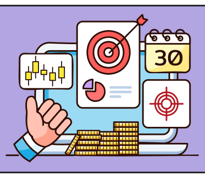
CHAPTER 7 : PUBLIC FINANCE

UNIT -1

Fiscal Functions : An Overview, Centre and State Finance

PUBLIC FINANCE INTRODUCTION

Meaning of Public Finance

	Public finance is a study of income and expenditure of the government at the central, state, and local levels.
	Government has to perform certain functions in a country such as, supply of public goods which individuals cannot produce.
	In order to provide those goods Govt needs revenue.

Public Finance Areas

Formulation of Fiscal Policy
- Generation of Revenue from Tax and Other Sources
- Expenses through Budgetary Allocations
- Public borrowings to meet deficit

Components of Public Finance

- Public Expenditure
- Public Revenue
- Public Debt
- Public financial administration
- Economic stabilization and economic growth

Role of The Government

- Provision of essential public goods
- Facilitating and regulating the private sector for promoting industries, financial institutions, and building infrastructures.
- Protect Private rights to land and capital (Défense)
- Good courts and legal systems
- Protections of individual liberties
- Creating good public healthcare and education systems

Public Finance...

Classical Papers on Public Finance

1959
The Theory of Public Finance by **Richard A. Musgrave**

1967
Public Finance in Democratic Process: Fiscal Institutions and Individual Choice by **James M. Buchanan**

1980
Lectures in Public Economics by **Anthony B. Atkinson** and **Joseph E. Stiglitz**

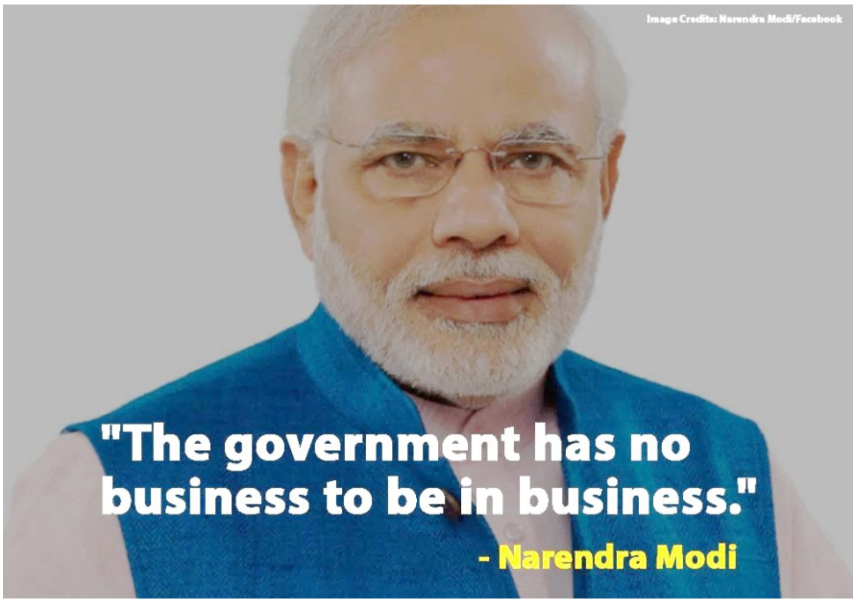
HALL OF FAME

Joseph Eugene Stiglitz : Nobel Laureate

Richard Musgrave American German economist

James McGill Buchanan Jr- Nobel Prize Winner

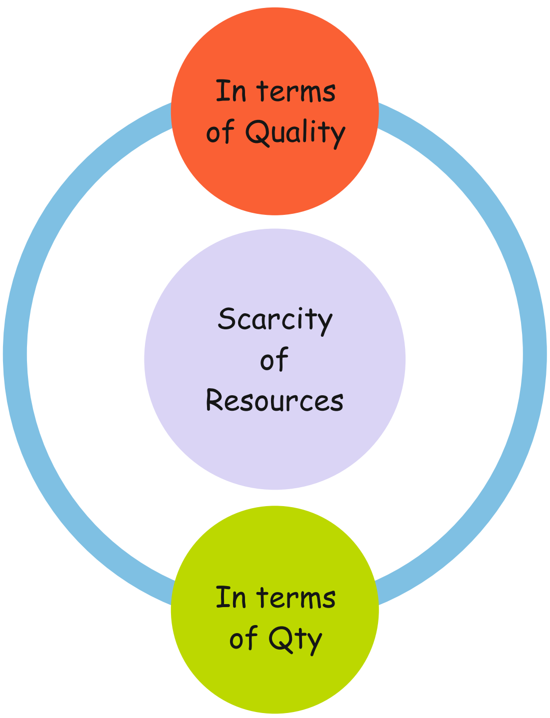
FISCAL FUNCTIONS - INTRODUCTION

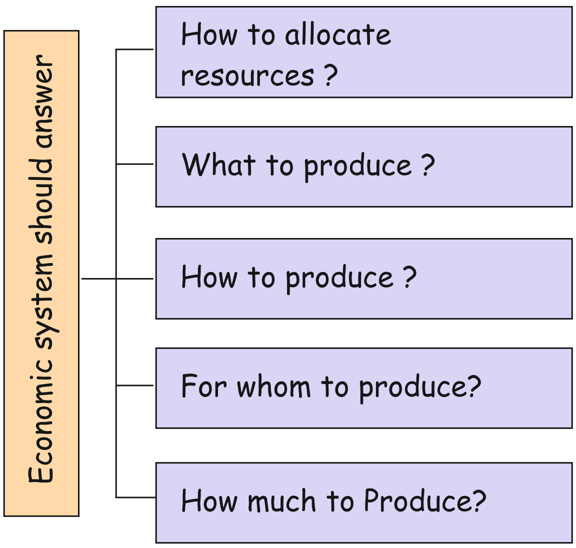


But why does Govt. intervene?

- Economic variable should achieve socio economic objectives
- However due to market imperfections these objectives are not met.
- If everything is left to Pvt. Sector then there will be exploitation.
- Hence Govt. intervention is must.

Why do we need Economic System?





Economic Systems

- **Capitalism**
  - Private ownership of the means of production
  - Free Trade
  - Govt. acts as a regulator
- **Socialism**
  - Social ownership of the means of production
  - Economic Planning by Govt.
- **Mixed Economy**
  - Public and private ownership of industry
  - market-based allocation with economic planning
  - Free markets with state interventionism

Do we really need Govt. intervention ?

- **Public Sector has a role to play in**
  - National Defense, Education, Healthcare, Law & Order & Justice, Public Infrastructure
  - If these sectors are left only to Pvt Sector, then proper allocation of resources wont take place.
- **Private Sector has a role to play in**
  - Remaining sectors. Can play role in few of the Public Sector areas
  - Driven totally by profit motive.

Government Functions

- **Traditional**
  - Defense, Education, Healthcare, Law and order etc.
- **Fiscal / Economic**
  - Functions which affect economic output, growth, inflation etc.

Fiscal Functions as per Richard Musgrave

- **Micro**
  - Resource Allocation (To ensure efficiency)
  - Income Redistribution (To gurantee fairness)
- **Macro**
  - Stabilization (To ensure price stability)

THE RESOURCE ALLOCATION FUNCTION

Meaning

1) Resource allocation refers to the way in which the available factors of production are allocated among the various uses to which they might be put.
2) Resources have utility for more than one thing. So economic system should determine appropriate allocation
   a) **Eg.** Sugarcane can be use to make sugar or ethanol.
   b) **Eg.** Uranium can make power or Bomb
   c) **Eg.** Water for agriculture or Industry
3) It determines how much of the various kinds of goods and services will actually be produced in an economy.
4) Optimal Allocation is real life is driven by
   a) **Market forces**
   b) **Government Actions**

Examples of improper resource allocation in India (World Bank Report 2014)

Savings are not channelized towards risky instruments	Agricultural produce and demand synchronization
Excessive labor force in rural areas dependent on agriculture	Water resources – more water in areas prone to flood

Guiding factors for resource allocation

Private Sector	Demand and Supply	Producer Profit motives
Public Sector	Revenue and expenditure activities of governmental budgeting	Social Objectives

REASON FOR MARKET FAILURE WHICH HINDERS EFFICIENT ALLOCATION OF RESOURCES

1) **Incomplete markets;** markets may fail to produce the right quantity merit goods, such as education and healthcare
2) **Imperfect competition**
3) **Presence of monopoly** power leading to
   a) under-production and
   b) higher prices
4) **Common property resources** (e.g. environment) are overused and exhausted in individual pursuit of self-interest.
5) **Externalities** which arise when the production and consumption of a good or service affect third parties (e.g. pollution).
6) **Factor immobility** which causes unemployment and inefficiency.
7) **Imperfect information** because it may not be in the interests of one party to provide full information to the other party, and
8) **Inequalities in the distribution of income and wealth**

Objectives of Govt. intervention

(Market failure is biggest reason for Govt. intervention)

- To Improve social welfare
- Avoid excessive production or shortfall in production
- To Provide public goods
- To correct market failures
- Demote demerit goods and promote Merit Goods

How does Govt. achieve resource allocation?

Expenditure Policy
- Provision of public goods
- Directs resources in appropriate channel

Tax Policy
- Who will be taxed?
- What will be taxed?
- How much will be taxed?

Instruments of allocation

A variety of allocation instruments are available by which governments can influence resource allocation in the economy. **For example:**

a) Direct Production of goods	e.g. Electricity, Public Transport
b) Influence private allocation through incentives and disincentives	e.g. Subsidy for backward area and High taxes on demerit goods
c) Influence allocation through its competition policies, merger policies	e.g. Competition Act, 2002 Prevents monopolistic situation and promotes efficiency in markets
d) Regulatory activities	e.g. License for Transport services
e) Legal and administrative frameworks	e.g. penalty for non compliance
f) Influence allocation through legislation and force.	e.g. Ban of single use plastic goods prevent resources moving into their production

THE REDISTRIBUTION FUNCTION

Meaning

1) Resource distribution refers to manner in aggregate output and wealth is spread across the households.
2) Distribution Function
   a) If left to Market – It is **skewed**
   b) With Govt. intervention – Bell shaped – **Just & Equitable**
3) Distribution function answers-

   For whom should an economy produce goods and services
4) Governments can redistribute income and wealth either through the **expenditure side** or through the **revenue side** of the budget.

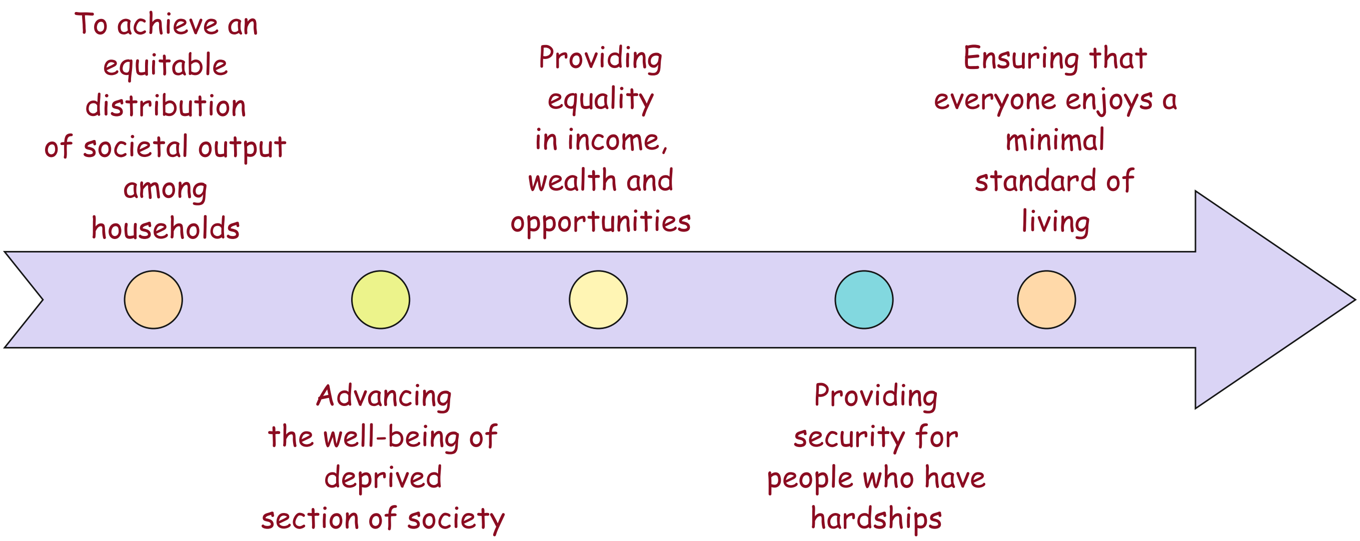
Expenditure side	Revenue side
Governments may provide free or subsidised education, healthcare, housing, food and basic goods etc. to deserving people.	Redistribution is done through progressive taxation.

Scope of distribution function

Distribution function is concerned with the **adjustment of the distribution of income and wealth** so as to ensure distributive justice namely, **equity and fairness.**

The distribution function also relates to the manner in which the effective demand over the economic goods is divided among the various individual and family spending units of the society.

Objective of distribution function



Examples of redistribution

1) **Progressive taxation** of the rich is combined with provision of subsidy to the poor households
2) Proceeds from progressive taxes used for **benefit of low-income households** (e.g. Supply of essential food grains at highly subsidized prices)
3) **Employment reservations** and preferences
4) **Regulation of the manufacture** and sale of certain products to ensure the health and well-being of consumers
5) Special schemes for **backward regions and for the vulnerable sections** of the population
6) Families below the poverty line are provided with **monetary aid and aid in kind**

Efficiency vs. Equity

1) Exercising the redistributive function, there would be a **conflict between efficiency and equity.**
2) **Eg.** High rates of taxes on the rich can
   a) act as a disincentive to work
   b) discourage savings and investments
   c) Discourage risk taking
3) So in turn high tax rates can **reduce Govt. revenue and govt spending.**
4) So one should strike **optimal balance between Equity and Efficiency.**

STABILIZATION FUNCTION

"The task of economic stabilization requires keeping the economy from straying too far above or below the path of steady high employment. One way lies inflation, and the other lies recession. Flexible and vigilant fiscal and monetary policy will allow us to hold the narrow middle course." -(US President John F.Kennedy 1962)

Stabilization Policy

1) Macroeconomic stability is said to exist when.
   a) an economy's output matches its production capacity,
   b) the economy's total spending matches its total output
   c) the economy's labour resources are fully employed, and
   d) Inflation is low and stable.
2) Policy options for macroeconomic stabilisation
   a) **Monetary policy**
   b) **Fiscal policy**

Meaning

Market economy does not automatically generate
a) Full employment and
b) Price stability

Business Cycles
a) Natural phenomena that Occur periodically
b) Market mechanism cannot resolve the disruptions caused by business cycle

Inaction on disruptions results in hardship through
a) Recessions
b) Inflation

Stagflation (Inflation and Unemployment exist side by side) may set in and make the problem more intricate.

Scope of Stabilization Function

Performance of the aggregate economy in terms of following:

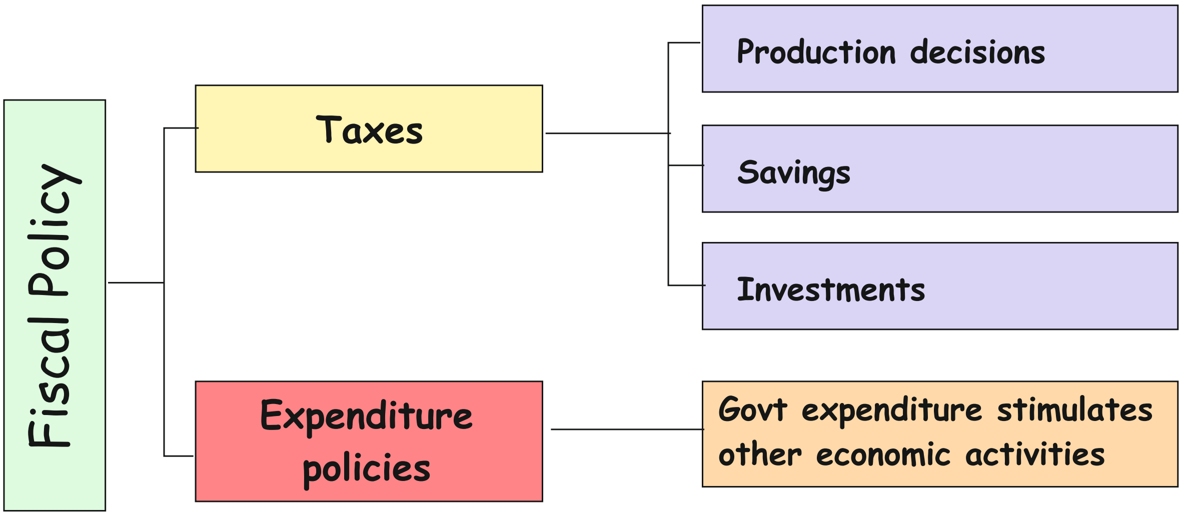
- **Labour employment and capital utilization**
- **Overall output and income**
- **General price levels**
- **The rate of economic growth**
- **Balance of international payments and**

FISCAL POLICY

- **Govt. Expenditure** injects more money and stimulates demand
- **Taxes** reduce disposable income of people and reduce effective demand
- Therefore **good spending, taxation, borrowing** influence the economy

Monetary Policy

- Controls Money supply and interest rates
- Affects Consumption, Investment and Prices



Types of Fiscal Policy

1) Expansionary Policy

a) Used in recession

b) Govt increase expenditure

c) Govt reduces taxes

d) Increase money supply

2) Contractionary Policy

a) Used in high inflation era

b) Govt cuts down expenditure

c) Govt raises taxes

d) Reduce money supply

CENTRE AND STATE FINANCE

1) Fiscal federalism deals with the division of governmental functions and financial relations among the different levels of government.
2) The **central government** should be responsible for the **economic stabilization and income redistribution**
3) But the **allocation of resources** should be the **responsibility of state and local governments.**
4) **Article 246** of the Constitution **demarcates the powers of the union and the state** by classifying their powers into **3 lists,** -
   a) **Union list** (on which the union parliament alone can legislate)
   b) **State list** (on which the state legislative assemblies alone can legislate) and
   c) **The concurrent list** on which both, the parliament and the legislative assemblies can legislate.
5) The **union government** can levy taxes such as **tax on income, other than agricultural income, customs and export duties, excise duties on certain goods, corporation tax, tax on capital value of assets, excluding agricultural land, terminal taxes, security transaction tax, Central GST, Union Excise Duty, taxes other than stamp duties etc.**
6) The **state governments** can levy **taxes on agricultural income, lands and buildings, mineral rights, electricity, vehicles, tolls, professions, as well as collect land revenue, and impose excise duties on certain items.**

FINANCE COMMISSION

1) **Article 280**, provides for an institutional mechanism, namely the **Finance Commission**, to facilitate such transfers.
2) It is responsible for evaluating-
   a) The state of finances of the union and state governments,
   b) Recommending the sharing of taxes between them and
   c) Laying down the principles determining the distribution of these taxes among States
3) The Finance Commission considers issues related to
   a) **Vertical equity** (deciding about the share of all states in the revenue collected by centre) and
   b) **Horizontal equity** (allocation among states their share of central revenue).

4) The **Fifteenth Finance Commission** recommended the **share of states in the central taxes** (vertical devolution) for the 2021-26 to be **41%.**

5) The criteria for distribution of central taxes among states for 2021-26 are-

   a) Income distance i.e the distance of a state's income from the state with the highest income,

   b) Area,

   c) Population (2011),

   d) Demographic performance (to reward efforts made by states in controlling their population),

   e) Forest and ecology and

   c) Tax and fiscal efforts.

6) States levy and collect state GST (SGST) and the union levies and collects the central GST (CGST). An integrated GST (IGST) is applied on inter-state movement of goods and services and on imports and exports.

7) For providing compensation to states, a cess is levied on luxury goods and demerit goods and the proceeds are credited to the compensation fund. GST compensation was extended beyond five years to enable states to tide over the pandemic induced economic slowdown.

8) The **central government** is entrusted with the responsibilities of provision of nationally important areas like defence, foreign affairs, foreign trade and exchange management, money and banking, cross-state transport and communication.

9) The **state governments** are entrusted with the responsibility of facilitating agriculture and industry, providing social sector services such as health and education, police protection, state roads and infrastructure.

10) The **local self governments** such as municipalities and panchayats are entrusted with the responsibility of providing public utility services such as water supply and sanitation, local roads, electricity etc.

11) For items that fall in the **concurrent list, both central and state governments** are responsible for providing services.