025	977258
	b) Non-tax revenue	11,976	2,18,602	1,21,672	137357	193226	212505
2.	**Revenue expenditure Of which:**	**73,516**	10,40,723	11,45,786	12,43,509	1399539	1568112
	a) Interest Payments.	21,498	2,34,022	2,73,150	3,13,169	380066	427011
	b) Major subsidies.	9,581	1,64,516	2,11,319	2,47,493	245451	251397
	c) Defense Expenditure.	10,874	92,061	1,03,011	1,11,277	124800	134412
3.	**Revenue Deficit (2 – 1)**	**18,562**	**2,52,252**	**3,94,349**	**3,65,896**	**370288**	**378349**
4.	**Capital Receipts (a + b + c)**	**31,971**	4,08,857	5,52,928	5,32,754	561183	605129
	a) Recovery of loans.	5,7120	12,420	18,850	16,268	10803	10527
	b) Other receipts (mainly from PSU disinvestments)		22,846	18,088	25,890	25841	63425
	c) Borrowings and other liabilities.	26,259	3,73,591	5,15,990	4,90,596	524539	531177
5.	**Capital expenditure**	**24,756**	**1,56,605**	**1,58,579**	**1,66,858**	**229129**	**226780**
6.	**Total expenditure [2 + 5 = 6(a) + 6 (b)]**	**98,272**	11,97,328	13,04,365	14,10,367	1590434	1794892
	a) Plan expenditure.	28,365	3,79,029	4,12,375	4,13,625	475532	575000
	b) Non-plan Expendt.	69,907	8,18,299	8,91,990	9,96,742	1114902	1219892
7.	**Fiscal Deficit [6 – 1 – 4(a) – 4(b)]**	**37,606**	**3,73,591**	**5,15,990**	**4,90,596**	**524539**	**531177**
8	**Primary deficit [7 – 2(a)**	**16,108**	**1,39,569**	**2,42,840**	**1,77,427**	**144473**	**104166**

overdraft facility for the first two financial years 1997-98 and 1998-99. However, the overdraft was to be vacated or cleared within a year. But after March 1997, no overdraft facility was to be permitted for more than 10 consecutive working days. The WMA and overdraft facility comes at an interest rate less than 3 percentage points of the market rate and two percentage points above the WMA rate respectively. However, RBI is expected to support the government market borrowing programs by subscribing to the government securities. For the year 1997-98, a provision of Rs.16, 000 crore was made. The immediate effect of this provision will be similar to the monetization of the government deficit. However, the RBI can neutralize the monetization effect by selling these securities through open market operations. The agreement also envisaged fixing up of yearly monetized deficits. As a result of WMA, the RBI will be more effective in pursuing its monetary policy and will have a greater control on money supply.

THE FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT BILL.

The Committee on Fiscal Responsibility and Budget Management was set up by the Government of India on 17th January, 2000 to recommend draft legislation on Fiscal Responsibility to the Government. In the same year, the Government introduced the Fiscal Responsibility and Budget Management (FRBM) Bill in Lok Sabha in December 2000. In the Budget of 2000-01, the Central Government announced that it would create a strong institutional mechanism in the form of Fiscal Responsibility Act to establish fiscal discipline at the Central government level. The FRBM Bill aimed at the following to establish fiscal discipline:

1. **Revenue Deficit.** Revenue deficit will be reduced by 0.5 percent or more of the GDP every year beginning from 01st April, 2001. The revenue deficit will be neutralized within a period of five years i.e. by 31st March, 2006. Thereafter, the Central government will generate surplus revenue to reduce liabilities in excess of assets.

2. **Fiscal Deficit.** The Gross Fiscal Deficit will be reduced by 0.5 or more of the GDP every year beginning from 01st April, 2001 and within a period of five years i.e., by 31st March, 2006, the fiscal deficit will be reduced to less than 2 per cent of the GDP.

3. **Public Debt.** Within a period of 10 years beginning from 01st April, 2001and ending with 31st march, 2011, the total liabilities of the Central government will not exceed 50 per cent of the GDP.

4. **Borrowing from the RBI.** The Central government will not normally borrow from the RBI. However, it may borrow by way of advances to meet temporary deficits in accordance with the agreement which may be entered into by the government with the RBI.

THE FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT, 2003.

The FRBM Act, 2003 came into effect on 05th July, 2003. **Accordingly, the Central Government is required to eliminate revenue deficit by March 2009 and to reduce fiscal deficit to 3 per cent of the GDP by March 2008.** The FRBM rules were to be framed under the Act to determine annual target for fiscal correction. The Government notified the rules under the FRBM Act on 02nd July, 2004 which came into force on 05th July, 2004.

The following FRBM rules were notified by the Central government. These rules were made effective from 05th July, 2004.

1. Reduction of revenue deficit by 0.5 per cent or more of the GDP every year beginning from 2004-05.

2. Reduction of fiscal deficit by 0.3 per cent or more of the GDP every year beginning from 2004-05.

3. The Central government liabilities will not exceed 9 per cent of the GDP from the financial year 2004-05 and this will be progressively reduced by one percentage point every year.

4. Four fiscal indicators to be projected in the medium term fiscal policy statement.

5. In order to ensure greater transparency in the budgetary process, the Central government is required to disclose changes, if any, in accounting standards, policies and practices that have a bearing on the fiscal indicators. The government is also required to submit statements of receivables and guarantees and a Statement of Assets at the time of presenting the annual financial statement latest by Budget 2006-07.

6. The rules prescribe the form for the quarterly review of the trends of receipts and expenditures. The rules mandate the Central government to take appropriate corrective actions in case of revenue and fiscal deficit exceeding 45 per cent of the Budget estimates or total non-debt receipts falling short of 40 per cent o the budget estimates at end of first half of the financial year.

The Central government appointed a Task Force under the chairmanship of Mr. Vijay Kelkar. According to the recommendations of the Task Force, the tax-GDP ratio of the Central government was to be raised from 9.2 per cent in 2003-04 to 13.2 per cent of GDP in 2008-09.

Fiscal Imbalance and the FRBM Act.

The FRBM Act is a commitment by the Central Government to ensure fiscal discipline. The impact of the Act on fiscal discipline can be seen in the following improvements achieved in the revenue and fiscal deficit targets:

1. Both the revenue and fiscal deficit figures have been brought down to 2.1 per cent and 3.8 per cent of the GDP in the year 2006-07 from 2.5 and 4 per cent respectively in the year 2004-05. This shows a marked improvement in fiscal consolidation as compared to the pre-FRBM period. However, in the years 2008-09 and 2009-10, both the revenue and fiscal deficits have gone up with the fiscal deficit being 7.8% and 6.9% in these years. The budget for 2010-11 announced going back to fiscal consolidation and the projected fiscal deficit for 2010-11, 2011-12 and 2012-13 is 5.5 %, 4.8% and 4.1 % respectively. However, the actual figures for these years show that the government had very little regard to their projections. The fiscal deficit for the years 2013-14 and 2014-15 were 4.6 (RE) and 4.1 (BE) respectively.

2. The FRBM Act mandated a reduction in revenue deficit together with the reduction in fiscal deficit. As a result, the proportion of revenue deficit to fiscal deficit declined by 22.7 percentage points in three years (See Table 5.2). In the year 2003-04, the revenue deficit as a percent of fiscal deficit was 79.7 per cent. **Thus the proportion of borrowed funds applied to assets creation increased from 21.3 per cent to 43 per cent in 2006-07.** In 2005-06, the fiscal targets were not according to the mandate as both the revenue and fiscal deficit were up by 0.2 and 0.1 percentage points in comparison to the previous year. In 2008-09 and 2009-10, the revenue and fiscal deficit had gone up due to fiscal intervention made by the Government of India in the wake of the Global Financial Crisis. Even thereafter, the government has not been able to meet the FRBM target in terms of fiscal deficit.

The fiscal consolidation effort of the Central and State governments are criticized on the following grounds:

1. Creating capital surpluses year after year by compromising on development expenditure on social and economic infrastructure would reduce equity and economic growth.

2. The FRBM Act is based on the following assumptions which are essentially wrong:
   a) Lower fiscal deficits lead to higher and more sustained growth.
   b) Larger fiscal deficits lead to higher inflation.
   c) Larger fiscal deficits increase external vulnerability of the economy.

CP Chandrashekhar and Jayati Ghosh reject these assumptions. Firstly, if the fiscal deficits are used to finance productive capital expenditure, it will not only lead to higher economic growth but also stimulate private investment. Secondly, inflation is caused by an excess of aggregate demand over supply and such excess may originate from both the public and private sectors. Hence fiscal deficit alone cannot be blamed for inflation. In India, the inflation rate had fallen in the late 1990s in spite of a fiscal deficit of more than 5 per cent of the GDP. Thirdly, external vulnerability depends more on capital and trade account convertibility and the perception of

international finance. Therefore capital flight may take place even when the fiscal deficit is low. Huge foreign exchange reserves have been accumulated in spite of large fiscal deficits.

Table 5.2: Trends in Deficits of Central Government.

Year	Revenue Deficit	Primary Deficit	Fiscal Deficit	Revenue Deficit As per cent of Fiscal Deficit
	(As per cent of GDP)			
1990-91	3.3	2.8	6.6	49.4
1991-92	2.5	0.7	4.7	52.7
1992-93	2.5	0.6	4.8	51.7
1993-94	3.8	2.2	6.4	59.2
1994-95	3.1	0.4	4.7	64.6
1995-96	2.5	0.0	4.2	59.2
1996-97	2.4	-0.2	4.1	58.2
1997-98	3.1	0.5	4.8	63.5
1998-99	3.8	0.7	5.1	74.8
1999-2000	3.5	0.7	5.4	64.6
2000-01	4.1	0.9	5.7	71.7
2001-02	4.4	1.5	6.2	71.1
2002-03	4.4	1.1	5.9	74.4
Enactment of FRBM Act				
2003-04	3.6	0.0	4.5	79.7
2004-05	2.5	-0.1	4.0	62.6
2005-06	2.7	0.4	4.1	64.7
2006-07	1.9	-0.2	3.3	57.6
2007-08	1.1	-0.9	2.5	41.4
2008-09	4.5	2.6	6.0	75.2
2009-10	5.2	3.2	6.5	66.6
2010-11	3.2	1.8	4.8	67.5
2011-12	4.4	2.7	5.7	77.2
2012-13	3.6	1.8	4.9	73.4
2013-14 RE	3.3	1.3	4.6	71.7
2014-15 BE	2.9	0.8	4.1	70.7
Source: IES 2014-15 and other issues.				

CONCEPT OF FISCAL FEDERALISM.

The Constitution of India is Unitary in spirit and Federal in character. The Indian political system is therefore federal in nature but all the powers are vested in the Central Government which gives a unitary spirit to the system. However, powers are distributed amongst the Central Government and the State Governments. The subjects that belong to the Central Government are found in the Central List and that of the State Governments are found in the State List. There is a third group of subjects known as Concurrent List which can either be taken over by the Central or the State Governments but not without the discretionary consent of the Central government. In order to look after the subjects provided for in these lists, financial powers of the State of

India needs to be distributed amongst the Central and State Governments. Fiscal federalism refers to the distribution of financial powers and the distribution of resources between the Central and State governments. While deciding the federal financial system, the following points needs to be considered:

1. Revenue sources assigned to the Centre and the States and their adequacy to meet the functional requirements of both Central and State governments.
2. Both the Centre and State governments should have independent financial authority to generate revenue, to borrow and to incur expenditure.

The two important concepts in Federal Finance are that of division of resources and transfer of resources.

Division of Resources.

Taxes which have an effect upon the economic life of the country are levied by the Central Government and taxes that have no effect in States other than the ones from which they are collected are levied by the States. However, the resources available to the Central Government outnumber that of the States and State Governments are found to be in deficit, a mechanism of transfer of resources from the Centre to the States is provided in the Constitution of India. Further, Article 275 of the Indian Constitution provides for Grants-in-aid to the States in need of assistance. Article 282 provides for grants by the Central government to the States for any public purpose. Article 275 provides for fixation of grants-in-aid on the advice of the Finance Commission and under Article 282, the Central Government can independently fix grants to the State Governments.

The State governments borrow from the Centre to carry out their functions. The transfer of resources from the Centre to the State governments are divided under three heads, namely: 1) share in taxes and duties, 2) grants, and 3) loans.

Transfer of Resources.

The share of resources transferred by the Central Government to the State governments in the total expenditure of the State governments has been in the range of 35 to 45 per cent. The largest transfer of resources from the Centre to the States takes place from taxes and duties, followed by loans and grants.

KEY ISSUES IN FISCAL FEDERALISM.

In the context of Federal Finance in India, the following issues needs to be considered:

1. **State Autonomy.** The Indian Constitution is federal in character and unitary in spirit. The Constitution of India therefore ascribes greater strength to the Central Government than to the State governments. The political history of free India also contributed to the strengthening of the Center vis-à-vis the States. The Constitution of India has vested all residuary powers in the Center and kept forty seven items in the concurrent list. This has

made the Central Government all powerful and States being dependent on the largesse provided by the Center. On account of one party rule at the Center for the greater part of the political history of India in the post-independence period have made the States dependent on the Center. Many State governments in India have asked for financial autonomy. The demand for financial autonomy of the States needs to be looked at for bringing about balanced regional development in India.

2. **Miss-match Between Requirements and Resources of State Governments.** The Constitution of India makes provision for division of financial powers between the Center and the States. However, the capacity to raise revenue depends upon the nature of revenue sources assigned to the States. Land revenue is a limited source in any country and India is therefore not an exception. Agricultural income is tax free. Excise duties on liquor, motor vehicles, entertainment etc are relatively less elastic than the taxes assigned to the Center. The tax base of Central taxes has widened considerably over the last six decades and hence the revenue receipts of the Central Government have increased manifold. The demand on the States' resources is increasing rapidly on account of the increasing focus on development. However, the revenue receipts of the States have not increased in tandem with the increased expenditure requirements on development. As a result, vertical imbalances have increased and the dependence of the State Governments on the Center has also increased.

3. **Primacy of the Planning Commission over the Finance Commission.** Transfers through the finance commission contribute only about one third of total transfers from the Center to the States i.e. about two-thirds of the transfers are made through the Planning Commission or the Central Government. The Center provides a large amount of resources in the form of discretionary grants to the States. As a result, the Central Government is able to influence the decision making process of the State Governments. Hence, there is not only less financial autonomy but also less political autonomy for the State governments.

4. **The Problem of Regional Imbalance.** The process of resource transfers through the Planning Commission and the Finance Commission has failed in correcting the horizontal imbalance among the State Governments and inequalities in their per capita incomes. Seventy percent of the Plan assistance is provided in the form of loans and the balance 30 per cent is given in the form of grants. The ratio is fixed and does not discriminate between forward and backward States. As a result, regional imbalance has only worsened with the passage of time.

THE 13TH FINANCE COMMISSION (2010-2015).

The Finance Commission of India was set up in 1951. It was established under Article 280 of the Indian Constitution by the President of India. The Commission was formed to define the financial relations between the Centre and the States. According to the Constitution, the commission is appointed every five years and consists of a chairman and four other members. Over the last six decades and more, the Indian economy has undergone massive changes. The

economy has moved away from the socialistic pattern set up by Prime Minister Nehru to a free market open economy under Prime Minister Narasimha Rao and his successors. This has led to major changes in the Finance Commission's recommendations over the years. Thus far, Thirteen Finance Commissions have submitted their reports.

The Indian State, like all other federations, is also ridden by the problems of Vertical and Horizontal Imbalances. Vertical Imbalances result because States are assigned responsibilities and in the process of fulfilling those, they incur expenditures disproportionate to their sources of revenue. This is because the States are able to assess the needs and concerns of their people more effectively, and hence, are more efficient in addressing them. Factors like historical backgrounds, differences in resource endowments etc. lead to widening Horizontal Imbalances. The Constitution of India, in recognition of these two problems, has made several provisions to bridge the gap of finances between the Centre and the States. These include various articles in the Constitution like Article 268, which facilitates levy of duties by the Centre but equips the States to collect and retain the same. Similarly, there are Articles 269, 270, 275, 282 and 293 all of which specify ways and means of sharing resources between Union and States. Apart from the above- mentioned provisions, the Indian Constitution provides an institutional framework to facilitate Centre- State Transfers. This body is the Finance Commission, which came into existence in 1951, under Article 280 of the Indian Constitution, which states:

1. The President will constitute a Finance Commission within two years from the commencement of the Constitution and thereafter and at the end of every fifth year or earlier, as deemed necessary by him/her, which shall include a Chairman and four other members.

2. Parliament may by law determine the requisite qualifications for appointment as members of the Commission and the procedure of selection.

3. The Commission is constituted to make recommendations to the President about the distribution of the net proceeds of taxes between the Union and States and also the allocation of the same amongst the States themselves. It is also under the ambit of the Finance Commission to define the financial relations between the Union and the States. They also deal with devolution of non-plan revenue resources.

Functions of the Finance Commission are as follows:

1. Distribution of net proceeds of taxes between Centre and the States, to be divided as per their respective contributions to the taxes.

2. Determine factors governing Grants-in Aid to the states and the magnitude of the same.

3. Work with the State Finance Commissions and suggest measures to augment the Consolidated Fund of the States so as to provide additional resources to Panchayats and Municipalities in the state.

MAJOR RECOMMENDATIONS OF THE 13TH FINANCE COMMISSION AND THE ROLE OF FISCAL POLICY.

1. The share of states in the net proceeds of the shareable Central taxes should be 32%. This is 1.5% higher than the recommendation of 12th Finance Commission.

2. Revenue deficit of the Center to be progressively reduced and eliminated, followed by revenue surplus by 2013-14.

3. Fiscal deficit to be reduced to 3% of the GDP by 2014-15.

4. A target of 68% of GDP for the combined debt of centre and states to be achieved by 2014-15. The fiscal consolidation path embodies steady reduction in the augmented debt stock of the Center to 45 per cent of GDP and that of the States to less than 25 per cent of the GDP by 2014-15.

5. The Medium Term Fiscal Plan (MTFP) should be reformed and made the statement of commitment rather than a statement of intent. Tighter integration is required between the multi-year framework provided by MTFP and the annual budget exercise.

6. Transfer of disinvestment receipts to the public account to be discontinued and all disinvestment receipts should be maintained in the consolidated fund.

7. Government should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee.

8. FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.

9. In case of macroeconomic shocks, instead of relaxing the States' borrowing limits and letting them borrow more, the Center should borrow and devolve the resources using the Finance Commission tax devolution formula for inter se distribution between States.

10. Structural shocks such as arrears arising out of Pay Commission awards should be avoided by, in the case of arrears, making the pay award commence from the date on which it is accepted.

11. An independent review mechanism should be set up by the Center to evaluate its fiscal reform process. The independent review mechanism should evolve into a fiscal council with legislative backing over time.

12. Given the exceptional circumstances of 2008-09 and 2009-10, the fiscal consolidation process of the States was disrupted. It is expected that States would be able to get back to their fiscal correction path by 2011-12, allowing for a year of adjustment in 2010-11.

13. States should amend or enact FRBM Acts to build in the fiscal reform path worked out. State specific grants recommended for a State should be released upon compliance.

14. Independent review/monitoring mechanism under the FRBM Acts should be set up by States.

15. Loans from Government of India to States and administered by ministries/department other than Ministry of Finance, outstanding as at the end of 2009-10 to be written off, subject to conditions prescribed.

16. Both Centre and States should conclude 'Grand Bargain' to implement the model Goods and Services Act (GST). To incentivize the States, the commission recommended a sanction of the grant of Rs 50, 000 crore.

17. Initiatives to reduce the number of Central Sponsored Schemes (CSS) and to restore the predominance of formula based plan grants.

18. States need to address the problem of losses in the power sector in time bound manner.

The 13th Finance Commission has recommended fiscal consolidation through the elimination of revenue deficit and reduction of fiscal deficit to three per cent of GDP by 2013-14 with a limitation on the combined Debt-GDP ratio of 68 percent. Fiscal policy of both the Center and the States will have to gear up to meet the recommendations of the 13th Finance Commission. It means fiscal consolidation or reduced non-developmental expenditure in the years to come.

Questions.

1. **Explain the concepts of fiscal deficit.**
2. **Critically examine the FRBM Act.**
3. **Explain the concept of Federal Finance and the key issues involved in federal finance.**
4. **Write a note on the 13th Finance Commission and its major recommendations.**

CHAPTER: 06

MONEY MARKET

PREVIEW.

- **Money Market.**
- **Components of Indian money market.**
- **Features and Defects of Indian Money market.**
- **Money Market reforms in India.**

MONEY MARKET.

Money market is a short term credit market for short term funds. Money market deals in financial securities whose period of maturity is in the range of one day to one year. Money market financial securities or assets are near substitutes of money. In the money market, the commercial banks are the major lenders of money. The central bank is the controlling authority of the money market.

COMPONENTS OF INDIAN MONEY MARKET.

The Indian money market is divided into two parts, namely; the organized and the unorganized money markets. Interest rates are different in both the markets and there is no relationship whatsoever between the two markets. The unorganized sector consists of indigenous bankers, money lenders and unregulated non-bank financial intermediaries such as finance companies, chit funds and nidhis. Farmers, artisans and other small time producers and traders borrow money from the unorganized money market. The interest rate charged is highly exploitative and therefore entrapping the borrowers into a debt trap. The organized money market is the formal market for money regulated by the central bank with commercial banks being the main players. Foreign banks, co-operative banks, Discount and Finance House of India, finance companies, provident funds, Securities Trading Corporation of India, Public Sector Undertakings and mutual funds are the other institutions which operate in the formal Indian money market. The Reserve Bank of India is the monetary authority controlling the formal money market.

The formal Indian money market is well organized and integrated. Mumbai, Kolkata, Delhi, Chennai, Ahmedabad and Bangalore are the main centers of the organized sector. Out of these, the Mumbai money market is the largest.

The Organized Sector of the Indian Money Market. The components of the organized Indian Money Market are as follows:

1. The Call Money Market.
2. The Treasury Bill Market.
3. The Repo Market.
4. The Commercial Bill Market.
5. The Certificate of Deposit Market.
6. The Commercial Paper Market.
7. Money Market Mutual Funds.

These components are briefly explained below.

1. **The Call/Notice Money Market.** In India, the Call Money Market is located mainly in Mumbai, Kolkata and Chennai. The Mumbai Money Market is the main market in the country. In this market, borrowing and lending transactions are carried out for one day. These loans are called **Call** Loans. They may not be renewed on the following day. It is also known as the **Inter-bank Call Money Market.** If the period is more than one day, it is called '**Notice Money**'. If money is lent for more than 14 days, it is called **'term money'**. Sundays and holidays are excluded from the duration of borrowing. The transactions do not involve deposit of any collateral security due to their short term nature. Scheduled commercial banks, co-operative banks and DFHI operate in it. The Unit Trust of India, the Life Insurance Corporation of India, the General Insurance Corporation of India, the Industrial Development Bank of India and the National Bank of Agriculture and Rural Development also operate in the Indian money market as lenders. The State Bank of India being the largest commercial bank in the country also operates on the lenders side. Brokers bring borrowing and lending banks together. In the banking system, there are no permanent borrowers and permanent lenders. The cash position of banks keeps on changing by the hour. The Call Money Market is a mechanism whereby temporary surplus of some banks is made available to others who have a temporary deficit. It is a very sensitive market and hence reflects the liquidity condition of the money market. The Reserve Bank of India monitors the call money market to make day to day adjustment in its monetary policy. The average call rates were 7.06 per cent in 2008-09, 3.24 % in 2009-10, 5.75 % in 2010-11 and 9.04 % in 2011-12. The call rate was between **6.0 and 7.75 % on 11th April 2015**. Depending upon the demand and supply of short term funds, the call rates fluctuate on a given day in the money market.

2. **The Treasury Bill Market.** In India, treasury bills have maturity periods ranging from 14 days to 364 days. They are short term liabilities of the central government. The different maturity periods are 14 days, 91 days, 182 days and 364 days. Out of these, the auction of 14 days and 182 days treasury bills was discontinued from May 2001. Treasury bills are issued for meeting temporary deficits which a government faces due to its excess of expenditure over revenue. Treasury bills are issued at a minimum amount of Rs.25000 and in multiples of Rs. 25000. They are issued at a discount to face value and are redeemed at par. Unfortunately, in India treasury bills had become a permanent source of funds for the central government. Every year the central government had been issuing more new bills and every year a part of the treasury bills held by the RBI was converted into long term bonds. From 01st April, 1997 ad-hoc treasury bills have been replaced by ways and means advances for financing the central government's temporary deficits. The Treasury bill market in India is in a state of underdevelopment. The RBI is a captive holder of the bills issued by the Central government. The RBI rediscounts treasury bills presented by other banks. This has resulted in monetization of public debt and has become a cause of expansion of money supply and price rise. Commercial banks, State governments and semi-government bodies also hold treasury bills but in small quantities. Non-bank Financial Intermediaries like the LIC and UTI and private firms do not hold treasury bills. During 2014-15, the total amount of money raised through 91, 182 and 364 days treasury bills was Rs.555.4 Billion, Rs.180.02 Billion and Rs.250.02 billion respectively (up to February 2015).

3. **The Repo Market.** Repo rate is the rate at which RBI lends to the commercial banks and reverse repo rate is the rate at which commercial banks lend to the RBI. The repo injects liquidity into the money market whereas the reverse repo absorbs excess liquidity from the money market. Repo is a repurchase agreement in which the seller sells a security under an agreement to repurchase at a pre-determined date and rate. It is a money market instrument which enables short term borrowing and lending through sale and purchase operations. The Repo was introduced in the year 1992. Under a reverse repo transaction, securities are purchased with a simultaneous agreement to resell at a pre-determined rate and date. The Reverse Repo was introduced in the year 1994 by the RBI. In the beginning, repos were permitted in the Central government treasury bills and dated securities created by converting some of the treasury bills. In order to make the repo market a balancing force between the money market and the government securities market, the RBI allowed repo transactions in all government securities and treasury bills of all maturities. Finally, State government securities, public undertakings' bonds and private corporate securities have been made eligible for repos to broaden the repo market. According to the Report on Currency and Finance 1999-2000, repos help to manage liquidity conditions. They are used to provide banks an opportunity to invest funds generated by capital inflows. During times of foreign exchange volatility, repos have been used to prevent speculative activity as the funds tend to flow from the money market to the foreign exchange market. On 11th April 2015, the repo rate was7.5 per cent and the reverse repo rate was 6.5 per cent. The reverse repo rate is always one per cent lesser than the repo rate.

4. **The Commercial Bill Market.** The commercial bill market is the market for short term bills of three months duration. It provides short term finance to trade and industry. The commercial bills are used to finance the transactions of goods taking place between different companies. When goods are sold on credit, companies which receive the goods become liable to make payment on a specific date in future. The companies who sell the goods can wait till the specified date or can make use of commercial bill of exchange. The seller of the goods draws the bill and the buyer accepts it. Once the bill is accepted, it becomes a marketable instrument. The drawer or the seller of goods can approach a commercial bank and get the bill discounted. The discount rate is the rate of interest charged by the bank for discounting the bill and paying the drawer the balance amount of the bill. The commercial banks in turn can rediscount these commercial bills with the Reserve Bank of India. The commercial bills are self liquidating in character and they have a fixed term to maturity called *usance* during which the drawee is likely to recover the cost of goods from the sale enabling him to make payments. The commercial bill market is the sub-market in which the commercial bills are transacted. In India, the commercial bill market is underdeveloped. The reasons being: i) popularity of cash credit system in bank lending and ii) the absence of will of the buyer to follow the discipline with regard to payment. The other factors being lack of uniformity in drawing bills, high stamp duty on usance bills, the practice of sales on credit without specified time limit and absence of a secondary market for commercial bills. The RBI has tried to develop the bill market in India. The two schemes initiated by RBI were not very successful. The bill market scheme of 1952 was not properly designed and hence was

not successful. The RBI introduced a new bill market scheme in 1970. The important features of this scheme are: (i) the bills covered under the scheme are genuine trade bills and (ii) the scheme provides for their rediscounting. However, the bill market had failed to take off in India. In order to promote the market, the RBI advised banks in 1997 that at least 25 per cent of inland credit purchases of borrowers should be through bills. However, the outstanding amount of commercial bills rediscounted by the commercial banks with different financial institutions have been below rupees one thousand crore.

5. **The Certificate of Deposit Market.** The certificate of deposit is a short term money market instrument introduced in the year 1989. Certificate of Deposits are issued by banks against the deposits kept by individuals, companies and institutions. Certificate of Deposits are issued at a discounted rate and the discount rate is market determined. They are freely transferable by endorsement and delivery. CDs are a marketable and negotiable instrument. The CDs were issued by scheduled commercial banks in multiplies of Rs.25 lakh (now Rs. 10 Lac) subject to the minimum size of an issue being rupees one crore and the maturity ranged between 3 months and one year. CDs were permitted to be issued by the term lending financial institutions like IDBI, ICICI and IFCI in 1991-92 for a maturity period of more than one year and up to three years. In 1993, SIDBI and EXIM bank of India were permitted to issue CDs. Banks pay a high interest rate on CDs and CD holders prefer to hold them till maturity and hence secondary activity in CDs is non-existent. Total outstanding CDs amounted to Rs.4,915 billion in March 2012 and the rate of interest on CDs in March 2012 was 11.1 % in March 2012 and 8.6 % in December 2012.

6. **The Commercial Paper Market.** The Commercial paper was introduced by RBI in March 1989 and was made effective in January 1990. The CPs was introduced to provide companies with good credit rating a source of short term borrowing. The CPs is issued in the form of unsecured usance promissory notes by the companies with good credit rating at a discount and the discount rate is market determined. They are freely transferable and negotiable. The issuance of CP is not related to any underlying self liquidating trade and hence the maturity of CP is flexible. Generally, borrowers and lenders adapt the maturity of a CP to their needs. Highly rated corporates which can obtain funds at a cost lower than the cost of borrowing from banks are interested in issuing CPs. Institutional investors also find CPs as an attractive outlet for their short term funds. Any person, bank, company and other registered bodies incorporated and unincorporated, NRIs can invest in CPs. However, NRIs can invest in CPs on a non-repatriable basis. In Sept 96, the primary dealers were allowed to issue CPs. In April 2001, the banks, financial institutions and primary dealers were advised to make fresh investments and hold CPs in the dematerialized form. The CP can be issued by a listed company which has a working capital of not less than Rs.5 crore. With maturity ranging from three months to six months they would be issued in multiples of Rs.25 lakh subject to the minimum size of Rs.1 crore. The company wanting to issue CP is required to obtain every six months a specified rating from an agency approved by the RBI. According to the RBI's guidelines, a company will have to obtain P2 rating from Credit Rating Information Services of India Limited or A2 rating from Investment Information and Credit Rating Agency of India Limited. Maturity period of CP issued by various

companies ranged from 3 months to 6 months. However, the minimum maturity period of CP is seven days. The outstanding amount on CPs was Rs.173.476 billion in November 2011 and the effective interest rates were in the range of 7 to 8.2 per cent per annum in the year 2006-07.

7. **Money Market Mutual Funds.** A scheme of money market mutual funds was introduced by the Reserve Bank of India in April 1992. The objective of the scheme was to provide one more short term avenue to the individual investors. Banks, public and private Financial Institutions were allowed to set up MMMFs in 1995. In April 1996, MMMFs were allowed to issue units to corporate enterprises and others on par with other mutual funds. The lock-in period was reduced from 45 to 15 days. Resources mobilized by MMMFs are required to be invested in call money, CDs, CPs, Commercial bills arising out of genuine trade transactions, treasury bills and government dated securities having an unexpired maturity up to one year. The MMMFs have been brought under the purview of SEBI regulations from March 2000. Banks are now allowed to set up MMMFs only as a separate entity in the form of a trust.

The Unorganized Sector of the Indian Money Market.

The constituents of the unorganized sector of the Indian Money Market are as follows:

1. **Non-Banking Financial Companies (NBFCs).** These companies assume various forms. Some of the prominent forms of NBFCs are loan/finance companies, chit funds and nidhis. Finance or loan companies are spread across the country. A large number of partnership firms and individuals are involved in the business of lending money. Finance companies are capable of raising considerable resources in the form of deposits. These companies offer loans to retailers, wholesale traders, artisans and self employed persons. They charge very high rates of interest ranging from 36 to 48 per cent. The Chit funds are saving institutions. A Chit fund has regular members who make periodic subscriptions to the fund. The periodic collection is given to some member of the chit fund selected on the basis of agreed criterion. Each member of the fund is assured of his/her turn before the second round starts and any member becomes entitled to get periodic collection again. The chit fund business is conducted all over the country but Tamil nadu and Kerala accounts for the largest share of the business. The RBI has no control over the activities of chit funds. The Nidhis are also largely located in south India. Their dealings are limited to their members. The main source of their funds is deposits from members. The loans are given members at reasonable rates of interest for purposes of house construction, repairs etc. These loans are secured. They are single office institutions. The RBI has started regulating NBFCs engaged in equipment leasing, hire purchase finance, loan and investment, residuary non-banking companies and the deposit receiving activity of miscellaneous non-banking financial companies. According to the amendment to the RBI Act in 1997, the NBFCs are obliged to apply for a certificate of registration. By June 2004, the RBI had received 38050 applications from NBFCs for registration of which the RBI approved 13671 applications.

2. **Indigenous Bankers.** Individual Bankers are individuals or private firms that receive deposits and give loans. These bankers have been engaged in the banking business from ancient times. On account of the emergence of modern banking system and its rapid development, the role of indigenous bankers have considerably reduced. However, indigenous bankers continue to thrive in some parts of the country. There are four main sub groups of indigenous bankers. They are: Gujarati shroffs, Multani or Shikarpuri Shroffs, Chettiars and Marwari Kayas. The Gujarati shroffs operate in Mumbai, Kolkata and in the cities of Gujarat. The Marwari shroffs operate in Kolkata, Mumbai, tea gardens of Assam and other parts of north east India. The Multani or Shikarpuri shroffs operate in Mumbai and Chennai and the Chettiars are found in the south. Out of these, the Gujarati shroffs are the most prosperous bankers.

3. **Money Lenders.** They are three types of money lenders. They are: professional money lenders, itinerant money lenders like pathans and Kabulis and non-professional money lenders. Money lenders do not receive deposits. Their funds are generally their own. The borrowers from money lenders are poor people like agricultural laborers, marginal farmers, artisans, mine and factory workers and small traders i.e., those who are not capable and eligible to access the organized money market take recourse to money lenders. These money lenders charge exploitative rates of interest indulge in manipulation of loan records and extract free labor from the poor borrowers. They also use arm twisting methods to force the debtors into bondage. They are not regulated or supervised by the government.

The unorganized money market survives and flourishes in India because of two important factors. They are: (1) a large amount of unaccounted wealth and income floats in the country and the creamy section of the black economy both on the lenders and the depositors side operate in this market, and (2) the poor who cannot access the organized market for want of securities look at the unorganized market as the lender of last resort. Several legislative measures have been passed to prevent exploitation of the borrowers by moneylenders but these measures have remained on paper. Exploitation of the poor borrowers will come to an end only if micro-finance system covers the entire population of poor in the country.

FEATURES AND DEFECTS OF INDIAN MONEY MARKET.

The features of Indian money market are as follows:

1. Lack of integration.
2. Lack of rational interest rates structure.
3. Absence of an organized bill market.
4. Shortage of funds in the money market.
5. Seasonal shortage of funds and changing interest rates.
6. Inadequate banking facilities.

These features are explained briefly in the succeeding paragraphs.

1. **Lack of Integration.** The Indian money market is divided into two segments; organized and unorganized. These sectors are mutually independent both in terms of operation and effects. India does not have a national money market. In fact money market in India is localized. For instance, the Kolkata and Mumbai money markets are the most developed money markets in India. There is competition between various segments of the money market. Thus, co-operative banks compete with commercial banks. Commercial banks compete with themselves and also with the foreign banks. The unorganized market

operates independently and has no supervision whatsoever from the Reserve Bank of India. The bank rate policy of the RBI lacks effectiveness on account of the absence of integration between the two markets.

2. **Lack of Rational Interest Rate Structure.** Due to the lack of co-ordination between different banking institutions, interest rate structure in India lacked rationality. However, in the post reform period after the liberalization of interest rates, interest rates in India had become standardized to a certain extent. As the system of administered interest rates has not been completely dismantled, some defects continue to remain. These are (1) poor return on government securities, (2) some concessional rates of interest, and (3) inappropriate deposit and lending rates of commercial banks. As a result of these defects, the demand for credit is excessive. In fact, the interest rate structure in India should be responsive to the bank rate as in the case of London. The bank rate should become the benchmark as far as interest rate structure is concerned. However, in India interest rates continue to be different amongst different banks.

3. **Absence of an Organized Bill Market.** The bill market in India is not fully developed. A limited bill market has been created by the RBI through its schemes of 1952 and 1970. On account of 1952 bill market scheme introduced by the RBI, it became possible for the commercial banks to obtain advances from the RBI on the security of 90 days usance promissory notes. Bills arising out of genuine commercial transactions were eligible for rediscount at the RBI with two good signatures, one of them being from a scheduled bank. Popularity of cash credit and lack of uniformity in commercial bills are serious obstacles in the development of a bill market in India. Further, due to the existence of an inter-bank call money market; commercial banks never felt the need of an organized bill market.

4. **Shortage of Funds in the Money Market.** The Indian money market suffers from the problem of shortage of funds. Shortage of funds is due to a number of reasons. Firstly, savings are small due to low per capita income. Secondly, inadequate banking facilities, lack of banking habit amongst the people and absence of adequate and diversified investment avenues had also contributed to the shortage of funds. Finally, vast amount of black money have caused shortage of financial resources in the money market.

5. **Seasonal Shortage of Funds and Changes in the Interest Rates.** India is a predominantly agricultural country. During the agricultural season beginning from October to June, agricultural activities need more finance. As a result, a shortage of funds is felt in the market and the interest rates go up. Thus interest rates go up in the busy season and come down during the rainy season when trading activity is less. Fluctuations in interest rate caused by seasonal changes in demand for money reflect upon the lack of elasticity in the supply of lendable funds.

6. **Inadequate Banking Facilities.** Banking facilities in India continue to remain inadequate. For instance, in the USA while every 1200 persons have a commercial bank branch, in India there is only one branch for every15500 persons. The difference in the two countries is very wide and much of it can be explained by the wide differences in economic development of both the countries. However, the difference also indicates that

much needs to be done in extending the banking facilities to all categories of people in India.

MONEY MARKET REFORMS IN INDIA.

According to the former Governor of Reserve Bank of India, Dr. VY Reddy, the main reforms initiated to develop the money market in India are as follows:

1. Setting up of the DFHI in 1988 with the purpose of imparting liquidity to money market instruments and helping the development of secondary market in these instruments.

2. Launching of commercial paper, certificates of deposits and inter-bank participation certificates in 1988-89 with the purpose of increasing the range of money market instruments.

3. Deregulation of money market interest rates from 1988-89.

In the post reforms period, the following initiatives were undertaken to develop the money market in India:

1. **Stamp Duty Reform.** In August, 1989, the government remitted stamp duty on usance bills which was considered to be a major administrative constraint in the use of bill system. However, this measure did not help in the increased usage of bills. According to experts, only if the cash credit system is abandoned, the use of commercial bills will increase.

2. **Liberalization of Money Market Interest Rates.** Money market interest rates were liberalized from 01st May 1989 by the RBI. Accordingly, all ceilings on money market interest rates were removed. This initiative was expected to infuse flexibility and transparency in the money market transactions.

3. **Reforms in the Call Money and Term Money Markets.** The call/notice money market was an interbank market till 1990. Only the UTI and LIC were allowed to operate as lenders from 1971. Currently, banks and primary dealers are operating as both lenders and borrowers and a number of non –bank financial institutions and mutual funds are also operating as lenders in this segment of the money market. The term money market in India has not been very active. A number of defects in the system which retarded the development of the market were removed by the RBI in the post reform period. However, the volume of operations in the term money market continues to be small.

4. **Introducing New Money Market Instruments.** New money market instruments such as the 182 day treasury bills, certificates of deposits, commercial paper and 364 day treasury bills have been introduced. The 182 day treasury bills were promoted by the DFHI and were the first security sold by auction for financing the fiscal deficit of the Central Government. The DFHI also developed a secondary market for these bills. In

1992-93, the 364 day treasury bills were introduced and the auction of 182 day treasury bills was discontinued from 14 May 2001.

5. **Repurchase Agreements (Repos).** The repos were introduced in December, 1992. A repo is an instrument of repurchase agreement between the RBI and commercial banks. The repo or the repurchase rate is the rate at which the Central Bank provides funds to banks. At present, the repo rate is 4.75%.The reverse repo rate is the rate at which the Central Bank takes funds from banks. At present the reverse repo rate is 3.25%. Repos are used by banks for short term liquidity management. The repo has become popular and it can now be effected between banks and between banks and financial institutions.

6. **Refinance by RBI.** Refinance is used by central banks to meet liquidity shortages in the system, to control monetary and credit conditions and direct credit to selective sectors. There are two refinance schemes in operation. They are export credit refinance and general refinance. The RBI is pursuing a policy of linking the refinance rate with the bank rate.

7. **Money Market Mutual Funds.** MMMFs were introduced in India in April, 1991. These institutions provide an additional short term avenue to investors and bring money market instruments within the reach of individuals. The portfolio of MMMFs consists of short term money market instruments.

8. **The Discount and Finance House of India.** The DFHI was set up on 25th April, 1988. Its task is to bring the entire financial system into the fold of money market so that their short term surpluses and deficits are equilibrated at market related rates through inter-bank transactions in case of banks and through money market instruments in the case of banks and other financial institutions.

9. **Liquidity Adjustment Facility.** The RBI introduced the Liquidity Adjustment Facility in June 2000 for adjusting liquidity through repos and reverse repos. The RBI is using repos and reverse repos to adjust liquidity in the money market in order to stabilize the short term interest rates. LAF is now used as a major instrument of monetary policy.

10. **The Clearing Corporation of India limited (CCIL).** The CCIL came into existence in April 2001. It was registered under the Companies Act and SBI is the chief promoter. The CCIL clears all transactions in government securities and repos reported on the Negotiated Dealing System of RBI and also Rupee/USD spot and forward deals. All trading in government securities below Rs.20 crore is mandatorily settled through CCIL and those above Rs.20 crore have the option to settle through the RBI or the CCIL.

Descriptive Questions.

1. **What is the meaning of Money Market? Explain briefly the components of Indian Money Market.**
2. **Explain the features and defects of the Indian Money Market?**
3. **Write a note on Money Market reforms in India.**

CHAPTER SEVEN

CAPITAL MARKET

PREVIEW.

- **Capital market.**
- **Functions of Capital Market.**
- **Structure of Capital Market.**
- **Capital Market Reforms in India.**

CAPITAL MARKETS.

The capital market is a part of the financial market consisting of the money and capital markets. It deals with medium and long term credit requirements of medium and large scale industries for purposes of investment. The capital market deals with long term credit with more than one year maturity period. It functions as an institutional arrangement to channelize long term funds from those who save to those who need them for productive purposes. It is a medium created to bring together entrepreneurs who want investible resources and households who save. In India, the capital market includes financial institutions such as the insurance companies, commercial banks, specialized financial institutions like IFCI, IDBI, SIDCs, SFCs, UTI etc, merchant banking agencies, mutual funds and individual investors.

FUNCTIONS OF CAPITAL MARKET.

The functions of capital market are as follows:

1) **Mobilization of Savings and Acceleration of Capital Formation.** Economic development particularly becomes important in the context of a developing country like India. The capital market provides the incentive to invest and as a result through various types of financial securities, savings from the various sections of the population could be mobilized. Mobilization of investible resources helps in increasing the productive capacity of the economy and thereby capital formation.

2) **Promotion of Industrial Growth.** Economic development of a country cannot be imagined in the absence or the lack of industrial growth. Investible resources available in the economy are channelized through the capital market and made available to the industrial sector of the economy. A sustainable high growth rate of the industrial sector brings about economic development in the country through employment generation, rising incomes and attendant infrastructural development.

3) **Organizing Long Term Capital.** The capital market helps firms to raise permanent capital and at the same time provides an opportunity to the investors to liquidate their investments through the secondary market. Thus the capital market provides investible resources to the economy for development purposes and also maintains their liquidity. In this way, the surplus generated by households is not locked permanently and the firms receive these surpluses on a permanent basis.

4) **Efficient Allocation of Resources.** Through the pricing mechanism of industrial securities, the capital market performs the function of allocating scarce resources to their most efficient use. The current market price of a security and the relative yield are the guiding factors for the people to invest their funds in a particular company.

5) **Provision of Multiple Services.** The capital market provides a number of services through its financial institutions. It provides medium and long term loans to entrepreneurs to enable them to set up expand or modernize their firms. Through the development banks, the capital market provides assistance in the promotion of companies. Term lending financial institutions helps in the setting up and expansion of public sector undertakings by participating in their equity capital. Finally, it provides advisory services for the management of investment in industrial securities.

STRUCTURE OF THE CAPITAL MARKET.

The capital market consists of two parts, namely the market in which medium and long term credit is made available by financial institutions and the securities market which offers ownership capital to business enterprises. It is through the capital market that the long term capital requirements of firms and the short term capital resources of individuals are reconciled. The stock exchanges in the capital market provide a medium through which these two requirements are met. The financial institutions such as the IFCI, IDBI, Export and Import Bank of India, SIDBI, IDFC, SFCs, LIC etc provide long and medium term finance.

The securities market consists of the government securities market and the corporate securities market.

THE GOVERNMENT SECURITIES MARKET (the Gilt-edged Market).

The government securities market deals with government securities carrying fixed interest rates. These securities consists of dated securities of both Central and State governments including financial institutions owned by the government. They are debt obligations of the government. 'Gilt' refers to gold. As the securities are floated by the government and repayment of principal and interest are the obligations of the government itself so these securities are risk free. Hence, they are called 'gilt edged securities'. These securities are issued with various maturities ranging from 2 to 31 years. Dated securities presently have a maturity period of up to 20 years. Securities with maturity period of more than 10 years are called long dated securities and those having tenure between 5 and 10 and less than 5 years are called medium and short term securities respectively. The securities are issued in denomination of Rs.10, 000/- and in multiples of Rs.10000/-. The Central government issues dated securities to fund budgetary deficits and meet

other short term funding requirements through RBI. Commercial banks and government insurance companies are the major investors in this market. The Reserve Bank of India regulates the market. The government securities market is divided into primary and secondary markets.

The Primary market in Government Securities.

Securities are issued through the primary market by auction. There are two types of treasury auctions. They are Discriminatory Price Auction also called French auction and the Uniform Price Auction or the Dutch auction. In case of DPA, the bidder who quotes the maximum price is the successful bidder and in the case of UPA, all successful bidders pay a uniform price which is the cut-off price. For instance, if the RBI decides the cut-off price for a 11.5 % 2014 paper as Rs.120.2582 then bids up to the next highest price of Rs.120.2582 will be declared successful and bidders at the cut-off price will receive allotments on pro-rata basis. If all the successful bidders have to pay the cut-off price of 120.2582 then the auction is called a Dutch auction or a UPA. If the successful bidders have to pay the prices they have actually bid and the auction fills up the notified amounts in various prices at which each of the successful bidders bid, then the auction is called French auction or DPA. The prices and yield of government securities is decided by Fixed Income Money Market and Derivatives Association of India (FIMMDA) on the basis of a yield curve calculated by FIMMDA for the purpose of valuation.

The Secondary Market for Government Securities.

Government securities are listed on the NSE's Wholesale Debt Market after their issue. The settlement of these securities occurs through Security General Ledger Account with RBI. SGL holder after the trade has to report the same within 24 hours. The settlement period is T + 1 but in the case of settlement through a broker of a permitted stock exchange, the settlement period is T + 2. All traders in government securities are reported to RBI-SGL account for settlement. These securities are held in dematerialized form in the SGL account. The settlement of transactions through SGL account is overseen by Public Debt Office. Transfer of funds is done by crediting or debiting the current account of seller/buyer maintained with RBI. Securities are transferred through credits/debits in the SGL account.

THE CORPORATE SECURITIES MARKET.

The corporate securities markets are divided into the new issues market or the primary market and the stock exchanges or the secondary market. There is a close interaction between these markets. The primary market creates long term instruments like bonds, debentures and shares through which corporate firms borrow from the capital market.
The secondary market provides liquidity and marketability to these instruments. The investors can sell their shares and claim their investments back along with capital gains or otherwise and firms can keep the capital on a permanent basis. An active and buoyant secondary market enables the firms to enter the new issue market or the primary market and raise funds. The depth of the secondary market depends upon the activities of the primary market because when more and more firms enter the primary market and raise funds, more instruments are made available in the secondary market and the level of activity goes up in the secondary market. The primary and secondary markets are explained in details below.

1. **The Primary or the New Issues Market.**

   The primary market attracts investible resources in the corporate sector. It helps the corporate sector to raise capital for setting up new firms or to expand and diversify the existing firms. The funds are raised by the corporate sector by issuing industrial securities and through bonds by public sector enterprises. The funds are mobilized from the households directly or through the financial institutions like commercial banks, co-operative banks, insurance companies, mutual funds and other non-banking financial intermediaries. Before 1992. The Capital Issues (Control) Act 1947 regulated the primary market. In 1992, the Act of 1947 was repealed and the new issue of capital was brought under the purview of SEBI. Accordingly, new issuers of capital are required to meet SEBI's guidelines for disclosure and investor protection. There are three ways in which new issues can be floated. These are as follows:

   a) **By the Issue of prospectus to the Public.** It is an open invitation to the public to subscribe to the issue by giving the details in the prospectus regarding the company, the issue, the underwriters etc.

   b) **By Private Placement.** The issue is privately placed with a few big financiers including brokers who may sell them to clients or to the public.

   c) **By Right Issue to the Existing Shareholders of the Company.** The existing share holders are invited to subscribe to a part or whole of the new issue.

   Depending up on the nature of capital i.e., creditor-ship or ownership, the new issue may assume the form of equity shares and debentures. Equity shares may assume the form of ordinary shares or preference shares. Ordinary shares are ownership securities involving permanent investment. However, these investments can be liquidated in the secondary market by selling them. Preference shares are also ownership security but with a fixed rate of return and maturity period. Debentures and bonds are creditor-ship or debt security with a fixed rate of return and maturity period.

2. **The Secondary Market.**

   The secondary market is where the outstanding or old securities are traded. The secondary market provides liquidity to the long term securities held by investors. It operates through the stock exchanges which regulates the trading activities and ensures some safety and fair dealing to the investors. The stock market in India is regulated by the Central Government under the Securities Contracts (Regulation) Act 1956. Under this Act, the Central Government has powers to supervise and control the stock exchanges and also keep a check on their governing bodies and super-cede it if they commit any kind of irregularities. The stock exchange is an auction market in shares and other securities and bulls and bears are two types of players in the auction market. The bulls are buyers in the market. A bull is known to be strong person and also an optimist. A bear is a seller and basically a pessimist. A bear believes in selling at minimum profit.

CAPITAL MARKET REFORMS IN INDIA.

The capital market was suffering from many problems such as lack of transparency in procedures, price rigging and insider trading. In order to remove these problems, the Government of India set up the SEBI in 1988. In January, 1992, SEBI was made a statutory body and was authorized to regulate all merchant banks on issue activity, lay guidelines and supervise and regulate the working of mutual funds and oversee the working of stock exchanges in India. SEBI has taken a number of steps to improve the functioning of the capital market in India. The Narasimham Committee recommended the abolition of CCI and proposed SEBI to protect the investors and take over the regulatory function of CCI. The Government of India repealed the CCI Act, 1947 and gave SEBI the power to control and regulate the stock exchanges in India. The following measures were undertaken by the Government to reform the capital market in India:

1) **Measures to Strengthen the Government Securities Market.** The following measures have been taken to strengthen the government securities market :

   a) The auction system for the sale of Government of India medium and long term securities was introduced from June 1992. New instruments such as conversion of auction treasury bills into term securities, zero coupon and capital indexed bonds, tap stocks and partly paid stocks were introduced.

   b) 364 day treasury bills auction was introduced in April 1992 and 91 day treasury bills auction from January 1993, 14 day treasury bills was introduced in June 1997. 182 day treasury bills were introduced once again in May 1999. The auction of 14 day and 182 day treasury bills was discontinued from 14th May 2001.

   c) The Securities Trading Corporation of India was established in 1994 to develop institutional structure for an active secondary market in government securities.

   d) A system of primary dealers was established in March 1995 and the guidelines for Satellite Dealers were issued in December 1996.

   e) From 01st April, 1997 a new scheme of ways and means advances was commenced and the practice of automatic monetization of central government budget deficit through ad hoc treasury bills was abandoned.

   f) The RBI initiated steps for the introduction of a Delivery versus Payment system for transactions in government securities in Mumbai. This system ensures settlement by synchronizing the transfer of securities with cash payment. This has reduced settlement risk in securities transactions and has also prevented diversion of funds.

g) The RBI started providing liquidity support to mutual funds dedicated to investments in government securities.

h) Foreign institutional investors with 100 per cent debt funds were permitted to invest in government securities and treasury bills. Other foreign institutional investors were also allowed to invest in debt market including government securities subject to the ceiling of 30 per cent.

i) The interest income on government securities was exempted from the provision of tax deduction at source.

j) Retail trading in government securities at select stock exchanges commenced in January 2003.

2) **Establishment of the Securities & Exchange Board of India.** The SEBI was set up in 1988. It was given statutory recognition in 1992. The SEBI has been created to develop an environment which would facilitate mobilization of adequate resources through the securities market and its efficient allocation.

3) **Establishment of the National Stock Exchange of India.** The NSE was set up in November 1992 and it started its operations in 1994. Four important innovations were made in the way in which trading takes place at the NSE. These innovations are :

a) Replacement of the physical floor by computerized order matching with strict price time priority.

b) Use of satellite communications by setting up 2000 satellite terminals all over the country. On a given day, about 3500 traders log into the trading computer over this network.

c) NSE is a limited liability company and brokers are franchisees. Hence NSE staff is free from pressures from brokers and is able to perform its regulatory and enforcement functions more effectively.

d) Traditional practices of unreliable fortnightly settlement cycle with the escape clause of badla were replaced by a strict weekly settlement cycle without badla.

These innovations brought the advantages of transparency, anonymity, efficiency and competition in the brokerage industry and also gave equal access to the trading floor from all locations in India.

4. **Establishment of the National Securities Clearing Corporation.** The National Securities Clearing Corporation was set up in 1996 to tackle the problem of counter party risks. The NSCC started guaranteeing all trades on NSE. Thus every trade that takes place is from the risk of counter party defaulting.

5. **Introduction of Dematerialization.** Share certificates were printed on paper resulting in operational cost and risk. Theft and counterfeiting of share certificates gave rise to criminal activities. In order to solve this problem, the National Securities Depository Services (India) Limited was set up in November 1996. The depository maintains a computer record of ownership of securities and dispenses with physical share certificates. This form of trading is known as "Demat".

6. **Derivatives Trading.** Derivatives are contracts whose value is derived from the underlying asset. The underlying asset can be equity/foreign exchange/any other financial asset. Derivatives help in transferring the price risks either partially or fully by locking-in asset prices. By doing so, derivatives minimize the impact of asset price fluctuations on profitability and cash flow status of investors who are averse to risk. Derivative trading in equities began in India in June 2000. There are four equity derivative products in India. They are stock options, stock futures, index options and index futures. Derivatives trading take place only in the National Stock Exchange and the Bombay Stock Exchange.

7. **Trading in Central Government Securities.** Trading in government securities was introduced in January, 2003. It can be carried out through a nationwide, anonymous, order-driven, screen-based trading system of stock exchanges. Retail investors are allowed to buy and sell government securities in stock exchanges. Individuals, firms, companies, corporate bodies, institutions, trusts and other entities approved by the RBI are allowed to participate in the retail market.

8. **Rolling Settlement**. Rolling settlement improves the efficiency and integrity of the securities market. Under rolling settlement, all trades executed on a trading day (T) are settled after certain days (N). This is called T + N rolling settlement. Since 01st April, 2002 trades are settled under T + 3 rolling settlement. The NSE has introduced T + 2 rolling settlement from 01st April, 2003. Under it, each order has a unique settlement date specified at the time of order entry. It is mandatory for trades to be settled on the predetermined settlement date.

9. **Mandatory PAN Requirement**. In order to maintain a good audit trail of the transactions in the securities market and to strengthen the 'know your client' concept, Permanent Account Number (PAN) has been made compulsory w.e.f. 01st January, 2007.

10. **Stock Exchanges permitted to set Trading Hours.** In 2009-10, the stock exchanges were permitted to set their trading hours in the cash and derivative segments subject to the condition that the trading hours are between 9 a.m. and 5 p.m. and the stock exchange has a risk management system and infrastructure commensurate with the trading hours.

11. **Investor Protection Measures.** The SEBI has introduced an autonomous complaints handling system to deal with investor complaints. It has given recognition to many investor associations. It issues advertisement to guide and enlighten investors on various issues related to the securities market. In October, 2001, the Central Government established the Investor Education and Protection Fund for protecting the rights of the investors.

Questions.

1. **What is the meaning of capital market and explain the functions of the capital market.**
2. **Explain the structure of capital market.**
3. **Write a note capital market reforms in India.**

QUESTION BANK

(Including QP Pattern & distribution of marks)

CLASS: **TYBCOM.** **YEAR: 2015-16.**

SUBJECT: **BUSINESS ECONOMICS-III – SEMESTER -V.**

Important Note: This question bank consists of all the questions framed by the Board of Studies, Business Economics, Paper-3, University of Mumbai and questions framed by me.

External Examination: Question Paper Pattern for Semester V.

i) There will be 5 questions. All the questions are compulsory having internal choice.

ii) All questions are for 15 marks each (Total Marks: 75).

iii) Question No.1 is based on **module I**. There will be three questions: A, B, C. **Attempt any TWO** – (Total marks 15)

iv) Question No.2 is based on **module II.** There will be three questions: A, B, C. **Attempt any TWO** – (Total marks 15)

v) Question No.3 is based on **module III.** There will be three questions: A, B, C. **Attempt any TWO** – (Total marks 15).

vi) Question No.4 is based on **module IV.** There will be three questions: A, B, C. **Attempt any TWO** – (Total marks 15).

vii) Question No.5 is an **objective type question** including:

Part A. True or False, with reasons (8 marks): Two statements from each module for 02 marks each. Total 08 statements. Attempt any 04 (4X2=8).

Part B. Multiple Choice Questions (7 marks): Three questions from each module for 01 mark each. Total 12 questions. Attempt any 07 (7X1=7).

DESCRIPTIVE QUESTIONS.

SEMESTER - V

Module-1 :Introduction to Public Finance.

1. Explain the meaning, scope and functions of Public Finance.
2. Distinguish between Public and Private Finance.
3. Write a note on Sound Finance v/s Functional Finance.
4. Explain the features of Sound Finance/Functional Finance.
5. Write a note on redistributive taxation.
6. Write a note on anti-inflationary taxation.
7. Explain Dalton's principles of Maximum Social Advantage.
8. Explain Musgrave's principle of maximum social advantage.
9. Explain the limitations of the principle of maximum social advantage.

Module 2 : Public Revenue.

1. Explain the meaning and sources of public revenue.
2. Explain the merits and demerits of direct taxes.
3. Explain the merits and demerits of indirect taxes.
4. Explain the impact and incidence of taxation.
5. Explain the factors affecting shifting of a tax.

Module 3: Public Expenditure and Public Debt.

1. What is public expenditure and explain the causes of increase in public expenditure in India?
2. Write a note on classification of public expenditure.
3. Explain the meaning and types of budget.
4. Explain the meaning and classification of public debt.
5. Explain the burden of internal and external debt.
6. Write a note on management of public debt.
7. Explain the methods of managing public debt.
8. Explain the concept of fiscal deficit.
9. Critically examine the FRBM Act.

Module 4: Financial Markets.

1) What is the meaning of Money Market? Explain briefly the components of Indian Money Market.
2) Explain the features of the Indian Money Market?
3) Write a note on Money Market reforms in India.
4) What is the meaning of capital market and explain the functions of the capital market.
5) Explain the structure of capital market.
6) Write a note capital market reforms in India.
7) What is the meaning of capital market and explain the functions of the capital market.
8) Explain the structure of capital market.
9) Write a note capital market reforms in India.

GIVE REASONS AND MULTIPLE CHOICE QUESTIONS AND ANSWERS.

Note:

1. **Question No.5 is objective type consisting of True/False with reasons and multiple choice questions based on all modules.**
2. **True or False with reasons will have eight statements, two each on each of the four modules and students are expected to answer any four. Marks allotted are 4 x 2 = 8.**

SEMESTER – V

MODULE-1 : INTRODUCTION TO PUBLIC FINANCE.

State whether the following statements are true or false and give reasons.

1. **Public Finance lies on the border line between economics and psychology.**

Ans. No, the statement is **false.** Public finance lies on the border line between economics and politics.It deals with problems relating to the raising and spending of money by public authorities. Public authorities include the Central Government, State Government and local bodies.

2. According to Phillips Taylor," **Public finance is concerned with the income and expenditure of public authorities, and with the adjustment of the one to the other**".

Ans. No, the statement is **false.**The above definition of public science is given H Dalton. According to Phillips Taylor, "Public **finance is the fiscal science, its policies are fiscal policies, and its problems are fiscal problems".**

3. **The scope of public finance includes public revenue, public expenditure, public debt, monetary policy and financial administration.**

Ans. No, the statement is **false.** The scope of public finance does not include monetary policy. It includes fiscal policy, public revenue, public expenditure, public debt and financial administration.

4. **The three functions of public finance are: the allocation, the distribution and the stabilization functions.**

Ans. Yes, the statement is **true.**Allocation refers to adjustment of resources in an economy through revenue and expenditure policies to achieve certain objectives.Distribution function refers to measures to be taken to ensure an equitable distribution of income in an economy and the stabilization function is concerned with price stability and full employment.

5. **In Public Finance, expenditure is adjusted to income and in private finance income is adjusted to expenditure.**

Ans. No, the statement is **false.** In Public Finance, first the expenditure is decided and then income is adjusted according to the expenditure. In Private Finance, the expenditure is determined according to income.

6. Public finance is motivated by profit maximization.

Ans. No, the statement is **false.** Public finance is motivated by welfare maximization.

7. Public finance is a secret affair and private finance is an open affair.

Ans. No, the statement is **false.** Public finance is a public affair whereas private finance is a secret affair. The income and expenditure records of government authorities are available for public scrutiny.

8. The sound finance approach is also known as the balanced budget approach.

Ans. Yes, the statement is **true.** The classical economist believed in the minimalist State and therefore advocated a balanced budget.

9. The functional finance approach is known as the unbalanced budget approach.

Ans. Yes, the statement is **true.**Functional finance involves fiscal instruments like public expenditure, public revenue and public debt management. These instruments are used to achieve macro-economic objectives like economic growth, full employment and price stability. Functional finance is interventionist in nature.

10. When equal people are compensated or taxed equally, vertical equity is said to be established.

Ans. No, the statement is **false.** When equal people are compensated or taxed equally, horizontal equity is said to be established.

11. When unequal people are compensated and taxed unequally, horizontal equity is said to be established.

Ans. No, the statement is **false.** When unequal people are compensated and taxed unequally, vertical equity is said to be established.

12. Anti-inflationary taxation means increasing taxes to control inflation in the economy.

Ans. Yes, the statement is **true.** When the tax rates are increased in the economy, aggregate demand falls by the extent of the reverse multiplier and the inflation rate is reduced.

13. The Marginal Social Sacrifice curve is downward sloping.

Ans. No, the statement is **false.** The MSS curve is upward sloping. There is a direct relationship between the rate of taxes and the marginal social sacrifice.

14. The Marginal Social Benefit curve is downward sloping.

Ans. Yes, the statement is **true.** The MSB curve is downward sloping due to the operation of the law of diminishing marginal utility..

15. The point of Maximum Social Advantage is determined to the left of the point of intersection between the MSS and the MSB curves.

Ans. No, the statement is **false.** The point of MSA is determined at the intersection point between the MSS and the MSB curves.

16. The Maximum Welfare Principle of Budget Determination was given by Musgrave.

Ans. Yes, the statement is **true.** According to this principle, the optimum size of the budget is determined at the point of equality between marginal social sacrifice and marginal social benefit.

17. After the great depression, the extent of state activities has decreased.

Ans. No, the statement is false. After the great depression, the extent of State activities have increased due to the adoption of the concept of Welfare State and the interventionist role of fiscal policy.

MODULE – 2: PUBLIC REVENUE.

18. Public revenue means income of the people.

Ans. No, the statement is false. Public revenue refers to the income of the government obtained through tax and non-tax sources.

19. A tax is a voluntary payment made by the residents and citizens of a country to the government.

Ans. No, the statement is false.A tax is a compulsory contribution made by the residents and citizens of a country to the Government.

20. According to FW Taussig, there is a direct quid pro quo between the tax payer and the government.

Ans. No, the statement is **false.**There is no direct quid pro quo between the tax payer and the Government.

21. In the case of indirect taxes, the impact or the initial tax burden and the incidence or the final tax burden falls on the same person on whom the tax is imposed.

Ans. No, the statement is **false.**In the case of indirect taxes, the impact or the initial tax burden is on the seller and the incidence or the final tax burden falls on the buyer on purchases goods and services.

22. A tax that can be shifted is an indirect tax and the one which cannot be shifted is a direct tax.

Ans. Yes, the statement is **true.** The final burden of indirect tax can be shifted to the buyer depending upon the elasticity of demand. However, the burden of direct tax cannot be shifted because the impact and incidence is on the same person.

23. Some of the demerits of direct taxes are tax compliance, simplicity and popularity.

Ans. No, the statement is **false.** The demerits of direct taxes are tax evasion, complexity and unpopularity.

24. Income tax has a narrow base in India.

Ans. Yes the statement is **true.** Income tax payers in India are less than three per cent of the population.

25. Tax evasion is not possible in the case of indirect taxes.

Ans. Yes, the statement is **true.** Indirect taxes are inbuilt in the prices and consumers end up paying indirect taxes. Hence tax evasion is not possible.

26. Fees and penalties are administrative non-tax revenue to the government.

Ans.**Yes, the statement is true.** Fee is obtained by the government from an individual for providing services whereas fine is imposed by the government for flouting the rules and regulations imposed by the government.

27. Indirect taxes on necessities are regressive in nature.

Ans. Yes, the statement is true. Necessities are consumed by all the sections of the society. When indirect taxes are imposed on necessities, the poorest sections below the income tax limit are also taxed by the government. Hence, indirect taxes on necessities are regressive in nature.

MODULE: III – PUBLIC EXPENDITURE AND PUBLIC DEBT.

28. Revenue expenditure can be incurred both on developmental and non-developmental activities.

Ans. Yes, the statement is **true.** Revenue expenditure made on social and community services such as health and education is developmental in nature whereas revenue expenditure made on defense, interest payments and administrative services is non-developmental in nature.

29. The government should not spend on expenditures like defense, interest payments as they are non-productive.

Ans. No, the statement is **false.** Interest payments are legal liabilities of the government on account of borrowings. Law and order and territorial security are the responsibility of the government. Although these expenditures are unproductive, they are legal and essential.

30. Old age pension is an example of non-transfer expenditure.

Ans. No the statement is **false.** It is an example of transfer expenditure because there is no exchange of economic values.

31. Not all capital expenditure is productive.

Ans. Yes, the statement is **true.** Capital expenditure on defense is non-developmental and non-productive in nature.

32. Public debt is used to finance the gap between anticipated public expenditure and current public revenue.

Ans. The statement is **true.** Government budgets are generally deficit budgets. In order to finance the deficit, public debt is used.

33. According to Dalton, productive debts are those which are not fully covered by assets of equal or greater value.

Ans. No, the statement is **false.**According to **Dalton,** productive debts are those which are fully covered by assets of equal or greater value.

34. The net burden of productive debt is positive.

Ans. No, the statement is **false.** The net burden of productive debt is zero.

35. Public borrowing for famine relief is an example of unproductive debt.

Ans. Yes, the statement is **true.** Such expenditure does not add to productive capacity and are not self-liquidating.

36. External public debt is more burdensome than internal public debt.

Ans. Yes the statement is **true.** External debt requires repayment in foreign exchange and causes drain of foreign reserves.

37. Unproductive public debt is self liquidating.

Ans. No, the statement is **false.** Unproductive debt will not generate income and therefore cannot be self-liquidating.

38. The FRBM Act was passed to tackle the problem of balance of payments deficits.

Ans. No, the statement is **false.** The major objectives were to set limits on borrowings under a time bound program, achieve zero revenue deficit, bring down fiscal deficit and reduce public debt.

39. **FRBM target of reduced fiscal deficit and limited borrowing may have a negative impact on growth.**

Ans. Yes, the statement is **true.** In order to achieve FRBM targets, the government may be forced to limit capital expenditure on development.

40. **External debt has an adverse impact on the future generations.**

Ans. Yes, the statement is **true.** Present generation enjoys the benefits received from expenditures incurred from current borrowings and the future generation pays for it.

41. **Irredeemable debt is perpetual in nature.**

Ans.Yes, the statement is **true.** Irredeemable debt is perpetual in nature. Such debts do not have fixed maturity. However, they involve regular interest payment. The burden of indebtedness on tax payers is more.

42. **External debt do not have direct money burden.**

Ans.**No, the statement is false.** External debt does have direct money burden because it must be repaid along with interest to the external creditors. In order to repay, exportable surplus needs to be generated. Exportable surplus is generated by imposing more taxes on domestic consumers thereby adding the money burden.

43. **Fiscal deficit is the difference between total revenue and total expenditure.**

Ans.**No, the statement is false.**The fiscal deficit is obtained by subtracting total receipts (excluding government borrowings) from the total expenditure.

MODULE-4: FINANCIAL MARKETS.

44. **Indigenous bankers are part of organized sector of Indian money market.**

Ans. No, the statement is **false.** Indigenous bankers are part of the unorganized money market and they are not regulated by the RBI.

45. **Call money rate is the most appropriate indicator of liquidity position in the money market.**

Ans. Yes, the statement is **true.** Call money market is highly sensitive as borrowing and lending transactions are for a period of minimum one day to a maximum of one week and the rate is determined by the demand and supply of very short term funds.

46. **Borrowing and lending transactions in the call/notice money market are carried out for 3 months.**

Ans. No, the statement is **false.** Transactions are for a period of one day to one week and 14 days for notice money market.

47. **There is close integration between organized and unorganized money markets in India.**

Ans. No, the statement is **false.** The unorganized money market is out of RBI's control. There are wide variations in interest rates between the organized and unorganized sectors.

48. The Commercial paper is a long term instrument of raising funds by corporate.

Ans. No, the statement is **false.** The CP is a short term borrowing instrument used by the corporate. It is an unsecured money market instrument issued in the form of a promissory note with fixed maturity of one year.

49. Certificates of deposits are negotiable and tradable in the short term money market.

Ans. Yes, the statement is **true.** CDs are bearer instruments and are readily marketable.

50. The Treasury bill market in India is very much underdeveloped.

Ans. Yes, the statement is **true.** TBs offer low returns. There is absence of competitive bids. RBI is a passive holder of TBs as it is required to rediscount the TBs presented to it banks and other financial institutions.

51. The money market in India is adequately diversified in the recent years.

Ans. Yes, the statement is **true.** New money market instruments such as 182 and 364 TBs, CPs, CDs provides new avenues to the government and financial institutions to raise funds.

52. Money Market Mutual Funds enable individual investors to participate in money market.

Ans.Yes, the statement is **true.** Small individual investors can invest in MMMFs and resources mobilized through these schemes can be invested Money Market instruments to generate returns.

53. Capital market plays a significant role in a country's industrial development.

Ans. Yes, the statement is **true**. It provides adequate, cheap and diversified long term finance to the industrial sector.

54. Primary market deals in securities which are already issued/outstanding/existing.

Ans. No, the statement is **false.** It is a market for new issues introduced for raising fresh capital in the form of equity shares, preference shares, debentures right issues etc.

55. Secondary market significantly contributes in a country's economic growth.

Ans. Yes, the statement is **true.** It contributes to economic growth through allocation of funds to the most efficient use through the process of disinvestment and reinvestment.

56. Credit Rating Agencies are passive participants in the capital market.

Ans. No, the statement is **false.** CRAs help to promote healthy development of the capital market. They guide the investors on the quality of financial instruments issued by fund raising institutions.

57. SEBI has allowed the companies to determine the par value of shares issued by them.

Ans. Yes, the statement is **true.** SEBI has dispensed with the requirement to issue shares with a fixed par value of Rs.10 or Rs.100 and has given freedom to companies to determine the par value of shares issued by them.

58. The unorganized money market in India consists of commercial banks, foreign banks, cooperative banks, DFHI etc.

Ans. No, the statement is **false.** The unorganized money market in India consists of money lenders, indigenous bankers, and unregulated non-bank financial intermediaries such as finance companies, chit funds and nidhis.

59. In the Inter-Bank Call Money Market, borrowing and lending transactions are carried out for three months.

Ans. No, the statement is **false.** In the inter-bank call money market, borrowing and lending transactions are carried out for a period between one day and one week.

60. Treasury bills are issued by the RBI for meeting its temporary deficits.

Ans. No, the statement is **false.** The treasury bills are issued by the RBI to meet the temporary deficits of the Central Government which arises on account of excess of expenditure over revenue.

61. The commercial bill market is not well developed in India.

Ans. Yes, the statement is **true.** The commercial bill market is not well developed in India because of the popularity of cash credit system in bank lending and because of the absence of will of the buyer to follow the discipline with regard to payment.

62. The secondary market for Certificate of Deposits is non-existent.

Ans. Yes, the statement is **true.** CDs are marketable and negotiable instruments. They are freely transferable by endorsement and delivery. However, CD holders prefer to hold them till maturity and hence secondary activity in CDs is non-existent.

63. The Money Market Mutual Funds can invest their money in the capital market.

Ans. No, the statement is **false.** The MMMFs can invest their money only in money market instruments.

64. Close-ended mutual funds do not have a lock-in period.

Ans. No, the statement is **false.** Close ended mutual funds do have a lock in period of three years.

65. Under T + 2, rolling settlement, all trades must be settled after two weeks.

Ans. No, the statement is **false.** Under T + 2 rolling settlement, all trades must be settled after two days.

66. In case of DPA, the bidder who quotes the minimum price is the successful bidder and in the case of UPA, all successful bidders pay different prices which are the cut-off price.

Ans.No, the statement is false. In case of DPA, the bidder who quotes the maximum price is the successful bidder and in the case of UPA, all successful bidders pay a uniform price which is the cut-off price.

67. The prices and yield of government securities is decided by SEBI.

Ans. No, the statement is false. The prices and yield of government securities is decided by Fixed Income Money Market and Derivatives Association of India (FIMMDA).

68. Corporate securities market is divided into primary market and tertiary market.

Ans. No, the statement is false. The corporate securities market is divided into primary and secondary markets.

69. In case of a Rights Issue, shares are issued to new applicants.

Ans. No, the statement is false. The shares are issued to existing share holders.

70. Debentures and bonds are ownership securities with a fixed rate of return and maturity period.

Ans. No, the statement is false.Debentures and bonds are creditor-ship or debt security with a fixed rate of return and maturity period.Debentures and bonds are creditor-ship or debt securities with a fixed rate of return and maturity period.

71. The stock market in India is regulated by the SEBI.

Ans. No, the statement is false.The stock market in India is regulated by the Central Government under the Securities Contracts (Regulation) Act 1956.

72. The Tarapore Committee recommended the abolition of CCI and proposed SEBI to protect the investors and take over the regulatory function of CCI.

Ans.No, the statement is false. The Narasimham Committee recommended the abolition of CCI and proposed SEBI to protect the investors and take over the regulatory function of CCI.

73. The Securities Trading Corporation of India was established in 1994 to develop institutional structure for an active primary market in government securities.

Ans. No, the statement is false. The Securities Trading Corporation of India was established in 1994 to develop institutional structure for an active secondary market in government securities.

74. The NSE was set up in November 1994 and it started its operations in 1996.

Ans. No, the statement is false. The NSE was set up in November 1992 and it started its operations in 1994.

75. Derivatives maximize the impact of asset price fluctuations on profitability and cash flow status of investors who are averse to risk.

Ans. No, the statement is false. Derivatives minimize the impact of asset price fluctuations on profitability and cash flow status of investors who are averse to risk.

76. There exist multiple interest rates in Indian money market.

Ans. Yes, the statement is true. The Indian money market is divided into organized and unorganized market. The interest rates in both these markets are different and numerous.

77. Capital market comes under the purview of SEBI.

Ans. Yes, the statement is true. The SEBI is a statutory body established by the government in 1988 to regulate the capital market in India.

Multiple choice questions (MCQs).

Note: There will be three MCQs on each module i.e. 12 MCQs. You will have to attempt any Seven (7 x 1 = 7)**.**

SEMESTER - V

MODULE: I – Introduction to Public Finance.

1) **Public finance lies on the borderline between:**

   a) Economics and Sociology.
   b) Economics and Psychology.
   c) Economics and Political Science.
   d) Political science and Sociology.

2) **According to Phillips Taylor:**

   a) Public finance is the fiscal science, its policies are fiscal policies, and its problems are fiscal problems".
   b) Public finance is a public science, its policies are public policies, and its problems are public problems.
   c) Public finance is a social science, its policies are social policies, and its problems are social problems.
   d) Public finance is a political science, its policies are political policies, and its problems are political problems.

3) **The scope of public finance includes:**

   a) Public revenue, public expenditure, public debt, monetary policy and financial administration.
   b) Public revenue, public expenditure, public debt, fiscal policy and financial administration.
   c) Public revenue, public expenditure, public debt, trade policy and financial administration.
   d) Public revenue, public expenditure, public debt, exchange rate policy and financial administration.

4) **The Allocation function of public finance refers to adjustment of resources in an economy:**

   a) Through revenue and expenditure policies.
   b) Through monetary and fiscal policy.
   c) Through monetary policy.
   d) Through expenditure policy.

5) **The stabilization function of public finance refers to achieving:**

   a) Price stability and full employment.
   b) Economic growth and development.
   c) Economic growth and full employment.
   d) Balance of payment equilibrium.

6) The distribution function of public finance refers to:

a) Establishing equitable distribution of income and wealth.
b) Distribution of income.
c) Distribution of goods and services.
d) Distribution of revenue.

..

7) Public finance is motivated by:

a) Profit maximization.
b) Revenue maximization.
c) Income maximization.
d) Welfare maximization.

8) The sound finance approach is known as:

a) The balanced budget approach.
b) The unbalanced budget approach.
c) The deficit budget approach.
d) The surplus budget approach.

9) The functional finance approach is known as:

a) The unbalanced budget approach.
b) The balanced budget approach.
c) The zero budget approach.
d) None of the above.

10) Anti-inflationary taxation means:

a) Increasing taxes to control inflation in the economy.
b) Decreasing taxes to control inflation in the economy.
c) Increasing taxes to control recession in the economy.
d) Decreasing taxes to control recession in the economy.

11) According to Musgrave, the major function of public finance is:

a) Allocative function.
b) Distributive function.
c) Stabilization function.
d) All of the above.

12) MSB is based on the principle of:

a) Increasing marginal utility.
b) Equi-marginal utility.
c) Diminishing marginal utility.
d) None of the above.

13) The concept of functional finance is attributed to:

a) David Ricardo.
b) Adam Smith.
c) JB Say.
d) AP Lerner.

MODULE:II – Public Revenue.

14) Which of the following explains a fine?

a) A fine is a penalty imposed on the offender for the infringement of a law.
b) A fine is a penalty designed to earn revenue for the government.
c) A fine is a fee obtained from the offender for the infringement of a law.
d) All of the above.

15) Forfeitures are penalties imposed by courts for:

a) The failure of individuals to appear before the courts,
b) The failure to abide by the terms of the contract.
c) The failure to protect valuable assets.
d) All of the above.

16) Escheat refers to reversion of property to the State:

a) Due to the absence of legal heirs.
b) Due to the absence of a Will in respect of the wealth and property left behind by a dead person.
c) Due to the indebtedness of the owner of the property.
d) All of the above.

17) Which of the following statement is correct about direct taxes?

a) A direct tax is not paid by the person on whom it is imposed.
b) The incidence and impact of direct tax is on the same person.
c) The incidence and impact of direct tax depends upon elasticity of demand.
d) The incidence is on one person and the impact is on another person.

18) Which of the following constitute direct taxes?

a) Corporation tax, wealth tax and sales tax.
b) Corporation tax, wealth tax and income tax.
c) Custom duties, wealth tax and income tax.
d) Excise duties, wealth tax, service tax and corporation tax.

19) Direct taxes are said to have built-in flexibility because:

a) The direct tax revenue changes with changes in national income.
b) The rate of Direct taxes changes with changes in national income.
c) Direct tax revenue falls with rise in national income.
d) Direct tax revenue rises with fall in national income.

20) Direct tax is used as an anti-cyclical measure. It means:

a) The rate of direct tax is increased during a recession.
b) The rate of direct tax is decreased during an inflationary period.
c) Direct tax rates are reduced during recession and increased during inflation.
d) Direct tax rates are increased during recession and reduced during inflation.

21) Which of the following statement is correct about a tax system?

a) The simpler the tax system, lesser will be the corruption in tax administration.
b) The simpler the tax system, greater will be corruption in tax administration.
c) Simplicity in the tax system has no relation with corruption in tax administration.
d) The complex the tax system, lesser will be the corruption in tax administration.

22) A progressive personal income tax system is one in which the rates of taxes:

a) Higher at a higher level of income.
b) Remains constant at all levels of income.
c) Lower at a higher level of income.
d) Remains constant after a certain level of income.

23) Indirect taxes do not create civic consciousness because:

a) The burden of tax is not felt by the tax payer.
b) Indirect taxes are included in the prices.
c) The incidence and impact of indirect taxes are on different persons.
d) All of the above.

24) Which one of the following is a demerit of indirect taxes?

a) Economic.
b) Creates civic consciousness.
c) Unjust and inequitable.
d) Certainty.

25) High indirect taxes on alcoholic and narcotic products is justified because:

a) They have negative externalities.
b) They are harmful to the consumers.
c) Consumption of alcoholic and narcotic products reduces social welfare.
d) All of the above.

26) Which one of the following is not a tax revenue?

a) Income tax.
b) Customs duty.
c) VAT.
d) Special assessment.

27) Impact of a tax refers to:

a) Final money burden.
b) Immediate money burden.
c) Indirect money burden.
d) None of the above.

MODULE: III – Public Expenditure and Public Debt.

28) Government expenditure on maintenance of defense establishments is an example of:

a) Development expenditure.
b) Non-development expenditure.
c) Capital expenditure.
d) Productive expenditure.

29) Public expenditure has shown which of the following trend since 1990:

a) Increasing.
b) Decreasing.
c) Constant.
d) None of the above.

30) When public expenditure is greater than public revenue, the budget will be called as:

a) Surplus budget.
b) Balanced budget.
c) Deficit budget.
d) None of these.

31) External loans can be raised from:

a) RBI.
b) SBI.
c) IMF.
d) WTO.

32) The full form of FRBM Bill is:

a) Financial Responsibility and Budget Management Bill.
b) Fiscal Responsibility and Budget Management Bill.
c) Fiscal Responsibility and Bank Management Bill.
d) Financial Revenue and Budget Management Bill.

33) Government expenditure on interest payment is an example of:

a) Development expenditure.
b) Non-development expenditure.
c) Capital expenditure.
d) Productive expenditure.

34) Which of the following is not an objective of the FRBM Act 2003?

a) To reduce corruption.
b) To bring about zero deficit.
c) To reduce the burden of debt repayment.
d) To improve transparency in fiscal operations.

35) Which of the following is not a part of the burden of internal debt?

a) Direct real burden.
b) Money burden.
c) Burden on future generation.
d) Effect on private investment.

36) Which of the following is not a feature of external debt?

a) Payment in foreign currency terms.
b) Causes income distribution effect.
c) Use of coercion for raising funds.
d) Involves money burden.

37) Transfer payments do not include:

a) Old age pension.
b) Defense expenditure.
c) Interest payments.
d) Subsidies.

MODULE-4: FINANCIAL MARKETS.

38) Which of the following is not a part of the unorganized sector of the Indian money market?

a) Unregulated non-bank financial intermediaries.
b) Co-operative Banks.
c) Money lenders.
d) Indigenous bankers.

39) Which of the following is not a part of the organized sector of the Indian money market?

a) Commercial banks.
b) Foreign banks.
c) Chit funds.
d) Mutual funds.

40) Which of the following statements regarding call money market is not correct?

a) Call money market is mainly centered at Mumbai, Kolkata and Chennai.
b) It is also known as inter-bank call money market.
c) It is the most appropriate indicator of the liquidity position of the money market.
d) The borrowing and lending transactions in the call money market are carried out for three days.

41) Which of the following is not a characteristic of Indian money market?

a) Lack of integration between the organized and unorganized sectors.
b) Seasonal stringency of funds.
c) Well developed bill market.
d) Excess demand for loanable funds.

42) Which of the following statements regarding gilt-edged market is not correct?

a) It is a risk free market and returns are guaranteed.
b) RBI plays a dominant role in the gilt edged market.
c) Investors in the market are mostly institutions.
d) Government securities are the most liquid instruments.

43) Which of the following statements regarding SEBI is not correct?

a) It was set up in 1988 and given statutory recognition in 1992.
b) It fixes prices of IPOs in the stock market.
c) It regulates substantial acquisition of shares and takeover of companies.
d) It regulates the business in stock markets and other securities markets.

44) In call/notice money market, loans are given for a period of:

a) *1 to 14 days.*
b) 15 to 45 days.
c) Up to one year.
d) Up to five years.

45) Certificates of deposits are issued by:

a) *Scheduled commercial banks.*
b) Regional Rural Banks.
c) Local area banks.
d) All of the above.

46) If money is lent for more than 14 days, it is known as:

a) Call money.
b) Notice money.
c) *Term money.*
d) None of the above.

47) The State Bank of India operates in the call/notice money market:

a) On the lenders side.
b) On the borrowers side.
c) On both lender as well as borrowers side.
d) None of the above.

48) In India, Treasury bills are:

a) *Short term liabilities of the Central government.*
b) Long term liabilities of the Central government.
c) Short and long term liabilities of both the Central and State Governments.
d) Short term liabilities of both the Central and State Governments.

49) Treasury bills are issued at:

a) Discount to face value and redeemed at par.
b) Face value and redeemed at a premium.
c) Premium to face value and redeemed at discount.
d) None of the above.

50) Repo rate is the rate at which:

a) RBI injects liquidity into the system.
b) RBI absorbs liquidity from the system.
c) Banks provide loan to business firms.
d) Banks provide loans to priority sectors.

51) Treasury bills are issued for meeting which one of the following deficits which a government faces due to its excess of expenditure over revenue.

a) Temporary.
b) Primary.
c) Fiscal.
d) Revenue.

52) Gilt-edged securities refer to:

a) Bonds.
b) Securities issued by municipal corporations.
c) Industrial issues.
d) Government securities.

53) According to the RBI's guidelines, a company issuing commercial paper will have to obtain which one of the following ratings?

a) P2 rating from Credit Rating Information Services of India Limited or A2 rating from Investment Information and Credit Rating Agency of India Limited.
b) P1 rating from Credit Rating Information Services of India Limited or A1 rating from Investment Information and Credit Rating Agency of India Limited.
c) P3 rating from Credit Rating Information Services of India Limited or A3 rating from Investment Information and Credit Rating Agency of India Limited.
d) P4 rating from Credit Rating Information Services of India Limited or A4 rating from Investment Information and Credit Rating Agency of India Limited.

54) Which one of the following States account for the largest chit fund business in India?

a) Tamil Nadu and Kerala.
b) Tamil Nadu and Maharashtra.
c) Punjab and Haryana.
d) Maharashtra and Gujarat.

55) Under the Liquidity Adjustment Facility, the RBI uses which one of the following measures to control liquidity in the money market?

a) Repos and Reverse Repos.
b) CRR and SLR.
c) CRR.
d) SLR.

56) Money market interest rates were liberalized by the RBI in the year:

a) 1989.
b) 1991.

c) 1992.
d) 1995.

57) The four main sub-groups of indigenous bankers in India are:

a) Gujarati shroffs, Multani or Shikarpuri Shroffs, Chettiars and Marwari Kayas.
b) Saurashtra shroffs, Sultani or Shikarpur shroffs, Chettiars and Marwari Kayas.
c) Secunderabadi shroffs, Shikarpuri shroffs, Chettiars and Marwari kayas.
d) Gujarati shroffs, Multani or Shikarpuri shroffs, Chettiars and Karwari Kayas.

58) In the money market, money lent for more than one day and up to fourteen days is known as:

a) Call money.
b) Notice money.
c) Term money.
d) None of the above.

59) Discriminatory Price Auction is also called as the:

a) French auction.
b) Uniform Price Auction.
c) Dutch auction.
d) English auction.

60) Which of the following is a equity derivative product:

a) Stock option.
b) Stock future.
c) Index option and index future.
d) All of the above.

As BOS Meeting on 4/1/2014
T. Y. B.Com. – Syllabus w.e.f. Academic Year 2014 – 2015
Semester – V
Subject – Business Economics

Module I – Introduction to Public Finance.

Concept of Public Finance - Meaning, Scope and Functions, Distinction between Public and Private Finance; Modern Trends in Public Finance – Sound Finance v/s Functional Finance, Redistributive Taxation - Anti Inflationary Taxation- Principles of Maximum Social Advantage – Dalton & Musgrave.

Module II – Public Revenue.

Public Revenue – Sources of Revenue -Tax & Non Tax Revenue – Merits and Demerits of Direct & Indirect Tax; Impact and Incidence of Taxation.

Module-III: Public Expenditure and Public Debt.

Public Expenditure – Classification and Causes of increase in Public Expenditure.Budget and types of budget.Public Debt – Types - Burden of Public Debt - Management of Public Debt.Concept of Fiscal Deficit – FRBM Act and its critical appraisal.Fiscal Federalism: Concept & Key Issues

Module IV – Financial Markets

(A) Money Markets – Components, Features and Defects of Indian Money Market – Money Market Reforms in India since 1991.
(B) Capital Market – Meaning, Functions, Structure and Reforms in India since 1991.

References

T. N. Hajela

Benson KunjuKunju

S. K. Mishra &Puri

MODEL QUESTION PAPER - 1

CLASS: TYBCOM (SEM – V)
SUBJECT: BUSINESS ECONOMICS, PAPER – 3

Note: All questions are compulsory and carry equal marks.

Q.1. **Answer any one of the following questions.** **15**

A. Explain the meaning, scope and functions of Public Finance.
B. Explain Dalton's principle of Maximum Social Advantage.
C. Distinguish between the sound finance and functional finance approach to public finance.

Q.2. Answer any two of the following questions: **15**

A. Explain the sources of public revenue.
B. Explain the merits of direct taxes.
C. Explain the impact and incidence of taxation.

Q.3. Answer any two of the following questions: **15**

A. Explain the meaning and types of budget.
D. Explain the classification of public expenditure.
E. Explain the burden of internal and external debt.

Q.4. Answer any two of the following questions: **15**

A. Explain the features and defects and Indian Money Market.
B. Write a note on money market reforms in India.
C. Explain the significance of capital market in economic development.

Q.5.

A. True or false giving reasons. Attempt any four. **08**

1. Public Finance lies on the border line between economics and psychology.
2. The scope of public finance includes public revenue, public expenditure, public debt, monetary policy and financial administration.
3. A tax is a voluntary payment made by the residents and citizens of a country to the government.
4. In the case of indirect taxes, the impact or the initial tax burden and the incidence or the final tax burden falls on the same person on whom the tax is imposed.
5. Not all capital expenditure is productive.
6. Irredeemable debt is perpetual in nature.
7. Indigenous bankers are part of organized sector of Indian money market.
8. Borrowing and lending transactions in the call/notice money market are carried out for 3 months.

B. Multiple Choice Questions. Attempt any seven. 07

1. **According to Phillips Taylor:**

   a) Public finance is the fiscal science, its policies are fiscal policies, and its problems are fiscal problems".
   b) Public finance is a public science, its policies are public policies, and its problems are public problems.
   c) Public finance is a social science, its policies are social policies, and its problems are social problems.
   d) Public finance is a political science, its policies are political policies, and its problems are political problems.

2. **The functional finance approach is known as:**

   a) The unbalanced budget approach.
   b) The balanced budget approach.
   c) The zero budget approach.
   d) None of the above.

3. **Anti-inflationary taxation means:**

   a) Increasing taxes to control inflation in the economy.
   b) Decreasing taxes to control inflation in the economy.
   c) Increasing taxes to control recession in the economy.
   d) Decreasing taxes to control recession in the economy.

4. **High indirect taxes on alcoholic and narcotic products is justified because:**

   a) They have negative externalities.
   b) They are harmful to the consumers.
   c) Consumption of alcoholic and narcotic products reduces social welfare.
   d) All of the above.

5. **A progressive personal income tax system is one in which the rates of taxes:**

   a) Higher at a higher level of income.
   b) Remains constant at all levels of income.
   c) Lower at a higher level of income.
   d) Remains constant after a certain level of income.

6. **Escheat refers to reversion of property to the State:**

   a) Due to the absence of legal heirs.
   b) Due to the absence of a Will in respect of the wealth and property left behind by a dead person.
   c) Due to the indebtedness of the owner of the property.
   d) All of the above.

7. **Government expenditure on maintenance of defense establishments is an example of:**

    a) Development expenditure.
    b) Non-development expenditure.
    c) Capital expenditure.
    d) Productive expenditure.

8. **Public expenditure has shown which of the following trend since 1990:**

    a) Increasing.
    b) Decreasing.
    c) Constant.
    d) None of the above.

9. **External loans can be raised from:**

    a) RBI.
    b) SBI.
    c) IMF.
    d) WTO.

10. **The State Bank of India operates in the call/notice money market:**

    a) On the lenders side.
    b) On the borrowers side.
    c) On both lender as well as borrowers side.
    d) None of the above.

11. **Treasury bills are issued at:**

    a) Discount to face value and redeemed at par.
    b) Face value and redeemed at a premium.
    c) Premium to face value and redeemed at discount.
    d) None of the above.

12. **Which of the following statements regarding SEBI is not correct?**

    a) It was set up in 1988 and given statutory recognition in 1992.
    b) It fixes prices of IPOs in the stock market.
    c) It regulates substantial acquisition of shares and takeover of companies.
    d) It regulates the business in stock markets and other securities markets.

MODEL QUESTION PAPER - 2

CLASS: TYBCOM (SEM – V)

SUBJECT: BUSINESS ECONOMICS, PAPER – 3

Note: All questions are compulsory and carry equal marks.

Q.1. **Answer any two of the following questions.** **15**

A. Explain the similarities and differences between public and private finance.
B. Explain the maximum welfare principle of budget determination.
C. Explain the concepts of redistributive taxation and anti-inflationary taxation.

Q.2. Answer any two of the following questions: **15**

A. Explain the demerits of direct taxes.
B. Explain the merits of indirect taxes.
C. Explain the factors affecting shifting of a tax.

Q.3. Answer any two of the following questions: **15**

A. Explain the burden of internal debt.
B. Explain the concepts of fiscal deficit.
C. Explain the concept and key issues in fiscal federalism.

Q.4. Answer any two of the following questions: **15**

A. Briefly explain the components of the organized Indian Money Market.
B. Write a note on capital market reforms in India.
C. Explain the functions of capital market in India.

Q.5.

A. True or false giving reasons. Attempt any four. **08**

1. When unequal people are compensated and taxed unequally, horizontal equity is said to be established.
2. Anti-inflationary taxation means increasing taxes to control inflation in the economy.
3. In the case of indirect taxes, the impact or the initial tax burden and the incidence or the final tax burden falls on the same person on whom the tax is imposed.
4. A tax that can be shifted is an indirect tax and the one which cannot be shifted is a direct tax.
5. External debt has an adverse impact on the future generations.
6. The FRBM Act was passed to tackle the problem of balance of payments deficits.
7. The Treasury bill market in India is very much underdeveloped.
8. Debentures and bonds are ownership securities with a fixed rate of return and maturity period.

B. Multiple Choice Questions. Attempt any seven. 07

1) The functional finance approach is known as:

a) The unbalanced budget approach.
b) The balanced budget approach.
c) The zero budget approach.
d) None of the above.

2) Anti-inflationary taxation means:

a) Increasing taxes to control inflation in the economy.
b) Decreasing taxes to control inflation in the economy.
c) Increasing taxes to control recession in the economy.
d) Decreasing taxes to control recession in the economy.

3) According to Phillips Taylor:

a) Public finance is the fiscal science, its policies are fiscal policies, and its problems are fiscal problems".
b) Public finance is a public science, its policies are public policies, and its problems are public problems.
c) Public finance is a social science, its policies are social policies, and its problems are social problems.
d) Public finance is a political science, its policies are political policies, and its problems are political problems.

4) Direct tax is used as an anti-cyclical measure. It means:

a) The rate of direct tax is increased during a recession.
b) The rate of direct tax is decreased during an inflationary period.
c) Direct tax rates are reduced during recession and increased during inflation.
d) Direct tax rates are increased during recession and reduced during inflation.

5) Which one of the following is a demerit of indirect taxes?

a) Economic.
b) Creates civic consciousness.
c) Unjust and inequitable.
d) Certainty.

6) High indirect taxes on alcoholic and narcotic products is justified because:

a) They have negative externalities.
b) They are harmful to the consumers.
c) Consumption of alcoholic and narcotic products reduces social welfare.
d) All of the above.

7) Government expenditure on interest payment is an example of:

a) Development expenditure.
b) Non-development expenditure.
c) Capital expenditure.
d) Productive expenditure.

8) Which of the following is not an objective of the FRBM Act 2003?

a) To reduce corruption.
b) To bring about zero deficit.
c) To reduce the burden of debt repayment.
d) To improve transparency in fiscal operations.

9) Which of the following is not a part of the burden of internal debt?

a) Direct real burden.
b) Money burden.
c) Burden on future generation.
d) Effect on private investment.

10) In the money market, money lent for more than one day and up to fourteen days is known as:

a) Call money.
b) Notice money.
c) Term money.
d) None of the above.

11) Discriminatory Price Auction is also called as the:

a) French auction.
b) Uniform Price Auction.
c) Dutch auction.
d) English auction.

12) Which of the following is a equity derivative product:

a) Stock option.
b) Stock future.
c) Index option and index future.
d) All of the above.