Chapter -2

Unit-1

FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

Economics

MICRO

Study of Individual

MACRO

Study of Economy as a whole

Macro Economic Goals

First

Economic Growth

Real GDP grows faster rate than Population

Second

High level of Employment

ensure Higher Income & Higher output

Third

Stable Price Level

avoid Prolonged inflation & deflation

INFLATION

Reduce Real Income & Purchasing power, disproportionately affect lower income families

DEFLATION

signals downturn in economic activity which cause recession or even Depression & large level of Unemployment

Role of Government in Economic system

✓ *The government does not expect the economy to function automatically; rather it intervenes to direct them to function in particular directions.*

✓ *Such intervention on the part of the government is based on the belief that the objective of the z with what is referred to as economic functions also called fiscal functions or public finance function.*

Three Branch Taxonomy

By Richard Musgrave
(Theory of Public Finance)
(1959)

Resource Allocation
To ensure efficiency

↓

It correct the sources of inefficiencies in the economy.

Income Redistribution
To ensure Fairness

↓

It ensure the fair distribution of wealth and Income

Macroeconomic stabilization
To ensure Price stability

↓

It ensure the stability, Growth High level of employment & price stability.

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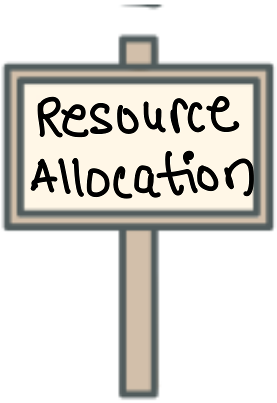
Micro-economic Function

Macro-economic Function

The Allocation Function



Resource allocation refers to the way in which the available resources or factors of production are allocated among the various uses to which they might be put.

It determines how much of the various kinds of goods and services will actually be produced in an economy.

Resource allocation is a critical problem because the resources of a society are limited in supply, whereas the wants of the members of the society are unlimited. In addition, any given resource can have many alternative uses.

In Private sector

Demand — Supply

Price Mechanism

In Public sector

Revenue — Expenditure

Government Budgeting

In the real world, resource allocation is determined by ***both market and the government.***

Efficient Allocation

When

Market is perfectly Competitive & Consumer is Rational

But

In Reality Market are not perfectly Competitive.

REASON

- ***Imperfect competition*** *and presence of* ***monopoly*** *power*
- ***collective public goods***
- ***Incomplete markets;***
- ***Common property resources***
- ***Externalities***
- ***Factor immobility***
- ***Imperfect information***
- ***Inequalities***

Market failures provide the rationale for government's allocative function

In the absence of appropriate government intervention, market failures may occur and the resources are likely to be misallocated with too much production of certain goods or too little production of certain other goods.

The allocation responsibility of the governments involves suitable corrective action when private markets fail to provide the right and desirable combination of goods and services.

Allocation function determine

(a) **who and what** will be taxed?

(b) **how much** and on what the government revenue will be spent?

(c) the **process** by which the total resources of the economy are divided among various uses?

(d) the **optimum mix** of various social goods (both public goods and merit goods)?

(e) the level of **involvement of the public sector** in the national economy?

(f) the **reallocation** of society's resources from private use to public use ?

Allocation Instruments

Direct Produce

Such as electricity & Public transport

Incentives & disincentives

Such as Subsidies for Merit goods & High Taxes on cigraettes

Legislation & Force

Such as Ban on single use plastic

Competition Policies

Such as competition Act to promote competition

Legal & Administrative Framework

AND

Combination of above

Regulatory activities

Such as Licensing, Min. wages, Directives on location of industries etc

The Redistribution Function

✓ Over the past decades there has been tremendous expansion in economic activities resulting in enormous increase in aggregate output and wealth. However, the outcomes of such economic growth have not spread evenly across the households.

✓ Socialist ideology which emphasized equality created strong pressure on the redistributive role of governments.

Government distribute Income & wealth

through

Expenditure side

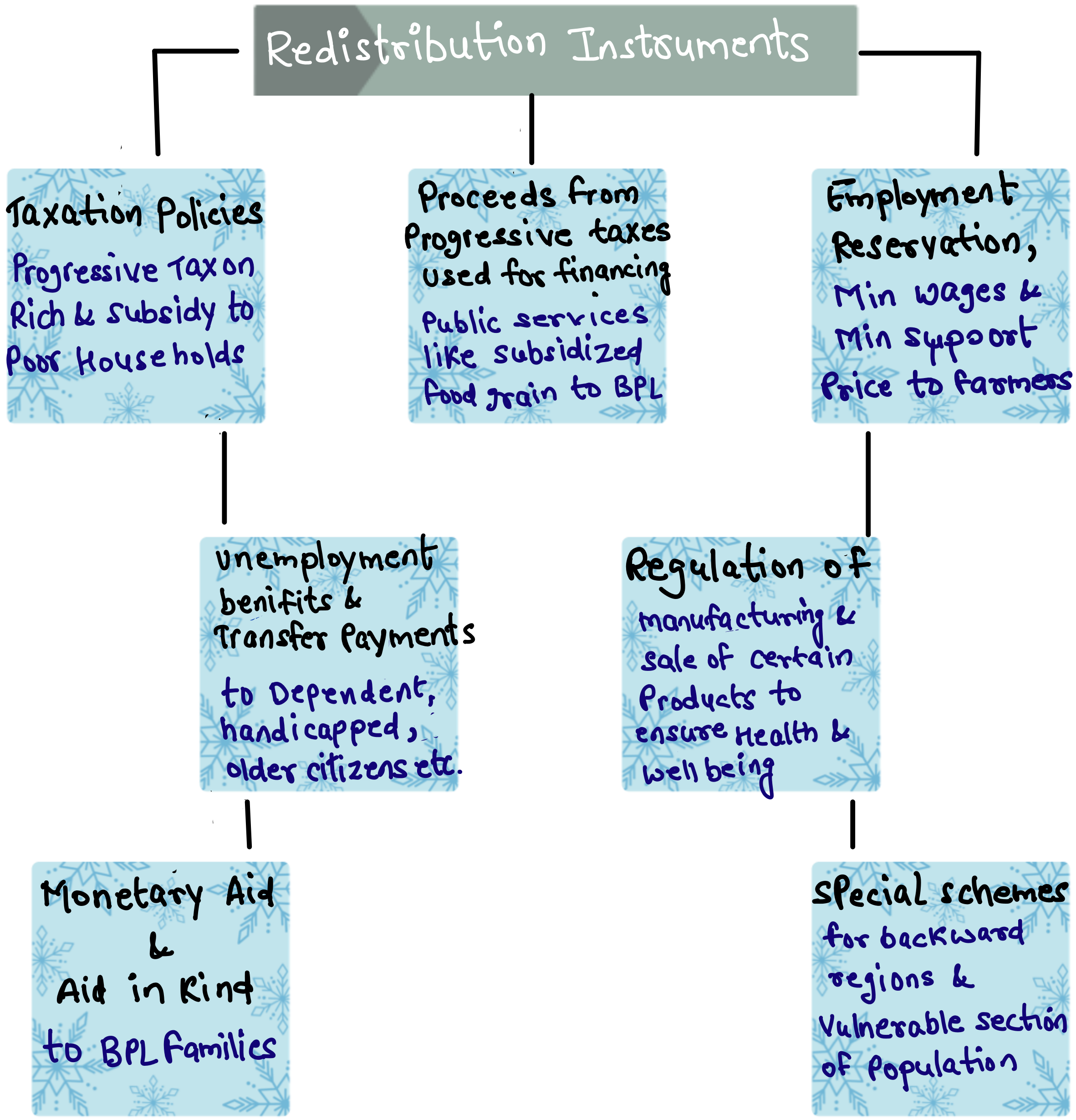
govt. Provide free or subsidised education healthcare, housing, etc. to deserving People.

Revenue side

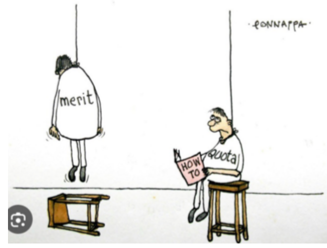
Redistribution is done through Progressive Taxation

Aim of Redistribution

- Achieve Equitable distribution
- Ensuring Minimum standard of Living
- Increased Social Welfare
- Well being of members suffer from Deprivation
- Equity of Income, wealth & opportunities


Redistribution Instruments
Taxation Policies
Progressive Tax on Rich & subsidy to Poor Households
Proceeds from Progressive taxes used for financing
Public services like subsidized Food grain to BPL
Employment Reservation,
Min wages & Min support Price to farmers
unemployment benifits & Transfer Payments
to Dependent, handicapped, older citizens etc.
Regulation of
manufacturing & sale of certain Products to ensure Health & well being
Monetary Aid & Aid in Kind
to BPL Families
Special schemes
for backward regions & Vulnerable section of Population

Deadweight losses



✓ There is, nevertheless, an argument that in exercising the redistributive function, there would be a conflict between efficiency and equity. In other words, governments' redistribution policies which interfere with producer choices or consumer choices are likely to have efficiency costs or ***deadweight losses***.

✓ For example, greater equity can be achieved through high rates of taxes on the rich; but high rates of taxes could also act as a disincentive to entrepreneurship and work, and discourage people from making savings and investments and taking risks.

✓ This in turn will have negative consequences for economic output, productivity and growth of the economy.

✓ Consequently, the potential tax revenue may be reduced in future and the scope for government's welfare activities would get seriously limited.

✓ As such, an optimal budgetary policy towards any distributional change should reconcile the conflicting goals of efficiency and equity by exercising an appropriate trade-off between them.

✓ In other words, redistribution measures should be accomplished with minimal efficiency costs by carefully balancing equity and efficiency objectives.

Equity at the cost of Efficiency is Deadweight loss.

Stabilization Function

stability said to exist when

- Economy's output matches its production capacity
- Economy's Total spending Matches its Total output
- Economy's Labour resources are fully employed.
- Inflation is Low and stable

Theoretical Rationale For stabilization Function

- ✓ *The theoretical rationale of the government is derived from the Keynesian proposition that a market economy does not automatically generate full employment and price stability and therefore, the governments should pursue deliberate stabilization policies.*
- ✓ *The market system has inherent tendencies to create business cycles. The market mechanism is limited in its capacity to prevent or to resolve the disruptions caused by the fluctuations in economic activity.*
- ✓ *The government and the country's central bank promote full employment and price stability through prudent fiscal policy and monetary policy.*
- ✓ *In the absence of appropriate corrective intervention by government, the instabilities that occur in the economy in the form of* ***recessions, inflation etc.*** *may be prolonged for longer periods causing enormous hardships to people, especially the poorer sections of the society.*

Further

Stagflation

A state of affairs in which inflation & Unemployment exist side by side

Contagion effect

Increased international interdependce & Financial integration cause forces of instability to get easily transmitted from one country to other Countries.

Effect of stabilization Function

It affect Following Areas

- Labour employment & capital utilization
- The Rate of Economic Growth
- Overall Output & Income
- General Price level
- Balance of international Payments

The stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation of resources.

Government stabilization Intervention

Government interven through Monetary policy & Fiscal policy.

Monetary Policy

Controlling the size of Money supply & interest Rate which affect prices consumption & investment

Fiscal Policy

Direct the actions of individuals & organisation by means of expenditure & Taxation decisions

Govt. Expenditure injects more money into economy & stimulate Demand

Taxes reduces disposable income & reduce effective Demand.

During Recession

Govt. cut down Tax increase Expenditure or Both so that Demand is boosted up.

Deficit Budget

During Inflation

Govt. Increase Tax or cut Expenditure to control the Demand of Economy

Surplus Budget

Expansionary Fiscal policy

Contractionary Fiscal Policy

To Sum up

- *If there is high inflation the government may decrease government spending, raise taxes, and/or reduce the money supply*
- *If there is high unemployment the government might increase government spending, reduce taxes, and/or increase the money supply*