

Chapter - 7

Public Finance

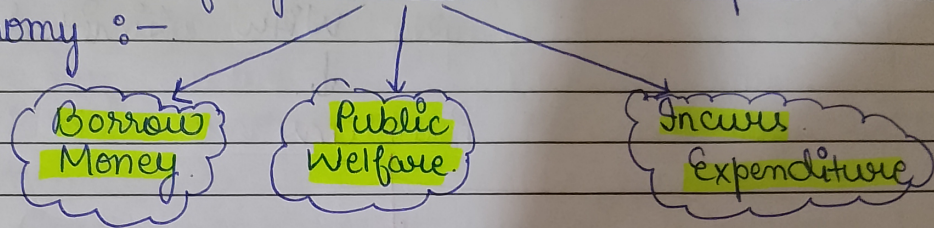
Unit - 1 — Fiscal Functions

(1) Introduction

* RBI makes monetary policy

* Govt. makes Fiscal Policies

→ The actions of government have impact on the Economy :-



* Three Main Macro Economics goals for any Nation :-

- Economic "Growth"
- High level of "Employment"
- "Stable" Price levels.

* Govt. has to intervene in all above matters and take decision.

② Role of Government in Economic System

Economic System

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

SCARCITY

1. Unlimited Human wants
2. With limited resources

Problems

What to produce

How to produce

For whom to produce

Three types of Economic System

Socialist

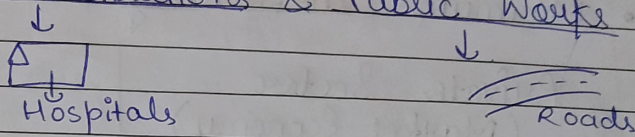
Capitalist

Mixed.

* **ADAM SMITH** (Father of Economics)
 → He favoured Free Market i.e. Capitalist.

but role of Government should be in:

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



* **1930 - Great Depression** :-

After this govt. role in economy gained importance.

Government performs Economic function

↓
 Fiscal functions (OR) Public Finance functions

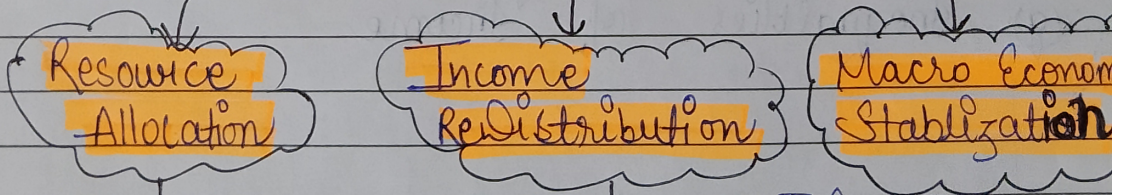
* **Richard Musgrave** :-

In 1959, he wrote a book



→ Theory of Public Finance

Introduced three Branch taxonomy of the role of government in market economy.



To Ensure Efficiently

To Guarantee "Fairness"

To Ensure Price Stability

③ The Allocation Function :-

- Optimal Allocation of Resources for **MAXIMUM SATISFACTION**
- Minimum **Waste**
- Minimum **Inefficiency**

Private Sector
(Market Economy)

State
(Socialist Economy)

- Role of Demand & Supply
- Consumer Sovereignty
- Public goods (↓)
- Merit goods (↓)

- Government decides
- Public goods (↑)
- Merit goods (↑)

- Efficient allocation takes place in **Perfectly Competitive Market**, but in reality markets are never perfectly competitive.

- Some reasons for inefficient allocation :-

- Imperfect Competition
- Lack of public goods
- Lack of merit goods - Incomplete market
- Overuse of resources (Environment)
- Externalities (ex - Pollution)
- Factor immobility
- Inequalities of Income.

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

↓
Ex:- Production & consumption of demerit goods (like alcohol) 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 revenue.

(c) Optimum mix of various social goods.

Public goods + Merit goods

- A variety of allocation instruments are available by which govt. can influence resources allocation in the economy.

For Example :

(a) government may directly produced an Economic goods like electricity.

(b) Government may influence allocation through "legislation" & force.

↳ Ban on single use plastic

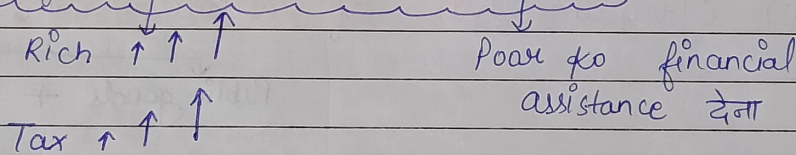
(c) Government's regulatory activities.
Ex - Licensing.

④ Redistribution Function

- Generally distribution of income & wealth is **SKEWED**.
 --> "Skewness" Rich 99% Poor 1%

- 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 & Subsidies



- 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)
- Few Examples :-
 - (a) Progressive Taxes
 - (b) foods grains at subsidised prices to BPL households.

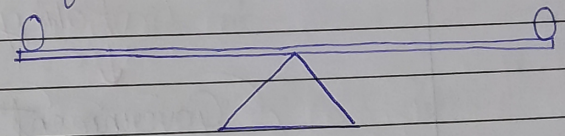
- (c) Employment reservation
- (d) Unemployment Benefits etc.

Efficiency v/s Equity

- Great Equity can be achieved through high taxes on Rich, but 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 Function :-

- Output = Production Capacity
- Spending = Total Output
- Labour = Fully Employed
- Inflation is low & stable



• Keynes believe that economy does not automatically generate full employment, therefore government has to interfere.

For Stability :-

- Monetary Policy (i.e Money Supply & Interest Rate)
- Fiscal Policy (govt. expenditure, govt revenue)

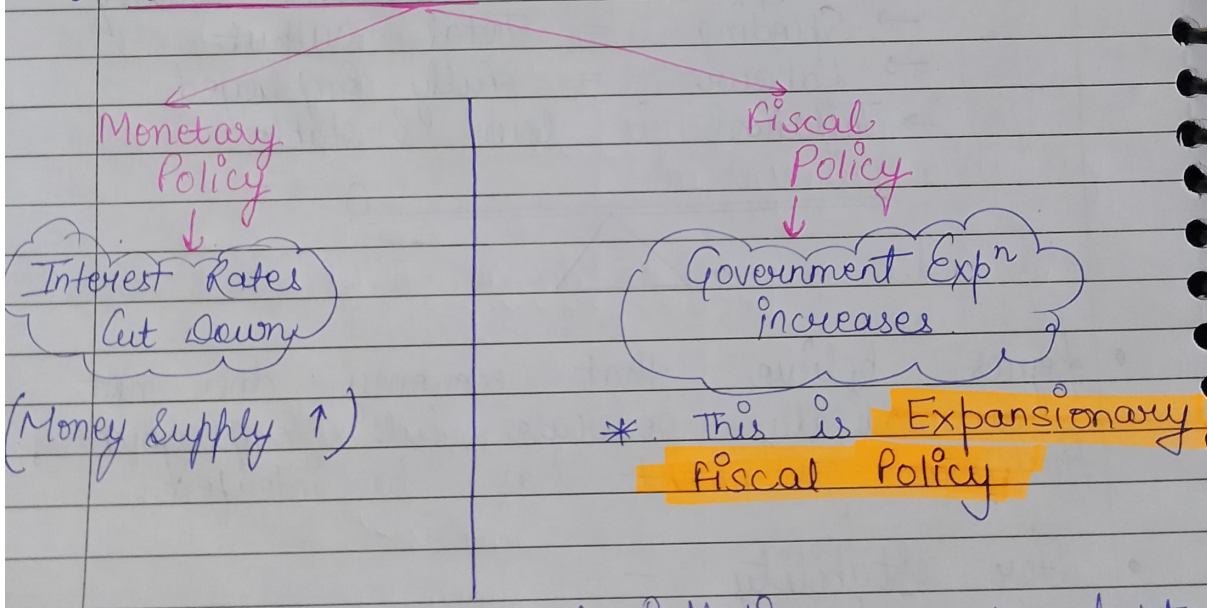
• **Stagflation** is also problem.

Stagnation + Inflation

•• • 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 and Rate of Economic Growth.

• "COVID Scenario"



* To control inflation, govt. adopte **contractionary fiscal Policy.**

- Richard introduced a term "fiscal federalism"

Division of Economic functions and resources among different layers of government.

Central Govt.

State Government

1. Income Distribution

1. Allocation of Resources

2. Economic Stabilization

- * In India, Article 246 of constitution demarcates the powers of the union and 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 Centre :- Income Tax, Corporate Tax, Wealth Tax, Export duties, STT, 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 facilitate such transfers

↳ It makes recommendations to President as well.

↳ 15th finance Commission was constituted on 27 Nov 2017

↳ finance Commission also consider 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	(xx)
↳ Tax	
(-) Surcharges	(xx)
(-) Non tax Revenue	(xx)

Net Divisible Pool (NDP)

xxx

Some share to states. ← → Remaining With centre.

See it for the first time as a newborn child that has no name.

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* GST

- 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 & Union Powers" to make laws on GST.

→ For 2021-26, % share of States in Central taxes 41% Criteria for determining this distribution includes :-

1) Income Distance

2) Population

3) Area

4) Forest & Ecology

5) Demographic performance

6) Tax & fiscal efforts

* Responsibilities

→ (Centre) → Defence, foreign Affairs, Foreign Trade, Exchange Management, Money & Banking, Communication etc.

→ (State) → Agriculture, Industry, Social Sector Services (Education & Health), Police Services, Roads, Infrastructure.