UNIT – 1: FISCAL FUNCTIONS:
AN OVERVIEW, CENTRE AND STATE FINANCE

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Introduction

The governments of all nations have important economic functions even where markets constitute the basic resource allocation mechanism.
The primary goal of the state is to promote the general welfare of the society.
What governments do, or do not do, will obviously have an important impact on the economic performance of an economy and the quality of life of its citizens.

As we know, Macroeconomics is the study of the economy as a whole.
There are three main macroeconomic goals for any nation:

1) The first is economic growth: If the *real gross domestic product* grows at a faster rate than population, then people can enjoy higher standard of living.

2) The second goal is high levels of employment: This will ensure higher income and higher output. When unemployment occurs, it harms not only the unemployed, but the society as a whole because there is loss of output that could have been produced

3) The third macroeconomic goal is stable price levels: Inflation reduces real incomes and purchasing power of some people, and disproportionately affects lower income families.
On the contrary, deflation signals a downturn in economic activity which may cause recession or even depression and large scale unemployment. By ensuring stable prices, an economy can avoid prolonged inflation and deflation and achieve high levels of economic activity and employment.

The purpose of this lesson is to examine the economic functions of the govt. and to understand why the government should invariably perform them.

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THE ROLE OF GOVERNMENT IN AN ECONOMIC SYSTEM

We shall first consider why an 'economic system' should be in place?

The basic economic problem of scarcity arises from the fact that *wants are unlimited and the resources available to any society are limited*. Consequently an economy cannot produce all economic goods and services that its members desire to have.

➡️ Therefore, an economic system by which a society (households, businesses, and government) makes decisions about allocating resources to produce products and about distributing those products should exist to answer the basic questions such as:

What, How and for Whom to produce and how much resources should be set apart to ensure growth of productive capacity?

There are three alternative Economic systems:

1) Market or Capitalism
2) Government or Socialism
3) Mixed

Each with different degrees of state intervention in economic activities.

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Adam Smith is often described as a bold advocate of free markets and minimal governmental activity. However, Smith saw an important resource allocation role for the government when he underlined the role of government in:

National Defence to protect the nation from external violence and invasion

Establishing a system of Justice to provide internal law and order and to protect property.

Establishment and maintenance of highly beneficial public institutions 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.

Since the 1930s, more specifically, as a consequence of the great depression, the state's role in the economy has been distinctly gaining in importance, and therefore, the traditional functions of the state have been supplemented with what is referred to as economic functions (also called fiscal functions or public finance function)

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 the functions of the government are to be separated into three, namely,

(a) Resource allocation (to ensure efficiency),- Microeconomic functions

(b) Income redistribution (to guarantee fairness), Microeconomic functions

(c) Macroeconmic stabilization (to ensure price stability) - Macroeconomic

The National budget, in general, reflects the economic policy of a government and the government exercises its economic functions partly through the budget.

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.

👉One of the most important functions of an economic system is the optimal or efficient allocation of scarce resources so that the available resources are put to their best use and no wastages are there. Economic efficiency indicates a situation in which all resources are allocated to serve each person in the best way possible, minimising waste and inefficiency.

Private sector resource allocation is characterized by market supply and demand and price mechanism as determined by consumer sovereignty and producer profit motives

State allocation is accomplished through the revenue and expenditure activities of governmental budgeting. In the real world, resource allocation is determined by both market and the government.

A market economy is subject to serious malfunctioning in several basic respects. While private goods will be sufficiently provided by the market, public goods and merit goods will not be produced in sufficient quantities by the market.

why do markets generate misallocation of resources?

What is Allocative efficiency?

Allocative efficiency is concerned with utilizing limited resources to produce goods and services that would maximize value to the society. Allocative efficiency achieves the largest possible output of goods and services from the existing stock of resources and technology.

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 failures which hinder efficient allocation of resources occur mainly due to the following reasons:

1) 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.
2) Markets typically fail to provide collective public goods such as defence which are, by their very nature, consumed in common by all people.
3) Incomplete markets; markets may fail to produce the right quantity merit goods, such as education and healthcare
4) Common property resources (e.g. environment) are overused and exhausted in individual pursuit of self-interest.
5) Externalities which arise when the production and consumption of a good or service affect third parties (e.g. pollution).
6) Factor immobility which causes unemployment and inefficiency.
7) Imperfect information because it may not be in the interests of one party to provide full information to the other party, and
8) Inequalities in the distribution of income and wealth

According to Musgrave, the state is the instrument by which the needs and concerns of the citizens are fulfilled. Therefore, Public finance is connected with economic mechanisms that should ideally lead to the effective and optimal allocation of limited resources.

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. Briefly put, market failures provide the rationale for government's allocative function.

Few of many examples of government intervention in resource allocation:

1) Government can provide us with goods and services that we cannot produce on our own or buy at a price from the market. For example, the government establishes property rights and makes the necessary arrangements for enforcing contracts through provision of law enforcement and courts.

2) When externalities are involved in the production and consumption of goods and services, prices do not reflect the true costs and benefits and government intervenes with appropriate corrective measures.

3) Merit goods which are greatly beneficial to the society are by and large provided by the government.

These interventions do not imply that markets are replaced by government action. In its allocation role, the government acts as a complement rather than as a substitute to the market system in an economy.

The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its expenditure and 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:

a) The government may directly produce an economic good (for example, electricity and public transportation services)
b) 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)
c) The government may influence allocation through legislation and force. For example, ban of single use plastic goods.

d) The competition policies, merger policies etc. affect the structure of industry and commerce (for example, the Competition Act in India promotes competition and prevents anti-competitive activities)
e) Government's ' regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.
f) government sets legal and administrative frameworks, and
h) governments may adopt any combination of possible remedies

THE REDISTRIBUTION FUNCTION

Socialist ideology which emphasized equality created strong pressure on the redistributive role of governments. The distribution responsibility of the government arises from the fact that, left to the market, the distribution of income and wealth among individuals in the society is likely to be skewed and therefore, the government has to intervene to ensure a more socially optimal and egalitarian distribution.

The distributive function of budget is related to the basic question of 'for whom' should an economy produce goods and services. Governments can redistribute income and wealth either through the expenditure side or through the revenue side of the budget

Revenue

Redistribution is done through progressive taxation

Expenditure

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

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Effective demand is determined by the level of income of the households and this, in turn determines the distribution of real output among people. Therefore, the distribution function also relates to the manner in which the effective demand over the economic goods is divided among the various individual and family spending units of the society.

The distribution function of the government Aims at:

- Redistribution of income to achieve an equitable distribution of societal output among households ensuring increased overall social welfare.
- Advancing the well-being of those members of the society who suffer from deprivations of different types
- Providing equality of income, wealth and opportunities
- Providing security (in terms of fulfillment of basic needs) for people who have hardships, and ensuring that everyone enjoys a minimum standard of living

A few examples of the redistribution function (or market intervention for socio-economic reasons) performed by governments are:

- Taxation policies of the government whereby progressive taxation of the rich is combined with provision of subsidy to the poor households
- Proceeds from progressive taxes used for financing public services, especially those that benefit low-income households (for example, supply of essential food grains at highly subsidized prices to BPL households)
- Employment reservations and preferences to protect certain segments of the population, minimum wages and minimum support prices for farmers for their output

• Unemployment benefits and transfer payments to provide support to the underprivileged, dependent, physically handicapped, the older citizens and the unemployed.
• Families below the poverty line are provided with monetary aid and aid in kind
• Regulation of manufacture and sale of certain products to ensure the health and well-being of consumers, and
• Special schemes for backward regions and for the vulnerable sections of the population.

Conflict between Equity & Efficiency

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.

STABILIZATION FUNCTION

Macroeconomic stability is said to exist when:

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

Rationale for STABILIZATION Function:

The theoretical rationale for the stabilization function 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 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 (Govt) and monetary policy. - RBI

- 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. It is also possible that a situation of stagflation (a state of affairs in which inflation and unemployment exist side by side) may set in and make the problem more complex.

- The stabilization issue also becomes more complex due to 'contagion effect' whereby the increased international interdependence and financial integration causes forces of instability to get easily transmitted from one country to other countries.

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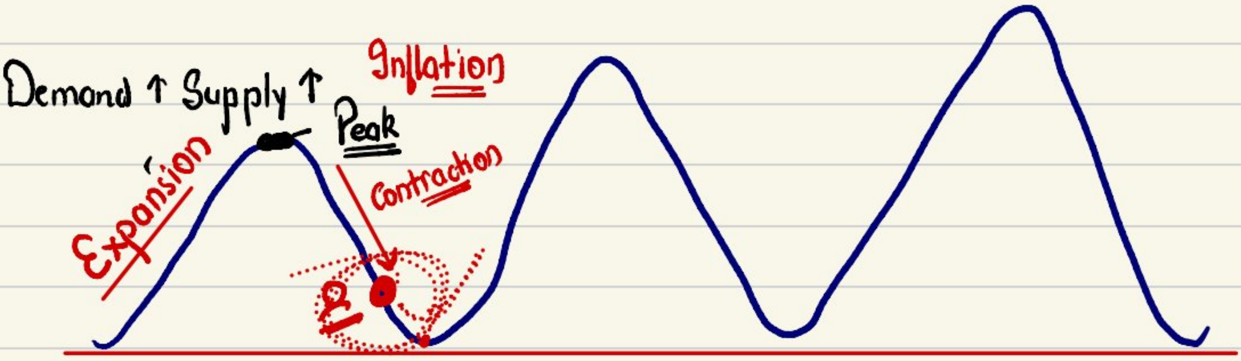

Inflation
→ Demand pull Inflation: Demand > Supply
Price ↑

↓ Cost pull Inflation
↓ Price of Raw Mat ↑
Final price ↑
Demand ↓
Production ↓
Unemployment ↑

Monetory Policy -
- Int Rate ↓ → Money Supply ↑ – Demand ↑
Investment ↑
- Int Rate ↑
↳ Money Supply ↓ – Demand ↓
Investment ↓

Fiscal policy - Expenditure ↑
└ Demand ↑
↳ Taxes ↑
└ Demand ↓

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The stabilization function is concerned with the performance of the aggregate economy in terms of:

- labour employment and capital utilization,
- overall output and income,
- general price levels,
- balance of international payments, and
- the rate of economic growth.

Government's stabilization intervention may be through monetary policy as well as fiscal policy.

Monetary policy : Controlling the size of money supply and interest rate in the economy which in turn would affect consumption, investment and prices.

Fiscal Policy : Attempts to direct the actions of individuals and organizations by means of its expenditure and taxation decisions

- Government expenditure injects more money into the economy and stimulates demand.
- On the other hand, taxes reduce the disposable income of people and therefore, reduce effective demand.

Expansionary fiscal policy: adopted to alleviate recession

- During recession, in order to ensure income protection, the government increases its expenditure or cuts down taxes or adopts a combination of both so that aggregate demand is kept stable or even boosted up with more money put into the hands of the people

Demand > Supply

Contractionary fiscal policy : resorted to for controlling high inflation.

- To control high inflation the government cuts down its expenditure or raises taxes.

Fiscal Policy

- **Expansionary**
  - Exp ↑
  - Taxes ↓
  - To Boost demand
- **Contractionary**
  - Currently, Demand > Supply
  - Inflation ↑
  - Taxes ↑
  - Expenditure ↓

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The nature of the budget (surplus or deficit) also has important implications on a country's economic activity.

- Deficit budgets (Expenditure > Revenue) are expected to stimulate economic activity

Expansion.

Rev. > Exp — Contractionary

- Surplus budgets tend to slow down economic activity.

There is often a conflict between the different goals and functions of budgetary policy. Effective policy design to meet the diverse goals of government is very difficult to conceive and to implement.

The challenge before any government is how to design its budgetary policy so that the pursuit of one goal does not jeopardize the other.

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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.

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.

Independently

As per Musgrave:

Economic Stabilization and Income Redistribution: Responsibility of Central govt

Allocation of resources : Responsibility of the state and local governments.

India is a federation of 28 states and 8 union territories.

An independent judiciary is established to resolve disputes between the central government and the states on issues related to division of power.

The Constitution of India has provided for the division of powers between the central and then state governments. Article 246 of the Constitution demarcates the powers of the union and the state by classifying their powers into three lists:

a) Union list - contains items on which the union parliament alone can legislate

b) State list - items on which the state legislative assemblies alone can legislate

c) Concurrent list - on which both the parliament and the legislative assemblies can legislate.

Union State

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

Fundamental matter in a Federation - Allocation of revenue and expenditure responsibilities to different levels of governments.

Sources of revenue for both the centre and states are clearly demarcated with regard to the financial relationship and the responsibilities between them.

Taxes levied by Centre & State:

The central government has greater revenue raising powers.

📝The union government can levy taxes such as :

a) tax on income, other than agricultural income,

b) customs and export duties,

c) excise duties on certain goods, → Terminal Tax

d) corporation tax, Wealth Tax

e) tax on capital value of assets excluding agricultural land,

f) security transaction tax,

g) central GST,

h) ~~union excise du~~ty, taxes other than stamp duties etc.

📝The state governments can levy taxes on:

a) agricultural income,

b) lands and buildings,

c) mineral rights,

d) electricity,

e) vehicles,

f) tolls,

g) professions,

h) collect land revenue and

I) impose excise duties on certain items.

▪ The property of the union is exempt from state taxation.

▪ The property and income of the states are not liable to be taxed by the centre.

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$100 \begin{cases} 41 ✓ \\ 1 \\ 58 \end{cases}$

Income Tax – 18 lac (60 lac)
+ cess @ 4%
+ Surcharge →

A significant element of fiscal federalism is inter-governmental transfers and revenue-sharing to fulfill diverse national objectives. There is substantial dependence of states on the union for securing necessary revenues.
Articles 268 to 281 of the constitution contain specific provisions in respect of distribution of finances among states.

Distribution of revenue between the union and states is based on the constitutional provisions as follows:

Article 268	**Duties levied by the union but collected and appropriated by the states.**
Article 269	Taxes levied and collected by the union but assigned to the states.
Article 270	Taxes levied and collected by the union and distributed between the union and states as ~~prescribed in clause 2and the States~~.
Article271 →	Surcharge on certain duties and taxes for purposes of the union
Article275 +4 →	Statutory Grants – in–aid from the union to certain states.
Article 282 +7	Grants for any public purpose – Discretionary
Article 293 +11	$\boxed{\text{Loans}}$ for any public purpose

Article 280 provides for an institutional mechanism, namely the Finance Commission, to facilitate such transfers.

Finance Commission is a constitutionally mandated body that is at the centre of fiscal federalism. 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

CFI → Total amt by union
CFS → " " by state

41 100 Vertical States Horizontal

Union 100 Union State 41 28 State

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Functions of Finance Commission:

(a) The distribution between the union and the states of the net proceeds of taxes which are to be divided between them and the allocation between the states of the respective shares of such proceeds.

(b) Determination of principles and quantum of grants-in-aid to states which are in need of such assistance.

Increase

(c) To make recommendations to the President on measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.

(d) Any other matter referred to the Commission by the President in the interests of sound finance.

While recommending transfers, the Finance Commission considers issues related to:

Vertical equity- deciding about the share of all states in the revenue collected by centre and

Horizontal equity- allocation among states their share of central revenue.

The Finance Commission broadly assesses the overall gross tax revenues of the union; cesses, surcharges and non-tax revenue are netted out from gross tax revenue to arrive at the net divisible pool (NDP).

NET Divisible Pool : Gross Tax Revenue of Union - cess - surcharge - Non tax revenue

? Finance

Considering the needs of the central and the state governments, the Commission determines what percentage out of the net divisible pool should be assigned to the state governments. The balance remains with the central government.

Gross Tax Revenue - cess - Surcharge - Non Tax Revenue

Total

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- The Fifteenth Finance Commission was constituted on 27, November 2017
- The commission recommended the share of states in the central taxes (vertical devolution) for the 2021-26 to be 41%, which is the same as that for 2020-21.
- This is less than the 42% share recommended by the 14th Finance Commission for 2015-20. The adjustment of 1% is to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the centre.

The criteria for distribution of central taxes among states for 2021-26 period are same as that for 2020-21. They are:

(a) Income Distance i.e the distance of a state's income from the state with the highest income.
(b) Area
(c) Population (2011)
(d) Demographic performance (to reward efforts made by states in controlling their population)
(e) Forest and ecology:
(f) Tax and fiscal efforts:

A	D	G	H	I
60	57	10	12	18

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GST📝

- The introduction of GST- on 1 July 2017
- Significantly changed the state of affairs of financial relations between the centre and states.
- The GST subsumes the majority of indirect taxes – excise, services tax, sales tax, octroi (entry tax). The GST has made India's indirect tax regime unitary in nature.
- Types of Taxes:

👉 SGST - levied and collected by state

👉 CGST - levied and collected by centre

Intra state

Inter-State

👉 IGST - administered and collected by central government.

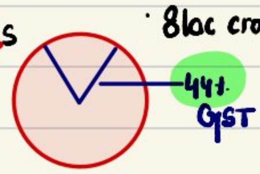
Applied on inter-state movement of goods and services and on imports and exports. IGST is simply a combination of SGST and CGST, kept in a separate account, and distributed between the union and states after settlement of input tax credit and verification of the destination of the goods and services.

- With many taxes subsumed under it, GST accounts for 35 per cent of the gross tax revenue of the union and around 44 per cent of own tax revenue of the states.

- As per the supreme court verdict in May 2022, the Union and state legislatures have "*equal, simultaneous and unique powers* "to make laws on Goods and Services Tax (GST) and the recommendations of the GST Council are not binding on them

Centre 10 lac crore

States · 8 lac crore



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Specific Reason

Concept of GST Cess:

- The GST system replaced the then prevailing production-based taxation system with a consumption based one.
- Since the manufacturing states had apprehension about loss of revenue, it was decided to provide compensation to states for loss of revenue arising on account of implementation of the Goods and Services Tax for a period of five years from the date of its implementation.
- For providing compensation to states, a cess is levied on some 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.
- During the five-year transition period, the top five GST compensation-receiving states were Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Punjab. The total amount of compensation released to the states and union territories during the year 2022-23 is Rs. 1,15,662 crore

In so far as expenditure decentralization is concerned:

- The Central Government is entrusted with the responsibilities of nationally important areas like defence, foreign affairs, foreign trade and exchange management, money and banking, cross-state transport and communication.

- The State governments are entrusted with the responsibility of facilitating agriculture and industry, providing social sector services such as health and education, police protection, state roads and infrastructure.

- The Local self governments such as municipalities and panchayats are entrusted with the responsibility of providing public utility services such as water supply and sanitation, local roads, electricity etc.

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Borrowings

Borrowing by the government of India and borrowing by states are defined under Article 292 and 293 of Constitution of India.

- **Borrowing by Centre:** The centre may borrow within the limits fixed by parliament by law upon the security of the Consolidated Fund of India or give guarantees within such limits, if any.

- **Borrowing by State:** The state governments may borrow within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such state by law, or give guarantees within such limits.

- The centre may give loans to the states within limits fixed under article 292 and give guarantees in respect of loans raised by the states.

- States need to obtain the centre's consent in order to borrow in case the state is indebted to the centre over a previous loan.

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UNIT – 2: MARKET FAILURE/ GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

Introduction

- The market is an environment where buyers and sellers transact or exchange goods and services.
- The general belief is that since rational individuals act to maximise self interest, a perfectly working market system is, by default, efficient and will effectively allocate scarce economic resources in the best possible manner.
- In other words, in a well functioning market, prices provide the accurate signals to producers and consumers and the right quantity of whatever consumers choose to consume will be produced and supplied at the right price.
- However, this is not always true. Under certain circumstances, 'market failure' occurs, i.e. the market fails to allocate resources efficiently and therefore, market outcomes become inefficient.

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Market Failure

- The inefficient allocation of resources in an economy is described as market failure.
- The term "market failure" does not mean the market is not working at all, it only means that the market does not function in the way that it should.
- Market failure is a situation in which the free market leads to misallocation of society's scarce resources in the sense that there is either overproduction or underproduction of particular goods and services leading to a less than optimal outcome.

Types of Market Failure

Complete Market Failure

This is a case of "missing markets" and occurs when the market does not supply products at all despite the fact that such products and services are wanted by people. E.g. Pure public goods.

Partial Market Failure

Market does actually function, but it produces either the wrong quantity of a product or at the wrong price. This results in loss of economic welfare.

Why do Markets Fail?

- Perfectly competitive markets will generate outcomes in which the economy's resources are allocated to their 'highest valued uses' and no one person can be made better off without making at least another person worse off.
- But we know that conditions such as large number of small firms, perfect knowledge, homogenous products etc. are not generally present in most markets.

There are four major reasons for market failure. They are:

- Market power,
- Externalities,
- Public goods, and
- Incomplete information

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Monopoly

$P = MC$, Normal profit
$P > MC$

Market Power

- Market power or monopoly power is the ability of a firm to profitably raise the market price of a good or service over its marginal cost. Firms that have market power are price makers and therefore, can charge a price that gives them positive economic profits.
- Excessive market power causes the single producer or a small number of producers to restrict output (i.e produce and sell less output than would be produced in a competitive market) and charge price higher than what would prevail under perfect competition. $D > S$
- These profits are not achieved due to operating efficiency, but due to market power and dominance.

Thus, market fails to produce the right quantity of goods and services at the right price

Externalities

- When a consumption or production activity has an indirect effect (either positive or negative) on consumption or production activities of others and such effects are not reflected directly in market prices, we call it an externality.
- Externalities are costs (negative externalities) or benefits (positive externalities), which are not reflected in free market prices. They are called externalities because they are "external" to the market.
- Externalities are also referred to as 'spillover effects', 'neighbourhood effects' 'third-party effects' or 'side-effects', as the originator of the externality imposes costs or benefits on others who are not responsible for initiating the effect.
- Since it occurs outside the price mechanism, it has not been compensated for, or in other words it is uninternalized or the cost (benefit) of it is not borne (paid) by the parties.

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Externalities

- **Production**
  - Receiver
    - Prod.
    - Cons.
      - Positive
      - Negative
- **Consumption**
  - Receiver
    - Prod.
    - Cons.
      - Positive
      - Negative

Cost ↑

Price ↑ — Demand ↓ → Overprod.

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Production Externalities

⛳ Negative Production Externality

A negative production externality initiated in production which imposes an external cost on others may be received by another in consumption or in production.

■ Received in consumption: when a factory which produces aluminium discharges untreated waste water into a nearby river and pollutes the water causing health hazards for people who use the water for drinking and bathing.

■ Received in production: when pollution of river affects fish output as there will be less catch for fishermen due to loss of fish resources.

The firm, however, has no incentive to account for the external costs that it imposes on consumers of river water or on fishermen when making its production decision. Additionally, these external costs are never reflected in the price of the product.

⛳ Positive Production Externality

A positive production externality initiated in production that confers external benefits on others may be received in production or in consumption.

■ Received in Production: A firm which offers training to its employees for increasing their skills generates positive benefits on other firms when they hire such workers as they change their jobs.

■ Received in consumption : A positive production externality is received in consumption when an individual raises an attractive garden and the persons walking by enjoy the garden.

These external effects were not in fact taken into account when the production decisions were made.

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Consumption Externalities

⛳Negative Consumption Externality

Negative consumption externalities initiated in consumption which produce external costs on others may be received in consumption or in production.

◾ Received in Consumption: Smoking cigarettes in public place causing passive smoking by others, creating litter and diminishing the aesthetic value of the room and playing the radio loudly obstructing one from enjoying a concert.

◾ Received in Production: The act of undisciplined students talking and creating disturbance in a class preventing teachers from making effective instruction and the case of excessive consumption of alcohol causing impairment in efficiency for work and production.

⛳Positive Consumption Externality

A positive consumption externality initiated in consumption that confers external benefits on others may be received in consumption or in production.

◾ Received in Consumption: if people get immunized against contagious diseases, they would confer a social benefit to others as well by preventing others from getting infected.

◾ Received in Production : Consumption of the services of a health club by the employees of a firm would result in an external benefit to the firm in the form of increased efficiency and productivity.

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Private costs and Social costs

Private cost: The money cost of production incurred by the firm i.e. costs such as wages, raw materials, heating and lighting which must be paid to carry out production, and these which would appear in the firm's accounts.

Social costs: It refer to the total costs to the society on account of a production or consumption activity.
Social costs are private costs borne by individuals directly involved in a transaction together with the external costs borne by third parties not directly involved in the transaction.
In other words, social costs are the total costs incurred by the society when a good is consumed or produced. It is thus private costs plus costs to third parties (i.e. private costs + total negative externalities).

👉Social Cost = Private Cost + External Cost

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How externalities cause inefficiency and market failure?

- As discussed before, each firm's cost which is considered for determining output would be only private cost or direct cost of production which does not incorporate externalities.
- The market prices determined without incorporating externalities are not ideal as they do not reflect all social costs and benefits.
- Such prices send incorrect signals to producers and consumers and cause either overproduction or underproduction.

Thus, we conclude that when there is externality, a competitive market will produce a level of output which is not socially optimal. This is a clear case of market failure.

Public Goods

■ Paul A. Samuelson who introduced the concept of 'collective consumption good' in his path- breaking 1954 paper 'The Pure Theory of Public Expenditure' is usually recognized as the first economist to develop the theory of public goods.

■ A public good (also referred to as collective consumption good or social good) is defined as one which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individuals' consumption of that good.

Private Goods v/s Public Goods

Private Goods

■ They are scarce, anyone who wants to consume them must purchase them at a price.

■ Private goods do not face any free-rider problem.

■ Private goods are 'excludable' i.e. it is possible to exclude or prevent consumers who have not paid for them from consuming them or having access to them.

■ Consumption of private goods is 'rivalrous' that is the purchase and consumption of a private good by one individual prevents another individual from consuming it.

Normally, the market will efficiently allocate resources for the production of private goods. A few examples are: food items, clothing, movie ticket, television, cars, houses etc.

Public Goods

■ Public good is non-rival in consumption. It means that consumption of a public good by one individual does not reduce the quality or quantity available for all other individuals.

For example, if, you eat your apple, (a private good) another person too cannot eat it. But, if you walk in street light, other persons too can walk without any reduced benefit from the street light.

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- Public goods are non-excludable. Consumers cannot be excluded from consumption benefits. If the good is provided, one individual cannot deny another individuals' consumption.

For example, national defence once provided, it is impossible to exclude anyone within the country from consuming and benefiting from it.

- Public goods are characterized by indivisibility i.e. the total amount consumed is the same for each individual.
- Once a public good is provided, the additional resource cost of another person consuming the goods is 'zero'. No direct payment by the consumer is involved in the case of pure public goods.

A few examples of public goods are: national defence, highways, public education, scientific research which benefits everyone, law enforcement, lighthouses, fire protection, disease prevention and public sanitation.

- Public goods are generally more vulnerable to issues such as externalities, inadequate property rights, and free rider problems.

The absence of excludability in the case of public goods and the tendency of people to act in their own self-interest will lead to the problem of free-riding. There is no incentive for people to pay for the good because they can consume it without paying for it. Since private goods are excludable, free-riding mostly occurs in the case of public goods.

Reason for Market Failure:

- If individuals make no offer to pay for public goods, there is market failure in the case of these goods and the profit-maximizing firms will not produce them.
- Producers are not motivated to produce a socially-optimal amount of products if they cannot charge a positive price for them or make profits from them.

As such, though public goods are extremely valuable for the well- being of the society, left to the market, they will not be produced at all or will be grossly under-produced.

Thus, there is market failure in the case of public goods.

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Incomplete Information

Complete information is an important element of a competitive market. Perfect information implies that both buyers and sellers have complete information about anything that may influence their decision making. However, this assumption is not fully satisfied in real markets because of:

- Complexity of products and services (e.g. cardiac surgery, financial products like mutual funds),
- Difficulty of getting correct information, and
- Deliberate misinformation by interested parties (e.g. highly persuasive advertisements).

Information failure results in market failure.

Asymmetric Information

Asymmetric information occurs when there is an imbalance in information between the buyer and the seller i.e. when the buyer knows more than the seller or the seller knows more than the buyer. This can distort choices. For example,

- the landlords know more about their properties than the tenants,
- a borrower knows more about their ability to repay a loan than the lender,
- a used-car seller knows more about the vehicle quality than the buyer,
- health insurance buyers know more about their state of health than the insurance companies and
- some traders may possess insider information in financial markets.

These are situations in which one party to a transaction knows a material fact that the other party does not. This phenomenon is an important source of market failure.

Adverse selection and moral hazard are two central concepts related to the problem of information gaps in many markets.

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Adverse Selection

Asymmetric information generates adverse selection and affects a transaction before it occurs.

When one party to a contract or negotiation, say X, possesses information relevant to the contract or negotiation that the other party Y does not have, the expected value of the transaction is known more accurately to X due to asymmetry of information. Then, the party which has more information i.e. X may take advantage Y's ignorance and this could potentially put the ignorant party Y at a loss.

Eg. Insurance company

Identify the health risk.

High Risk ↑
High premium

Low Risk
Low premium

→ But Insurance co. knows less about health conditions of buyers.

↓

Unhealthy people do not reveal their actual state of health, so that ins. prem. remains low.

Unhealthy → Heavy Ins. Claims → Insurance ↑ Premium

↓

Healthy people chose not to be Insured → This further increases the proportion of unhealthy people → Raising the premium even more

→ Ins. co. stop selling insurance – Missing Market

→ Incur considerable cost for identifying the extent of risk.
↳ Premium ↑

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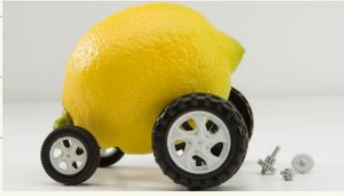
2nd Case



Lemon problem - George Akerlof

└ Second hand car Market

Good Quality

Poor Quality cars
└ defined as lemons

Seller of Second hand car → May not disclose all the Mechanical defects.

Buyer → Since there is quality uncertainity, the price offered is likely to be less.

↓

Seller of good quality car will not place their car for sale in the Market

→ The good quality car disappears from the Market

&

Market becomes flooded with 'Lemons'

↓

Market failure - Market has only lower price & low quality cars.

→ Asymmetric info. leads to elimination of high-quality goods from the Market.

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Moral Hazard

- Moral hazard arises whenever there is an externality (i.e., whenever an economic agent can shift some of its costs to others).
- It is about actions made after making a market exchange which may have adverse impact on the less-informed person.
- In other words, it is about the opportunism characterized by an informed person's taking advantage of a less-informed person through an unobserved action.
- It arises from lack of information about someone's future behaviour.
- It occurs when one party to an agreement knows that he need not bear the consequences of his bad behaviour or poor decision making and that the consequence, if any, would be borne by the other party.

Therefore, he engages in risky behaviour or fails to act in good faith or acts in a different way than if he had to bear those consequences by himself.

eg - Insurance Market

1] Driver with Car insurance Policy → Tends to be less careful, act irresponsibly ↓ Probability of Insurance Claim ↑

2] Patient With Medical Insurance → Does not care whether doctor charges excessive fees or uses costly procedures → Insurance claim ↑ ↓ Insurance Premium ↑

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Government Intervention

Government can ensure economic efficiency by providing the necessary legal and regulatory system that facilitates efficiency and /or it can intervene to correct specific market failures. The role of the government is discussed below:

Government plays a vital role in ensure a well functioning market by:

- Creating the necessary physical infrastructure such as roads, bridges, airports and waterways
- Provision of institutional infrastructure such as legal and regulatory framework, establishment of the 'rule of law', protection of property rights, ensuring performance of contracts
- Ensuring an appropriately framed competition and consumer law framework that regulates the activities of firms and individuals in their market exchanges

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Government Intervention to Minimize Market Power

- Governments intervene by establishing rules and regulations designed to promote competition and prohibit actions that are likely to restrain competition.
- These legislations differ from country to country. For example, in India, we have the Competition Act, 2002 (as amended by the Competition (Amendment) Act, 2007) to promote and sustain competition in markets. The Antitrust laws in the US and the Competition Act, 1998 of UK etc are designed to promote competitive economy by prohibiting actions that are likely to restrain competition.

Such legislations generally aim at prohibiting contracts, combinations and collusions among producers or traders which are in restraint of trade and other anticompetitive actions such as predatory pricing.

Other measures include:

- Market liberalisation by introducing competition in previously monopolistic sectors such as energy, telecommunication etc.
- Controls on mergers and acquisitions if there is possible market domination
- Price capping and price regulation
- Profit or rate of return regulation
- Patronage to consumer associations
- Tough investigations into cartelisation and unfair practices such as collusion and predatory pricing

Single buyer
- Restrictions on monopsony power of firms
- Reduction in import controls and
- Nationalisation

⛳However, sometimes we find that governments protect monopoly positions of firms that have developed unique innovations.

- For example, patent and copyright laws grant exclusive rights of products or processes to provide incentives for invention and innovation.
- Another example is that of permitted natural monopoly. Natural monopolies can produce the entire output of the market at a cost that is lower than what it would be if there were several firms.

Examples of such natural monopoly are electricity, gas and water supplies. In order to control the market power of such natural monopolies, governments usually regulate the price of the goods and services provided by them.

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Government Intervention to Correct Externalities

👉🏻Freely functioning markets produce externalities because producers and consumers need to consider only their private costs and benefits and not the full social costs.
⛳To promote the overall welfare of all members of society, social returns should be maximized and social costs minimized. This implies that all costs and benefits (both private and external) need to be internalized by consumers and producers while making buying and production decisions.

The key to internalizing an externality (both external costs and benefits) is to ensure that those who create the externalities include them while making decisions.

Government initiatives towards **negative externalities** may be classified as:

Direct Control

openly regulate the actions of those involved in generating negative externalities.

Market Based

policies that would provide economic incentives.

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Direct controls

- Also known as command solutions, prohibit specific activities that explicitly create negative externalities or require that the negative externality be limited to a certain level.
- A few examples are:

📝The government may, through legislation, fix emissions standard which is the legal limit on how much pollutant a firm can emit. If the firm exceeds the limit, it can invite monetary penalties or/and criminal liabilities.

📝Licensing, production quotas and mandates regarding acceptable production processes are other examples of direct intervention by governments.

📝Production, use and sale of many commodities and services are prohibited in our country.

📝Smoking is completely banned in many public places.

📝Stringent rules are in place in respect of tobacco advertising, packaging and labeling etc.

📝Governments may pass laws to reduce the effects of negative externalities. Government established environmental standards are rules that protect the environment by specifying actions by producers and consumers. For example, India has enacted the Environment (Protection) Act, 1986.

📝Government may limit the amounts of certain pollutants released into water and air by individual firms or make it mandatory to use pollution control devices.

📝Government may insist that the polluting firms install pollution-abatement mechanisms to ensure adherence to the emission standards. This means additional expenditure to the firm leading to rise in the firm's average cost. New firms will find it profitable to enter the industry only if the price of the product is greater than the average cost of production plus abatement expenditure.

📝Governments may also form special bodies/ boards to specifically address the problem, for instance the Ministry of Environment & Forest, the Pollution Control Board of India and the State Pollution Control Boards.

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The market-based approaches ➡️ environmental taxes and cap-and-trade, operate through price mechanism to create an incentive for change. In other words, the government tries to alter the prices of goods through taxes and subsidies and thus change the behaviour of market participants. This is achieved by:

1. Setting the price directly through a pollution tax
2. Setting the price indirectly through the establishment of the cap-and-trade system.

⛳Pollution Taxes

- These taxes are named Pigouvian taxes after A.C. Pigou. The size of the tax depends on the amount of pollution a firm produces. These taxes have the effect of 'making the polluter pay'.
- Tax increases the private cost of production or consumption as the case may be, and would decrease the quantity demanded and therefore the output of the good which creates negative externality.

However, there are **problems** in administering an efficient pollution tax:

- Pollution taxes are difficult to determine and administer because it involves the use of complex and costly administrative procedures for monitoring the polluters.
- If the demand for the good is inelastic, the tax may have only an insignificant effect in reducing demand. In such cases, the producers will be able to easily shift the tax burden in the form of higher product prices.
- Pollution taxes also have potential negative consequences on employment and investments because high pollution taxes in one country may encourage producers to shift their production facilities to those countries with lower taxes.

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⛳Tradable Emissions Permits - Cap & Trade systems

■ A tradable permit is a license that allows a company to release a unit of pollution into the environment over some period of time.

■ By issuing a fixed number of permits, the government determines the total level of pollution that can be legally emitted during each period (the 'cap'). Each firm has permits specifying the number of units of emissions that the firm is allowed to generate.

■ A firm that generates emissions above what is allowed by the permit is penalized with substantial fines.

■ Since the permits are tradable (the firm can sell for a price), a polluting firm faces an opportunity cost i.e. for each unit of pollution that it creates, it must either buy a permit, or it must forgo the revenue it could earn by selling the permit to some other firm. A firm which produces less pollution can sell their permits and earn money.

■ A firm whose technology would make it very costly to reduce pollution generally buys permits in the market. At the same time, a firm whose technology enables it to discharge less pollution or can reduce pollution rather cheaply will sell its permits.

■ The high polluters have to buy more permits, which increases their costs, and makes them less competitive and less profitable. The low polluters receive extra revenue from selling their surplus permits, which makes them more competitive and more profitable. Therefore, firms will have an incentive not to pollute.

■ Usage of tradable permits:

👉 USA - usage since early 1980s to reduce several types of pollution. In 1994 the United States began a cap and trade system for sulphur dioxide emissions.

👉INDIA - India does not have an explicit carbon price or a market-based mechanism such as cap-and-trade; but India has many schemes and mechanisms. For example, the Perform, Achieve & Trade (PAT) scheme, carbon tax in the form of a cess on coal, lignite and peat, Renewable Purchase Obligations (RPO) and Renewable Energy Certificates (REC), Internal Carbon Pricing (ICP) etc. In 2017, the coal cess was abolished and replaced by the GST compensation cess since it failed to achieve the desired outcomes.

■ The Energy Conservation (Amendment) Bill, 2022 empowers the central government to specify a carbon credit trading scheme and to stipulate energy consumption standards.

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100 unit Permit 120 unit

110 unit

90 unit

30 units - Carbon credit

Buy

Buy & sell

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However, firms with a relatively inelastic demand for its product can easily shift the extra cost incurred for procuring additional permits in the form of higher price.

Government Initiatives towards Positive Externalities

When positive externalities are present, government may attempt to solve the problem through -

- corrective subsidies to the producers aimed at increasing the supply of the good
- corrective subsidies to consumers aimed at increasing the demand for the good.

As we are aware, a corrective production subsidy involves government paying part of the cost to the firms in order to promote the production of goods having positive externalities. This is in fact a market-based policy as subsidies to producers would lower their cost of production.

E.g. fertilizer subsidy is a production subsidy & subsidy on fee for education is an example of consumption subsidy.

■ In the case of products and services whose externalities are vastly positive, the government enters the market directly as an entrepreneur to produce and provide them. Public education, health care and fundamental research are the obvious examples.

■ Governments also engage in direct production of environmental quality. Examples are: aforestation, reforestation, protection of water bodies, treatment of sewage and cleaning of toxic waste sites.

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GOVERNMENT INTERVENTION IN THE CASE OF MERIT GOODS

- Merit goods are goods that have substantial positive externalities and hence they are socially desirable.
- Merit goods can be provided through the market, but are likely to be under-produced and under-consumed through the market mechanism so that social welfare will not be maximised.
- Examples of merit goods include education, health care, welfare services, housing, fire protection, waste management, public libraries, museum, public parks etc.
- The possible government responses to under-provision of merit goods are regulation, subsidies, direct government provision and a combination of government provision and market provision.

👉Regulation determines how a private activity may be conducted.

CBSE

For example, the way in which education is to be imparted is government regulated. Governments can prohibit some type of goods and activities, set standards and issue mandates making others oblige. For example, government may make it compulsory to avail insurance protection. Compulsory immunization may be insisted upon as it helps not only the individual but also the society at large. Government could also use legislation to enforce the consumption of a good which generates positive externalities. E.g. use of helmets, seat belts etc.

👉An additional option is to compel individuals to consume the good or service that generates the external benefit.

The Right of Children to Free and Compulsory Education Act, 2009 which mandates free and compulsory education for every child of the age of six to fourteen years is another example. If suspected of having a contagious disease such as COVID, an individual may be forced to get medical treatment.

👉The ultimate encouragement to consume is to make the good completely free at the point of consumption: for example freely available hospital treatment for various diseases.

GOVERNMENT INTERVENTION IN THE CASE OF DEMERIT GOODS

Demerit goods are goods which are believed to be socially undesirable.
Examples of demerit goods are cigarettes, alcohol, intoxicating drugs etc.
The consumption of demerit goods imposes significant negative externalities on the society as a whole.
👉However, it should be kept in mind that all goods with negative externalities are not essentially demerit goods; e.g. Production of steel causes pollution, but steel is not a socially undesirable good.
👉The production and consumption of demerit goods are likely to be more than optimal under free markets.

How do governments correct market failure resulting from demerit goods?

- At the extreme, the government may enforce complete ban on a demerit good. e.g. the possession, trading or consumption of intoxicating drugs is made illegal.
- Through persuasion which is mainly intended to be achieved by negative advertising campaigns which emphasize the dangers associated with consumption of demerit goods.
- Through legislations that prohibit the advertising or promotion of demerit goods in whatsoever manner.
- Strict regulations of the market for the good may be put in place so as to limit access to the good, especially by vulnerable groups such as children and adolescents.
- Regulatory controls in the form of spatial restrictions e.g. smoking in public places, sale of tobacco to be away from schools, and time restrictions under which sale at particular times during the day is banned.
- Imposing unusually high taxes on producing or purchasing the good making them very costly and unaffordable to many is perhaps the most commonly used method for reducing the consumption of a demerit good. Refer the GST rates in India for demerit goods, you will find how high they are.
- The government can fix a minimum price below which the demerit good should not be exchanged.

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The demand for demerit goods such as, cigarettes and alcohol is often highly inelastic, so that any increase in their price resulting from additional taxation causes a less than proportionate decrease in demand. Also, sellers can always shift the taxes to consumers without losing customers.

The effect of stringent regulation such as total ban is seldom realized in the form of complete elimination of the demerit good; conversely such goods are secretly driven underground and traded in a hidden market.

GOVERNMENT INTERVENTION IN THE CASE OF PUBLIC GOODS

Production

- Direct provision of a public good by government can help overcome the free-rider problem which leads to market failure.
- The most important public goods like defence, establishment and maintenance of legal system, fire protection, disease prevention etc are invariably provided by the government.

  everytime

- Excludable public goods such as parks, universities, museums etc can be provided by government and the same can be financed through entry fees.
- Government may grant licenses to private firms to build a public good facility and charge fee from the user. In such cases, the government regulates the level of entry fee chargeable from the public and keeps strict watch on the functioning of the licensee to guarantee equitable distribution of welfare.
- Some public goods are provided by voluntary contributions and private donations by corporate entities and nongovernmental organisations.
- Some goods are produced and consumed as public goods and services despite the fact that they can be produced or consumed as private goods. This is because, left to the markets and profit motives, these may prove dangerous to the society. Examples are scientific approval of drugs, production of strategic products such as atomic energy, provision of security at airports etc.

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Imp

PRICE INTERVENTION: NON-MARKET PRICING

■ Price intervention generally takes the form of price controls which are legal restrictions on price.

Price controls may take the form of :

👉Price floor - a minimum price buyers are required to pay or

👉Price ceiling - a maximum price sellers are allowed to charge for a good or service.

Fixing of minimum wages and rent controls are examples of such market intervention.

Price floor Price ceiling

■ Government usually intervenes in many primary markets which are subject to extreme as well as unpredictable fluctuations in price. For example in India, in the case of many crops the government has initiated the Minimum Support Price (MSP) programme as well as procurement by government agencies at the set support prices. The objective is to guarantee steady and assured incomes to farmers.

■ When prices of certain essential commodities rise excessively, government may resort to control in the form of price ceilings (also called maximum price) for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity.

■ With the objective of ensuring stability in prices and distribution, governments often intervene in grain markets by building and maintenance of buffer stocks. It involves purchases from the market during good harvest and releasing stocks during periods when production is below average.

1. Price floor

MSP

Floor

Minimum price

2. Price Ceiling

Max. Price

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GOVERNMENT INTERVENTION FOR CORRECTING INFORMATION FAILURE

Governments actively intervene in the market for combating the problem of market failure due to information problems and considering the importance of information in making rational choices. A few examples are:

- Government makes it mandatory to have accurate labeling and content disclosures by producers. E.g. Labeling on cigarette packets, display of nutritional information on food packages.
- Mandatory disclosure of information, for example: SEBI requires that accurate information be provided to prospective buyers of new stocks.
- Public dissemination (spread) of information to improve knowledge
- Regulation of advertising and setting of advertising standards to make advertising more responsible, informative and less persuasive.

GOVERNMENT INTERVENTION FOR EQUITABLE DISTRIBUTION

- One of the most important activities of the government is to redistribute incomes so that there is equity and fairness in the society.
- Some common policy interventions include: progressive income tax, targeted budgetary allocations, unemployment compensation, transfer payments, subsidies, social security schemes, job reservations, land reforms, gender sensitive budgeting etc.
- Government also intervenes to combat black economy and market distortions associated with a black economy.
- Government intervention in a market that reduces efficiency while increasing equity is often justified because equity is greatly appreciated by society.

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Government Failure

■ Government failures where government intervention in the economy to correct a market failure creates inefficiency and leads to a misallocation of scarce resources occur very often.

■ Government failure occurs when:

👉intervention is ineffective causing wastage of resources expended for the intervention

👉intervention produces fresh and more serious problems

There are costs and benefits associated with any government intervention in the market, and it is important that policy makers consider all the costs and benefits of a policy intervention.

Unit over :)

MCQs
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UNIT – 3: THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

Introduction

- The need for budgeting arises from the need to efficiently allocate limited resources to ensure maximum social welfare.
- The government also needs to reallocate resources in accordance with its declared priorities.
- By proper budgeting, the government is able to ensure redistribution of income and wealth.
- The other objectives of budgets are:

🎯 reduction/elimination of economic fluctuations to bring in stability,

🎯 sustainable increase in real GDP and reduction in regional disparities.

- Budget is a statement that presents the details of 'where the money comes from' and 'where the money goes to'.
- A government budget is a schedule of the ~~entire~~ revenues and expenditures that the government expects to receive and plans to spend during the following year.
- The budget includes projections for the economy and its various sectors such as agriculture, industry, and services. The budget also contains estimates of the government's accounts for the next fiscal year called budgeted estimates.
- Being the document which consolidates revenues from all sources and outlays exp. for all activities, the budget is the most comprehensive report of the government's finances.
- Apart from the union budget, state and the local bodies have their own budgetary processes for the next financial year

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The Process of Budget Making

- The finances of the government of India have traditionally been controlled by the Ministry of Finance. The budget is prepared by the Ministry of Finance in consultation with NITI Aayog and other relevant ministries.
- The budget must be presented and approved by both houses of parliament before the beginning of the fiscal year (April 1 to March 31).
- Despite the fact that the term 'budget' has not been used in the Indian Constitution, the process of making it is generally referred to as budgeting. Article 112 of the constitution provides that in respect of every financial year the 'president shall cause to be laid before both the houses of parliament a statement of the estimated receipts and expenditure of the government of India for that year, referred to as the "Annual Financial Statement".

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Budgetary Procedures

Preparation of Budget

↓

Presentation and enactment of the budget

↓

Execution of Budget

The budget process mainly consists of two types of activities:

1. The administrative process, wherein the budget along with the accompanying documents are prepared in consultation with various stakeholders;
2. The legislative process wherein the budget is passed by the parliament after discussions.

⛳Despite the fact that the union budget is presented on 1st February (or any other suitable date as decided by the government), the process of budget preparation commences in August-September of the previous year.

⛳The Budget Division of the Ministry of Finance prepares a comprehensive schedule for carrying out the budget preparation activities.

The process of budget making

⛳ Set off with the Budget Division issuing the budget circular containing detailed instructions and formats for preparing the estimates to all ministries, states, union territories and autonomous bodies.

■ The detailed estimates of expenditure are prepared by ministries and departments according to their assessment of requirements for the subsequent year. Every department prepares estimates for receipts and expenditure separately.

⛳A series of pre-budget consultations 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 obtain their suggestions on the proposed budget.

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Budget Documents

Broadly,depicts information relating to receipts and expenditure for two years. They are:

(i) Budget estimates (BE) of receipts and expenditure in respect of current and ensuing following financial year

(ii) For the current year through Revised Estimates (RE); and

(iii) Actuals of the year preceding the current year 23-24 PY

Budget Speech

- The budget speech is mainly a policy document which draws attention to the proposed policies and programmes of the government.
- The finance minister makes a detailed budget speech at the time of presenting the budget before the Lok Sabha.
- The budget speech present details of the proposals for the new financial year regarding taxation, borrowings and expenditure plans of the government.

The budget speech of the Finance Minister is usually in two parts:

Existing

⛳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. Elaborating the priorities of the government, the minister presents a broad framework of the total funds raised by the government via taxes or borrowings, proposed government expenditure allocations for different sectors and fresh schemes for different sectors.

⛳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 including variations in the current taxation system.

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Budget

The Annual Financial Statement shows the receipts and expenditure of government in three separate parts under which government accounts are maintained, namely:

1. Consolidated Fund of India

■ All revenues received, loans raised and all moneys received by the government in repayment of loans are credited to the Consolidated Fund of India and all expenditures of the government are incurred from this fund.

■ Money can be spent through this fund only if appropriated by the parliament. The consolidated Fund has further been divided into 'revenue' and 'capital' divisions.

2. Contingency Fund of India

■ A fund placed at the disposal of the President to enable him/her to make advances to the Government to meet urgent unforeseen expenditure.

■ Contingency fund enables the government to meet unforeseen expenditure and does not require prior legislative approval, unlike with the Consolidated Fund.

■ For meeting such exigencies, advances are made to the government from the contingency fund which is subsequently reported to the Parliament for recoupment from the Consolidated Fund of India.

3. Public Account

■ Under provisions of Article 266(1) of the Constitution of India, public account is used in relation to all the fund flows where government is acting as a banker.

■ Examples include Provident Funds and Small Savings. This money does not belong to government but is to be returned to the depositors.

■ The expenditure from this fund need not be approved by the parliament.

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

(a) Annual Financial Statement (AFS) - Budget

(b) Demands for Grants (DG)

(c) Finance Bill

(d) Statements mandated under FRBM (Fiscal Responsibility & Budget Management) Act:

i. Macro -Economic Framework Statement

ii. Medium-Term Fiscal Policy cum Fiscal Policy Strategy Statement

Nine other documents which are in the nature of explanatory statements supporting the mandated documents are also presented along with the documents mentioned above.

Expenditures charged on Consolidated Fund of India

The expenditures of certain categories like:

- The emoluments and allowances of the President of India and his/her office, and
- Emoluments of Judges of supreme courts and high ranking personnel of constitutional bodies across India,

are not subject to the vote of parliament and are indicated separately in the budget.

By convention in an election year, the budget may be presented twice.

- The first one is to first secure a Vote on Account for a few months.
- followed by the Annual financial statement for that year or the full-fledged Budget.

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The budget is discussed in two stages in the Lok Sabha:

- First, there is the general discussion on the budget as a whole.
- After the first stage of general discussion on the union budget is over, the house is adjourned for a fixed period. During this period, the demands for grants of various ministries/ departments are considered by the standing committees concerned, and once the reports are presented by these committees within the stipulated time, the house proceeds to discussion and conducts ministry-wise voting on demands for grants.

- The Lok Sabha has the power to concur or to refuse any demand or even to reduce the amount of grant sought by government.
- Motions for reduction to various demands for grants are made in the form of 'cut motions' seeking to reduce the sums sought by government.

- The budget is laid on the table of the Rajya Sabha soon after the Finance Minister has completed her/his budget speech in the Lok Sabha. The Rajya Sabha, does not vote on the demands for grants and there is only a general discussion on the budget.

- After the general discussion on the budget proposals and voting on demands for grants have been completed, the government introduces the Appropriation Bill.
- The Appropriation Bill is intended to give authority to government to incur expenditure from and out of the Consolidated Fund of India.

26 days

- 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.

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FINANCE BILL

- The Finance Bill seeking to give effect to the government's taxation proposals is introduced in Lok Sabha immediately after the presentation of the general budget.
- It is accompanied by a memorandum explaining the provisions of the bill and their effect on the finances of the country.
- The motion for leave to introduce a finance bill cannot be opposed.
- The finance bill is taken up for consideration and passing after the Appropriation Bill is passed.
- The Parliament has to pass the Finance Bill within 75 days of its introduction.
- After the Finance Bill has been passed by the Lok Sabha, it is transmitted to the Rajya Sabha for Its recommendations. The bill being a money bill, Rajya Sabha has to return it within a period of 14 days, with or without recommendations. The recommendations of Rajya Sabha may be accepted or rejected by the Lok Sabha.

However from 2017-18, the date of presentation of the budget has been advanced to 1st February. An important budgetary reform was the merger of railway budget with the general budget from the budget for financial year 2017-18.

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Source of Revenue

- The Department of Revenue of the Ministry of Finance exercises control in respect of the revenue matters relating to direct and indirect union taxes.
- The department is also entrusted with the administration and enforcement of regulatory measures provided in the enactments concerning goods and services tax (GST), central sales tax, stamp duties and other relevant fiscal statutes.

- The Department of Revenue exercises control in respect of matters relating to all the direct and indirect union taxes through two statutory boards, namely,

1. the Central Board of Direct Taxes (CBDT) - Matters relating to the levy and collection of all direct taxes are looked after by the CBDT
2. the Central Board of Indirect Taxes and Customs (CBIC)- Matters relating to levy and collection of goods and service taxes (GST), Customs and central excise duties, service tax and other Indirect taxes fall within the purview of the CBIC.

Government receipts are classified under two categories:

1. Revenue receipts which consists of tax revenue and non tax revenue.
2. Capital receipts which consists of debt receipts and non debt capital receipts

Capital receipts are those receipts that lead to a reduction in the assets or an increase in the liabilities of the government

The broad sources of revenue are:

1. Corporation tax
2. Taxes on income
3. Wealth tax
4. Customs duties
5. Union excise duties
6. Goods and services tax including GST compensation cess
7. Taxes on union territories

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Centre's net tax revenue is the total of tax revenue after paying of the states' share and the National Calamity Contingent duty (NCCD) transferred to the National Calamity Contingency.

Centre's net tax revenue = Total tax revenue - state's share - NCCD

Revenue Receipts

Non-tax revenues comprise the following:

1. Interest receipts,
2. Dividends and profits from public sector enterprises and surplus transfers from Reserve Bank of India
3. Other Non-tax revenues and
4. Receipts of union territories

Various social services provided by the government such as medical services, public health, broadcasting, education, sports, art and culture, housing and economic services such as communication, energy, transport, science, technology and environment, railways and general administrative services also yield revenue for the government.

Capital Receipts include:

1. Non debt capital receipts which include

(a) Recoveries of loans advanced by the government to PSEs, state governments, foreign governments and union territories

(b) Miscellaneous capital receipts (disinvestments and others) - sale proceeds of government assets, including those realized from divestment of government equity in public sector undertakings (PSUs).

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2. Debt capital receipts which include

(a) Market loans for different purposes

(b) Short term /Treasury bill borrowings

(c) Securities issued against small savings, NSC,

(d) State provident fund (Net)

(e) Net external debts

(f) Other receipts (Net) - *Sovereign Gold Bond Scheme, receipts from international financial institutions and saving bonds.*

Public Expenditure Management

- Developing economies like India require enormous amount of public spending to initiate and accelerate economic growth and to promote employment opportunities.
- Effective reduction in fiscal deficit requires an ingenious mix of revenue and expenditure policies.
- Government expenditure affects allocation of resources among various uses and therefore, great care should be taken to channelize the resources to socially desirable areas.

- Public expenditure management is the process that allows governments to be fiscally responsible. Public expenditure programmes or projects should be designed and implemented to provide given levels of outputs or achieve specific objectives at minimum cost.

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The economic costs of unproductive public expenditures can be extensive and may have far reaching effects such as:

- larger deficits Exp > Rev.
- higher levels of taxation,
- lower economic growth,
- fewer resources available for use elsewhere, and
- greater debt burden in the future.

The Department of Expenditure of the Ministry of Finance is the main nodal department for overseeing the public financial management system in the central government and matters connected with state finances. It is responsible for

- the implementation of the recommendations of the Finance Commission and the Central Pay Commission, for Govt employee.
- monitoring of audit comments/observations, and
- preparation of central government accounts.
- Additionally, it also assists central ministries/departments in controlling the costs and prices of public services,
- reviewing systems and procedures to optimize outputs and outcomes of public expenditure.

Govt — CAG
Audit

- The requirements of funds for all categories of expenditure including various programmes and schemes, along with receipts of the departments are discussed during the pre-budget meetings chaired by Secretary (Expenditure).
- Expenditure estimates are provisionally finalised and communicated to ministries/departments after the approval of Finance Minister.
- One of the explanatory documents of the budget document is the 'Expenditure Profile' (earlier known as expenditure budget) consisting of relevant data across all ministries/departments to outline a profile of the general financial performance of the government of India. It gives an aggregation of various types of expenditures.

The total expenditure through budget of various ministries and departments is composed of central expenditure and transfers. In Expenditure budget, the Central government expenditure is classified into six broad categories as below:

A. Centre's Expenditure:

- Establishment Expenditure of the Centre; Administration
- Central sector schemes, and fully funded by CG
- Other central expenditures including those on CPSEs (central public sector enterprises) and Autonomous Bodies

B. Centrally Sponsored Schemes and other Transfers:

The transfers include

- Centrally sponsored schemes
- Finance Commission transfers and
- Other transfers to states

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Public Debt Management

■ In emerging market and developing economies, the government is generally the largest borrower.

■ Government debt from internal and external sources contracted in the Consolidated Fund of India is defined as Public Debt.

■ The government raises funds primarily from the domestic market using market-based and fixed-rate instruments to finance its fiscal deficit.

■ Public debt, in simple words, means debt incurred by the government in mobilizing savings of the people in the form of loans, which are to be repaid at a future date with interest.

■ Public debt is not a one-time exercise of borrowing and repaying. Debt servicing is a continuous exercise as a portion of debt falls due each month, government does not usually cut expenditure or raise taxes to provide funds to retire or repay the maturing bonds. Rather, the government simply refinances the debt, i.e. it sells new bonds and uses the proceeds to pay off holders of the maturity bonds.

■ Hence public debt management becomes a crucial task or responsibility of the government and plays an important role in macroeconomic stability of a country.

■ Debt sustainability is in great part a function of the level of debt and the government's capacity to service the outstanding debt.

MOF RBI

■ Public debt management refers to the task of determining, by the fiscal and monetary authorities, the size and composition of debt, the maturity pattern, interest rates, redemption of debt etc.

■ It is the process of setting up and implementing the strategy for managing public debt in order to raise the required amount of funding at the desired risk and cost levels.

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The overall objective of the central government's debt management policy is to "meet the central government's financing needs at the lowest possible long term borrowing costs and also to keep the total debt within sustainable levels. Additionally, it aims at supporting development of a well-functioning domestic bond market".

Debt management strategy is based on three broad pillars namely:

👉low cost of borrowing,

👉risk mitigation and

👉market development.

Loan - $1000

1/4/23 - 1$ = ₹82
1000x82 = 82000

31/3/24 - 1$ = 84
84000

The institutions responsible for public debt management are:

1. Reserve Bank of India – domestic marketable debt i.e., dated securities, treasury bills and cash management bills.
Long term
2. Ministry of Finance (MOF); – external debt
3. Ministry of Finance; Budget Division and Reserve Bank of India – Other liabilities such as small savings, deposits, reserve funds etc.
PF, NSC

RBI

- The responsibility of managing the domestic debt of the central government and of 28 state governments and two union territories is entrusted with the Internal Debt Management Department (IDMD) of the Reserve Bank of India.
- While treasury bills are issued to meet short term cash requirements of the government, dated securities are issued to mobilise longer term resources to finance the fiscal deficit.
- From 1997 onwards, the Reserve Bank also provides short-term credit up to three months to state governments banking with it in the form of Ways and Means Advances (WMA) to bridge temporary mismatches in cash flows.

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Loan from 1 country. Group of countries - ADB

- External debt (bilateral and multilateral loans) is managed by the Department of Economic Affairs in the Ministry of Finance (MoF).
- Most of the external debt is sourced from multilateral agencies (International Bank for Reconstruction and Development, Asian Development Bank, etc.).
- There is no sovereign (Govt) borrowing from international capital markets. The entire external debt, in terms of original maturity, is on long -term basis and a major part is at fixed interest rates.

1$ = 82 → 1$ = ₹84] Depreciation

- The risk associated with external debt is the depreciation in the value of the domestic currency i.e., the currency of denomination of external loans leading to increase in the government's debt servicing cost.

The Fiscal Responsibility and Budget Management (FRBM) was passed in 2003 to provide a legislative framework for reduction of deficit and thereby debt of the central government to a sustainable level. The objectives of the act are:

- inter-generational equity in fiscal management,
- long run macroeconomic stability,
- better coordination between fiscal and monetary policy, and
- transparency in fiscal operation of the government.

The Public Debt Management Cell (PDMC) was created in 2016 under the Department of Economic Affairs.

- The Medium Term Debt Management Strategy or MTDS 2021-24 is a framework to determine the appropriate composition of the debt portfolio.
- The objective of the debt management strategy is to efficiently raise debt at the lowest possible cost in the medium term while ensuring that financing requirements are met without disruption.

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During Pandemic

- In line with the global trend, the government of India also responded to the pandemic challenges and increased its expenditure on health and social sector. At the same time, the revenue receipts declined substantially due to the adverse effects of the pandemic on economic activity.
- Consequently, fiscal deficit widened necessitating an increase in the size of the borrowing programme significantly during 2020-21 and 2021-22 in order to render counter-cyclical fiscal policy support and to provide targeted support to segments deeply hit by the pandemic.

The Reserve Bank has been proactively engaged in the development of the government securities (G-sec) market including broadening of investor participation. As part of continuing efforts to increase retail participation in G-sec, 'RBI Retail Direct' facility was announced on February 5, 2021:

- for improving the ease of access by retail investors through online access to the primary and secondary government securities market
- to provide the facility to open their government securities account ('Retail Direct') with the Reserve Bank.

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Important Budget Concepts

Type of budgets

■ **Balanced budget**: - A balanced budget is a budget in which revenues are equal to expenditures. Thus, neither a budget deficit nor a budget surplus exists.

Revenue= Expenditure

■ **Unbalanced budget**: The budget may either be surplus or deficit

👉**A surplus budget**: when estimated government receipts are more than the estimated government expenditure it is termed as surplus budget.

Public revenue exceeds Public expenditure (R>E.)

👉**A deficit budget**: when estimated government receipts are less than the government expenditure, it is termed as a deficit budget.

A deficit budget increases the liability of the government or decreases its reserves.

In modern economies, most of the countries follow deficit budgeting.

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Revenue Expenditure : Revenue expenditure is expenditure incurred for purposes other than creation of physical or financial assets of the central government. It relates to those expenses incurred for the normal functioning of the government departments and various services.

■ interest payments on debt incurred by the government, and grants given to state governments and other parties

Capital Expenditure: There are expenditures of the government which result in creation of physical or financial assets or reduction in financial liabilities.

■ This includes expenditure on the acquisition of land, building, machinery and equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties.

Loan- ₹100 — Int on Loan - Rev exp

└ Repay . Cap Exp.

Budgetary Deficit or Overall Deficit

Budgetary Deficit is defined as the excess of total estimated expenditure over total estimated revenue, both revenue and capital.

Revenue Deficit

- The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts.
- It shows the shortfall of government's Revenue current receipts over current expenditure. It shows the government revenue is insufficient to meet the regular expenditures in connection with the normal functioning of the government. Revenue

Revenue deficit = Revenue expenditure – Revenue receipts

Fiscal Deficit

Rev. Cap

When the government's non-borrowed receipts fall short of its entire expenditure, it has to borrow money from the public to meet the shortfall. The excess of total expenditure over total receipts excluding borrowings during a given fiscal year is called the fiscal deficit.

👉It is often presented as a percentage of the gross domestic product (GDP).

- Total Receipts excluding borrowing = Revenue Receipts + Capital Receipts excluding borrowing or (Non debt creating capital receipts).

👉Non debt creating capital receipts include recoveries of loans advanced by the government and sale proceeds of government assets, including those realized from divestment of government equity in public sector undertakings (PSUs).

- Fiscal deficit = Total Expenditure –Total Receipts excluding borrowing

Fiscal Deficit = (Revenue Expenditure + Capital Expenditure) – (Revenue Receipts + Capital Receipts excluding borrowing)

Fiscal Deficit = (Revenue Expenditure- Revenue Receipts) + (Capital Expenditure – Capital Receipts excluding borrowing)

- Fiscal Deficit = Revenue Deficit + (Capital Expenditure - Capital Receipts excluding borrowing)

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The fiscal deficit will have to be financed by borrowing.

- Therefore fiscal deficit points to the total borrowing requirements of the government from all sources.
- In case revenue deficit occupies a substantial share of fiscal deficit, it is an indication that a large part of borrowing is used for consumption purposes rather than for investment.

Rev Exp

Primary Deficit

Primary deficit is defined as fiscal deficit of current year minus interest payments on previous borrowings.

- In other words whereas fiscal deficit indicates borrowing requirement inclusive of interest payment, primary deficit indicates borrowing requirement exclusive of interest payment.
- It tells how much of the government's borrowings are going towards meeting expenses other than interest payments.
- Primary deficit thus gives an estimate of borrowings on account of current expenditure exceeding current revenues.

Primary deficit = Fiscal deficit – $\boxed{\text{Net}}$ Interest liabilities

Net interest liabilities interest payments minus interest receipts by the government on domestic lending.

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Outcome budget

- The outcome budget establishes a direct link between budgetary allocations of schemes and its annual performance targets measured through output and outcome indicators.
- The outcome budget is a progress card on what various ministries and departments have done with the outlays (Exp) in the previous annual budget. It measures the development outcomes of all government programs and whether the money has been spent for the purpose it was sanctioned including the outcome of the fund usage.

Fiscal Deficit

└ Total exp − Total Receipts excluding Borrowings

Total exp: Rev. / Cap.

Total Receipts: Revenue Receipt / Capital Receipts

Capital Receipts: Debt ✗ / Non-Debt Receipt

Revenue Deficit

→ Rev. Deficit + Cap Exp − Cap Rec. └ excluding borrowing

Eg = Total Revenue [excluding borrowings] = ₹100

Total Govt exp = ₹150

Interest payment = ₹30
[Rev Exp].

→ Fiscal Deficit = 150 − 100
= ₹50

Eg. Primary Deficit └→ Exp (excluding Int) = ₹120 [150 − 30]

Rev. − ₹100

Primary Def = ₹20

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UNIT – 4: FISCAL POLICY

Introduction

- Fiscal policy is the deliberate policy of the government under which it uses the instruments of taxation, public expenditure and public borrowing to influence both the pattern of economic activity and level of aggregate demand, output and employment.
- Fiscal policy is in the nature of a demand-side policy.
- An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

The classical economists held the belief that the government should not intervene in the economy because the market mechanism makes the economy self-adjusting and keeps the economy at or near the natural level of real GDP at all times. The government should have a balanced budget and any deliberate fiscal policies are unnecessary.

The Depression resulted in very low aggregate demand along with high levels of unemployment. The classical economics could not provide any solution to this problem. In 1936, the British economist John Maynard Keynes in his book 'The General Theory of Employment, Interest, and Money' advocated increase in government spending to combat the recessionary forces in the economy and to solve the problem of unemployment. In recent times, especially after being threatened by the global financial crisis and recession, many countries have preferred to have a more active fiscal policy.

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Objectives of Fiscal Policy

Since nations differ in numerous aspects, the objectives of fiscal policy also may vary from country to country. However, the most common objectives of fiscal policy are:

- Achievement and maintenance of full employment,
- Maintenance of price stability, - Moderate Inflation.
- Acceleration of the rate of economic development, and
- Equitable distribution of income and wealth

The importance as well as order of priority of these objectives may vary from country to country and from time to time. For instance,

📌 while stability and equality may be the priorities of developed nations,

📌 economic growth, employment and equity may get higher priority in developing countries.

- Governments may directly as well as indirectly influence the way resources are used in an economy. Fiscal policy is a powerful tool for managing the economy because of its ability to influence the total amount of output produced viz. gross domestic product.
- The ability of fiscal policy to influence output by affecting aggregate demand makes it a potential instrument for stabilization of the economy.

$$\boxed{AD/GDP = C + I + \overset{\text{Direct}}{G} + NX}$$

- The governments can influence the level of economic activity (GDP) by directly controlling G (government expenditure i.e purchases of goods and services by the government) and indirectly influencing C (private consumption), I (investment), and NX (net exports or exports minus imports), through changes in taxes, transfer payments and public expenditure.

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1. Expansionary - Job contraction होता है
Hume Expansion chahiye

Types of Fiscal Policy

Contra cyclical fiscal policy or fiscal policy measures to correct different problems created by business-cycle instability are of two basic types namely, expansionary fiscal policy and contractionary fiscal policy.

📝Expansionary Fiscal Policy

boost

■ Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of a business cycle or when there is an anticipation of a business cycle contraction.

■ A recession is said to occur when the overall economic activity declines, or in other words, when the economy 'contracts'. A 'demand-deficient' recession sets in with a period of falling real GDP, low aggregate demand and reduced consumer spending and rising unemployment. To combat (Fight) such a slump (fall) in overall economic activity, the government can resort to expansionary fiscal policies.

📌We may technically refer to this as a policy measure to close a 'recessionary gap'.
How does the government achieve this?

AD < AS
Output

Income Tax GST

🎯The government may cut all types of taxes, direct and indirect, leaving the taxpayers with extra money to spend so that there is more purchasing power and more demand for goods and services. Consequently aggregate demand, output and employment increase.

🎯An increase in government expenditure will pump money into the economy and increase aggregate demand. This in turn will increase output and employment.

🎯A combination of increase in government spending and decrease in personal income taxes and/or business taxes.

E > R

■ While resorting to expansionary fiscal policy, the government may run into budget deficits because tax cuts reduce government income and the government expenditures exceed tax revenues in a given year.

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Jab Expansion chal Raha hoga → AD > AS → Inflation ↑ → Price ↑

Contractionary fiscal policy

■ Contractionary fiscal policy is designed to restrain (Control) the levels of economic activity of the economy during an inflationary phase or when there is anticipation of a business-cycle expansion which is likely to induce inflation.

■ Contractionary fiscal policy refers to the deliberate policy of government applied to curtail (decrease) aggregate demand and consequently the level of economic activity.

📌In other words, it is fiscal policy aimed at eliminating an 'inflationary gap'. AD > AS

■ If the state of the economy is such that its growth rate is extraordinarily high causing inflation and asset bubbles, contractionary fiscal policy can be used to confine it into sustainable levels.

Contractionary fiscal policy works through:

🎯Decrease in government spending: With decrease in government spending, the total amount of money available in the economy is reduced which in turn has the effect of reducing the aggregate demand.

🎯Increase in personal income taxes and/or business taxes: An increase in personal income taxes reduces disposable incomes leading to fall in consumption spending and aggregate demand. An increase in taxes on business profits reduces the surpluses available to businesses, and as a result, firms' investments shrink causing aggregate demand to fall. Increased taxes also dampen the prospects of profits of potential entrants who will respond by holding back fresh investments.

🎯A combination of decrease in government spending and increase in personal income taxes and/or business taxes.

Deficit ↑ ↓E > R↑ — Deficit ↓ / Surplus R > E

■ Contractionary fiscal policy should ideally lead to a smaller government budget deficit or a larger budget surplus.

↓ Revenue ↑ Exp ↓

INFLATION

fiscal policy aims at controlling excessive aggregate spending

↓

Contractionary Fiscal policy

DEFLATION

fiscal policy aims to increase effective demand by boosting aggregate spending.

↓

Expansionary Fiscal policy

THE INSTRUMENTS OF FISCAL POLICY

1) Government Expenditure as an Instrument of Fiscal Policy

- Public expenditure includes governments' expenditure towards consumption, investment, and transfer payments.

Rev. Exp

Cap Exp

- Fiscal policy relates to decisions that determine whether the government's expenditure is more or less than what it receives. A reduction or increase in it may result in significant variations in the country's total income. As such, public expenditure can be instrumental in adjusting consumption and investment to achieve full employment.

- Public expenditures are income generating and include all types of government expenditure such as capital expenditure on public works, relief expenditures, subsidy payments of various types, transfer payments and other social security benefits

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Exp ↑ — Requires Paisa — But Taxes can't be ↑ — Borrowing ↑ / Printing ↑

Government expenditures include:

- current expenditures to meet the day to day running of the government,
- capital expenditures which are in the form of investments made by the government in capital equipments and infrastructure, and
- transfer payments i.e. government spending which does not contribute to GDP because income is only transferred from one group of people to another without any direct contribution from the receivers.

- During a recession, it may initiate a fresh wave of public works, such as construction of roads, irrigation facilities, sanitary works, ports, electrification of new areas etc.
- Government expenditure involves employment of labour as well as purchase of multitude of goods and services.
- These expenditures directly generate incomes to labour and suppliers of materials and services.
- Apart from the direct effect, there is also indirect effect in the form of working of multiplier. The incomes generated are spent on purchase of consumer goods. The extent of spending by people depends on their marginal propensity to consume (MPC). There is generally surplus capacity in consumer goods industries during recession and an increase in demand for various goods leads to expansion in production in those industries as well.

A relevant question here is; from where will the government find resources to increase its expenditure?

👉 We know that if government resorts to increase in taxes, it is self- defeating as increased taxes will reduce the disposable incomes and therefore aggregate demand. The government should in such cases go for a deficit budget which may be financed either through borrowing or through monetization (creation of additional money to finance expenditure).

Additionally, a programme of public investment will strengthen the general confidence of businessmen and consequently their willingness to invest.

AD > AS

Public expenditure is also used as a policy instrument to reduce the severity of inflation and to bring down the prices. This is done by reducing government expenditure when there is a fear of inflationary rise in prices. Reduced incomes on account of decreased public spending help eliminate excess aggregate demand.

2) Taxes as an Instrument of Fiscal Policy

- Tax as an instrument of fiscal policy consists of changes in government revenues or in rates of taxes aimed at encouraging or restricting private expenditures on consumption and investment.

  Tax ↓ Tax ↑

- Taxes determine the size of disposable income in the hands of the general public which in turn determines aggregate demand and possible inflationary and deflationary gaps.
- The structure of tax rates is varied in the context of the overall economic conditions prevailing in an economy:

📝During recession and depression, the tax policy is framed to encourage private consumption and investment. A general reduction in income taxes leaves higher disposable incomes with people inducing higher consumption. Low corporate taxes increase the prospects of profits for business and promote further investment. The extent of tax reduction and /or increase in government spending required depends on the size of the recessionary gap and the magnitude of the multiplier.

MPC ↑

Inv. Multiplier ↑

📝During inflation, new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes and to wipe off the surplus purchasing power. However, excessive taxation usually stifles new investments and therefore the government has to be cautious about a policy of tax increase.

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3) Public Debt as an Instrument of Fiscal Policy

■ Public debt may be internal or external; when the government borrows from its own people in the country, it is called internal debt.

■ On the other hand, when the government borrows from outside sources, the debt is called external debt.

■ Public debt takes two forms namely, market loans and small savings.

📝In the case of market loans, the government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets. For financing capital projects, long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued.

📝The small savings represent public borrowings, which are not negotiable and are not bought and sold in the market. In India, various types of schemes are introduced for mobilising small savings e.g., National Savings Certificates, National Development Certificates, etc.

NSC

📌Borrowing from the public through the sale of bonds and securities curtails the aggregate demand in the economy.

📌Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

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4) Budget as an Instrument of Fiscal Policy

■ The budget is simply a statement of revenues earned from taxes and other sources and expenditures made by a nation's government in a year. The net effect of a budget on aggregate demand depends on the government's budget balance.

A government's budget can either be balanced, surplus or deficit.

📝A **balanced budget** results when expenditures in a year equal its tax revenues for that year. Such a budget will have no net effect on aggregate demand since the leakages from the system in the form of taxes collected are equal to the injections in the form of expenditures made.

Tax

Inv./Exp.

R>E

📝A **budget surplus** that occurs when the government collects more than what it spends, though sounds like a highly attractive one, has in fact a negative net effect on aggregate demand since leakages exceed injections.

Taxes > Exp

📝A **budget deficit** wherein the government expenditure in a year is greater than the tax revenue it collects has a positive net effect on aggregate demand since total injections exceed leakages from the system.

E>T

📌While a budget surplus reduces national debt, a budget deficit will add to the national debt.

Tax Rev > Exp

E > R

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AD > AS
High Inflation

Fiscal Policy for Long-run Economic Growth

We know that economic growth is indispensable for sustainable development and favourable social outcomes. The demand-side fiscal policies unaccompanied by policies to stimulate aggregate supply cannot produce long-run economic growth.

Fiscal policy influence economic growth through its effects on the incentives faced by individuals and firms. For example;

- Fiscal policies such as those involving infrastructure spending generally have positive supply-side effects. When government supports building a modern infrastructure, the private sector is provided with the requisite overheads (Support / Services) it needs.
- Government provision of public goods such as education, healthcare, nutrition, research and development etc. provide momentum for long-run economic growth through human capital formation. Increase in human capital makes physical capital more productive.
- Taxes can have either positive or negative impact on economic growth depending on whether it encourages or discourages saving and investment.
- A well designed tax policy that rewards innovation and entrepreneurship, without discouraging incentives will promote private businesses who wish to invest and thereby help the economy grow. For example, an increase in corporate taxes to raise extra revenue may have adverse consequences on incentives and output.
- Tax and spending policies (e.g. subsidies) can be effectively used to correct market failures resulting from externalities.
- Increase in environment taxes increase the cost of firms and reduce their output
- Subsidies on inputs and support prices to producers (e.g. farmers) generate higher output.

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Fiscal Policy for Reduction in Inequalities of Income and Wealth

Many developed and developing economies are facing the challenge of rising inequality in incomes and opportunities. Fiscal policy is a chief instrument available for governments to influence income distribution and plays a significant role in reducing inequality and achieving equity and social justice.

The distribution of income in the society is influenced by fiscal policy both directly and indirectly. We shall see a few such measures as to how each of these can be manipulated to achieve desired distributional effects.

- A progressive direct tax system ensures that those who have greater ability to pay contribute more towards defraying to pay the expenses of government and that the tax burden is distributed fairly among the population.
- Indirect taxes can be differential: for example, the commodities which are primarily consumed by the richer income group, such as luxuries, are taxed heavily and the commodities the expenditure on which forms a larger proportion of the income of the lower income group, such as necessities, are taxed light or not taxed at all.

- A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society. This is done through spending programmes targeted at welfare measures for the disadvantaged, such as

(i) poverty alleviation programmes
(ii) free or subsidized medical care, education, housing, essential commodities etc. to improve the quality of living of the poor
(iii) infrastructure provision on a selective basis (e.g. rural roads, water supply for tribal area)
(iv) various social security schemes under which people are entitled to old-age pensions, unemployment relief, sickness allowance etc.
(v) subsidized production of products of mass consumption
(vi) public production and/ or grant of subsidies to ensure sufficient supply of essential goods, and
(vii) strengthening of human capital for enhancing employability etc.

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■ Choice of a progressive tax system with high marginal taxes may act as a strong discourage deterrent to work, save and invest. Therefore, the tax structure has to be carefully framed to mitigate possible adverse impacts on production and efficiency.

■ Additionally, a highly redistributive fiscal policy with excessively generous social programs can reduce incentives to work and save.

Limitations of Fiscal Policy

■ One of the biggest problems with using planned fiscal policy to counteract fluctuations is the different types of lags involved in fiscal-policy action. There are significant lags namely:

👉**Recognition lag**: The economy is a complex phenomenon and the state of the macro economic variables is usually not easily Understood comprehensible. There is difficulty in collecting accurate and timely data. There may be delay on the part of the government to recognize the need for a policy change.

👉**Decision lag**: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to make a decision on the most appropriate policy.

👉**Implementation lag**: even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them on account of bureaucracy. This is specially so under a democratic set up.

👉**Impact lag**: impact lag occurs when the outcomes of a policy are not visible for some time.

■ Fiscal policy changes may at times be badly timed due to the various lags so that it is highly possible that an expansionary policy is initiated when the economy is already on a path of recovery and vice versa.

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■ There are **difficulties in instantly changing governments' spending and taxation** policies.

■ It is practically **difficult to reduce government spending** on various items such as defence and social security as well as on huge capital projects which are already midway.

■ **Public works cannot be adjusted easily** along with movements of the trade cycle because many huge projects such as highways and dams have long gestation period. Besides, some urgent public projects cannot be postponed for reasons of expenditure cut to correct fluctuations caused by business cycles.

■ **Supply-side economists are of the opinion that certain fiscal measures will cause disincentives**. For example, increase in profits tax may adversely affect the incentives of firms to invest and an increase in social security benefits may adversely affect incentives to work and save.

$E > R \rightarrow Emp\uparrow \rightarrow Income\uparrow \rightarrow AD\uparrow$ but $AS\uparrow \times \rightarrow AD > AS \rightarrow Prices\uparrow$

■ **Deficit financing** increases the purchasing power people. The production of goods and services, especially in under developed countries may not catch up simultaneously to meet the increased demand. This will result in prices spiraling beyond control.

■ **Increase ~~is~~ in government borrowing creates perpetual burden on even future generations** as debts have to be repaid. If the economy lags behind in productive utilization of borrowed money, sufficient surpluses will not be generated for servicing debts. External debt burden has been a constant problem for India and many developing countries.

■ If governments compete with the private sector to borrow money for spending, it is likely that interest rates will go up, and firms' willingness to invest may be reduced. Individuals too may be reluctant to borrow and spend and the desired increase in aggregate demand may not be realised.

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Crowding Out

- Some economists are of the opinion that government spending would sometimes substitute private spending and when this happens the impact of government spending on aggregate demand would be smaller than what it should be. In such cases, fiscal policy may become ineffective.

- Substantial government borrowing in the credit market tends to reduce the amount of funds available and pushes the interest rates up. Higher interest rates slow down business investment expenditures and consumption expenditures that are sensitive to interest rates. An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy. In other words, when spending by government in an economy replaces private spending, the latter is said to be crowded out. 👉As a result, the effectiveness of expansionary fiscal policy in stimulating aggregate demand will be diminished to a great extent. This may also possibly reduce the economy's prospects of long-run economic growth.

- However, during deep recessions, crowding-out is less likely to happen as private sector investment is already minimal and therefore there is only insignificant private spending to crowd out. Moreover, during a recession phase the government would be able to borrow from the market without increasing interest rates.

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Govt Exp ↑ → Govt Borrowing ↑ → Demand for Loans ↑

↓ (Govt Exp ↑) AD for Goods & Services ↑ → Private Business Sector wants to Inc Investment → Int Rate ↑ [D>S]

→ Discourage, Disincentive

Chapter over :)