24/6

PUBLIC FINANCE

UNIT 1 :-

Primary goal → promote general welfare of the society

3 Main macro economic goal :-

* economic growth
* high level of employment
* stable price levels.

Inflation → reduces real income and purchasing power.

↑ employment → high income, high output

↓ employment → loss of output produced, harms the unemployed.

Adam Smith → bold advocate of free markets and minimal govt. activity. He says govt role in society should be limited.

Role of govt (according to smith).

* national defence, national security.
* establish a system of justice to provide law and order and protect property.
* establishment of highly benificial public institutions. ISRO, Railways, Roads etc.

* Govt. has to do things which profit seeking private individuals may not do.

Richard Musgrave → 1959 → Theory of Public Finance.

Fiscal Functions ←

State and local govts

central govt

Allocation Function	Redistribution Functions	Stabilisation Function
↓ MICRO	↓	↓ MACRO
optimum utilization of resources	Equal and fair distribution of income	Price ⌉ Stability

The Allocation Function :-

* refers to the way in which available resources are allocated among various uses.
* determines how much goods and services will actually be produced since resources are scarce/limited.
* Efficient allocation of resources is done in Perfectly competitive market.

De-merit goods :- Liquor, Tobacco etc ⌉
Supply > Demand. ← Over-production

Merit goods :- Education, health care etc ⌉
Supply < Demand ← under production.

*Note :- Both the situations face Market Failure. and govt comes to solve this

Market failure hinders efficient allocation of resources.

Market failure occurs due to :

* Imperfect competition, presence of monopoly.
  ↳ leads to under-production and high prices
* Markets fail to provide collective public goods
  ↳ Defence, roads etc
* Incomplete Markets → Markets fail to produce right qty of merit goods.
* Common Property resources → over-used for self-interest
* Externalities → consumption affects the third person (Eg pollution)
* Factor immobility → causes unemployment and inefficiency
* Imperfect information → One with more knowledge abt the good misuses knowledge

In the absence of govt. intervention :-
* Market failures may occur.
* resources are misallocated
* over-production or under-production
(↑ demerit, ↓ merit)

Allocation responsibility of govt :-
Suitable correct action when ~~govt~~ pvt. markets fail to provide right or desirable goods and services.

* Market failures provide the rationale (reason) for govts. allocative function.

Resources Allocation in Govt Policy :-
* who and what will be taxed
* how govt. revenue will be spent.
* process of division of total resources.
* optimum mix of various goods
* level of involvement of public sector in national economy.
* re-allocation of society's resources from private to public use.

Focuses on potential of govt to improve economic performance through expenditure or tax policies.

Instruments of Allocation :-
* govt can directly produce an economic good.
* govt may use the price mechanism.
* to influence private allocation by policies
Ex Tax concession, Subsidies → Merit goods.
Tax Rise → Demerit goods.
* govt. can influence allocation through legislation and force.
Ex → Ban of single use plastic goods.
* Make competition policies, merger policies which affect the structure of industry or commerce.
* govts. regulatory activities → licensing, control, wages, location etc → affects resource allocation.
* govt sets legal or administrative framework
* May adopt any mix of possible solutions.

Redistribution Function :-
No govt interference → distribution of income or wealth in society likely to be skewed.
Govt interference → ensure more desirable distribution.

This function is related to the question of for whom should the economy produce goods and services.

The Redistribution Function in govt Economics:-

Govt can redistribute through expenditure side or through revenue side of budget.

Expenditure side: Provide free or subsidised education, health care, housing etc. to poor people.

Revenue side: Redistribution is done through progressive taxation.

AIM OF REDISTRIBUTION FUNCTION

* equitable distribution of societal output.
* Ensure well being of people who suffer from lack of amenities.
* Equality in income, wealth, opportunities.
* Provide security for people with hardships
* Ensure minimal standard of living for everyone.

EXAMPLES OF REDISTRIBUTION FUNCTION:-

* Taxation policies:- Rich → ↑ Tax
  Poor → ↑ Subsidies
* Receipts from taxes used in public services.
* Employment reservations → protect certain segments of population.
* Unemployment benefits and transfer payments to handicaped, older citizens, dependent etc.
* Families with income below poverty line are provided with monetary aid.
* Regulating manufacture and sale of certain products for consumer health and well being.
* Special schemes for backward regions and for vulnerable sections.

FISCAL POLICY / BUDGETARY POLICY :-

Refers to the policy of central govt related to change in govt expenditure and tax rates.

If govt wants to increase Agg. demand ↑

How? Expansionary fiscal policy

Tax ↓, Govt. Exp ↑.

used to correct deflationary situation

FISCAL POLICY

used to correct inflationary situation

AD ↑	AD ↓
Expansionary Fiscal policy	Contractionary Fiscal policy
Tax ↓, Govt. Exp ↑	Tax ↑, Govt. Exp ↓

How?

Deflationary / Recessionary / Contractionary Situation

↓

Price level ↓ → Profit ↓

Employment ↓ ← Output ↓

National Income ↓

To correct this situation ⇒ AD ↑

Tax ↑, Govt. Exp ↑

Inflationary Situation P↑

Cause? → AD ↑

To correct this situation ⇒ AD ↓

Tax ↓, Govt. Exp ↓

Monetary Policy :-

Policy of central bank related to change in Money Supply and reduce in interest.

Money Supply ↑ → loan ↑ (easily given)

interest ↓

To correct deflationary situation

MONETARY POLICY

To correct inflationary situation.

AD ↑	AD ↓
Money Supply ↑	Money Supply ↓
Interest ↓	Interest ↑
Expansionary Monetary policy	Contractionary Monetary policy

Stabilization Function :-

Full Employment → Full Capacity → Spending

↑

Price Stable

Macro Economic Stability ~~is~~ exists when?

* economy's output = production capacity
* eco's total spending = total output
* eco's labour resources are fully employed.
* Inflation is low or stable → Price Stability

Key Areas of Concern in Stabilization
* Labour employment, capital utilization
* Overall output, Income
* General price levels
* Balance of intl. payments.
* The Rate of economic growth.

Reason for govt to interfere :-
* Market economy → don't generate employment and price stability ?
leads govts to start deliberate stabilization process.
* No. govt. involvement → stagflation & Recession (Inflation + unemployment)
* Stabilization → gets complex due to contagious effect.
→ increases international interdependence
→ forces of instability gets shifted to other country.

Role of Fiscal and Monetary Policy :-
Monetary policy - works through changing money supply and int. rate.
* affects consumption & saving

Fiscal policy :- Ex - Covid-19 :- govt gave free ration & etc.
Expenditure Activities :- Govt spends to boost up other economic activities.
Taxation decisions :-

Expansionary Fiscal policy → Remove recession and deflation.
* govt increases it's expenditure } to ensure income protection
* govt cuts down taxes

Contractionary Fiscal policy :- Controls inflation.
* govt decreases expenditure
* increases taxes.

Deficit budget → stimulate economic activity, Total Exp > Total revenue.
Surplus budget → slows down eco. activ
Total Exp < Total revenue.

FISCAL FEDERALISM :-

* deals with - division of governmental functions or financial relations among the different levels of govt.
* Federalism - institutional arrangement - ~~an~~ accommodate 2 sets of govt - national level and regional level - Each govt is autonomous - Independent judiciary - to solve disputes between central and state govt - related to division of powers.
* Article 246 - divides the powers of union and state - classifies powers into 3 lists.
  - Union list - union parliament - legislate
  - State list - state assembly - legislate
  - Concurrent list - parliament and assemblies - legislate.
* 1 July 2017 - GST was introduced

3 types of GST - SGST / UTGST
- CGST
- IGST

Union Govt. levies taxes on:-

* Tax on income (except agricultural income)
* customs or export duties
* excise duties or certain goods
* corporation tax
* capital value of assets (except agri. land)
* terminal taxes
* Security transaction tax
* Central GST
* Union excise duty.

State govt levies taxes on:-

* agricultural income
* lands and buildings
* Mineral rights
* Electricity
* vehicles
* Tolls
* Professions
* Land Revenue
* Stamp duty
* Impose excise duties on certain items.

Govt levies tax on tax which is called CESS. This is credited to ~~a~~ fund which is GST Compensation fund. - provides compensation to states (Maharashtra, Gujarat etc).

GST compensation - extended beyond 5yrs.
↳ given to states to compensate the lost revenue due to GST.

State and union legislatures - equal rights powers on GST - as per Supreme court verdict 2022 May.

GST - replaced production based tax system to consumption related tax system.

* GST :- 35% of tax - union
  44% of tax - state.

Article of 268-281 - provisions related to distribution of finances ~~of~~ among states

268 - levied by union, goes to state
269 - levied by union, assigned to state
270 - levied & collected by union and distributed b/w union & state as per ~~class~~ clause 2.
271 - Surcharge on duties & tax for union
275 - statutory grants -
282 - Grant for public purpose
293 - Loan for any public purpose

Article 292 and 293 - borrowing by govt. of India and borrowing by states.
Article 280 - mechanism for Finance commission - facilitate such transfers.

Functions of Finance Commission :-
* distribute - share b/w union & state - of net proceeds of tax.
* determination of rules and taxes of grants - to states which are in need.
* Make recommendations - to president - abt measures needed to support - consolidated fund of a state - supplement the resources - of panchayats and municipalities in state.
* Any matter - referred to commission - by president - in interests of sound finance

15th Finance Commission - 27 Nov, 2017 - against abolition of planning commission - intro of GST.
Commission - recommended share of states - vertical devolution - 2021 to 26 - 41% - less than 42% ~~recom~~ - 1% share provided to J&K and ladakh.

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Finance Commission considers issues related to :- ① vertical equity
② horizantal equity.

The criteria of distribution of central tax :- income, area, population (2011), forest, demographic performance, ecology, fiscal efforts.

EXPENDITURE DECENTRALISATION.

CENTRAL :- defence, foreign affairs, foreign trade, exchange movement, money, banking, cross-state transport and communication

STATE :- Agriculture, Industry, health, education, police, state roads, infra.

LOCAL :- Water, Sanitation, Roads, electricity.