CHAPTER – I
INTRODUCTION

Local self government constitutes an important segment of federal administration. It deals with the functions relating to local areas and their requirements. The ultimate aim of public finance is maximum social advantage. It may be difficult for central and state governments to take proper care of the needs which possess local character as in the case of provision of water and sanitation, maintenance of local roads, street lighting etc., The delegation of these functions to local self governments relieves the central as well as the state governments of their administrative burden. The allocation of these functions to local bodies is based on the canons of public expenditure like economy and efficiency. The effective performance of these functions requires a sound and efficient financial system.

As Pandit Nehru pointed out “Local self government is and must be the basis of any true system of democracy”. In a Federal Finance set – up, especially in a vast democratic country like India, local finance occupies a dominant place. The rationale of local finance arises from the fact that there are certain functions which can be carried out efficiently only by local governments. There are variations in economic conditions in different localities which require flexible approach. Local bodies can judge these individual requirements properly and satisfy the local needs.

On the political side it had been recognized that local government "has a value as an 'education' for democracy. It is educative for the electors, who are called upon to do
their voting in relation to issues that are readily comprehensible to them; and for the councillors who can gain experience in the art of responsible leadership, without being confronted (before they have gained experience) with issues that at that stage may be beyond their grasp.

In the mixed economic system private enterprise is assigned the main responsibility for the increase in output and the development of new industries. Yet public bodies are required to provide essential services such as the economic overheads (roads, ports, water, power and so on) and the social overheads (education and public health). "Under each of these heads some useful economic functions for local government are to be found". Larger items of overheads should be left to the Central Government while the responsibility for smaller ones should be with the local government because they can be undertaken more suitably at the lower level.

On the side of finance the role of local government is even more striking. In his work on the financing of economic development in Indonesia, Douglas S. Pauw observes that "the success of domestic financing of economic development in Indonesia will depend in large measure upon taking full advantage of the resources that can be mobilized through local fiscal processes."

This will be applicable to many other developing countries as well.

When local bodies are given autonomy and responsibility, it is likely that a relatively high rate of locally financed investment will be undertaken. Further, local

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1 U.K. Hicks, 1961, Development from below, Clarendon Press, p.4.
authorities may have large access to compulsory labour services for local public works; and it may turn out to be an important source of financing capital formation. There are evidences to show that local bodies undertake development investment of both output-increasing and welfare type. Furthermore, rapid economic development creates additional income. Some parts of this income must be mobilized by the public bodies otherwise they would exercise an inflationary pressure on prices or cause embarrassment to the balance of payments. This is a difficult task for the fiscal policy of developing countries. The central government in these countries levies income taxes which exempt many types of income and are notorious for evasion and indirect taxes like customs and excises whose incidence may fall on all classes are relatively ineffective in taxing the affluent people. Local taxes might be so devised as to tax these people effectively.

The importance of local finance has further increased in developing countries due to the rapid growth of urban areas. This growth poses a serious problem for urban local bodies because they need to create additional services. "Furthermore, if the experience of the Soviet Union and Brazil can be relied upon as a guide, a number of urban settlements will probably spring up in places where no cities or towns existed before."\(^2\) Since economic development is hindered by city slums by preventing the growth of an industrial working force, and local services in poor countries are maintained at very low standards creating slums in towns and cities, investment on a large scale should be organised by urban local bodies as part of the more general programme of economic development to improve local services. As Froomkin observes, "Municipal improvements

\(^2\) Ibid, P.6.
are likely to reinforce the forces which foster development." But it should be noted that the existence of a modern municipality may not result in the establishment of new industry. "The improvement of municipal services should be planned after an initial impetus from the establishment of new industry swells the population of the city. The establishment of a cement plant, a smelter...usually increases the population in a small town in an underdeveloped country in a few years. If this town is selected as the site of additional industrial installations, and the location of the town is believed to be favourable for further industrial growth, then it might be worthwhile to gamble on investment in the improvement of municipal services." If better housing accommodations have a favourable impact on worker attitudes, local bodies should undertake building of houses too.

There is another side of the picture too. Improved local services may attract wealthy rural people. This may provide impetus to small-scale and service industries. But it may also cause absentee landlordism with all its attendant evils. However, it is a negligible disadvantage compared with the numerous advantages that improved local services such as sewers, public health, education, buildings and so on are likely to have on economic development.

The normative aspects of federal finance led to the conclusion that of the three major fiscal functions only the allocation function is directly related to fiscal federalism. It was further shown that "benefit region" should be the guiding principle of allocation. It

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means that each service should be decided upon and paid for within the confines of the jurisdiction to which the benefits accrue.

This principle is similar to the distinction between beneficial and onerous taxation, which Marshall and Edgeworth make. Those activities which benefit the local people should be locally financed. Activities which are primarily of national interest ought not to be financed locally. From this point of view, a sewerage system is beneficial while public education is onerous on local finance.

A.R. Prest makes a similar, though not identical, classification and distinguishes between local authorities as business enterprises and local authorities as Government. The principles which should govern the finances of the former (i.e., local authorities as business firms) are the same which govern the finances of nationalized industries. Provision of water, running of local transport services and the like are already the commercial activities of local authorities and they may be charged on commercial basis.

There are many other areas such as education, provision of parks and so on where local authorities must be thought of as government. Prest's classification is somewhat different from Marshall-Edgeworth distinction between onerous and beneficial taxation. "Whereas it might be true that a particular service is purely, for the benefit of local people and of no consequence to rest of the country, it nevertheless might well be impossible to charge for it on a commercial basis. Thus a local fire service must be judged 'beneficial', but it cannot be placed in the commercial category. Once we have decided how much a

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5 Ibid, note 3, p. 428.
local authority is part of government and how much part of the business sector of the economy, we should discuss the next question of how its revenue and expenditure be integrated with those of the Central Government. Since local units are widely heterogeneous it is better to assume an average local authority analogous to an average firm.

We take first the expenditure relationship between the average local authority and the central government. What principles should be followed for the division of expenditure between the two? Administrative efficiency should be the first principle. If expenditure is to be incurred on a large scale so that economies of scale arise, the job is not suitable for local authority. When the need is for flexibility and maneuverability, the job should be entrusted to local bodies.

The division of expenditure is also decided on the basis of the political principle of conformity to popular wishes. Nearness makes the authorities more susceptible to the needs and uneasiness of voters. It calls for decentralization of some public expenditure but without succumbing to pressure groups. In the words of Prest, "closeness to popular wishes can all too easily turn into susceptibility to pressure groups, and therefore the argument in favour of the local authority should not be pushed too far."

Let us now take up the revenue side of local finance. There are two basic problems here. One is concerned with the "extent to which local authorities should be
financially self-supporting." The other is the "most appropriate method of raising revenue for which they are themselves responsible."

There are five sources of local revenue, as given under:

(i) Local Taxes;

(ii) Sharing of tax revenue with the Central or State government as the case may be;

(iii) Borrowing from the market or higher layer government;

(iv) Levy of supplementary tax rates; and

(v) Grants from the higher level government.

Motivation of the Study

Finance is the source of all economic problems. The available finance should be utilized in a profitable manner by government firms and individuals. The financial problems arise when government always spends more than the income. But individuals are very economic in spending his money. In most of the cases the individual tries to save their money. Government being an institution which is meant for augmenting the welfare of the people, it always spends more amount of money. Local bodies also spend more than their income. Municipalities functioning in urban areas always spend more than their income.

The development of the human resources management and welfare of the people depend upon the efficient functioning of municipalities. Unnecessary expenditure of the local government is to be effectively controlled. Finance is very scarce. Shortage of finance will curb the growth rate of the region. The needed amount of finance is to be
raised by municipalities within their jurisdiction. But people should not be overburdened by taxation. This would ultimately result in non payment of tax by the people. Because its finance is peoples’ money the government is answerable to the people. So the municipal finance study of has been undertaken.

Need of the Study

The first is the need to preserve the community from internal disorders and external attacks. Here it is assumed that society is worth preserving. It is not a strictly economic test of social advantage, yet it is true that no society can progress without peace.

The second is strictly economic and it relates to increasing the economic welfare of the community. Two conditions are necessary for this. They are improvements in production and improvements in the distribution of what is produced. The former requires (a) increase in productive power – larger product per capita with a smaller effort and (b) improvement in the organization of production in order to minimise the waste of economic resources, through misdirection and unemployment. The latter means a reduction in the highly unequal distribution of income and wealth. Such a reduction will lead to increasing capacity to use income and a greater stability in the economic life of the community, particularly in the incomes and employment of individuals. The father of the nation, Gandhiji rightly pointed out that the local bodies should be self reliant, self sufficient and self – supportive. The local body administration should be ruthlessly efficient and has to perform all welfare and development functions. This will enhance
the quality of the life of the people. This necessitates two important concordant conditions viz.: i) The local bodies, panchayaths, municipalities and corporation should have adequate resources and finances to fulfil their ever increasing commitments and ii) the allocation of the resources should be based on both efficiency and distribution practice. In this context a study on the financial aspects of a corporation is a worthy researchable problem. This study demystifies the various intricacies of financial operations of Tirunelveli City Municipal Corporation with special emphasis on mobilization of resources and actual expenditure.

**Statement of the Problem**

The importance of local finance is increasing in developing countries due to rapid growth of Urban areas. As growth takes place, a number of urban settlements spring up in places where no cities or towns existed before. Provision of sanitation, slum clearance schemes, water and drainage facilities need greater attention. The responsibility of providing such overheads falls on local governments as they can perform them well. When local bodies are given autonomy and responsibility financial investments will increase. Local bodies like City corporation undertakes activities and welfare services. As rapid economic development takes place, additional income is generated and it should be mobilised to control inflation. Federal government and state governments may not be able to mobilise resources in remote areas. Local taxes may be so devised as to tax the public in local areas. Local finance constitutes a study on the sources of revenue, expenditure and problems of the local bodies. Local finance is the third and bottom rung
in fiscal federalism, next to central and state finances. Under the globalised economy, the role of the government has not minimized.

The researcher wants to study the impact of privatization on the role of state and central governments in providing essential welfare services. Hence the researcher has undertaken a study on the financial aspects of City Corporation of Tirunelveli.

Objectives

The overall objective of the study is to examine the financial aspects and performance of the Tirunelveli City Municipal Corporation. The following are the specific objectives of the study.

1. To study the various sources of tax and non-tax resources of Tirunelveli City Municipal Corporation.
2. To find out the developmental and welfare activities undertaken by the Tirunelveli City Municipal Corporation.
3. To examine the trend and composition of expenditure incurred by the Tirunelveli City Municipal Corporation.
4. To identify the prospects and problems faced by the Tirunelveli City Municipal Corporation.
5. To offer suitable measures and steps to improve the financial soundness and performance of Tirunelveli City Municipal Corporation.
**Hypotheses**

Based on the above objectives the following hypotheses are formulated.

1. The revenue of the Tirunelveli City Municipal Corporation is significantly different between years and months during the study period.

2. The growth rate of receipts from different sources of revenue to the Tirunelveli City Municipal Corporation is not consistent.

3. The expenditure of the Tirunelveli City Municipal Corporation is consistently on the higher trajectory.

**Study area**

This research study concentrates on the Financial Aspects of Tirunelveli City Municipal Corporation of Tirunelveli. The specific financial functions and performance were identified to know the working of the Tirunelveli City Municipal Corporation. The list of relevant information for the study was collected from the records of the concerned Tirunelveli City Municipal Corporation. The study is primarily based on secondary data.

**Period of the Study**

This study was conducted for a period of 11 years (1994 – 2005). An indepth study of the period was conducted and interviews were also conducted from relevant sources.

**Sources of Data**

This study is solely based on secondary data. The secondary data was collected from the records of the Tirunelveli City Municipal Corporation and other administrative
authorities. The trends of financial aspects of the corporation during the study period are compiled from the ledgers of the corporation.

**Theoretical Framework**

The role of public expenditure in the functioning of the economy is important at almost all stages of development, though this role will change when the economy passes from one stage to another in the development process. Musgrave\(^6\) has analysed this changing role under what he calls "theory of public expenditure development." Determinants of expenditure development are economic as well as conditioning and social factors.

As economic development proceeds, needs of the economy change and such a change is related to both the allocation and distribution aspects of expenditure. The former, the allocation aspect, is concerned with the level of public expenditure - the proper share of public resource use course of rising income. The size of governmental outlay depends on the income elasticity' demand for private as against public consumer goods. The latter is concerned with the question as to whether there is an increasing or decreasing need for distributional measures as the economy grows. All these come under economic factors.

Although allocation and distribution questions can be answered mainly on the basis of economic factors yet conditioning and social factors should also be taken into consideration. Conditioning forces are those which include changes in technology and

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demographic factors. Technological changes affect the product mix of public and private goods in both the capital and consumer goods sectors. Demographic changes affect demand patterns and so the appropriate output mix. Political, cultural and social factors determine "the environment in which budget policy operates" and also "affect the underlying value judgements or the political weights attached to them". It should be noted that the dividing lines between these forces are not clear-cut, nor are they wholly independent of each other.

Economic Factors

(a) Allocation:

Ever since Wagner propounded his law of expanding state activity, economists have offered its justification and discussed the causes. In the last chapter various causes of the growth of public expenditure as a whole are gone into. But it should be noted that this growth "is not a dependent variable by itself but must be reduced to its components if prediction is to be made."

In order to study the components of government expenditure, Musgrave divides total public expenditure into defence and civilian expenditures. Civilian expenditures are further divided into public capital formation, public consumption, and transfers.

Public capital formation such as transportation, irrigation, etc. are of particular importance at early stage of development because benefits of such investment are largely external. Hence, they must be provided by the Government. But once they come into
existence as the economy grows and savings become available. Capital formation takes place in the private sector and public capital formation one's share in total capital formation? declines. However, as the economy grows from middle stages, public component of net investment may rise again. Private goods will need complementary public investment such as highway facilities, correction of urban congestion and air pollution, human investment, etc.

The demand for public consumption has an income elasticity in excess of unity. Hence, the share of public consumption such as education, health, safety, etc. rises with rising per capita income.

(b) Distribution:

Transfer outlays together with progressive tax structure help in the redistribution of income. Whether the share of transfer in total income will rise or fall depends on the goal of redistribution. Suppose the goal is the reduction of inequality. In this case, the share of transfer in total income will remain unchanged though the absolute level of transfers will rise. Now assume that the objective of redistribution is the assurance of an absolute minimum standard of living determined by nutritional requirements and not reduction of inequality. Here the share of transfers will decline with the increase in per capita income.

Conditioning Factors:

The conditioning factors have an important bearing on expenditure. "Demographic factors are an important determinant of the level of public expenditures
and the share of public expenditures in total outlay. Both changes in absolute population size and in age structure are relevant."

Absolute increase in population with constant per capita income will call for absolute expansion of basic public services and so an increasing level of government expenditure. The effect on the share of public expenditure in total income is not obvious in this case. It may, however, be pointed out that the location pattern of the growing population, changes in age composition and so on may have some influence on the relative size of expenditures.

The impact of technological change is crucial in the historical approach to expenditure growth. When technological changes make new products available, greater need for public expenditures may be felt. In the inter-war period the invention and rise of automobiles led to the construction of highways and consequently to the expansion of State finances in the United States. Europe was passing through the same experience in the post-war period. Constant change in the military technology is another illustration.

**Social, Cultural and Political Factors**

These non-economic factors should also be considered. Demand for transfer expenditures increases with the growing sense of social responsibility for the welfare of individuals. With the acceptance of a larger role of the state, political resistance to increased governmental activities is weakened. Transition from the authoritarian to representative government quickens this process.
War and social disturbances such as the great depression of the 1930's have profound effect and may either cause sharp temporary departure from underlying trends or have a lasting effect on the trend line itself.

**Pattern of Public Expenditures**

(a) Pattern in the 1950s. In this section we disaggregate the total government expenditure into its components and examine the growth pattern of each part separately for richer and poorer countries. Musgrave has divided total public expenditure into two components, namely, civilian and defence. He concludes that "the hypothesis of a rising public share is borne out for the two components separately as well as for the total." Further, defence accounts for the highest growth is followed by social services (education, welfare programmes, etc).

Martin and Lewis explain the great differences between the richer and poorer countries. They state that as far as total expenditure goes, public expenditure rises relatively to national income as income grows. This is true of all countries. But let us put total current expenditure separately from the total excluding expenditure on social insurance, food or agricultural subsidies, defence and public debt. 'The great differences between the richer and the poorer countries are in the amount spent on defence, on public debt (which reflects past defence expenditure), on social insurance schemes and on food or agricultural subsidies.' The major expenditure heads of the poor countries are the civilian, administrative services, health and education called "basic expenditure' by Martin and Lewis.
Basic Expenditure:

The basic expenditure is common to countries at all levels of development, though it shows only a slight correlation with income per head. Martin and Lewis state that three reasons may be given for expecting this proportion to grow with GNP. The first reason is based on analogy. The proportion has grown in fact in Europe and in North America during the past hundred years. This reasoning is fallacious—the fallacy of post hoc proper hoc. Richer countries relatively spend more now on their public services not because they are richer but because they have a different conception of the duties of the State. This conception of the State which allows a greater role to it is no longer confined to richer countries and has no proportional relationship with per capita income. It has affected the poor countries as well and they spend almost as much of the GNP as richer countries do.

A second reason for the increase in expenditure on public services of the basic nature is the relatively slow growth of productivity in the public sector. The third reason is that these public services constitute a function of output. So the proportion of population engaged in basic public services should increase with income per head. It is for this reason that the difference between basic expenditure and total expenditure is small in poor countries but very large in richer countries. "Probably the main explanation of this paradox is the fact that a public servant usually costs more in relation to average income per head in poor rather than in rich countries. In Britain or the U.S.A, government employees receive an average income not very different from the average in the country. This is not so in the poorer countries. It is not merely that the higher civil servants and scientists cost relatively more. There is also the mass of clerks, nurses, teachers and other
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subordinate grades. This is why the poor and the rich spend almost the same percentage of GNP on the various items of basic current expenditure such as administration, economic services, education and health. The expenditure on health varies most widely, while that on education varies less than health, though more than administrative or economic expenditure.

Among the poor countries, India and Nigeria stand out as the poorest in the provision of basic public services. This proves that the proportion of national income spent on public services is determined not mainly by per capita income but by the "backwardness" or "progressiveness" of the government as well.

Other Current Expenditure: The richer countries spend far more on defence, public debt, social insurance and agricultural subsidies. U.K.'s cost of the public debt is the highest for owed by New Zealand. New Zealand leads in the field of social insurance, while U.S.A. leads in defence expenditure.

Capital Expenditure:

"Capital expenditure is less easy to compare than is "basic" current expenditure, because the extent to which governments provide for capital formation through the budget varies more widely. "India spent 2.3 per cent of GNP in 1953-54, while Sweden's capital expenditure was 14.0 per cent. This gives an idea of the wide range of variation. The extent of public capital expenditures depends mainly on how far the productive sectors of the economy, namely, agriculture, transport and industry, lean on the government for finance. But the fact should be noted that the importance of the
government as a source of saving is on the increase. It is so for three reasons - (i) the amount of private saving in poor countries is small. Private international investment is also not adequate. (ii) Total investment exceeds saving and the gap has to be met by budget surplus. (iii) Many developing countries want to create new capital in the public sector. This is particularly true of governments with socialist learning’s.

**Principles of Public Expenditure**

In the general explanation of why governments intervene in the free market allocation of goods and services, a closely related question is that of the optimum level of government activities. The theory of public expenditure attempts to answer it.

How much government should spend, that is, whether point A (with less of public goods) or B (with more of public goods and less of private goods) should be chosen, has received attention. It is true that there is no logical and complete exposition of public outlay in Ricardo's book Principles of Political Economy and Taxation (1817). But earlier Adam Smith devoted much space to "Expenses of the Sovereign or Commonwealth". He cites three reasons for public outlay, namely, (i) protection against foreign aggression (i.e. national defence), (ii) administration of law and justice internally, and (iii) "that of erecting and maintaining those public institutions and those public works, which though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals, and which therefore cannot be expected that any individual or small number of individuals should erect or maintain. The performance of this duty too requires
"different degrees of expenses in the different periods of society." This, rather long, statement of Adam Smith is extremely flexible and can be adapted to almost any set of circumstances. But Smith himself was not in favour of very wide use of this function. He mentioned public works that favoured trade and commerce, e.g. roads, canals and harbours, education of youth and education of entire people.

Though J.B. Say was the publisher of Smith in the European continent, he conceded very little room for state activity. Say's view was conditioned by the weakness and excesses of French governmental finance in the aftermath of monarchic decadence. Malthus\textsuperscript{7} was willing to concede a greater role to the State but he was thinking more in terms of stabilization aspect of budget policy than the allocation aspect. Increasing government activities might be useful in a situation of glut or over-production. However, Malthus was against wanton and profligate attitude toward public expenditure. Though clinging to his classical heritage, J.S. Mill adopted a less rigid attitude than Ricardo and Say. He showed keen interest in social reform and so favoured government regulation of hours of work, public spending on education, and so forth; but he was not for a completely planned and socialized economy.

Marginalism, as developed by Jevons, Walras and the Austrians, is well illustrated in the following words of Dalton as far as the spending side of the budget is concerned. "Public expenditure in every direction should be carried just so far, that the advantage to the community of a further small increase in any direction is just counterbalanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other source of public income."

It means that the level of public spending is determined when the marginal social benefit of each programme is equated with its marginal social cost.

There has been considerable interest in the theory of public spending in recent years. This has developed in three directions incorporating three aspects, namely, (i) a pure theory of public expenditure, (ii) the question of translating theory into action in a democracy and (iii) the controversy whether the public sector of the economy is undernourished. Let us analyse them closely.

**Pure Theory of Public Expenditure**

The pure theory of public expenditure relates to those principles which govern the "optimal" provision of public goods. Two principles are generally considered in this context. They are "ability-to-pay" principle and the "benefit" principle.

**Pigou and Ability-to-pay Theory**

The use of the ability -to-pay theory to the determination of the optimum level of public expenditure has received most comprehensive treatment in the hands of Pigou. He says that goods and services which are provided by government departments can be sold for fees so arranged as to cover cost of production pose no problem. The amount of resources which should be devoted to these purposes is determined automatically by public demand. But fees can cover neither bulk of non-transfer expenditure of government such as defence, civil administration and so forth nor transfer expenditure. "Hence there is no automatic machinery to determine how far expenditure shall be carried; and some other method has to be employed."

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Bulk of current transfer expenditure—debt services, war pensions, old age pensions—is regulated by practically irrevocable contracts. But large parts of non-transfer expenditure are optional. Optional parts of public outlay—transfer as well as non-transfer—need to "regulate with some reference to the burden involved in raising funds to finance them." And he proposed the principle of balance based on the concept of margin. The optimum amount of government expenditure is determined at the point at which the satisfaction obtained from the last rupee spent is equal to the satisfaction lost in respect of the last rupee called upon by government service. Pigou states the conditions when government expenditure could be larger. First, the greater is the aggregate income of the community, the larger will be the optimum amount of the government expenditure. Second, suppose new opportunities for expenditure by government are opened up but there is no corresponding opportunity for private expenditure. In this case the balance between marginal benefit of expenditure and marginal disutility of revenue will be struck at a higher point. Third, given the aggregate income and population, greater is the concentration of income in the hands of a few rich persons and higher is the optimum level of public expenditure. It is for these simple reasons that tax scheme can be so framed as to raise a given revenue with lower marginal sacrifice.

The principle of balance-equality of marginal satisfaction of expenditure with the marginal sacrifice of raising revenue—can be applied to the distribution of government resources between battle-ships and poor relief," that is, between different types of expenditure by the Government. As Pigou states, "... just as an individual will get more satisfaction out of his income by maintaining a certain balance between different sorts of
expenditure, so also will community through its government." Expenditure should be so distributed among different heads that the last rupee "devoted to each of them yields the same return or satisfaction."

The Benefit Principle

The optimal determination of public expenditure on the basis of benefit principle finds its first clear statement in the voluntary exchange theory of Erik Lindahl. It was further developed and refined by Johnsen and Bowen. The most recent analysis based on this principle is presented by Samuels and Musgrave.

Kaldor's View

Kaldor argues, however, that income tax creates difficulties in respect of work-income and property-income, temporary and permanent sources of wealth and genuine and fictitious capital gains. But once actual spending is taken as the basis of taxation all problems of income tax are resolved. Capital gains are taxed to the extent that they are actually spent and there is no need to inquire whether they are real or fictitious. The only way to assess the spending power derived from wealth is to measure the extent to which this power is in fact exercised on personal expenditure. Kaldor does not find any justification for excluding capital wealth in the measurement of taxable capacity. In fact spending out of capital should be treated in the same way as spending out of income.

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On equity ground, four arguments are advanced against the use of actual expenditure as a test of ability to pay. These arguments have been examined by Kaldor thus:

(i) The traditional argument which is most frequently encountered is that expenditure is an inadequate criterion. This is for the simple reason that the richer a man is the less is his actual expenditure relative to his income and wealth. In the words of Sir Josiah Stamp (quoted by Kaldor) "If a man is so rich that he finds it hard work to spend his money and it is accumulated almost without effort on his part, is it any reason why this taxation should be restricted (to his expenditure)". Kaldor observes that Stamp wrongly extends the argument that is valid in the case of a proportional tax to a progressive tax. "If the tax system is a progressive one the relationship between spending power and spending (or between income and expenditure) can itself be taken into account in the determination of the rate of progression of the tax," Moreover, under the present tax, it is the taxable income of the rich which lags behind their spending power more than their actual spending which remains behind income. Consequently, the wealthiest of the community is more lightly taxed under the income tax system than it would be under an expenditure tax system, using the same progressive rates as under income taxation.

Kaldor does not accept the related argument that the exemption of savings from expenditure taxation would increase the inequality in the distribution of wealth by making accumulation easier. He does not doubt the fact that this tax will increase the incentive to save and discourage saving. But the pattern of the distribution of savings in the community would be influenced and controlled by the scale of progression of tax. An
expenditure tax has the further advantage to be reaped from increase in capital accumulation and the tax enhances the opportunity for exceptional men to make fortunes through enterprise.

(ii) The second argument against an expenditure tax relates to different tastes and temperaments of individuals. "If, as between two people with equal incomes and otherwise similar circumstances, one chooses to spend little, whereas the other chooses to spend a lot, why should the first man be more lightly taxed than the second?" It can not be denied that a miser is taxed lightly under expenditure taxation than under income taxation. A spendthrift, on the other hand, is taxed heavily. But should tax systems be constructed by taking into account the peculiarities of individual temperament? The answer must be 'no', says Kaldor.

(iii) The third argument relates to differences in needs. Needs vary according to the size of the family. A taxpayer with a large family, is compelled to spend more. Since this factor is taken into account in the existing income tax, it can be taken care of in the expenditure tax system as well.

(iv) The last argument relates to fluctuations in expenditure between two periods. These differences arise due to the purchase of consumer durables in anyone period. As we know, purchase of furniture, motor cars, refrigerators, etc. is uneven. Kaldor says that this type of problem arises in the case of income taxation as well because of fluctuations in income. Besides, it is possible to take care of it by a system of averaging either in relation to particular categories of goods or in relation to expenditure as a whole.
Kaldor's conclusion, in his own words, is: "Some of the arguments against an Expenditure Tax which we have reviewed are without any validity; others have some validity but lack weight. Set against the serious shortcomings of our existing system of income taxation they are light-weight." Kaldor's forceful advocacy of an expenditure tax has been debated further. Some of the important points of this debate are summarised next.

**Double Taxation of Savings**

A very important argument for a tax on expenditure relates to the treatment of saving. An income tax discriminates against saving because it is said to give rise to the "double taxation of savings." This arises from the fact that an income tax first falls on that part of income which is saved and then on the earnings from such savings. Let us take an example. Let us assume a world, in which only an income tax is levied. Further we may assume that there are two taxpayers with the same income and pay the same tax. One taxpayer spends his whole income in the current year and pays no more tax. The second decides to save up and spend the money next year. Now the taxpayer earns some interest on his savings. Under an income tax the taxpayer is required to pay on his interest income as well. It means that he pays the tax on his current income as well as on income earned as interest on savings. This is said to be double taxation.

The conclusion to be drawn from the double taxation argument is that an income tax leads to a distortion of the choice of an individual between present and future consumption by reducing the net-income from savings and thus making them less attractive. As a result of the very high marginal rates of income taxation, the high income groups in Great Britain, observes Kaldor, have ceased to save. In a recent study M.A.
King has shown that on an average the U.K. income tax does provide an incentive to immediate consumption and hence acts as a disincentive to saving by individual. An expenditure tax is likely to reverse this trend. This would be a definite gain for developing countries where an increase in the saving-investment rate is one of the essential conditions of economic development. In the words of the Meade Committee, "Expenditure tax falls more heavily than progressive income tax on the wealthy who are financing high levels of consumption out of capital resources, but at the same time it gives much greater opportunity than does a progressive income tax for the finance of the development and growth of private enterprises out of private savings. It could have the political appeal of encouraging enterprise and economic development and at the same time heavily taxing high levels of consumption expenditure which, at present, is financed out of capital, goes untaxed."

The validity of the above argument would depend largely on the motives which influence individual savings. These factors may be economic as well as non-economic and are very diverse such as level of income, rate of interest, tax rate, inflation, etc. "We know very little about the response of aggregate savings to changes in interest rates, and it is clear that, despite the large negative real rates of returns on savings of recent years," because of price inflation, "people go on saving. It is unlikely that changes in tax system would have a major effect on saving's. Further, the rates of expenditure tax are likely to be higher than those of income tax. And normally people do not accept any reduction in their consumption level to which they become accustomed. In this situation the substitution of income tax by an expenditure tax is likely to reduce saving and not augment it."
Effect of Risk-Taking

Another argument in favour of an expenditure tax and against an income tax is the unfavourable effects of the latter on the incentive to undertake the risks of business development. It has been argued that a system of income taxation which does not treat capital gains favourably causes the shifting of investment from risky investments. "The expenditure basis, which does not apply to earnings so long as they are saved and used for further business expansion or other purposes, avoids the excessive draining of savings away from investing groups and the incentive penalties."

The significance of this argument cannot be accepted without a critical appraisal. Some authorities have attempted to show that income tax does not necessarily cause a shift of resources from risky investments. It is for this reason that the government participates in the gains as well as in the losses. Doubt has been expressed whether there are serious incentive effects of the income tax on investment. If the purpose of investment is the income to augment consumption expenditure, the relative advantage of an expenditure tax is very much lost.

Income Tax in Practice

At present there are generally two taxes on income, namely, personal income tax (or simply, income tax) and corporate income tax (or simply, corporation tax). These taxes have been so modified through the application of special provisions that they are no longer straightforward income-based taxes; they have become in effect taxes based on consumption expenditure. Let us take a few examples of the deductions allowed under income taxes.
(I) Relief to Savings:

Relief given to certain forms of savings introduces clear elements of a consumption-expenditure tax into the income tax system. Some of the approved types of savings are as under:

(a) Saving made in the form of contributions to provident fund;
(b) Premia paid on life insurance policies;
(c) Premia paid for securing retirement annuities; and
(c) Certain types of fixed deposits in banks and post offices.

(2) Capital allowances:

Remission of income tax on certain types of savings means a movement from an income base to an expenditure base. A result similar to this is attained when certain types of investment are granted full or partial exemption from the tax. A few examples are cited below:

(a) development rebate;
(b) industrial undertakings in backward areas';
(c) industries in priority sectors;
(d) incentives to small industries; and
(e) incentives for increasing productivity.

As a result of the above modifications and special provisions, the present income tax has moved closer to an expenditure tax. The Meade Committee has, therefore, expressed itself in favour of moving towards an expenditure tax. But the Committee does not favour an immediate and complete switchover. It recommends a two-tier expenditure
tax to be introduced by a more gradual process of change. Let us examine these proposals a little more closely.

The Meade Committee considered first the possibility of moving to a comprehensive income tax. It was defined as a tax on the "accretion of economic spending power" and not the actual use of such opportunities. Comprehensive income is measured in terms of current consumption plus the current addition to the taxpayer's net capital worth. The Committee was, however, convinced that "it would be extremely difficult, if not impossible, to introduce all the features of a comprehensive tax. In particular, we think that many of the measures which would theoretically be necessary to index the system for proper capital-income adjustments against inflation would not be practicable. "So a move towards an expenditure basis would be practicable. An expenditure tax would be feasible, provided a system of self-assessment was first introduced for direct taxation.

The Meade Committee presented four possible types of expenditure tax, namely, (a) a progressive expenditure tax on taxpayer's total expenditure on consumption, (b) a proportionate expenditure tax on value added, (c) an income tax which exempted investment expenditure with a system of capital allowances and (d) an income tax which would exempt investment from income tax. Of these possible combinations, the Committee came in favour of two particular forms of expenditure tax. One was a universal expenditure tax (UET) based on the first method. The second was a two-tier expenditure tax (TTET). The upper tier of TTET would be a restricted version of ET that would be levied at higher rates on taxpayers with higher levels of expenditure. The lower
tier would consist of a single basic rate levied through a value added tax. TTET would provide a transitional stage in a move to a full-fledged VET.

**Raja J. Chelliah's View**

Recently Raja J. Chelliah\(^\text{11}\) has presented a case for an expenditure tax. A good direct tax system should satisfy the criteria of equity, efficiency and administrative simplicity.

Equity embraces two aspects, namely (1) the choice of an index of ability to pay, and (2) people with equal ability should pay the same tax and those with unequal abilities should pay differing amounts of tax. In so far as the choice of an index of ability is concerned, Chelliah concludes that consumption cannot be taken to be a better index of ability to pay than income. Consumption cannot measure ability in the normally understood and accepted sense of the term. Income is a better measure of ability to pay. This conclusion is valid when we compare the abilities and circumstances of taxpayers over a year. If we compare life-time incomes and expenditures a different picture would emerge. For it "could be argued that if endowment or potential earning capacity is regarded as a measure of ability to pay over life time, a consumption or expenditure base would be superior to an income base." But the prevailing notion of equity cannot accept that tax burden related to potential income and not to actual income of the taxpayer.

In relation to economic efficiency it is argued that an expenditure tax would promote savings compared to an income tax. It is an old argument that income tax subjects savings to double taxation. Chelliah is of the opinion that the replacement of the

income tax by the expenditure tax may be said to increase private savings. This tendency would be stronger if wealth and inheritance are not severely taxed and if the government is willing to undergo some reduction of revenue in short run. However, he does not consider it realistic that progressive expenditure tax combined with heavy wealth and inheritance taxes would serve two purposes simultaneously, namely, promotion of savings and reduction of inequalities of wealth.

The usually accepted opinion is that expenditure tax is more difficult to administer than income tax. Chelliall observes that while expressing this view what we compare is the present form of income tax with the full-fledged expenditure tax.

A really equitable income should be such in which income so defined as to adequately reflect spending power. This is possible when comprehensive definition is adopted. Defective coverage leads to inequities and distortions. Capital gains, which are unrealized, are generally excluded from income tax. It creates the lock-in effect and discriminates between those who realize capital gains and reinvest them and those who do not realise them. Inflation that has become endemic in the modern world creates several complications in the equitable application of income tax. Consumer durables also present difficulties, particularly the problem of imputation. All these show that formidable difficulties in the designing and enforcement of real world income tax arise.

Should we then conclude that the administration of the expenditure tax would be relatively easy? Chelliah says that no clear cut answer can be given. Expenditure tax would pose the following problems:
(a) How to estimate expenses of production or costs of earnings in order to arrive at the total of spend able receipts?

(b) Consumption is the difference between receipts and increase in net worth. How to compute increases in net worth from year to year?

(c) Treatment of lumpy expenditure such as expensive consumer durables, marriages, and children's education are yet another area which pose difficulties. Chelliah, however, concludes that "in spite of these important operational problems that need to be tackled in enforcing an expenditure tax, it cannot be denied that the accounting requirements and detailed adjustments needed for administering an equitable expenditure tax are less than those required for administering a comprehensive income tax." This conclusion is not acceptable to Mahesh Bhatt (Economic and Political Weekly, June 7, 1980). He is of the opinion that for the majority of the people the choice between income tax and an expenditure tax would make very little difference. It is for the reason that for most of our life-time consumption is likely to equal our life-time income. "The taxation of consumption rather than income would but serve to shift the tax burden from the middle age, when saving is usually at its peak, to youth and old age, when funds are usually being borrowed or assets drawn". Further, anomalies and inequities of the income tax created due to arbitrary distinction between taxable and non-taxable income cannot be removed by adopting an expenditure tax. There are several reasons for this.

First, an expenditure tax starts with an arbitrary distinction between taxable expenditure and investment or expenses of production. In practice it is extremely difficult
to make a distinction between consumption expenditure and investment outlay. Second, direct measurement of taxable expenditure is not possible. Hence an indirect route is followed in which total assets at the beginning of the period plus total receipts during the period indicate the total amount that can be spent during the period. From this amount the total asset at the end of the period is to be subtracted to get the amount actually consumed. It means that adoption of an expenditure tax requires additional information on bank balances, cash holdings, money borrowed and lent, the proceeds of the sales and purchase of investments and gifts made or received. It is true that such information is already available in connection with taxes on income, gifts and wealth. Since tax avoidance and evasion occur on a large scale in less developed countries like India, the coverage of these taxes is extremely limited. It suggests that the administration of an expenditure tax would pose far more difficult and serious problems and it cannot be accepted that on balance the choice lies with this tax.

From the foregoing study the following limitations to the arguments in favour of an expenditure tax emerge:

(i) A strong relationship between the level of saving and the return to saving cannot be postulated. An expenditure tax may increase the return to saving but this does not necessarily increase the level of saving substantially.

(ii) Suppose a strong relationship exists in the above case. We may not still think of a close link between an increase in saving and an increase in economic growth. Savings are not automatically invested, as Keynes argued convincingly. In
underdeveloped countries savings are not always converted into productive investments that might be taken as conducive to economic growth.

(iii) An expenditure tax would have to be levied at higher rates than an equivalent income tax. Hence an expenditure tax may have adverse effects on work incentives.

(iv) If we take the life cycle of a taxpayer, expenditure tax is likely to impose greater hardship than an income tax. Expenditure tax burden would be heavier in those years when a family is required to spend larger amount.

(v) An expenditure tax does not treat spending and saving equally. Wealth confers not only pecuniary advantages but also such benefits as security, independence, influence, status and so on. (See, also the previous chapter). Hence a person who saves enjoys greater taxable capacity. An expenditure tax on its own would not cover such additional taxable capacity.

The New International Debate on Expenditure Tax

It is due to the economic depression of the 1930s that Fisher's proposal for an expenditure tax could not catch the attention of the policy makers in 1937. Expenditure tax was believed to curtail private expenditure, while depression called for expansion of aggregate spending. Its rebirth on the hands of Kaldor in the 1950s too was not considered sympathetically either by the British Royal Commission on Taxation of Profit and Income or by the British Government. Kaldor reiterated his suggestion in his reports on tax reforms of India and Sri Lanka. He recommended its introduction as a supplementary to income tax. In order to curb tax evasion and reduce inequality of
income and wealth, Kaldor recommended it as an integral part of an "integrated direct fix system" consisting of income tax, expenditure tax, estate duty, gift tax, capital gain tax and wealth tax, all operating simultaneously. An expenditure tax was imposed in 1958 in India, but with drawn in 1962. It was reintroduced in 1964 only to be finally abolished in 1966. In the 1970s there was a revival of interest in this context as a result of American Blueprints, Swedish proposal and Meade Committee Report. In 1974 the Advisory Commission on Inter-governmental Relations (ACIR) prepared a report on the expenditure tax under the title "The Expenditure ax : Concept, Administration and Possible Applications". Blueprints for Basic Tax Reform re prepared in 1977 by Simon, the Secretary of the Treasury. In 1976 the Swedish Government Commission on Taxation initiated a detailed study on progressive expenditure tax. An authentic summary of the Swedish proposal was published in 1978 by Sven-of Lodin. The Committee Report also saw the light of day in 1978.

All the three reports, i.e., the USA, Swedish and the UK reports have shown preference for expenditure tax. In their views, an expenditure tax is superior to an income tax on grounds of economic efficiency and administrative feasibility.

Though not acceptable during the years of depression, it became popular during the 1970s because of its potential to curb inflation by reducing consumption expenditure. In the 1970s lack of adequate saving was also a problem. Hence expenditure tax was advocated to encourage individual as well as corporate savings.
These proposals have examined the revenue implication as well. They suggest that there will be loss of revenue in the immediate future if expenditure tax replaces the income tax. In the long run the yield will increase because savings and investment will be encouraged by an expenditure tax.

A Study Group on taxation of expenditure was constituted in December 1985 under the chairmanship of Raja J. Chelliah. It submitted its final report in April 1987. The Report concluded that, while restructuring the direct tax system on the basis of the expenditure tax principle it, could be advantageous in several ways, an expenditure tax proper would face insurmountable administrative problems and cause great hardships to the average taxpayer. Hence, the next best alternative for the country (India) would be to retain formally the income tax principle to the extent possible, subject to requirements of revenue.

"World War I and II and consequent increases in expenditure, the Depression and the associated changes in the approaches of state and fiscal policy, the inexorable growth in government expenditure after World War II, and the need for economic stabilization and achievement of full employment have... influenced the budget objectives."

Government budget serves several purposes

(i) It sets a framework for policy formation. Decisions are needed about actions to be taken to reach objectives. Objectives may be competing. Choices are made to see the extent to which various objectives can be advanced simultaneously.
(ii) Budgeting is a means of policy implementation. The budget is a guide for management. Anti-budgetary procedures are instruments of administrative control.

(iii) The budget is a means of legal control. At each stage of the process of budget formulation and execution, the question can be raised whether actions have been taken or omitted in conformity with legal requirements. The emphasis in legal control is on prevention of abuse of power and diversion or improper use of public funds.

(iv) The budget document may be a source of public information on past activities, current decisions and future prospects.

The purposes and associated features of the budget should be considered in the following terms:

(a) A tool of accountability: purpose of expenditure is to be clearly stated and presented in the form that will be useful for legislative action.

(b) A tool of management: a budget, as an operational document, specifies either directly or implicitly the cost, time and nature of expected results.

(c) An instrument of economic policy: budgeting here has varied functions. It indicates the direction of the economy and determination of national growth and investment goals. It promotes macroeconomic balance in the economy. It is a vehicle of reducing economic inequalities. It is an annual part of a medium-term plan.
Budgetary Theory

(i) The Classical Approach: Balanced Budget

The essence of budget, in classical writings, is the balancing of revenues and expenditures. This view was based on the analogy of behaviour expected of an individual that he must not spend more than his income. As Adam Smith put it, "What is prudence in the conduct of every private family can scarcely be folly in that of a great kingdom." The exception to this principle was situations of emergencies such as wars. This approach governed the thinking during the eighteenth and nineteenth centuries. Bastable stated this principle clearly in these words, "under normal conditions, there ought to be a balance between these two sides of financial activity. Outlay should not exceed income... tax revenue ought to be kept up to the amount required to defray expenses. "In order to avoid the possibility of a budget deficit, Bastable suggested that the government should aim at a moderate surplus in the budget." The constraint of the balanced budget became a key operating factor for politicians and civil servants alike, and any departures approach were considered to be journeys towards profligacy that would erode the prosperity of the country and eventually lead to financial ruin."

The French economist, J.B. Say, who popularised Adam Smith on the continent of Europe, was a achievement as the master in his opposition to unbalanced budgets. He was of the opinion that wasteful public expenditure leads to budget deficits. Lutz recommended balanced budget as being indicative of fiscal stability. Further, it provides long-term stimulus to private effort which an unbalanced budget is incapable of doing.
Hugh Dalton\textsuperscript{12} says that a balanced budget is often regarded, not only as an unquestioned precept of finance, but as a moral precept too. It was advocated by orthodox financial experts and reinforced by a primitive and widespread fear, artificially stimulated, of the consequences of an unbalanced budget.

Dalton raises three preliminary questions relating to a balanced budget. They are:

i) What should be included in "expenditure"?
ii) What should be included in "revenue"?
iii) What length of time should be chosen as the accounting period?

In considering the balancing of a budget Dalton seems to take the stand that only current budget should be balanced. Then he adds "Where new capital expenditure is financed: not by loan, but by taxation, the budget is, to this extent, balanced with an extra margin." This may be termed as extra sound finance. Ordinarily in the case of a balanced budget debt repayment and loan expenditure for public works should be excluded from public expenditure.

So far as revenue is concerned Dalton suggested to exclude all receipts which are in the nature of capital. He says that a budget is balanced if during the accounting period there is no increase in the net deadweight public debt. A year is the usual accounting period.

The classical budgetary theory of balanced budgets was based on the assumption that full employment is the normal condition. In a condition of full employment, financing of budget deficits by public borrowing means withdrawal of funds from private

employment where they are more productively used. Secondly, financing of deficits by borrowing is a less painful method than taxes. It will therefore invite irresponsible government actions. In other words governmental activities will expand under unbalanced budget. The classical writers wanted, however, not only a balanced budget but a small budget as well. Thirdly, their view of public debt was different from the modern approach. Government borrowing makes further financing more difficult since fixed charges of interest on revenue have to be paid. Furthermore, public debts are expensive as financing of public expenditure in this way has to be paid twice, once in meeting interest charges and secondly in repaying the debt. In the view of these writers, unbalanced budget leads to currency deterioration.

Since this approach does not accept the prevention of unemployment through budgetary action as the goal of financial policy, balanced budget principle did not raise much problem. Keynesian revolution of under-employment equilibrium revealed, however, that full employment is not automatically attained. So in order to ensure the full employment of resources, a flexible budgetary policy is called for. Balanced budget principle becomes irrelevant in this context as large government expenditure may be needed.

It is also to be noted that no unanimity of opinion exists on the question when a budget is balanced. According to one view, a balanced budget means equilibrium between income and outgo without incurring any funded debt. (Funded debt is redeemable after a year or not at all). All expenditures and all revenues are current, and the total revenues equal total expenditures over the course of the year. It is an idyllic
condition which is seldom realized. Governments generally carry considerable long-term debt.

A second view is that under a balanced budget, current expenditures must be covered by current revenues, while capital expenditures are to be financed by borrowing without unbalancing the budget. It is also conceded that emergency or extraordinary expenditures which are incurred in wars, depressions or in case of natural calamities, may be financed by borrowing. But it is not always easy to distinguish normal expenditure from extraordinary ones. The decision must be a matter of opinion.

(ii) The Modern Approach

It should be clear from the above that annual balancing of the budget, one of the principles of sound government finance in the classical system, loses its glamour when widespread involuntary unemployment exists. Economists like Keynes, Hansen, Beveridge, Dalton, etc., maintain that a budget policy should aim at attaining and maintaining full employment. This view is different from the classical standpoint which rules out the use of budgetary measures to attain such an objective.

In order to understand the difference between the classical and Keynesian approaches clearly, we must distinguish between two concepts of public saving. In the classical system, the entire income received at full employment is always spent on either consumption or investment. Saving is automatically converted into investment. Hence saving is always matched by a corresponding amount of planned investment. In such a system all public revenues-taxes or borrowing -reduce private spending. This reduction
will take the form of decline in consumption or investment. Hence government expenditure does not add to aggregate demand of the commodity.

The concept of saving is different in the Keynesian system. In this system private sector does not provide full employment automatically and savings are not automatically matched by planned investment. Hence the operation of the budget is likely to affect aggregate demand and a deficit in the budget may be required to reduce unemployment.

Alvin Hansen\(^\text{13}\) made a vehement attack on the principle of balanced budget. He states, "If one adopts wholeheartedly the principle that government financial operations should be regarded exclusively as instrument of economic and public policy, the concept of a balanced budget, however defined, can play no role in the determination of that policy. Hansen commends the Swedish practice of double budget in which current and operating expenses are accounted for in the operating or revenue budget, whereas capital expenditures are assigned to the capital or investment budget. It is not necessary that even revenue budget be annually balanced. He emphasized increased government outlays in a period of depression in order to "prime the pump" of the economy. In Keynesian terms, budget deficits are viewed as positive instruments to raise aggregate income to stimulate all sectors to spend more. "Budgets have come to be linked with management of the economy, in turn bringing a greater consideration of the effects of expenditures on the economy". This role of the budget is quite comprehensive. It is not only concerned with management of aggregate demand, which is a short-term measure but also takes up the questions of distribution and balance of payments.

Dual budgets grew from the idea that originated in the 1930s. According to it, current spending is equivalent to current consumption and so it should be financed by taxation. As against this, capital spending is investment-generating return in future. So, for reasons of efficiency and intergenerational equity, such spending should be financed by borrowing or other capital revenues. Current view, as expressed by experts of World Bank, is that borrowing "to build assets is acceptable, because assets increase in line with liabilities, while borrowing to fund consumption is not." The balance on current account, called balance from current revenue in India, is public savings which can be used for investment.

**Advantages of the dual budget system are the following:**

i) The distinction between current and capital spending gives a clear picture of the extent of both borrowing and capital formation.

ii) Since a current surplus is a positive indicator, the distinction helps to impose discipline on current spending and favours investment implicitly.

The following are the disadvantages:

i) If capital spending is spending on physical assets with a life of more than one year, the distinction between current and capital spending is likely to introduce a bias toward investment in tangible capital at the expense of current operations and maintenance. Consequently, the largest investment may go to infrastructure and smaller one to social sectors.

ii) Emphasis on balance in the current budget may be misplaced. For macroeconomics stabilization the important variables are the overall budget balance and its means of financing.
iii) Borrowing will not be desirable if public investment financed by such fund does not yield long-term returns high enough for debt servicing. Low return on such investments contributed significantly to the international debt crisis of the 1980s.

iv) Often two separate bodies are entrusted with the job of making the two budgets. In developing countries, current budget is the responsibility of the ministry of finance, while the ministry of planning is entrusted with the work of capital budget. Lack of co-ordination between the two can lead to serious inefficiencies and biases in the allocation of overall spending.

(iii) Case of Developing Countries

The role of budget in a developing economy is much different from that of an industrialized economy. In developed countries budgetary measures can minimize the cyclical influence through the maintenance of aggregate demand. In developing countries, unemployment is not cyclical in nature but chronic, reflecting structural bottlenecks of the economy. Power, instead of increasing the level of production and employment, causes larger imports and raises the price-level. This is why budget is used in developing countries as an integral part of development plans. (see also next chapter).

Another factor that is important and hence should be noted is that budgetary policy assumes greater importance in developing countries than monetary policy. A developing economy lacks financial markets or where they are present they are not well developed. The existence of a large non-monetized sector reduces the efficiency of monetary instruments. Further, the public sector is assigned a dominant role in the economy, occupies commanding heights. Under-developed economies face the serious
problems of inflation and balance of payments. In order to tackle all these problems budgetary measures are more suitable than monetary measures. Thus budgets play a more positive role in developing economies.

In view of the persistent budget deficits, some developing countries have adopted laws that require the national budget to be balanced. The intention is to have a budget consistent with targets for inflation, public debt, and private sector growth. A budget which attains these targets need not necessarily be balanced. It may have a deficit but it should be "prudent." One way to decide whether a public deficit is prudent is to determine whether financing it is consistent with the government's other macroeconomic objectives such as external credit worthiness, growth of private investment and control of inflation. In order to do this, financing must be broken down into its components, as given below.

Public investment + private investment = public savings + private

Savings + foreign savings = total investment

or, Public investment-public savings = Private savings - private investment + foreign savings while, Public deficit = Public investment-public savings; private surplus = private savings-private investment and current account deficit = foreign savings

The above identities state that

(i) Sum of all investment in the economy = savings available from both residents and foreigners;
(ii) foreign savings = the excess of foreigners' income from domestic economy over
their spending in it = current account deficit in the balance of payments.

(iii) Private savings = GNP-taxes-private consumption = gross national savings (in the
private sector).

(iv) Public savings = public current revenue-public current spending.

(v) Public deficit = public spending-public savings.

A public deficit must be balanced by a domestic private sector that saves more
than it invests and, or by an external current account deficit. A prudent fiscal deficit
depends on the desired level of private savings, the desired level of private investment,
and the desired level of current account deficit.

Higher growth in exports, real demand for money and overall financial savings
means that a higher deficit can be financed without violating the objectives of external
credit worthiness, low inflation brings higher deficit within the bounds of prudence. It is
so because faster growth usually implies faster growth of exports and demand for money.
In a slowly growing economy with low financial savings and stagnant exports, the
prudent fiscal deficit is likely to be low.

Limitations

This study concentrates only on Tirunelveli City Municipal Corporation. The
inferences of the study have limited applicability. The revenue and expenditure aspects
of the corporation can widely differ from other corporations. Hence generalization can
be made with caution and care.
There is no effective means of quantifying utility and non utility. Equating of marginal utility and disutility is spoken of for the "society as a whole", not for "individual members" of the society. So there is the possibility that some individual marginal utility of public expenditure may be higher or lower than the marginal disutility of taxation. This raises the question of distributional equity. How should the marginal utilities and disutilities be divided among individual members of society. The basic weakness of this principle is that it gives neither a concrete standard by which the efficiency of various expenditure programmes can be determined nor an operational means of allocating tax shares.

Organization of Thesis

The thesis is divided into seven chapters including the introductory chapter.

The first chapter consists of introductory aspects such as introduction, motivation of the study, need of the study, statement of the problem, objectives, hypotheses, Study area, period of the study, source of data, theoretical frame work, limitations and organization of the thesis. The second chapter deals with the review of literature. The third chapter brings out the methods and materials. The fourth chapter is devoted to the profile of the study area. The fifth chapter brings out the analysis of the revenue collected by Tirunelveli City Municipal Corporation. The sixth chapter analyses the expenditure on Tirunelveli City Municipal Corporation. The chapter seventh records of the summary, policy implications and the conclusion.