



# CHANAKYA 2.0

*For CA Foundation*

**One Shot** **BUSINESS ECONOMICS**

**Chapter - 7**

**Public Finance**

**By- LOVE KAUSHIK SIR**



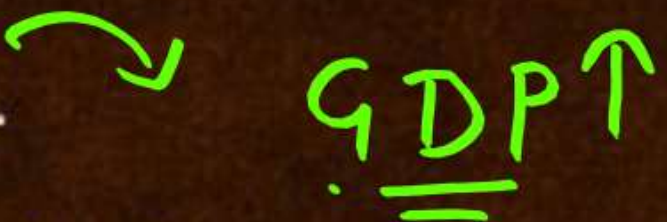
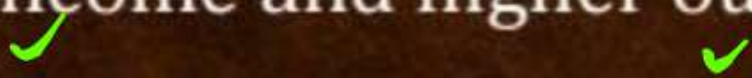



## Chapter 7: Public Finance



- ✓ • Unit 1: Fiscal Functions: An Overview, Centre and State Finance
- Unit 2: Market Failure/ Government intervention to correct Market Failure
- Unit 3: The Process of Budget Making: Sources of Revenue, Expenditure Management and Management of Public Debt
- Unit 4: Fiscal Policy

There are **three** main macroeconomic goals for any nation.

1. The first is economic growth.  GDP ↑
2. The second goal is **high levels of** employment which will ensure higher income and higher output. 
3. The third macroeconomic goal is stable price levels. 



Adam Smith is often described as a bold advocate of free markets and minimal governmental activity. Smith believed that government's roles in society should be limited, but well defined.



However, Smith saw an important resource allocation role for the government when he underlined the role of government in:

- (a) national defence ✓
- (b) establishing a system of justice to provide internal law and order and to protect property
- (c) establishment and maintenance of highly beneficial public institutions like ISRO, Railway etc. and public works such as roads, bridges, canals, harbours, and postal system that profit-seeking individuals may not be able to efficiently build and operate.



Richard Musgrave, in his classic treatise 'The Theory of Public Finance' (1959), introduced the three-branch taxonomy of the role of government in a market economy.

Musgrave believed that, for conceptual purposes, the functions of the government are to be separated into three, namely,

- (a) resource allocation (to ensure efficiency), → local, state
- (b) income redistribution (to guarantee fairness), and → central
- (c) macroeconomic stabilization (to ensure price stability). → govt.

The allocation & distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function



## Topic: 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 because resources are scarce.

Efficient allocation of available resources in an economy is assumed to take place only when the markets are perfectly competitive and economic agents make rational choices and decisions. In reality, markets are never perfectly competitive.



# Market failure

mismatch  
b/w D and S

over-production  
 $S > D$

Under-production  
 $D > S$

Lack | shortage





Public goods → collective goods

Merit good → Education, Health

Demerit good → Alcohol

Resources → Environment → Exploit  
✓ CPRI

Lukka - Chuppi

Heart → 5 lakh



Theft Insurance



# Externalities





- Market failures which hinder efficient allocation of resources occur mainly due to the following reasons:
- Imperfect competition and presence of monopoly power in different degrees leading to under-production and higher prices than would exist under conditions of competition. Markets may fail to control the abuses of monopoly power.
- Markets typically fail to provide collective public goods such as defence which are, by their very nature, consumed in common by all people.
- Incomplete markets; markets may fail to produce the right quantity merit goods, such as education and healthcare.
- Common property resources (e.g. environment) are overused and exhausted in individual pursuit of self-interest.



- Externalities which arise when the production and consumption of a good or service affect third parties (e.g. pollution).
- Factor immobility which causes unemployment and inefficiency.
- Imperfect information because it may not be in the interests of one party to provide full information to the other party, and
- Inequalities in the distribution of income and wealth

Kota  
Laxmi

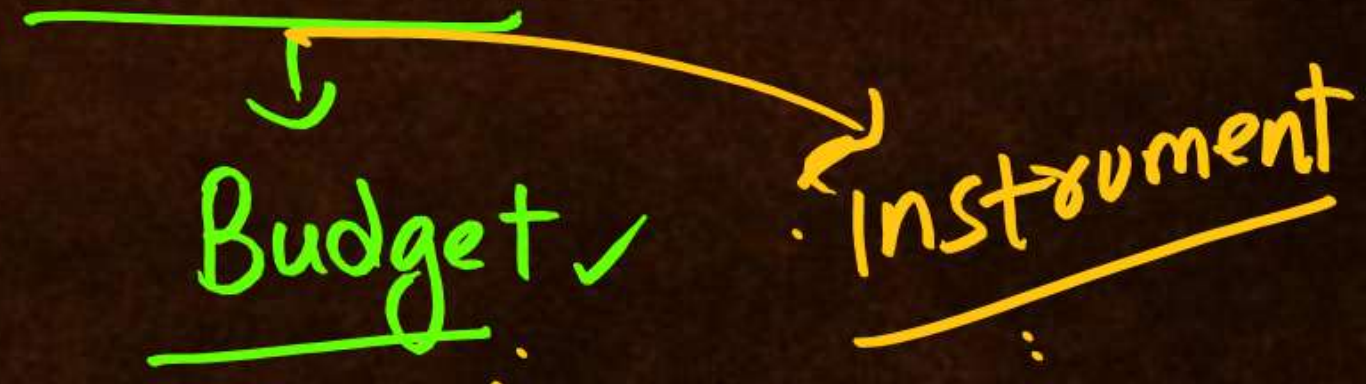
Rajendoo

Rural → Development

65 →



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. For example, the society may produce too much of demerit goods and too little of merit 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. Briefly put, market failures provide the rationale for government's allocative function.





The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its expenditure & tax policies. **The allocative function in budgeting determines:**

- (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.



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

- 1 the government may directly produce an economic good (for example, electricity and public transportation services)
- 2 the government may use the price mechanism (i.e. altering the market prices determined by demand and supply through taxes and subsidies) to influence private allocation by policies that change the behaviour of consumers and producers. In other words, the government may direct resource allocation through incentives and disincentives (for example, tax concessions and subsidies may be given for the production of goods that promote social welfare and higher taxes may be imposed on goods such as cigarettes and alcohol so that their prices are higher)





- ③ the government may influence allocation through legislation and force. For example, ban of single use plastic goods prevent resources moving into their production.
- ④ The competition policies, merger policies etc. affect the structure of industry and commerce
- ⑤ governments' regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.
- ⑥ government sets legal and administrative frameworks, and
- ⑦ governments may adopt any combination of possible remedies



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- (a) resource allocation (to ensure efficiency),
- (b) income redistribution (to guarantee fairness), and
- (c) macroeconomic stabilization (to ensure price stability).

The allocation & distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function



## Topic: Redistribution Function in Govt. Budgeting



inequality ↓

### ✓ Expenditure side of budget

Governments may provide free or subsidised education, healthcare, housing, food etc. to deserving people.

### ✓ Revenue side of budget

Redistribution is done through progressive taxation ✓



## Topic: Redistribution Function



- If left to the market, distribution of income and wealth among individuals in society is likely to be skewed and therefore government has to intervene to ensure more desirable and just distribution
- It is related to question of for whom should an economy produce goods and services



## Topic: Aim of Redistribution Function



- (1) Achieve an equitable distribution of societal output among households
- (2) Advancing the well-being of those members of the society who suffer from deprivations
- (3) Providing equality in income, wealth and opportunities
- (4) Providing security (in terms of fulfilment of basic needs) for people who have hardships
- (5) Ensuring that everyone enjoys a minimal standard of living



## Examples of Redistribution function OR

### Market intervention for socioeconomic reasons

1. Taxation policies- progressive taxation of rich & provision of subsidy to poor households
2. Proceeds from progressive taxes used for financing public services that benefit low-income households
3. Employment reservations & preferences to protect certain segments of population
4. Unemployment benefits and transfer payments to provide support to deprived sectors
5. Families below the poverty line are provided with monetary aid and aid in kind
6. Regulation of manufacture and sale of certain products to ensure health and well-being
7. Special schemes for backward regions & for vulnerable sections



## Topic: Stabilization Function

Macroeconomic stability is said to exist when:

- an economy's output matches its production capacity,
- the economy's total spending matches its total output
- the economy's labour resources are fully employed, and Inflation is low and stable.



## Topic: Stabilization Function



It ensures achievement of macroeconomic stability, maintenance of high levels of employment and price stability.

### Rationale

A market economy does not automatically generate full employment and price stability and therefore, the governments should pursue deliberate stabilization policies

- 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.

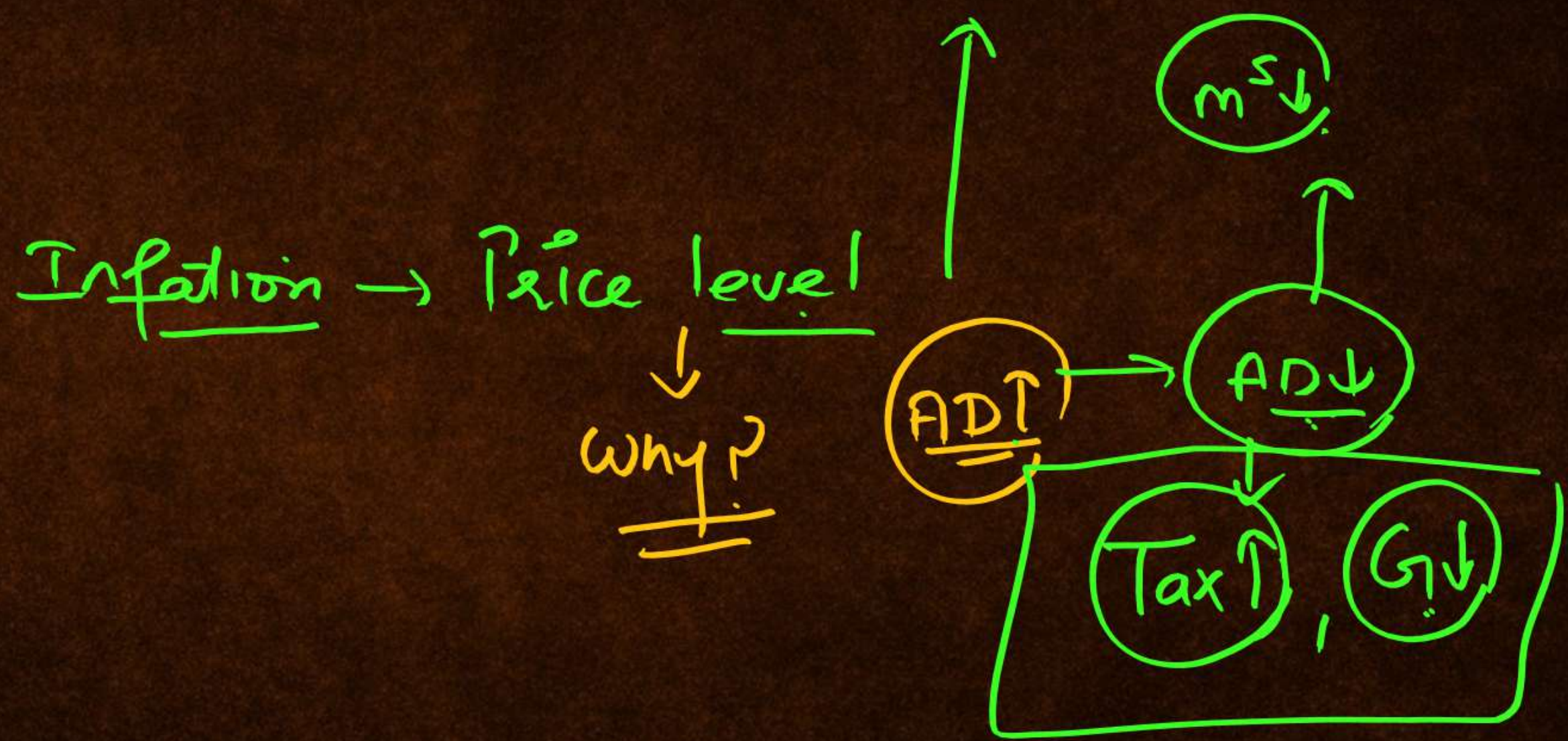




➤ Stabilization issue becomes more complex due to 'contagion' effect whereby increased international interdependence & financial integration causes forces of instability to get easily transmitted from one country to other.

**Stabilization function is concerned with performance of aggregate economy in terms of:**

1. Labour employment and capital utilization
2. Overall output and income
3. General price levels .  $(P \uparrow)$   $(P \downarrow)$
4. Balance of international payments ✓
5. The rate of economic growth





## **Government's stabilization intervention may be through :**

### **Monetary policy**

It works through controlling the size of money supply and interest rate, which in turn would affect consumption, investment and prices.

### **Fiscal policy**

It directs the actions of individuals and organizations by means of its

- Expenditure decisions- Government can choose to spend in such a way that it stimulates other economic activities
- Taxation decisions



# Expansionary fiscal policy is adopted to alleviate recession

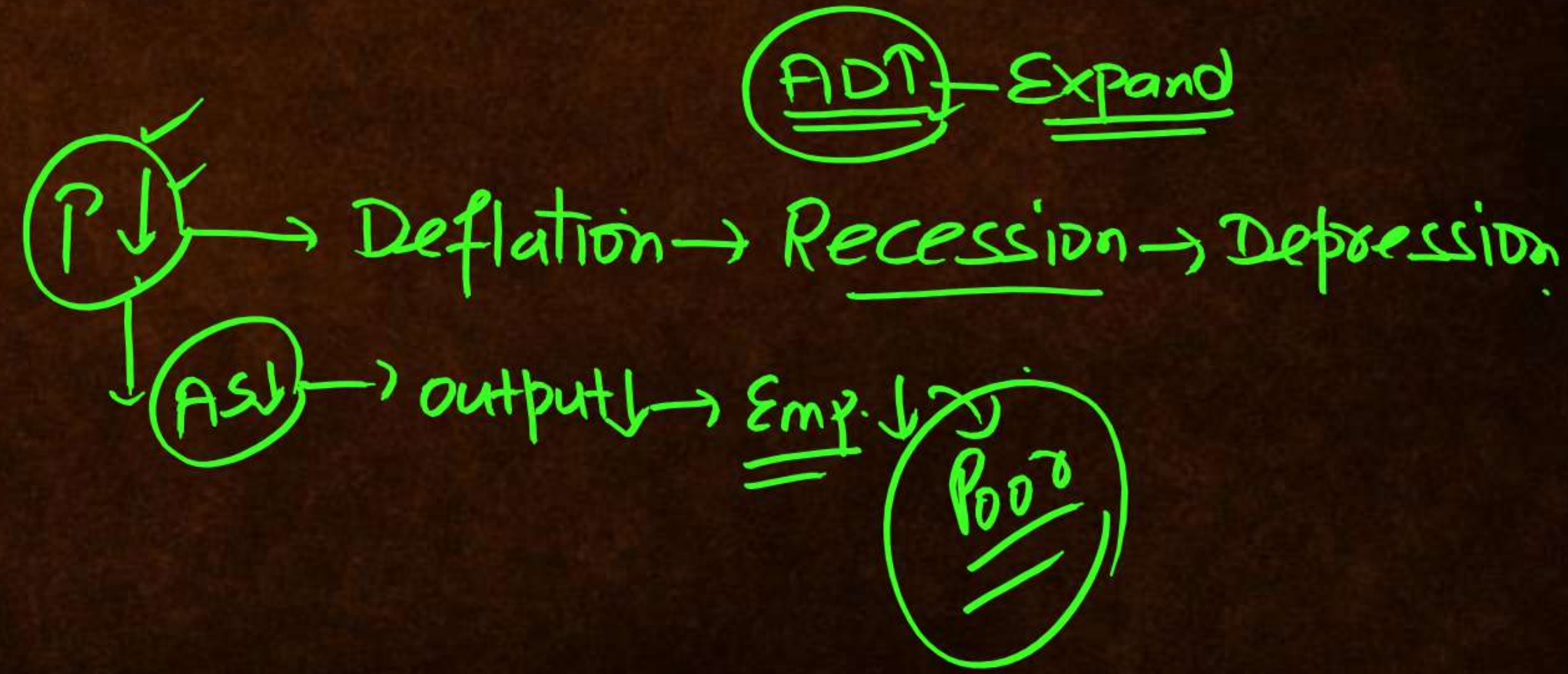
During recession, government increases its expenditure or cuts down taxes in order to ensure income protection,

$$G \uparrow \rightarrow AD \uparrow, T \downarrow \rightarrow AD \uparrow$$

# Contractionary fiscal policy is resorted to for controlling high inflation

During high inflation, government decreases its expenditure or increases taxes

4.



Fiscal Policy →  $G \uparrow, G \downarrow$   
 $T \uparrow, T \downarrow$

Deflation

Expansionary

$AD \uparrow$

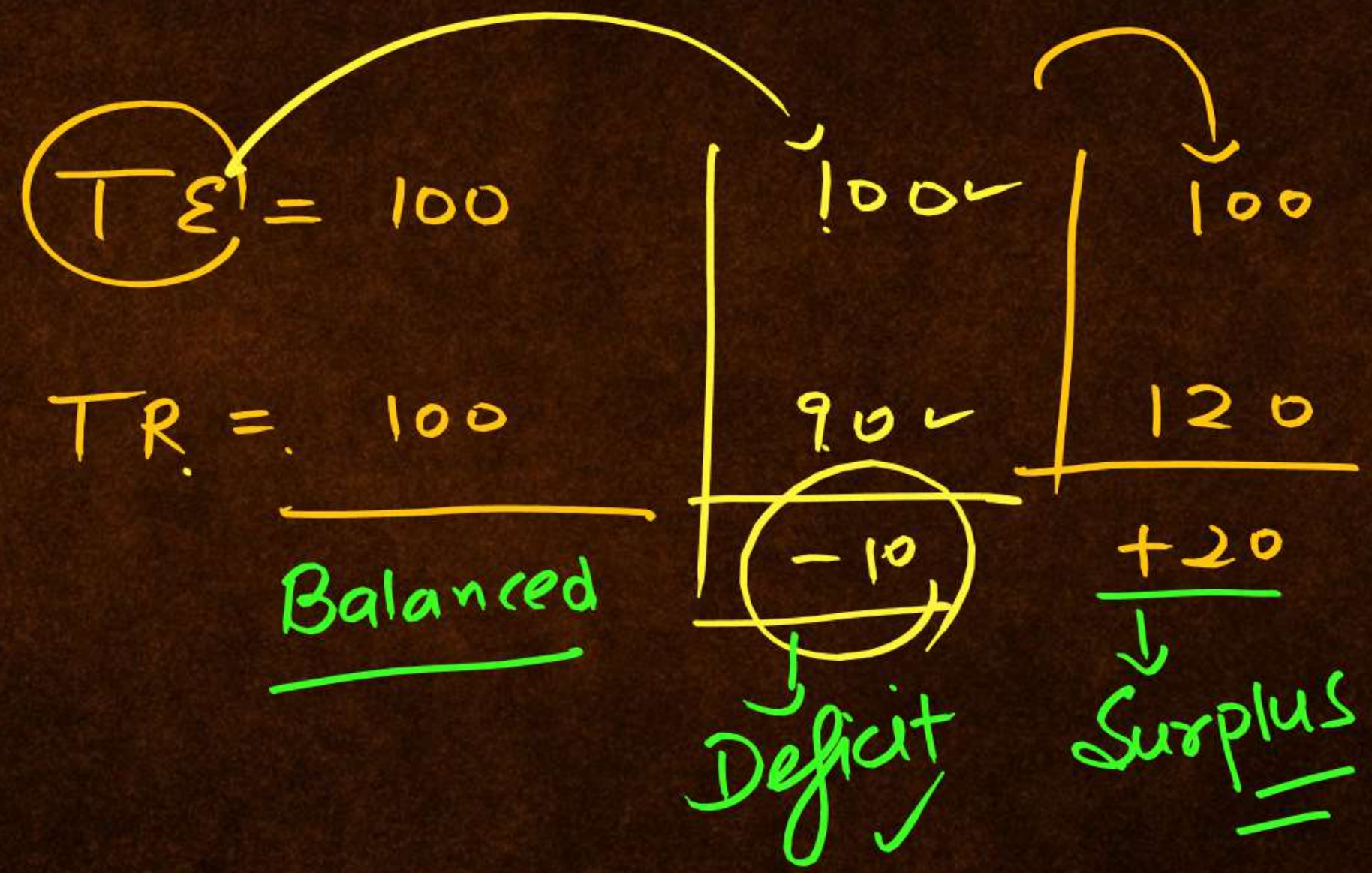
$T \downarrow, G \uparrow$

Contractionary

$AD \downarrow$

$T \uparrow, G \downarrow$

Inflation





Deficit budgets are expected to stimulate <sup>↑</sup> economic activity

$$\begin{array}{r} TE = 100 \\ TR = \underline{90} \\ \hline -10 \end{array}$$

$$\text{GT} \rightarrow \underline{\underline{AD}} \uparrow$$

Surplus budgets tend to slow down economic activity.

$$\begin{array}{r} TE \downarrow \\ \downarrow \\ \underline{\underline{100}} \end{array}, \begin{array}{r} TR \uparrow \\ \downarrow \\ \underline{\underline{150}} \end{array}$$



# QUIZ!



#Q. Redistribution policies are likely to have efficiency costs because

- A** They will reduce the efficiency of governments.
- B** They may create disincentives to work and save.
- C** Governments have to forego taxes.
- D** They are likely to make the poor people dependent on the rich

10 lakh → 100000  
20 lakh → 600000

✓ (B)

#Q. Macroeconomic stabilization may be achieved through

**A** Free market economy

**B** Fiscal policy

**C** Monetary policy

**D** (B) and (C) above

**D**

#Q. Which of the following policies of the government fulfils the redistribution function

- A Parking the army on the northern borders of the country
- B Supply of food grains at subsidized prices to the poor people
- C Controlling the supply of money through monetary policy
- D All of the above

#Q. The justification for government intervention is best described by ✓

- A** The need to prevent recession and inflation in the economy.
- B** The need to modify the outcomes of private market actions
- C** The need to bring in justice in distribution of income and wealth (C)
- D** All the above.

#Q. When a government offers unemployment benefits and also resorts to progressive taxation which function does it seem to fulfill?

- A It is trying to establish stability in an economy
- B It is trying to redistribute income and wealth
- C It is trying to allocate resources to their most efficient use
- D It is creating a source of market failure

#Q. Government of Emeline Land decides to provide most modern road infrastructure throughout the nation. This can be classified as

A Distribution function

B Allocation function

C Stabilization function

D None of the above

B

Development  
growth

#Q. Providing social sector services such as health and education is

- A** the responsibility of the central government ✓ **A**
- B** the responsibility of the respective state governments
- C** the responsibility of local administrative bodies
- D** none of the above



## Topic: Centre & State Finance



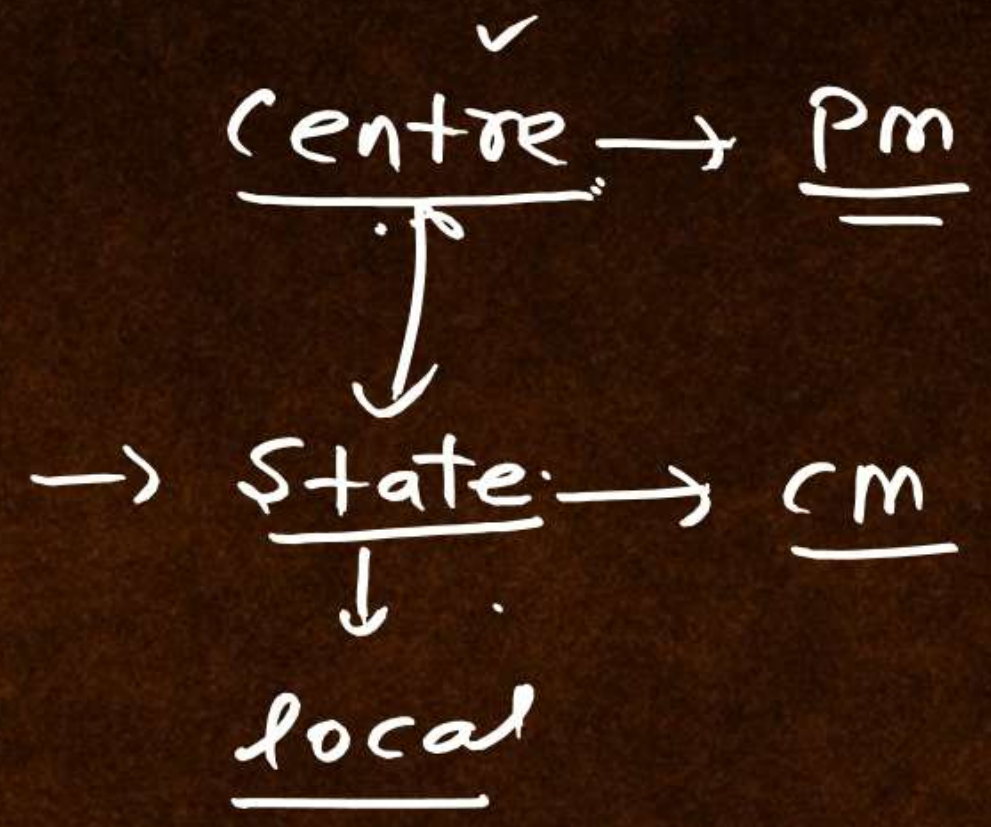
Fiscal federalism, a term introduced by Richard Musgrave, deals with the division of governmental functions and financial relations among the different levels of government. Musgrave argued that the federal or central government should be responsible for performing functions related to economic stabilization and income redistribution, and the allocation of resources should be the responsibility of the state and local governments.



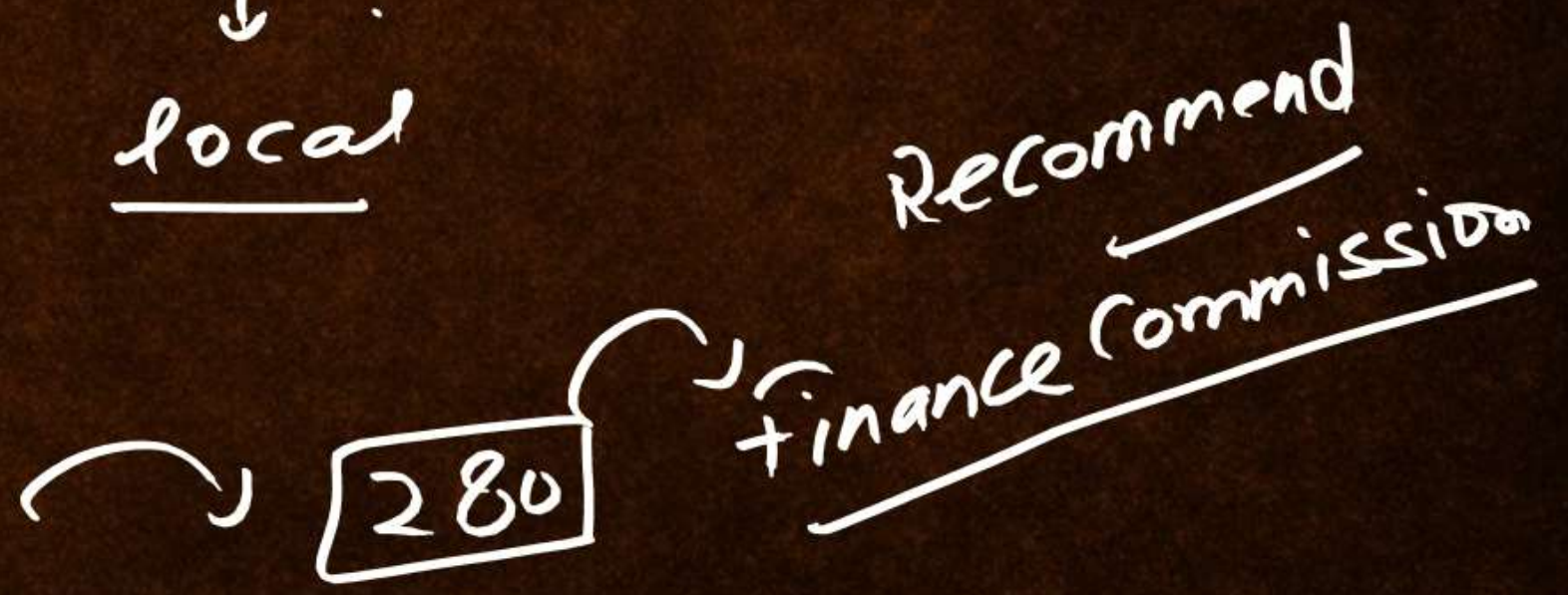


fiscal  
↓  
govt.

Federalism  
↓  
Division



Constitution  
↓  
448 Articles





## Topic: Centre & State Finance



India is a federation of 28 states and 8 union territories. Fundamentally, federalism is an institutional arrangement to accommodate two sets of government - one at the national level and the other at the regional level. Each government is autonomous in its own sphere. An independent judiciary is established to resolve disputes between the central government and the states on issues related to division of power.

## QUESTION

CA

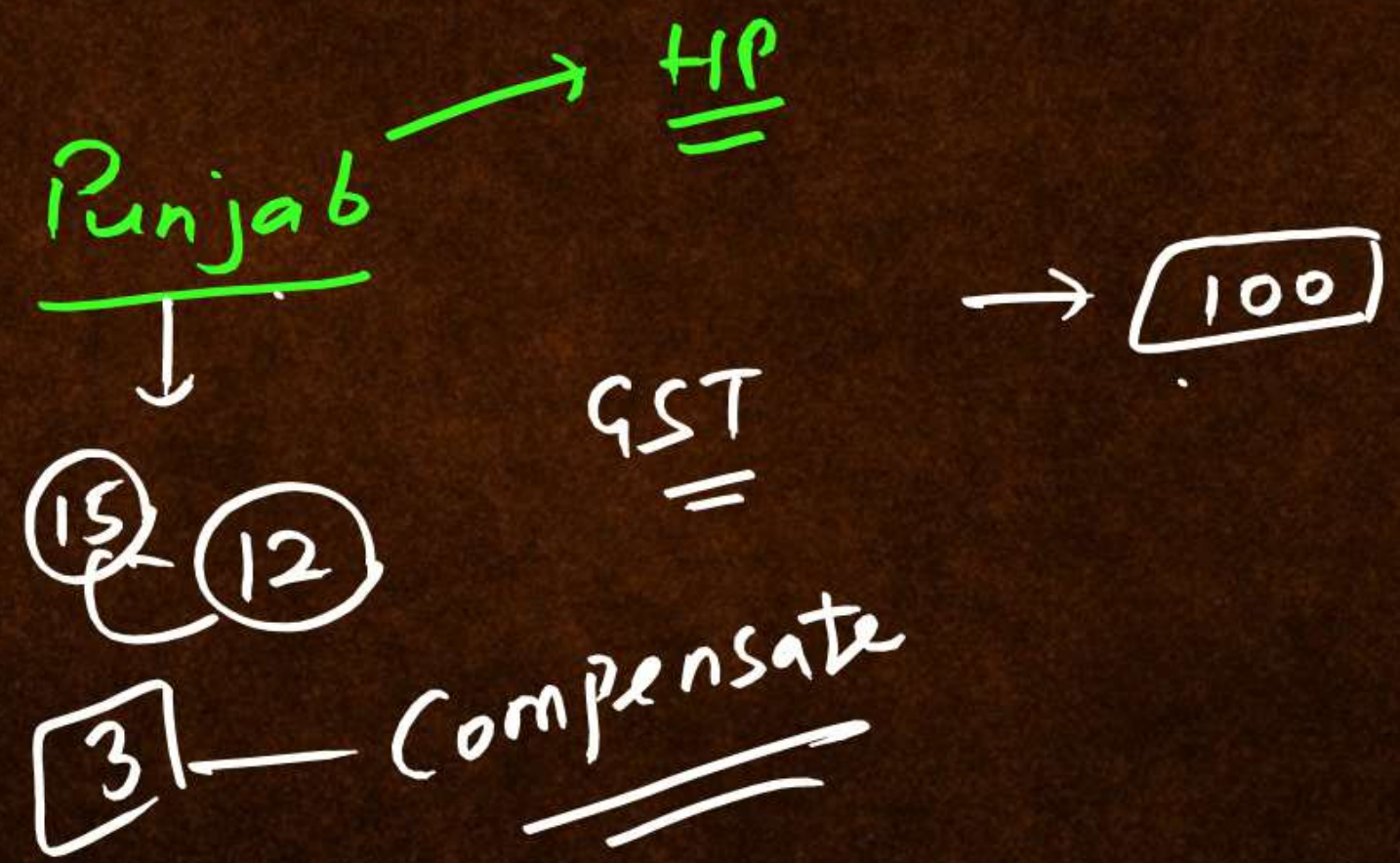
#Q. As per the supreme court verdict in May 2022

1 July 2017 → GST

- A** The union has greater powers than the states for enacting GST laws
- B** The union and state legislatures have "equal, simultaneous powers" to make laws on Goods and Services Tax **B**
- C** The union legislature's enactments will prevail in case of a conflict between those of union and states
- D** The state legislatures can make rules only with the permission of central government



Centre





- Article 246 of the Constitution demarcates/divides the powers of the union and the state by classifying their powers into 3 lists, namely union list<sup>1</sup> (on which the union parliament alone can legislate) state list<sup>2</sup> (on which the state legislative assemblies alone can legislate) and the concurrent list on which both, the parliament and the legislative assemblies can legislate.
- 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.



- **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.
- Articles 268 to 281 of the constitution contain specific provisions in respect of distribution of finances among states.
- ★ Article 280, provides for an institutional mechanism, namely the Finance Commission, to facilitate such transfers. It is responsible for evaluating the state of finances of the union and state governments, recommending the sharing of taxes between them and laying down the principles determining the distribution of these taxes among States.



- The Finance Commission considers issues related to vertical equity (deciding about the share of all states in the revenue collected by center) & horizontal equity (allocation among states their share of central revenue).
- The Fifteenth Finance Commission recommended the share of states in the central taxes (vertical devolution) for the 2021-26 to be 41%.
- The criteria for distribution of central taxes among states for 2021-26 are income distance i.e the distance of a state's income from the state with the highest income, area, population (2011), demographic performance (to reward efforts made by states in controlling their population), forest and ecology and tax and fiscal efforts.
- 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 & on imports and exports.







- 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.

QUIZ!

#Q. Which of the following is true in respect of centre and state government finances?

- A** The centre can tax agricultural income and mineral rights
- B** Finance commission recommends distribution of taxes between the centre and states. **(B)** **(280)**
- C** GST subsumes majority of direct taxes and a few indirect taxes
- D** IGST is collected by the state governments

## QUESTION

CA

#Q. GST compensation is given to

- A** to the industries which have made losses due to the introduction of GST
- B** to compensate for the lower rates of GST on essential items
- C** to the states to compensate for the loss of revenue due to the introduction of GST
- D** to compensate for the loss of input tax credit in manufacturing

#Q. Which one of the following taxes is levied by the state government only?

**A** Corporation tax

**B** Wealth tax

**C** Income tax

**D** None of the above ✓

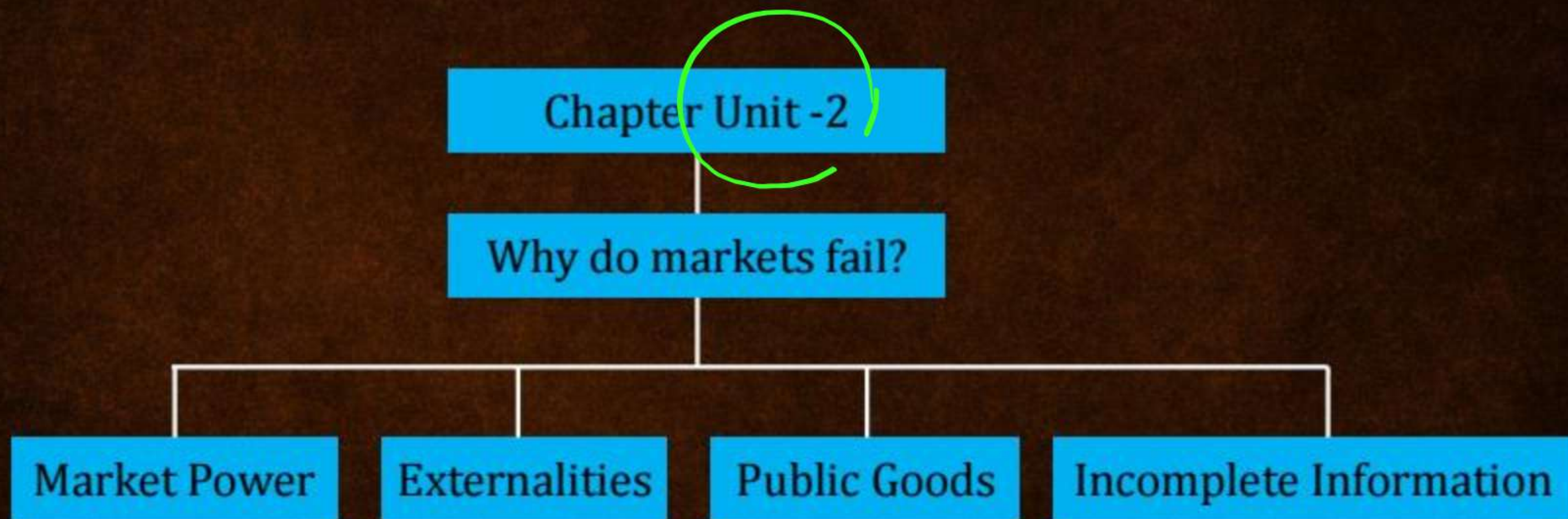
D

#Q. The percentage of share of states in central taxes for the period 2021-26 recommended by the Fifteenth Finance Commission is

- A 38 percent
- B 41 percent
- C 42 percent
- D The commission has not submitted its report

#Q. Providing social sector services such as health and education is

- A** the responsibility of the central government ✓
- B** the responsibility of the respective state governments ✗
- C** the responsibility of local administrative bodies ✗
- D** none of the above







Two types of Market failures

Complete  
Market Failure

Partial  
Market Failure

## Externalities

Positive  
Externalities

Negative  
Externalities



## Topic: Public Goods





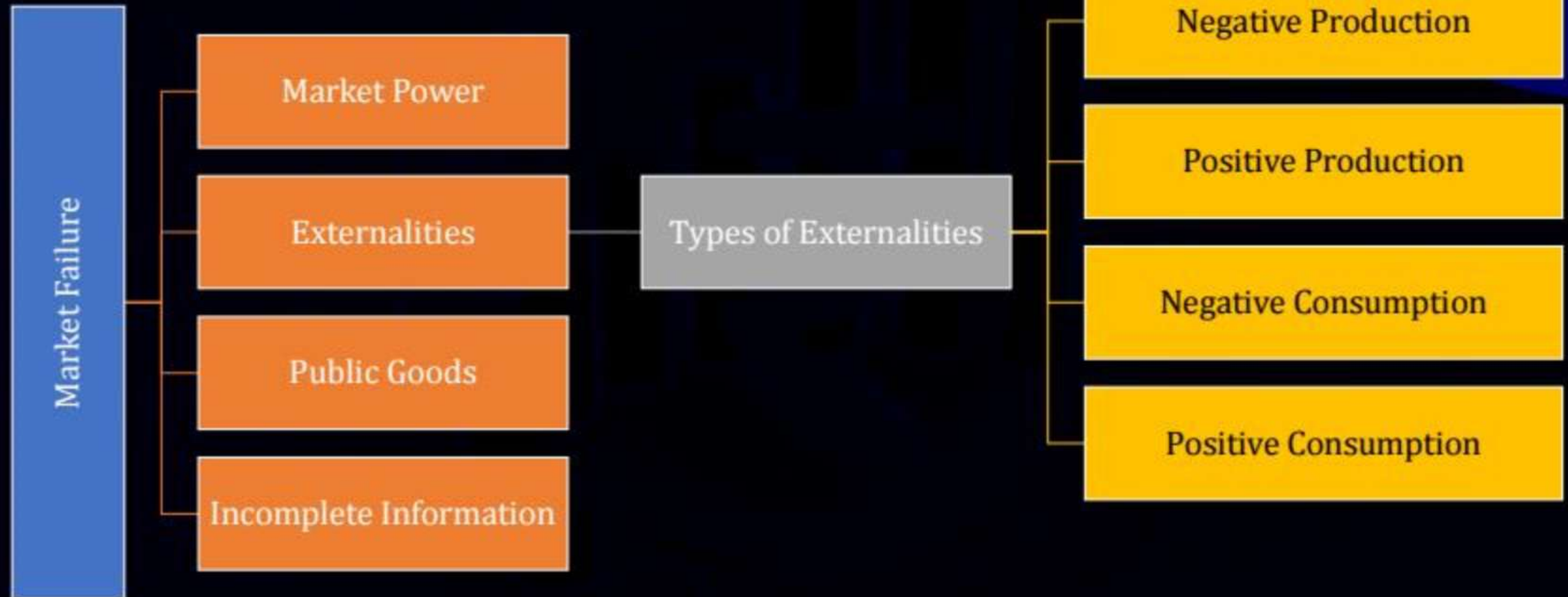
## Topic: Characteristics of Public Goods



1. Consumption is **collective** in nature. No direct payment by the consumer Aka collective consumption good or social good
2. **Non-Rivalrous** It means that consumption of a public good by one individual does not reduce the quality or quantity available for all other
3. **Non-excludable** If the good is provided, one individual cannot deny other individuals' consumption, even if they have not paid for it
4. **Indivisible**
5. More vulnerable to issues such as externalities, inadequate property rights, and free rider problems.
6. Once a public good is provided, the additional resource cost of another person consuming the goods is 'zero'.

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**Social Cost = Private cost + External Cost**

**#Q. Smoking in public is a case of**

1. Negative consumption externality
2. Negative production externality
3. Internalising externality
4. None of the above



## Government Intervention to correct Market Failure

✓ Minimize  
Market  
Power

Correct  
Externalities

✓ Merit &  
Demerit  
Goods

Correcting  
Information  
Failure

Equitable  
Distribution



# ① minimize market Power



govt. Rules

- Competition Act, 2002
- USA → Antitrust Laws

other

- mkt. Liberalisation
- Control on Mergers
- Reduction in import control
- Price Capping

# To correct Negative Externalities

Direct Control

- Law, Ban,  
Licensing
- Emmission fee

Market Based Policies

- Pollution Tax / Pigouvian Tax
- Tradable Emissions Permit  
OR  
Cap and Trade

# Positive Externalities

- ① Direct Production ✓
- ② Subsidies

# Merit goods

- ① legislation  
→ use of Helmet
- ② Set Standard ✓  
→ Compulsory Vaccine
- ③ RTE, 2009

# demerit goods

- Ban ✓
- high Tax ✓
- Negative Advertising
- fixing minimum price
- Spatial Restriction  
Smoking is not allowed in Public Place.

## Public goods

→ Direct Provision

→ Entry fee

## Equitable Distribution

→ Progressive income tax

→ targeted budgetary allocations

→ Job reservation, Subsidies

Unemployment Compensation  
etc.

## Correcting Information failure

- mandatory rules for → labelling, content disclosures
- Regulation of advertising
- Public dissemination of information → जागू ग्राहक जागू

① Problems

② Solution

#Q. If an individual tends to drive his car in a dangerously high speed because he has a comprehensive insurance cover, it is a case of

- A free riding
- B moral hazard
- C poor upbringing
- D Inefficiency

(B) ✓





unit-3 → Budget → Process



✓  
Exp<sup>n</sup> →

✓  
Revenue  
Receipt

1 APR. 2025

↓

Exp <sup>n</sup>	Receipt



2016

2017-18

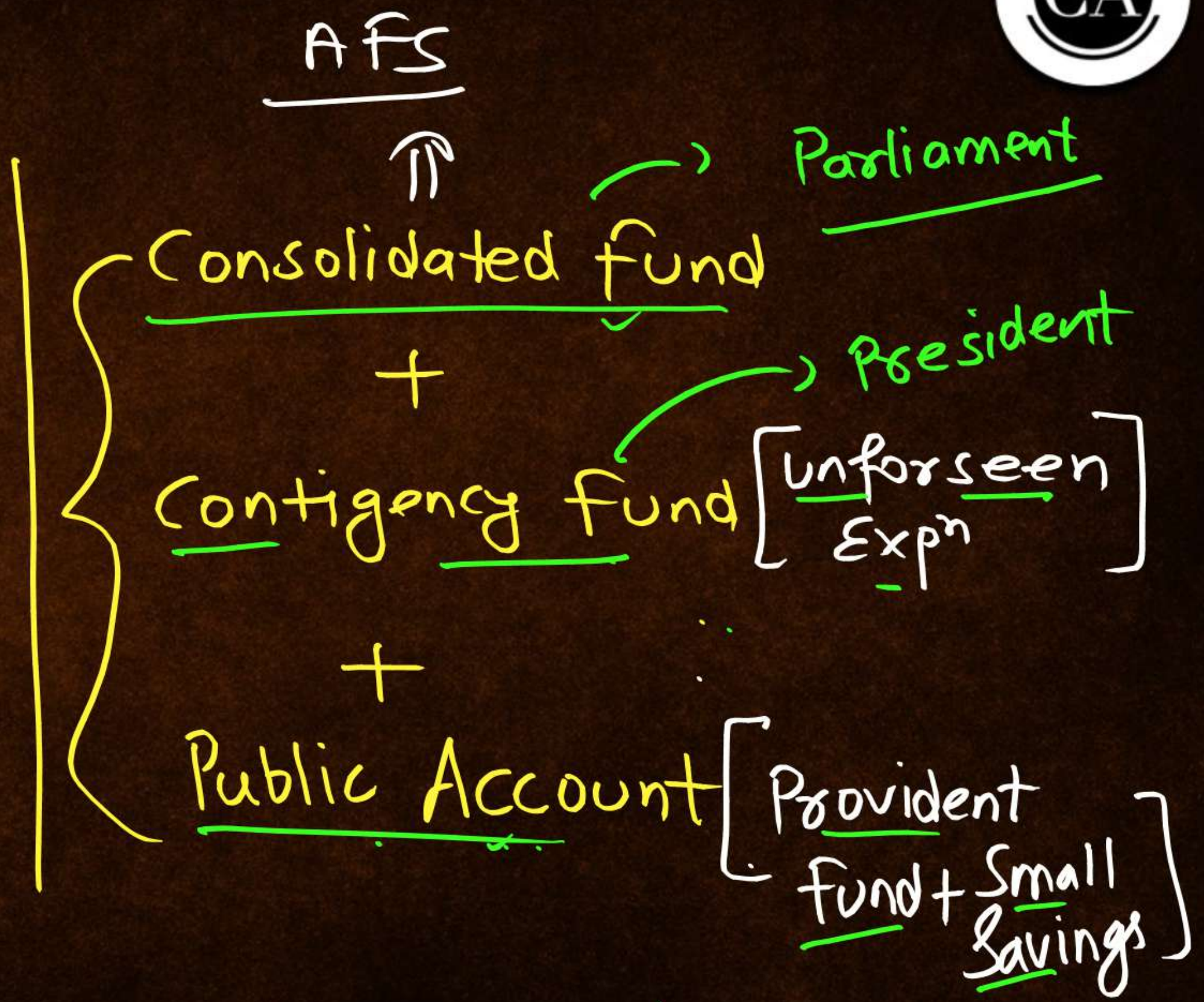
1 February

F M I I





- Guillotine
- finance Bill  
↳ Tax Alter
- Cut motions





1-04-2025 - 31-03-2026



2024 - Sept - Oct.  
↓  
Minister

NITI AYOJ

### The process of budget making: ✓

- (1) The detailed estimates of expenditure are prepared by ministries and departments.
- (2) Pre budget consultation are done by the union finance minister with the finance ministers and chief ministers of states, various stakeholders and interest groups including industry associations, representatives from agriculture and social and welfare sectors, labour organisations, experts from NITI Aayog, economists etc. to elicit their suggestions on the proposed budget.
- (3) The budget is presented in the parliament.
- (4) The budget document contains information of receipts and expenditure of current year (estimates) and previous year (actual figures) ✓

(5) The budget speech of the Finance Minister is usually in two parts. Part A of the budget speech gives an outline of the prevailing macro economic situation of the country and the budget estimates for the next financial year.

Part B of the budget speech details the progress the government has made on various developmental measures, the direction of future policies and the government's tax proposals for the upcoming financial year.

(6) The list of budget documents presented to the parliament, besides the finance minister's budget speech, is given below:

- a) Annual Financial Statement (AFS) (it has three parts namely consolidated funds of india, contingency fund & public accounts)
- b) Demands for Grants (DG)
- c) Finance Bill
- d) Statements mandated under FRBM (Fiscal Responsibility and Budget Management) Act:

- I. Macro-Economic Framework Statement
- II. Medium-Term Fiscal Policy cum Fiscal Policy Strategy  
Statement



- (7) Discussion of budget:  
First in lok sabha (discussion + voting for grants)  
Then in rajya sabha (only general discussion)
- (8) After the general discussion on the budget proposals and voting on demands for grants have been completed, the government introduces the Appropriation Bill.
- (9) The Appropriation Bill is intended to give authority to government to incur expenditure from and out of the Consolidated Fund of India.
- (10) The finance bill is taken up for consideration and passing after the Appropriation Bill is passed. The finance bill seeks to give effect to the financial proposals of the government for the next financial year. The parliament has to pass the Finance Bill within 75 days of its introduction.

- (11) On the last day of the days allotted for discussion on the demands for grants, the speaker puts all the outstanding demands for grants to the vote of the house. This process is known as 'Guillotine'. It is a device for bringing the debate on financial proposals to an end within a specified time.
- (12) the date of presentation of the budget is 1st February.

Railway Budget + Union Budget



Govt. Exp<sup>n</sup>

Revenue Exp<sup>n</sup>

Capital Exp<sup>n</sup> ✓

Interest

Neither A↑  
nor L↓

either A↑ or L↓

Construction



# Govt. Receipts

Revenue

Neither A ↓ Nor L ↑

Non-tax

Tax

Indirect

Direct

Capital

Debt creating

Non-Debt creating

either A ↓ or L ↑

→ Disinvestment

→ Borrowing

→ Provident fund

Recovery of Loan (A ↓)



	<u>Exp<sup>n</sup></u>		<u>Receipts</u>
Revenue	40	Revenue	30
Capital		<u>Capital</u>	
	100		90

Deficit Budget  
TE > TR



# Types of Budget Deficit

① Revenue Deficit  $\Rightarrow RE > RR$

② Fiscal Deficit  $\Rightarrow I\epsilon > TR$  [Excluding Borrowings]  
 $= \boxed{RE + CE} - [RR + \text{Non-debt creating}]$

③ Primary Deficit = F.D. - i

Q Which of the following is revenue exp

(A) Interest Payment

(B) Subsidies

(C) Both A & B (C)

(D) None

- ① Public Expenditure management
- ② Public Debt management



## Unit 4 - Fiscal Policy

### Instruments

- Government Expenditure ✓
- Tax ✓
- Public Debt
- Budget

### Types

- Expansionary ✓
- Contractionary ✓

### Limitations of Fiscal Policy

- Lags
- difficulties in instant change
- difficult to reduce government spending
- Public works cannot be adjusted easily
- perpetual burden
- Crowding out

### Crowding out

①  
②  
③  
④  
⑤

objectives :-

- Full Employment
- Price stability
- Equitable Distribution
- Economic growth



Expansion → AD↑ ← correct

AD↓

Recessionary

EFP ✓ → Tax↓, Govt. Exp<sup>n</sup>↑

Contraction → AD↓ → correct

✓  
inflationary

CFP → Tax↑, Govt Exp<sup>n</sup>↓

Correct

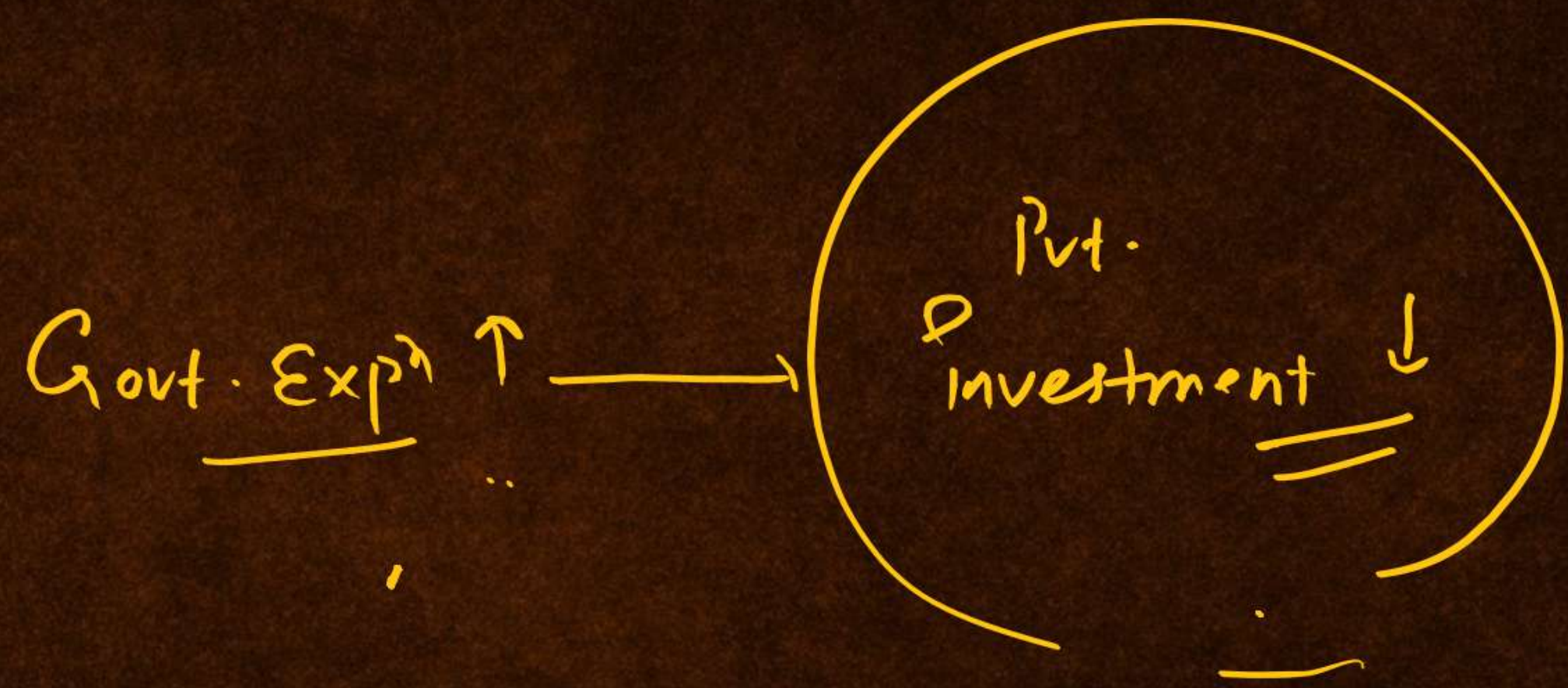
Lags | Delay

→ Recognition

→ Decision

→ Implementation

→ Impact





① → Icaí module → MCQS



Thank You!!!