C H A P T E R - II

THEORETICAL FRAMEWORK

CHAPTER-II

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2.1 INTRODUCTION :

Governments of all over the world have entered into a great number of public projects such as social protection and other services of public utility like railway, automic energy etc. Government business is the largest single business in every advanced modern state. The total expenditure and revenues of a Government is very large and because of the expansion in the functions of modern government, total public expenditure is increasing at a very rapid rate. The methods of public finance can be used as instruments or means for brining about desired social and economic changes.

Public finance deals with the income and expenditure of public authority. Public authority includes all sort of governments i.e. central, state and local government. As Prof. Dalton defines public finance "It is concerned with the income and expenditure of public autnority and with the adjustment of one another."[1] That means public finance deals with problems to adjust income and expenditure of the governments. In modern times public finance includes four major sub-divisions, these are public revenues, public expenditure, public debt, and financial administration. In financial administration the method of administration, control

and problems relating to the preparation of budget are studied and analysed. So we have to study theory of public finance. Some important theories are as follows :

2.2 THEORIES OF PUBLIC FINANCE :

2.2.1(I) Classical Theory of Public Finance :

According to J.B.Say "Supply creates its own demand," and therefore the classical economist assumed that there can never be any great unemployment or over production. It assumes full employment i.e. full utilisation of public resources.

From view of classical economist[2] :

1. The state should not increase the level of economic activity within the country.
2. The budget should be balanced.
3. Taxes that are injurious to community are those that impigne most heavily on savings, like income tax, death duties, pre contra taxes on consumption are less harmful.
4. If a deficit cannot be avoided, issue long term bonds.
5. The best budget is small budget.
6. Borrow only for the purpose of productive investment.

2.2.2(II) Modern Approach -i.e. Keynes-Theory of Public Finance :

Keynes "General Theory" rests on the simple proposition that one man's expenditure is another man's

income. If the whole income is spent it results in a corresponding income. The circuit of income and expenditure remains constant. But if whole income is not spent this will lead to unemployment or to employment at lower level of real income i.e. fall in national income.[3]

This profound change in the general theory of economics affects the principles of public finance in following ways :

1 The budget is regarded as a powerful instrument for achieving certain aims such as full employment, a high-level of investment, non-inflation and a better distribution. If there is too much inflation the case is a budget surplus if there is too much deflation the case is a budget deficit and if there is non-inflation the total value of new saving must be equal to the total value of new investment.

2 Modern economists consider deficit financing and public borrowings as important methods of public finance to bring economic stability or it increases economic growth.

3 Modern economists favoured progressive and direct taxation as an instrument of collecting public revenue and to make equitable distribution of income in the country.

4 Public borrowings are considered very useful for the development of natural resources of under developed countries.

2.2.3(III) Musgrave's Views on the Theory of Public Finance

According to Prof. Musgrave the theory of public finance can be approached in following two ways :

1 It snould determine the optimal budget plant on the basis of initially defined conditions and see how it can be achieved. He refered this as a normative or optimal theory of public household.

2 It should develop a theory that permits us to explain why existing policies are pursued and to predict which policies will be pursued in the future. He refered this as a theory of budget policy as a sociology of fiscal policies.[4]

2.3 MEANING OF BUDGET :

The word budget has been derived from the French word, "bougette" which means a small bag. The use of term budget for the annual financial plans of th government dates back to 1733.[5] The relevance of the budget has undergone vast changes . A public budget is a format of listing of the revenues and expenditures of a governmental unit. It is a financial plan for future. The budget document records the dicisions that have been made througn the political interaction of citizens legislators, bureacrates and public executors.

Definitions of budget[6] :

1. Rene Stourn : "It is a document containing a priliminary approved plan of public Revenue and Expenditure."

2. Gaston Geaze : "The budget in a modern state is a forecast and an estimate of all public receipts and expenses and for certain expenses and receipts an authorization to incur them and collect them."

3. P.L.Beautieu : "It is a statement of the estimated receipts and expenses during a fixed period. It is a comparative table giving the amounts of the receipts to be realised and of the expenses to be incurred. It is furtnermore an authorization or command given by the proper authority to incur the expenses and collect the revenues."

All the above definitions of budget reveal the same things. The main elements of the budget are as follows :

1. It is a statement of expected revenue and proposed expenditure of the autnority concerned.
2. It requires some authority to sanction it.
3. It is a periodical, generally it is annual.
4. It also sets forth the procedure and manner in which the collection of revenue and the administration of expenditure is to be executed.

The budget persues the economic policies of the various activity of government. This is done for the purpose of raising revenues and incurring expenditure for public purposes. The intentions and policies of government are thus reflected in a statement of projection for the coming period which is normally a year. The financing plan appears in the budget in the form of estimating budgets and a proposed expenditures and disbursements under various heads. Taxation, borrowings, expenditures and fixed measures are all predications, interconnected with the governmental plan. The budget shows the financial accounts of the previous years accompanied with the budget and revised estimates of current year and the budget estimates of the coming year. The budget thus reveals fiscal policy and financial plan. The budget may be presented in parts.

2.4 FISCAL POLICY AND BUDGET :

According to Arthur Smithies, fiscal policy means "A policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment."[7]

According to Mr.Hicks "fiscal Policy is concerned with the manner in which all different elements of public finance, while still primarily concerned with carrying out their on duties may collectively be geared to forward the aims of the economic policy."[8]

Classical econoists believed in the policy of laissez fair. They believed that supply creates its own demand. They considered government expenditure in economic field as unproductive, therefore, Government should undertake minimum essential functions and should not interfere with the working of economic system. According to them that government is best which spends the least and imposes the lowest amount of taxes. This they called as the principle of sound finance.

Modern economists like Keynes and Lerner have not accepted the classical concept of fiscal policy. They believed that the government has to play a positive role, so as to regulate and control the economy by means of taxes and expenditure, which they called as the principle of functional finance. Thus modern fiscal policy is nothing but the application of principle of functional finance. The concept of functional finance was first stated by Keynes and was developed by Prof.A.P.Lerner. He believed that fiscal measures should be judged only by their effects. According to him, the way in which the fiscal measures work in the economy is called as functional finance. The government fiscal policy involves government's spending and taxing, spending and borrowing of loans, issue of new money and withdrawal of money from circulation should be viewed with the concideration of their impact upon the national economy as a

whole and not to any established doctrine of finance such as sound finance. Hence judging a fiscal policy by its effects or the way it functions in an economy is called as functional finance. It is based on the idea that budget is an instrument for achieving and maintaining full employment with stability.[9]

The good and effective fiscal policy is that in which all the necessary ingredients like expenditure, loans, transfers, tax revenue, income from property, debt management, and the like are kept in a proper balance so as to achieve desired economic objectives. Its formulation should be direcrted to achieve desired economic objectives. Its formulation should be directed to achieve chosen set of objectives such as economic growth distributive justice, economic and price stability, restricting monopolies, counteracting concentration of economic power, growth of public sector and so on. Fiscal policy tries to achieve its objectives by regulating the working of market mechanism while retaining the mechanism itself. So the extent of success of policy depends upon some factors like working of market forces, the state of economic growth of the economy, tools of fiscal policy and the extent of their use and the flows of foreign trade and capital etc.

2.5 CONCEPTS USED IN THE STUDY :

2.5.1 Balanced Budget :

A budget would be balanced if the revenue of the government meets its expenditure over the period under consideration. Balanced budget compares the total revenue of the government with its total expenditure.

2.5.2 Surplus Budget :

A budget would be surplus if the revenue of the government exceeds its expenditure over the period under consideration.

2.5.3 Deficit Budget :

A budget would be deficit if the expenditure of the government exceeds its revenue over the period under consideration.

2.5.4 Revenue Deficit :

Revenue dificit refers to the excess of revenue expenditure over revenue receipts.

2.5.5 Budgetary Deficit :

Budgetary deficit refers to the excess of total expenditure over total receipts. This gap is financed by the issue of 91 days Treasury Bills. These bills are mainly held by the Reserve Bank of India.

2.5.6 Fiscal Deficit :

Fiscal deficit is the difference between the revenue receipts plus certain non-debt capital receipts and the total expenditure including loans, net of repayments. This indicates the total borrowing reqquirements of Government from all sources.

2.5.7 Primary Deficit :

Primary deficit is measured by fiscal deficit less interest payments.

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