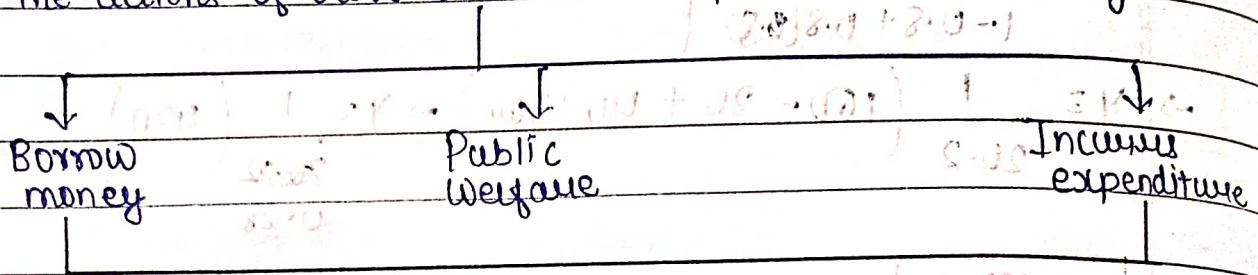


Unit I: Fiscal Functions

- The actions of Government have impact on the economy.



- Three main Macro Economic goals of any Nation :-

(a) Economic growth (b) High level of employment (c) Stable Price Level

- Government has to intervene in all above matters and take decision.

* Role of Government in Economic System

ECONOMIC SYSTEM



It is a system which provides means to work & earn a living



SCARCITY

(unlimited human wants with limited resources)



PROBLEMS

What to Produce

For whom to Produce

How to Produce

- Three Types of Economic System

(i) Capitalist

[Refer Ch. 1]

(ii) Socialist

[Refer Ch. 1]

(iii) Mixed

[Refer Ch. 1]

• Adam Smith

(i) Favoured FREE MARKET / CAPITALIST

but role of Government should be in:-

- (a) National Defence (b) Justice System (c) Public Institutions & Public work

• 1930 - Great Depression

After this, Government's role in economy gained importance

→ Government performs Economic Functions

↓
Fiscal Function / Public Finance Function

• Richard Musgrave

→ 1959 → Theory of Public Finance

→ introduced three branch Taxonomy of the role of Government

in market economy:-

- (i) RESOURCE ALLOCATION → to ensure efficiency
(ii) INCOME REDISTRIBUTION → to guarantee fairness
(iii) MACRO ECONOMIC STABILIZATION → to ensure price stability

* The Allocation Function

• Optimal allocation of resources for MAXIMUM SATISFACTION

• Minimum waste

• Minimum inefficiency

MARKET ECONOMY	SOCIALIST ECONOMY
<ul style="list-style-type: none"> • Role of Demand & Supply • Consumer Sovereignty • Public goods (↓) • Merit goods (↓) 	<ul style="list-style-type: none"> • Government decides • Public goods (↑) • Merit goods (↑)

• Effective allocation takes place, in Perfectly Competitive Market. but, in reality, Markets are never perfectly competitive

• Some reasons for inefficient allocation :-

- (a) Imperfect competition
- (b) Lack of public goods
- (c) Incomplete market - lack of merit goods
- (d) Overuse of resources (environment) :-
- (e) Externalities (eg. Pollution)
- (f) Factor immobility
- (g) Inequalities of Income

• According to Richard, Government should intervene in market to bring about improvement in Social Welfare.

eg. Production & Consumption of De-merit goods are controlled by gov.

• 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 spent
- (c) Optimum mix of various social goods
 - ↳ Public goods
 - ↳ Merit goods

• If variety of allocation instruments are available by which government can influence resource allocation in the economy.

for eg. (a) Govt may directly produce an economic good like electricity

(b) Govt. may influence allocation through legislation & force

(eg. Ban on single use plastic)

(c) Government's regulatory activities eg. Licensing

* Redistribution Function

• Generally distribution of income and wealth is SKewed.

• 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 and Subsidies

↓

Rich ↑

Taxes ↑

↓

Financial assistance

to POOR

• This function aims at :-

(a) redistribution of income

(b) social welfare

(c) provide equality of income

(d) provide security (in terms of fulfillment of basic needs)

• Examples :-

(a) Progressive taxes

(b) Food grains at subsidised price to BPL holders

(c) Employment reservation

(d) Unemployment benefits

Efficiency vs Equity

Rich provide efficiency

upliftment of poor

→ Greater equity can be achieved through HIGH TAXES ON RICH, but this could act as DISINCENTIVE to entrepreneurship and discourage people from making Savings & Investments.

→ Therefore, Redistribution measures should be accomplished with MINIMAL EFFICIENCY COSTS.

* Stabilization Function

- Output = production capacity
- Spending = total output
- Labour = fully employed
- Inflation is low & stable

→ Macroeconomics Stability

→ Keynes believed the economy does not automatically generate full employment, Therefore Govt. has to interfere.

• For Stability

- MONETARY POLICY (i.e. Money Supply & Interest rate)
- FISCAL POLICY (i.e. Govt. expenditure & 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 utilisation
 - overall output
 - General price level
 - Balance of International Payments
 - Rate of economic growth

COVID Scenario.

↓
MONETARY
POLICY



- Interest rates cut down (Money Supply ↑)

↓
FISCAL
POLICY



- Government Expenditures increased (Money Supply ↑)

• This is EXPANSIONARY FISCAL POLICY

- To control inflation, government adopts CONTRACTIONARY FISCAL POLICY.

- Richard introduced a term → **FISCAL FEDERALISM**
→ Fiscal Federalism ⇒ Division of economic function & resources among different layers of Government.

↓
Central Government



- Income Redistribution
- Economic Stabilisation

↓
State Government



- Allocation of resources

- In India, Article 246 of Constitution demarcates the powers of the Union & State by classification of power 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 CENTRE : Income Tax, Corporate Tax, Wealth Tax
Export Duties, Securities Transaction Tax
Customs, CGST

↳ by STATE : Tax on agricultural income, Tax on electricity,
Toll Tax etc.

- Article 268 to 281 of Constitution contain specific provision in respect of distribution of finances among State

- Finance Commission facilitates transfer of finance from centre to state.

→ It makes recommendations to President as well.

→ 15th Finance Commission was constituted on 27 Nov. 2017

→ It also considers issues related to :-

(a) Vertical Equity - Share of all states in revenue collected by centre.

(b) Horizontal Equity - allocation among states

• Gross Tax Revenue (of Union)	XXX
(-) Cesses (tax)	(XXX)
(-) Surcharges	(XXX)
(-) Non tax Revenues	(XXX)
Net Divisible Pool (NDP)	XXX



From NDP, some shares are given to states & remaining with centre.

• GST (Goods & Services Tax)

- ↳ CGST
- ↳ SGST
- ↳ IGST (Integrated)

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

• 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 taxes is 41%.

→ Criteria for determining this distribution includes :-

- (i) Income distance (distance of income of state from highest income state)
- (ii) Population
- (iii) Area
- (iv) Demographic condition
- (v) Forest & Ecology
- (vi) Tax & fiscal efforts

• Responsibilities :-

- (a) Centre → Defence, Foreign affairs, Foreign Trade, Exchange Management, Money & Banking, Communication etc,
- (b) State → Agriculture, Industry, Social Sector Services (Education & Health) Police Services, Roads, Infrastructure etc,