CHAPTER – 7 : Public Finance

UNIT-1 : Fiscal Functions: An Overview, Centre and State Finance

There are three main macroeconomic goals for any nation.

1. economic growth.
2. high levels of employment.
3. stable price levels.

- Adam Smith advocates limited govt. role
  1. Defense (national)
  2. Justice system
  3. Public infrastructure like railway etc.
- 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.

Resource Allocation (Efficiency) | Income Redistribution (fairness) | Macro Economic Stabalisation (Price Stability)

- Central govt's functions : Economic stabilization & Income redistribution
- State govt & Local govt's functions : Resources allocation

Government Functions

Macroeconomic Stabalisation

Microeconomic
1. Allocation
2. Distribution

■ Allocation Function

- Distribution of limited resources among various uses
- Determines goods and services produced in economy
- Challenge - addressing unlimited wants with limited resources

■ Economic Efficiency

Seeks	using resources optimally, minimizing wastage & inefficiency
Ensures	allocation benefits each person
Private sector	allocation relies on market supply, demand, prices, consumer sovereignty & profit motive
Govt's role	budgeting activities

- Market Failure- it is a situation where goods are either under provided or over provided
  (1) Private goods are sufficiently provided whereas public & merit goods are not provided sufficiently
  (2) Missing markets or non-existent markets is common

- Causes of Market Failure

Imperfect Competition	Varying degrees of monopoly power leading to low production and high prices.
Public Goods	Markets fail to provide collective public goods (e.g., defense), consumed by all.
Incomplete Markets	Underproduction of merit goods (e.g., education and health care).
Resources	Overuse and exhaustion of resources like the environment for self-interest.
Externalities	-ve effects caused by production/ consumption affecting third parties
Immobility	Causes unemployment and inefficiency.

- Govt. Intervention
  To connect, efficient resource allocation, social welfare
  - Examples of Govt. Intervention
    - Property rights establishment
    - Addressing externalities
    - Providing merit goods
    - Controlling demerit goods
    - Stability of market system

- Govt. Policy for Resource Allocation

Expense	Tax policy	deciding who is taxed	govt. spending	mix of social goods

- Instruments for Resource Allocation (allocation instruments)
  - direct production (economic goods, e.g. electricity)
  - price mechanism may be used by the govt.
  - legislation like ban of single use plastic
  - competition & merger policies
  - regulatory activities like licensing, minimum wages etc.
  - legal & administrative frameworks

- Redistribution Function
  - govt's intervention for fair redistribution (income & wealth)
  - It is related to 'for whom' to produce in an economy

- Aims
  - Distribution: Equitable distribution of societal output among households
  - Welfare: Social welfare enhancements
  - Wellbeing: Improve wellbeing of deprivation (of varied types) facing individuals
  - Standard of living: Promote income, wealth & opportunities equality, security & standard of living

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

- Stabalisation Function
  - Stability exists when economies
    - output matches production capacity
    - total spending matches total output
    - labour resources fully employed
    - inflation - low & stable

- Keynesian Theory
  - Market economy doesn't reach full employment and price stability alone, it needs govt. intervention
  - Market tendencies cause business cycles & without govt's intervention thus will be prolonged inflation & recession
  - Tools used by govt.
    - monetary policy, fiscal policy

Challenges

- Stagflation
- Contagion effect
- Prolonged inflation or recession
- unresolved economic disruptions caused by market fluctuation

Role of Fiscal and Monetary Policy

- Fiscal Policy: eliminates fluctuation through expenditure& taxation decisions
- Govt's expenditure: injects money in economy
- Taxes: reduce disposable income & effective demand

	Govt. Expenditure	Taxes
Recession	Increases	Decreases
Inflation	Decreases	Increases

Budget Surplus	Budget Deficient
Stimulates economic activity	Slows down economic activity

Conflicts

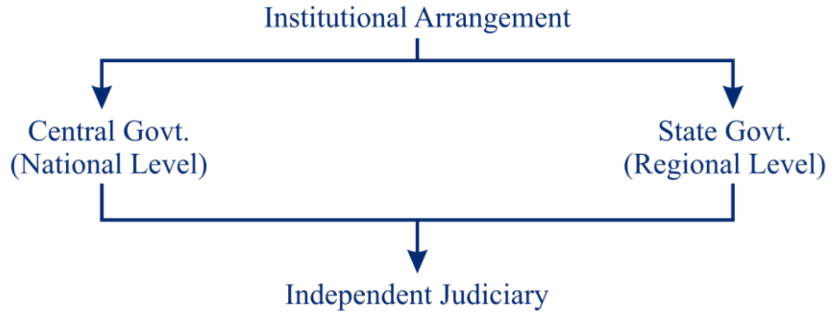
Conflicts among various goals & budgetary policy

- Effective policy designs: Balance multiple govt. objectives without jeopardizing one for the sake of others

Center and State Finance

- Fiscal Federalism: (by Richard Musgrave) division of govt. functions and financial relations among diff levels of govt.
- Central govt's functions : Economic stabilization & Income redistribution
- State govt & Local govt's functions : Resources allocation

Federal Structure



Federal Structure

Power Distribution Through Lists

Central List	State List	Concurrent List
Central Legislation	State Legislation	Centre + State Legislate

In case of a conflicting legislation in concurrent list, decision of center prevails.

Revenue Expenditure Allocation

- It is crucial in federation
- Distinct central & state revenue sources
- Centre and state levy taxes
- Center has greater revenue raising powers
  - Taxes income tax, central GST, etc.
- State taxes: agriculture, electricity, mineral rights etc.

Article 268	Duties levied by the union but collected and appropriated by states.
Article 269	Taxes levied and collected by the union but assigned to the states.
Article 270	Taxes levied and collected by union and distributed between the union and states as prescribed in clause 2 and the States.
Article 271	Surcharge on certain duties and taxes for purposes of the union
Article 275	Statutory Grants - in-aid from the union to certain states.
Article 282	Grants for any public purpose
Article 293	Loans for any public purpose

Finance Commission (Article 280)

Facilitates transfer of resources (financial between center and state)

Functions:

- Tax sharing
- Assessing finances
- Grant distribution
- Recommends President regarding financial decisions

Criteria of Distribution of Center Taxes

- Income distance
- Area
- Tax & Fiscal efforts
- Population
- Demographic performance
- Forest & ecology

Fifteenth Finance Commission

- Formed November 2017
- Recommendation
  - state receive 41% of central taxes for 2021-2026
  - Additional 1% for newly formed UT's. Eg- J&K

Introduction of GST (1 July2017)

GST	Goods and Service Tax
SGST	State Goods and Service Tax
IGST	Integrated Goods and Service Tax
CGST	Central Goods and Service Tax

- Aim – consolidated indirect taxes

Supreme court verdict May 2022

- Union & state legislation has equal powers to make laws on GST, GST council recommendations are not binding

GST Compensation

- A fund was created to offset revenue losses for state
- It was implemented for 5 year but was extended for another 5 years to tide over pandemic induced economic slow down
- CESS was limited on some luxury & demerit goods, process of which are credited to compensation fund

Expenditure Decentralization

It assigns responsibilities

Central Govt.
Defense, forgein affairs etc

State Govt.
agriculture, social, services

Local Govt.
Public utilities

Borrowing (Article 292/293)	
Central Govt.	• within limit set by parliament • guarantee upon securities of consolidated funds of India
State Govt.	• within limits of state legislation • provide guarantee + obtaining center's consent in case of previous loan
Centre's Role in State Borrowing	• within limits fixed under Article 292 • give guarantees in respect of loans raised by the states

Unit – 2 : Market Failure

Concept of Market Failure

- Inefficient allocation of resources in an economy
- It means the market is not functioning optimally (not that it isn't functioning at all)
- Types of Market Failure

Market Failure

- **Complete Failure**
  Missing market
  (Failing to Supply Despite Demand)
- **Partial Failure**
  Produces long Quality or wrong price
  (Welfare Loss)

Reasons of Market Failure

- Market Power
- Externalities
- Public Goods
- Incomplete Information

1. Market Power
   - It is monopoly power where Firm can profitably raise market price over its marginal cost.
   - firm acts as price maker.
   - Excess market powers cause one or less producer, restricting output.
   - Prices higher than what would prevail under perfect competition
   - Operating efficiency < Price domination
2. Externalities
   - Indirect effects of an individual's actions on others
   - Operates through price mechanism, causing price change
   - But if these changes do not reflect in market prices, it results in externalities.
   - Other names: Spillover effect, neighborhood effects, third party effects' or side-effects

Types

- **Positive** (Imposing costs to other parties)
- **Negative** (Conferring benefits on another party)

Production Externalities

Negative Production externalities	Positive Production externalities
Imposes external cost on others.	Confers external benefit on others
No incentive to account for external cost of decision making.	External factors not considered for production decision
Uninternalized costs not reflecting in product price.	Uninternalized benefits not factorial into production choices
Eg – pollution affecting fish output, reducing cath for fisherman.	Eg – individual creating attractive garden, benefits passers-by.

Consumption Externalities

Indirect affects of an individual's consumption action on others

Negative Consumption externalities	Positive Consumption externalities
Produces external cost on others.	Confers external benefit for others
Eg – smoking in public places causing passive smoking/litter	Eg – immunization against contagious diseases preventing others from infection.

Effect of Externalities on Efficiency and Market Failure

Private Cost	• Money cost of production incurred by firm • Eg – wages, raw materials etc
External Costs	• These are not included in firm's income statement or consumer decisions, although they are important for society
Social Cost	• Total cost to society • Social Cost= Private Cost + External cost

3. Public Goods

- Product enjoyed collectively one person's consumption first substance from others consumption
- Others names: collective consumption goods, social goods

Private Goods	• Scarce goods that must be purchased for consumption • Excludable: prevent consumers to use without paying for it fixtures Eg - cars, food, etc
Public Goods	• Consumption or social goods that can be used freely in common sense. Characteristics • non rival in consumption (eg- parks) • non excludable • Indivisibility (TC same for each individual)

- Market Failure in Public Goods
  - Free rider problem: Tendency of individuals to benefit from public goods without contributing to their costs
  - Profit maximizing firms: Firms produce socially optimal amounts only if they change a +ve price for it.
  - Under-production: Public goods are either not produced at all or less, causing market failure.

4. Incomplete Information
   - Complete information is crucial for competitive
   - market and helps buyers & sellers in decision making
   - Challenges - Real market
   - complexity of products + services
   - difficulty in gathering correct info.
   - deliberate misinformation (advertisement)

- Asymmetric Information
  - Imbalance of information b/w buyer and seller i.e. when the buyer knows more than the seller or the seller knows more than the buyer.
    Eg – second hand car market, landlords and tenants
  - Asymmetric Information leads to adverse selection and moral hazard

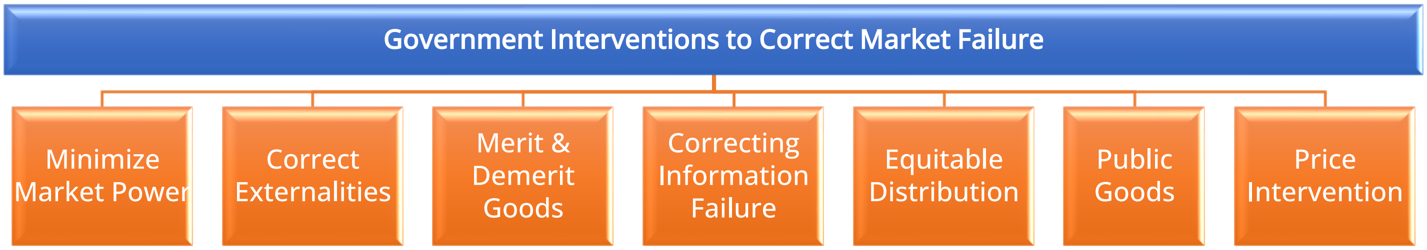
- Adverse Selection (sellers knows more than buyer)
  - Asymmetric information causes adverse selection, hence impacting transaction
  - Health insurance companies could offer low premium
  - To low risk buyers, due to asymmetrical information
  - People with higher risk are preferred by insurance company.

- Lemon Problem (in used car markets)

- Adverse Selection causes Market Failure
  - elimination of high quality cars
  - economic agents choose sub-quality goods or leave the market
  - low quality cars dominates the market

- Moral Hazard (buyer knows more than seller)
  - It arises when economic agents shift some of its cost to others
  - It takes advantage of less-informed person
    Eg - Insurance market leads to increased risk taking by policy holders, causing inefficiency & distrust.

- Hence making governing intervention crucial to combat market failure by :
  - ➢ legal and regulatory framework
  - ➢ infrastructure. Eg. roads, airport etc
  - ➢ enforcing competition
  - ➢ consumer protection law



Govt. Intervention - Minimize Market Power

Indian competition act 2002 (amended in 2007) promotes and sustains market competition.

Methods

- Market liberalization (competition in monopolistic sectors Eg- telecom etc)
- Controls on merger & acquisition (to avoid market domination)
- Price capping and regulation
- Profit on rate of return regulation
- patronage to consumer association
- restriction on Monopoly powers of firm
- investigate unfair practices
- reduction in impact controls
- nationalism

Moral Hazard

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  Eg – Insurance market leads to increased risk taking by policy holders, cussing inefficiency and distrust.
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- Govt. Intervention - Correct Externalities

Towards negative externalities

Government Intervention to Correct Negative Externalities

- Direct Controls
- Market Based Policies

- Direct control or regulation (actions on source of negative externalities) - prohibits specific activities creating -ve externalities. Eg-
  - Smoking banned in many places
  - Production, use and sale of many commodities
- Market based policies -
  - Pollution taxes
  - Cap and trade system (limits total emission & permits tradables)
  - Govt, schemes and mechanisms

Towards positive externalities

- Corrective subsidies to consumers and producers
- Direct govt. production: goods and services with significant +ve externalities, govt. directly enters market as producers, Eg – Health

- Govt. Intervention in Public Goods

Public Goods	1. Some Public Goods are provided only by the government. Examples: Defense, fire protection, Legal system Atomic Energy, Nuclear Power Facility, Security at Airports, etc. 2. For Public Goods where Entry Fees can be charged (Excludable Public Goods), the Government can- (a) Itself provide such Goods, and charge Entry Fees (which can be used to finance the cost of providing such Goods), (b) Grant Licenses to Private Firms to build a public good facility, and (c) Setting Maximum Prices of Foodgrains during times of scarcity, (d) Government Procurement and stocking of Foodgrains to stabilize prices and Consumption.

- Govt. Intervention in case of Demerit Goods

- Demerit Goods - (a) are socially undesirable, (b) involve high negative externalities in their consumption.
- Examples: Tobacco, Cigarettes, Alcohol, Intoxicating Drugs, Narcotic Substances, etc.

- Measures are below-
  1. Complete Prohibition/ban
  2. Persuasion: Negative Advertising Campaigns which emphasize the dangers associated with consumption of Demerit Goods, are launched to provide information to Consumers, and persuade them to reduce or avoid the consumption, e.g. Cigarettes.
  3. No Promotion: Govt. may prohibit the Advertising or Promotion of Demerit Goods in whatsoever manner.
  4. Time & Space Restrictions:
  5. Higher Tax Rates:
  6. Price Controls:

- Govt. Intervention

Non-Market Pricing	• Price flooring (minimum price) • Ceiling price (maximum price) • Minimum wages, rent controls • Minimum Support Price (MSP) for steady and assured income, govt. intervenes in agriculture crop pricing
Information failure	• Mandatory labeling/content disclosure • Disclosure of information • Public dissemination (spreading) goods • Regulation of advertisement
Inequitable Distribution	• Redistribution policy (progressive income taxation) • Combating block economy • Ensuring equity (e.g., land reforms)

Unit – 3 : The Process Budget Making

Budget:– Budget is a powerful financial policy instrument. It involve estimated revenues and estimated receipts of govt. during a fiscal year.

The process of making budget is referred to as budgeting and the fact is that the term 'budget' has not been used in the Indian Constitution. Article 112 of the constitution gives Annual Financial Statement.

Types of Budget

- Balanced Budget
- Unbalanced Budget

Exp = Revenue

Expenditure ≠ Revenue

- Surplus Budget
  - Expenditure < Revenue
- Deficit Budget
  - Expenditure > Revenue

Budget prepared by Ministry of finance +NITI Aayog+other relevant ministries.

Budget Division Sends budget circular

↓

Ministries, States, UT,

Asking detailed estimates of expenditure

↓

Suggestions on Budget

↓ MoF

There presented in LokSabha

↓

Budget Speech is 2 parts

↓

Part – A Present Macro-Economic Situation, estimates of next FY, expenditure allocations for different sectors and fresh schemes.

Part – B it includes details the progress the government has made on various developmental measures, the direction of future policies, Govt. tax proposals

+

Annual Financial Statements (AFS)

Contingency Fund, Public accounts

+

Documents → (i) AFS

(ii) Demand for grants (DG)

(iii) Finance Bill

(iv) Statements as per FRBM Act 2003

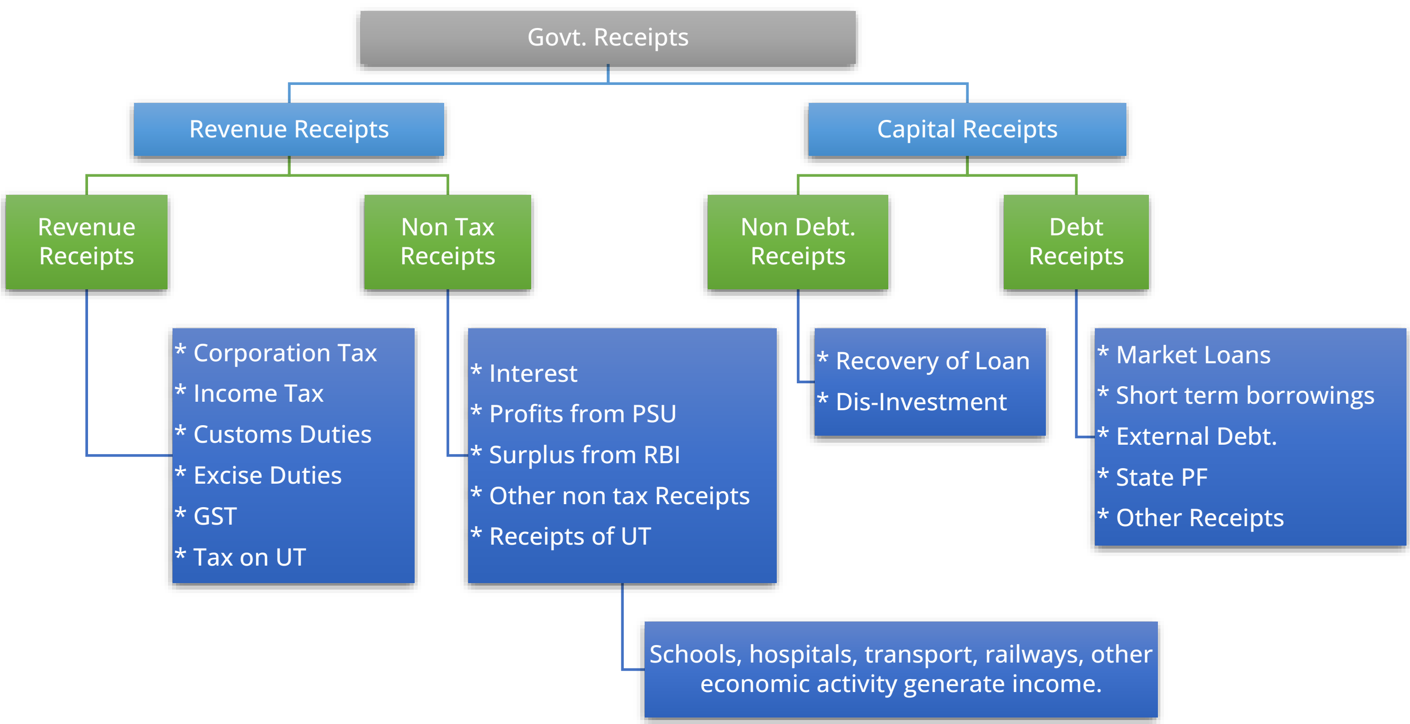
(a) Macro Economic Framework Statement

(b) Medium Term Fiscal Policy Cum Fiscal Policy Strategy Statements

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

- Budget Discussions:
  - First there is discussion on General Budget and then parliament is adjourned for a fixed period.
  - During this period, demand for grants of various ministries are discussed by standing committees.

- After the reports on DG are submitted voting on DG takes place. In Lok Sabha.
- Lok Sabha can cut / reduce any demand for grants.
- Budget is presented in Rajya Sabha after Lok sabha.
  In Rajya Sabha general discussion on Budget is done and no voting of DG
- After budget discussions and voting of DG, Govt. Introduce the appropriation Bill. Appropriation Bill gives authority to govt. To make expenditure from CFI.
- Motions for reductions for DG are in the form of 'cut motions'
- After appropriation bill, Finance bill is taken up for consideration.
- Parliament has to pass the bill within 75 days of its introduction.
- Guillotine discussion on DG is put for voting only with specified time.
- After Loksabha Finance Bill Presented Rajya Sabha.
- Rajya Sabha has 14 days to return the money bill with or without recommendations.
- These recommendations may be accepted or rejected by LokSabha.
- Since 2017-18 Budget date has been advanced to 1st February.
- Also since 2017-18 Railway Budget was merged with General Budget.



Corporation Tax = Corporate Tax It is income tax paid by companies It is collected by union Govt.

- Capital Receipts = ↓ in assets
  ↑ in liability

Eg. sale of asset. Disinvestment, recovery of loans etc.

- **Revenue Receipt -**

  They neither create any liability nor reduces assets of govt.

  Govt. has 2 sources of revenue receipts (i) Tax revenue, (ii) Non-Tax revenue.

- **Revenue Expenditure Are required for**

  (i) Normal functioning of Govt.

  (ii) Interest payment (on debt.)

  (iii) Payment of grants to states |UT| others

- **Capital Expenditure = Expenditure** which result in creation of assets or reduction of liability.

  Eg. Purchase of machinery, repayment of loans etc.

- **Public Debt. Management** (Debt ≡ Loans)
  - 2 types of govt. Debts
    - (i) Internal debt. (Domestic debt)
    - (ii) External debt.
  - Public Debt. Management is crucial to achieve macro economic stability.
  - Debt. Management is based on 3 pillars
    - (i) Low lost of borrowing
    - (ii) Risk Mitigation
    - (iii) Market development
  - Domestic Debt. $\xrightarrow{\text{Managed by}}$ IDMD of RBI

    External Debt. $\xrightarrow{\text{Managed by}}$ Dept. of Economic Affairs in MoF.

    There is a PDMC under Dept. of Economic Affairs.

    IDMD = Internal Debt Management Dept.
  - Internal Debt. (from Public)

    Treasury Bills $\rightarrow$ Short Term Cash Requirements of Govt.

    Dated Securities $\rightarrow$ are issued to generate long term resources to finance fiscal deficit.

    Ways and means Advance (WMA) $\rightarrow$ RBI Short term credit upto 3 months $\rightarrow$ State Govt.

    $\downarrow$

    To meet temporary mismatches in cash flow.
  - External Debt $\rightarrow$ Loans from Asian Development Bank / International banks

    $\downarrow$ $\rightarrow$ Long term and fixed int rate

    Risk is Depreciation in value of domestic currency
  - RBI announced RBI Retail Facility on 5th Feb. 2021 to ↑ retail participation in G-Sec. (More investors through online access)

- G-Sec. = Govt. Securities

Outcome Budget - The outcome budget is a progress card on what various ministries and departments have done with the outlays in the previous annual budget.

Consolidated Fund of India - Money can be spent through this fund only if appropriated by the parliament.

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

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.

Deficit	=	Exp. – Income
Rev. Deficit	=	Rev. Exp – Rev. Income
Fiscal Deficit	=	Total Exp. – Total Receipts (Excluding Borrowing)
Fiscal Deficit	=	Rev. Exp + Cap Exp – [Rev. Receipts + Cap Receipts Excluding borrowings)
	=	Rev. Exp. – Rev. Receipt + Cap Exp. – Cup Receipts
	=	Rev. Deficit + Cap Exp. – Cap Receipt Excl Borrowing.

Fiscal deficit indicates governments borrowing requirement. It is indicated as % of GDP.

Primary Deficit = Fiscal Deficit – Interest Payment

Interest Payment means Debt Service payments.

Unit – 4 : Fiscal Policy

Objectives

- Achievements & maintenance of full employment
- Maintenance of price stability
- Acceleration of rate of economic development
- Equitable distribution of income & wealth

Fiscal policy's ability to influence output by affecting aggregate demand makes it potential tool for economic stabilization

Types of Fiscal Policy

(i) Expansionary Fiscal Policy

(ii) Contractional Fiscal Policy

Expansionary Fiscal Policy

Objective

- To increase AD
- To stimulate economy during contractionary phase of business cycle.

"Demand Deficient/recession occurs when –

(1) Falling real GDP

(2) Low aggregate demand

(3) Reduced consumer spending

(4) Rising Unemployment

Measures:

- Tax cuts – increase purchasing power – increase in AD
- Decrease in Govt. expenditure

Impact

- May lead to budget deficit because tax cut reduce govt. income and expenditure exceeds tax revenues

Contractionary Fiscal Policy

Objective

- Reduces AD
- Restrain economic activity during inflationary phase or anticipation of business cycle expansion likely to induce inflation.

Implemented phase

- Economy has high growth rates
- Inflation
- Asset Bubbles

Measures

- Decrease in Govt. Spending
- Increase in Taxes

(1) Govt. Expenditure

Govt. expenditure Includes

- Revenue expenditure
- Capital expenditure

(2) Taxes

Most significant revenue source for government used to establish economic stability.

During Recession	After Recession
• Income tax reduction and low corporate tax • Disposable income	• Increase tax rates reduce disposable income

(3) Public Debt.

(i) Internal Debt. (Borrowed from own people)

(ii) External Debt. (Borrowed from other sources)

Public debt can be categorized in 2 broad categories

(1) Market Loans – Treasury bills, Govt. loans

(2) Small Savings – Non Negotiable, not traded

Impact

- Borrowing curtails aggregate demand
- Debt repayment inc. money available, boosting AD

(4) Budget

(1) Balanced - No net effect on AD

(2) Surplus - May have -ve effect on AD

(3) Deficit - +ve effect on AD

- Fiscal Policy for Long Run

Important for sustainable development

- Incentive effect of fiscal policy:

Infrastructure Spending	• +ve supply side effects • happens when govt. interests in infrastructure • provides necessary overhead for private sector
Public Goods Provision	• Enhances human capital formation, physical capital becomes more productive • Eg – healthcare, education, etc
Tax impacts	• can have +ve or –ve effect • depends on its encouragement for savings/investment
Well Designed Tax Policies	• Rewards innovation & entrepreneurship • Does not discourage incentives • Promote private investment in business
Market Failure Correction	• Tax & spending policies corrects market failure • environment taxes (cost of firm, output) • Subsidies - boost output

- Fiscal Policy for Reduction in Inequalities of Income and Wealth
  - Progressive Direct Tax System: greater ability to pay higher taxes, tax burden is equally distributed
  - Differential Indirect Tax System: luxury goods taxes and necessities taxed
  - Planned Expenditure: redirects income from rich to poor through target spending programs.
    Eg. poverty - alleviation program

- Challenges
  - Progressive Tax- shouldn't discourage work, savings & investment
  - Redistribution Policy - shouldn't be generous enough to reduce incentives to work and save

- Limitations of Fiscal Policy

  Types of Lags in Fiscal Policies:

Recognition lag	• lag in recognizing need for policy change due to complex economic variable & data collection challenge
Decision lag	• lag in evaluating alternative policies
Implementation lag	• bureaucratic delays in enacting & implementation
Impact lag	• outcomes are not visible for a time

- Bad Timing: Poorly timed changes in fiscal policy, due to lags, can cause initiation of expansionary policy at the time of economy recovery
- Policy change: Instant policy change not possible
- Expenditure: like defense & on going capital projects are hard to alter
- Disincentives: Supply side economists concern over certain fiscal measures causing disincentives
- Inflation: Deficit financing purchasing power of people. (leads to inflation/price spiraling)
- Govt. borrowings: creates a burden on future generations as debt
- If govt. borrowing to compete with private sector, cause rise in interest rates, reduced private sector investment, etc.

■ Crowding Out (here fiscal policy becomes ineffective)

Increased govt. spending can replace private spending, diminishing the effectiveness of expansionary fiscal policy

Fiscal Policy effects	• if govt. spending substitutes private spending, it reduces impact on AD
Ineffective Fiscal Policy	• govt's deficit spending during recession leads to borrowing, rising interest rates and crowding out private investors
Growth implication	• crowding out weakens long term economic growth prospects by reduced private sector investment
Exception	• deep recessions may limit crowding out as investments (private sector) are already low, allowing govt. borrowing without rise in interest rates