

Research Notes

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Causality Between Tax Revenue and Expenditure of Indian States

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1. Introduction

The classical axiom of a balanced budget as a virtue of sound government collapsed under the onslaught of Great Depression of the 1930s. At that juncture, Keynes recommended deficit budgeting as an important tool for the revival of an economy. Eversince, deficit budgeting is being advocated as a means of financing economic development by both developing and developed countries. However, the problem of rising budget deficit over the years in most countries has aroused a lot of concern among economists and policy makers. The presentation of a budget has also been anxiously awaited by all classes of people in anticipation of a rise, cut or introduction of a new tax by the Government.

Government expenditures have exceeded their receipts over the years, causing budget imbalances. Imposition of higher taxes to meet the rising fiscal deficits has triggered off a heated debate between its supporters and critics. Broadly, the supporters opine that higher taxes would help to balance the budget and reduce the ill-effects of deficits, while the critics believe that increasing taxes would only lead to increased Government spending. These arguments culminate into three possible patterns on the intertemporal link between Government revenues and expenditures. As von Furstenberg *et.al.* (1986) have put it, the first pattern is the fiscal synchronization wherein expenditure changes are balanced by concurrent taxation. The second and third patterns respectively refer to situations of tax revenue leading to expenditure, and tax revenue gradually adjusting to expenditure.

Economists like Friedman (1972) have argued that raising taxes would only lead to further increase in spending. To quote him, "The problem is not that we are not taxing enough but that we are spending too much. Increasing taxes would mean that you would have just as large as deficit but at a higher level of Government spending". According to him, taxation is a key variable that affects Government spending, thereby implying causation running from tax revenue to Government spending.