8 marks

Ch. 7

Public Finance

(Unit - 1) Fiscal functions : overview

① * Introduction :-

RBI → monetary policy

Govt. → Fiscal policy.

=> The actions of government have impact on the economy.

Government

- Borrow money
- Public welfare
- incurres expenditure

=> ~~Ther~~ Three main macro-economic goals for any nation :-

- Economic Growth.
- High level of employment
- Stable Price Levels.

* Government has to intervene in all above matters and take decisions.

② * Role of Government in economic system:-

Economic System :- It is a system which provides means to work and earn a livinghood.

SCARCITY

(unlimited human wants with limited Resources)

Problems

What to produce

How to produce

For whom to produce

Three types of economic system

Capitalist

Socialist

Mixed.

* ADAM SMITH

- Favoured :- FREE MARKET i.e. Capitalist.

but role of government should be in:-

a) National Defense.

b) Justice System.

c) Public Institutions & Public Works

Institutions → Hospital

Works → Roads/Bridges/etc.

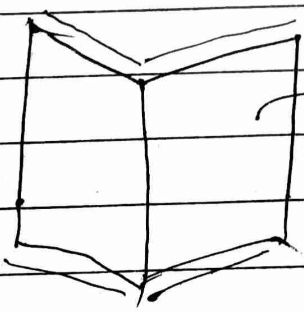
* 1930 - "Great Depression"

After this Government roles in economy gained importance.

Government perform economic functions
↓
Fisical functions/Public finance functions

* Richard Musgrave

1959



→ Theory of Public finance.

Page No.
Date

introduced three branch taxonomy of the role of government in market economy.

⇒ Three branch taxonomy :-

a) Resource allocation.

b) Income Redistribution.

c) Macro economic stabilization.

> to ensure efficiency.

> to guarantee fairness.

> to ensure price stability.

③ * "THE ALLOCATION FUNCTION"

- ~~OR~~, Optimal allocation of resources for MAXIMUM SATISFACTION.

- Minimum waste.

- Minimum inefficiency.

Private Sector (market Economy)	State (socialist economy)
• Role of demand & Supply.	Government Decides
• Consumer Soverignity.	Public Goods (↑)
• Public goods. (↓)	merit Goods (↑)
• merit goods (↓)	

- Efficient allocation takes place in perfectly competitive market, but in reality markets are never perfectly competitive.

- Some reasons for ~~inefficiency~~ inefficient allocation :-

  a) Imperfect competition.

  b) lack of public Goods.

  c) Incomplete markets – i.e. lack of merit Goods.

  d) Over use of resources (environment)

  (e) Externalities (eg. pollution)

(f) Factor immobility.

g) Inequalities of Income.

- According to Richard, Govt. should intervene in market to bring about improvement in social welfare.

(eg. Production & consumption of demerit goods are controlled by govt.)

- The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its expenditure & tax policies. It determines:-

a) Who and what will be taxed.

b) How much and on what govt. revenue will be ~~tax~~ spent.

c) optimum mix of various social goods.

Public goods + merit goods, etc.

- A variety of allocation instruments are available by which govt. can influence resource allocation in the economy. For eg:-

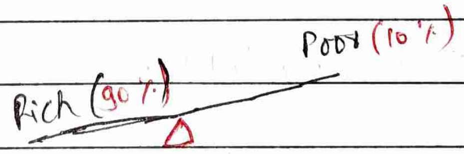
  a) Government may directly produce an economic goods like electricity.

  b) Government may influence allocation through legislation & force.
  ↓
  ban on single use plastic.

  c) Government's regulatory activities
  eg. licensing.

④:- "REDISTRIBUTION FUNCTION"

- Generally distribution of income & wealth is SKEWED
  ↓
  "Skewness"



- This function relates to the basic question of FOR WHOM TO PRODUCE.

- This function also relates to the manner in which effective demand over the economic goods is divided among the various individuals.

- Progressive taxes & Subsides.

Rich ↑↑↑
Tax ↑↑↑

Poor को financial assistance देना.

- This functions aims at :-

  a) redistribution of income.

  b) Social welfare

  c) Provide equality of income

  d) Provid security (in terms of fulfilment of basic needs)

- Few examples :-

  a) Progressive taxes

  b) Food grains at subsidised price to BPL house holds

  c) Employment Reservation

Page No.
Date

(d) Unemployement benefits. etc.

* $\boxed{\text{Efficiency vs Equity}}$

Efficiency ↓
Rich & increase the production that ~~takes~~ gives efficiency

Equity ↓
Upliftment of poor.

=> Greater equity can be achieved through:

high taxes on Rich., this could act as disincentive to entrepreneurship & discourage people from making savings & investments.

=> Therefore, redistribution measures should be accomplished with minimal efficiency costs.

(5) "STABILIZATION ~~FUM~~ FUNCTION"

Output = Production Capacity
Spending = total output.
Labour = fully employed.
inflation is low & stable.

Page No.
Date

- Keynes believe that economy does not automatically generate full employment., there Govt. has to interfere.

- For Stability
  - → Monetary Policy. (i.e. Money Supply & Interest Rates)
  - → Fiscal Policy. (govt. expd., govt. revenue)

- Stagflation is also problem.

  ↓

  Stagnation (+) inflation

  ↓

  Unemployment.

- Stabilization issue also become more complex due to CONTAGION EFFECT

  ↓

  (i.e. increased international interdependence & financial integration causes forces of instability)

- Stabilization function is concerned with :-

  labour employment, Capital utilization,

overall output, general price level, balance of internation payments and rate of economic growth.

- "COVID Scenario"

Monetary policy

Interest Rates cut down

(money supply ↑)

Fiscal policy

Govt. expenditure increased

(money supply ↑)

* This is Expansionary Fiscal policy

* To control inflation, govt. adopts Contractionary Fiscal policy.

- Richard introduced a term "FISCAL FEDERALISM"

Division of economic functions and resources among different layers of government

Government

Centre govt. → Income redistribution

State govt → Allocation of Resources.

Economic Stabilization

* In India Article 246 of Constitution demarcates the power of the Union & the state by classifying their powers into three lists :-

a) Union list.

b) State list.

c) Concurrent list.

* In case of conflicting legislation in concurrent list, the law passed by centre prevails.

* "TAXES"
  - → by State :- Tax on agriculture income, Tax on electricity, Toll tax etc.
  - → by Centre :- Income tax, corporate tax, wealth tax, Export duties, STT, Customs, CGST.

Ajanta
Page No.
Date

* Article 268 to 281 of Constitution contain specific provision in respect of distribution of finances among state.

Centre

→ All states

Allocation of revenues.

* Finance Commission facilitate such transfers

→ It makes recommendations to president as well

→ 15th finance commision was constituted on 27 Nov. 2017

→ Finance commission also consider issues related to :-

a) Verticale equity - share of all states in revenue collected by centre.

Page No.
Date

b) Horizontal equity - allocation among states

* Gross Tax Revenue (of Union) xxx

(-) Cesses (xxx)
↓ Tax

(-) Surcharges. (xxx)

(-) Non Tax Revenues (xxx)

Net Divisible Pool (NDP) xxx

NDP →
- Some share to states.
- Remaining with centre.

* GST
  - CGST
  - SGST
  - IGST (integrated)

GST compensation is given to State to compensate for loss of revenue due to introduction of GST.

Page No.
Date

* In may 2022, Supreme Court said that Union & State government have "Equal simultaneous & unique powers" to make laws on GST.

* For 2021-26, % share of states in central ~~taxe~~ taxes is 41%.
Criteria for determining this distribution includes :-

(i) Income distance

2) Population

3) Area

4) Demographic performance.

5) forest & ecology.

6) Tax & fiscal efforts.

* Responsibilities

→ $\boxed{\text{Centre}}$:- Defence, foreign affairs, foreign trade, exchange management, money & banking, communication, etc.

Page No.
Date

↳ State :- Agriculture, Industry, Social Sector Services (Education & Health), Police services, Roads, Infrastructure, etc.