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BA Economics Honours | Semester 1 | Calicut University

Fiscal Tools for Policy Formulation

Course Code: ECO1MN101 • Module 3

Module III: Public Revenue

Public revenue encompasses all financial receipts, incomes, and funds mobilized by sovereign government authorities from diverse sources to finance public expenditure obligations. Public revenue is fundamental to state sovereignty; without dependable revenue streams, government cannot maintain civil order, provide public goods, or execute developmental policies.

Unit 9: Meaning and Sources of Public Revenue

Public revenue is broadly categorized into two primary divisions:

- **Tax Revenue:** A compulsory financial contribution levied by the sovereign state on individuals, households, and corporate entities under legislative authority, for which no direct, proportionate *quid pro quo* (specific reciprocal commercial service) is promised to the taxpayer. Tax revenues are subdivided into:
  - *Direct Taxes:* Taxes levied directly on the income, wealth, or corporate profits of persons, where the legal liability to pay the tax (impact) and the actual economic burden (incidence) fall upon the exact same entity (e.g., Personal Income Tax, Corporate Income Tax, Capital Gains Tax).
  - *Indirect Taxes:* Taxes levied on the production, sale, importation, or consumption of goods and services, where the legal obligation to pay rests on the manufacturer or seller, but the economic burden is shifted forward onto the final consumer via prices (e.g., Goods and Services Tax - GST, Customs Duties, Excise Duties on petroleum).
- **Non-Tax Revenue:** All government receipts mobilized from sources other than statutory taxation:
  - *Commercial Revenue (User Fees and Prices):* Charges levied for specific public services rendered (postal services, railway passenger fares, irrigation water fees).
  - *Administrative Receipts:* Fees (passport fees, court fees), fines and penalties imposed for statutory violations.
  - *Dividends and Profits:* Financial surpluses returned by state-owned public sector enterprises (e.g., ONGC, SBI dividends to the Government of India).
  - *Escheat:* Claims by the state on assets of deceased individuals who die without legal heirs or a valid will.
  - *Grants-in-Aid and External Donations:* Voluntary financial transfers received from foreign governments or multilateral organizations.

Unit 10: Concepts of Taxation: Proportional, Progressive, and Regressive

The structure of tax rates relative to the taxpayer's income base defines the equity character of a tax system:

- **Progressive Taxation:** The marginal tax rate increases as the taxpayer's income increases ($ATR < MTR$). High-income individuals pay a higher percentage of their income in taxes than low-income individuals. Progressive taxation is grounded in the principle of vertical equity and the diminishing marginal utility of income, functioning as an automatic fiscal stabilizer and income equalizing mechanism.
- **Proportional Taxation (Flat Tax):** The tax rate remains strictly constant regardless of income level ($ATR = MTR$). A flat 15% tax on all income levels extracts ₹15,000 from an individual earning ₹100,000 and ₹150,000 from an individual earning ₹1,000,000. While simple to administer, it does not alleviate income inequality.

- **Regressive Taxation:** The effective tax rate decreases as income increases ($ATR > MTR$). While statutory tax codes rarely state a regressive rate explicitly, indirect consumption taxes (sales tax, GST on essential food items) are inherently regressive in economic incidence, because poorer households consume a far higher percentage of their total income than wealthy households.
- **Degressive Taxation:** A hybrid structure where the tax rate increases progressively up to a specified income threshold, beyond which a flat proportional rate is maintained.

Unit 11: Principles and Canons of Taxation

In *The Wealth of Nations* (1776), Adam Smith established the four celebrated **Canons of Taxation**:

1. **Canon of Equality (Equity):** Citizens ought to contribute toward the support of the government in proportion to their respective abilities to pay—that is, in proportion to the revenue which they enjoy under the protection of the state. Modern economics interprets this via *horizontal equity* (equals treated equally) and *vertical equity* (those with greater ability paying progressively more).
2. **Canon of Certainty:** The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, and the exact quantity to be paid ought all to be clear and plain to the contributor and to every other person.
3. **Canon of Convenience:** Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it (e.g., collecting agricultural tax at harvest time, deducting income tax monthly at source via TDS).
4. **Canon of Economy:** Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury. Tax administration costs should be minimal relative to revenue yield.

Unit 12: Requirements of a Good Tax System

Modern fiscal doctrine expands upon Smith's canons, requiring that an optimal tax system satisfy:

- **Revenue Productivity / Adequacy:** Generating sufficient fiscal yield to finance essential public expenditures without generating unsustainable deficits.
- **Economic Efficiency / Neutrality:** Minimizing the *excess burden* or deadweight loss of taxation. Taxes inevitably distort relative prices, inducing agents to alter behavior (substituting away from taxed goods). A good tax system minimizes distortionary deadweight loss.
- **Elasticity and Buoyancy:** *Tax elasticity* measures the automatic responsiveness of tax yields to changes in national GDP without changing tax rates. *Tax buoyancy* measures the total change in tax revenue resulting from both GDP growth and discretionary changes in tax rates and coverage.
- **Simplicity and Transparency:** Avoiding Byzantine legal ambiguities that encourage aggressive tax avoidance, litigation, and corruption.

Unit 13: Taxable Capacity

Taxable capacity refers to the maximum volume of tax revenue that a sovereign government can extract from its citizen population without causing catastrophic damage to productive economic incentives, capital accumulation, and standard of living.

- **Absolute Taxable Capacity:** The absolute biological and economic limit of taxation in a single nation. It represents the surplus of national output remaining after providing for the basic subsistence requirements of the population and the minimum capital depreciation replacements needed to maintain

existing production. In practice, absolute taxable capacity is an abstract concept that cannot be measured precisely.

- **Relative Taxable Capacity:** The comparative fiscal capacity of two or more communities, provinces, or sovereign nations to bear tax burdens, commonly used in intergovernmental revenue sharing and Finance Commission award formulas.
- **Determinants of Taxable Capacity:** Size of national per capita income, distribution of wealth (higher inequality increases taxable capacity because wealthy households possess larger taxable surpluses), efficiency of tax administration, public trust in the state, and the perceived benefits derived from public expenditures.

Unit 14: Impact, Incidence, and Shifting of Taxation

Analyzing the ultimate economic resting place of a tax burden requires distinguishing between three vital concepts:

- **Impact of a Tax:** The immediate financial blow or legal liability to pay the tax. The impact falls on the individual or enterprise that writes the cheque to the tax authority (e.g., the factory owner who legally deposits excise duty).
- **Shifting of a Tax:** The economic process by which the legal taxpayer transfers the tax burden to another economic agent through modifications in market prices:
  - *Forward Shifting:* The tax is transferred downstream to final consumers through an increase in the retail selling price of the commodity.
  - *Backward Shifting:* The tax is transferred upstream to factor suppliers (raw material providers or workers) through reduced purchase prices or lower wages.
- **Incidence of a Tax:** The ultimate resting place of the economic burden of the tax. The incidence falls upon the final person who cannot shift the tax burden any further and whose real disposable income is reduced.

Concept	Definition	Key Characteristic	Illustration in GST
Impact	Initial legal obligation to deposit tax with treasury.	Assessed on statutory registered taxpayer.	Retail shopkeeper who files monthly GST returns.
Shifting	Mechanisms of price adjustment transferring tax.	Depends on price elasticity of demand and supply.	Adding 18% GST onto the final invoice price.
Incidence	Final economic resting place of the financial burden.	Borne by agent who cannot shift the burden further.	Final household consumer paying the retail invoice.

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

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Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

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Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
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Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

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Policy Synthesis and Analytical Evaluation

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