CA Foundation – Business Economics

Economics Chapter 7
Public Finance

PRE-EXAM MARATHON

(using Last Minute Notes)

By CA Mohnish Vora (MVSIR)

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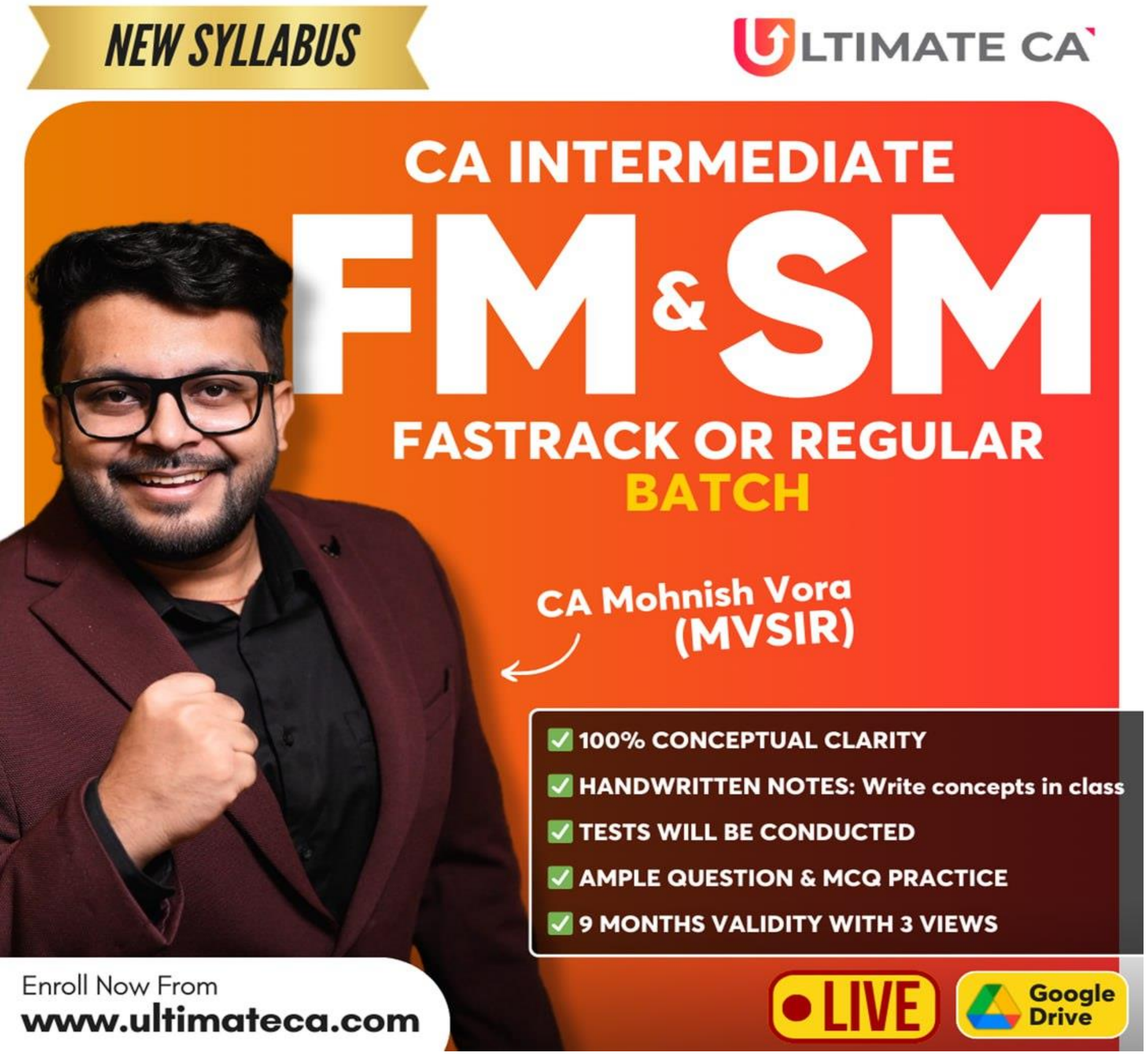

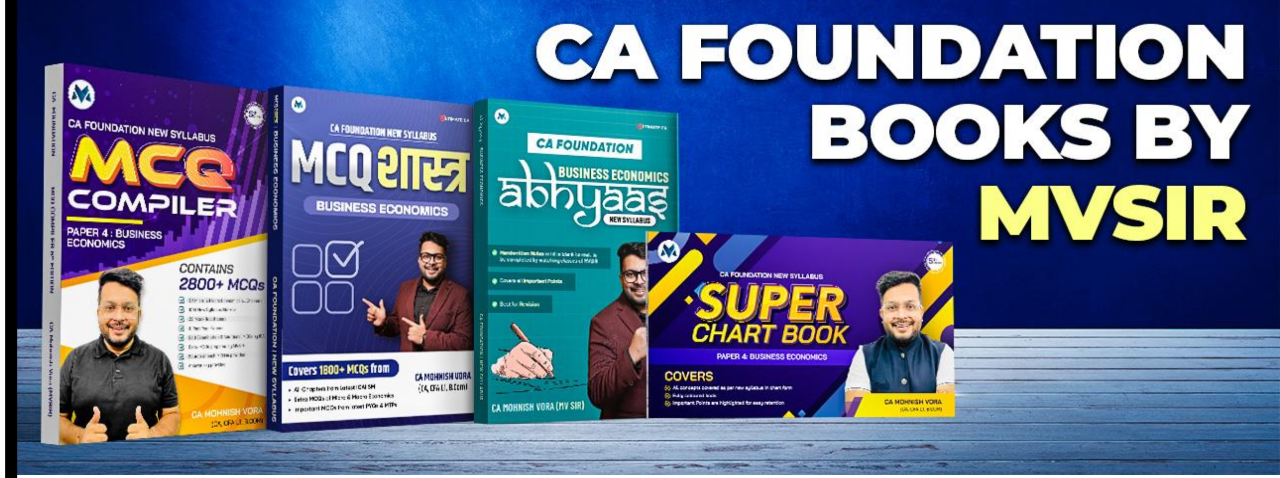

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Last Minute Notes

(Only Important Points)

Economics Chapter 7

Public Finance (Unit 1 & 2)

CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

1	**Macroeconomics→ study of economy as a whole.** **3 main macroeconomic goals for any nation-** **economic growth**, **high levels of employment** & **stable price levels**.
2	**Adam Smith** was a **bold advocate of free markets** & **minimal governmental activity**. As per him, govt.'s functions are- **national defense, establishing a system of justice, establishment & maintenance of public institutions**
3	**Richard Musgrave**, in his book '**The Theory of Public Finance**' (1959), gave **3 roles of government-** ➢ **Microeconomic functions** ✓ **Allocation Function** - to correct sources of inefficiency ✓ **Redistribution Function** – ensures distribution of wealth & income is fair ➢ **Macroeconomic function** ✓ **Stabilization Function**- Monetary & fiscal policies for macroeconomic stability
4	**Economic efficiency** → where all resources are **allocated in best way possible**, minimizing waste & inefficiency. If a **market** is **left to itself**, it leads to **inefficient & misallocation of society's scarce resources**. Thus, market failures provide for government's allocative function
5	**Allocation instruments which govt. can use to influence resource allocation** 1) Govt may **directly produce** an economic good 2) Govt may **influence private allocation** through- ✓ **Incentives** : Tax concessions, Subsidies ✓ **Disincentives** :Increase in Taxes, Bans 3) Govt may influence allocation through **competition policies.** **Eg- Competition Act 2002** 4) Govts' **regulatory activities→** licensing, min wages etc. 5) Govt sets **legal & administrative frameworks** 6) any **mixture** of above
6	**Distribution Function-** If **left to market**, **distribution of income** in society is likely to be **skewed** & thus govt. has to **intervene** to **ensure more socially optimal & egalitarian distribution.** ➢ Related to question→ **for whom should an economy produce G/S**. ➢ It also also relates to manner in which **effective demand** is **divided among individuals** of society

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7	**Examples of Redistribution function** 1) Taxation policies- **progressive taxation** of rich & provision of **subsidy to poor** **2) Proceeds from progressive taxes** used for **financing public services** that benefit poor **3) Employment reservations** to protect certain segments **4) Unemployment benefits** & **transfer payments** to deprived sector 5) Families **below poverty line -monetary aid** & **aid in kind** **6) Regulation** of **mfg. & sale** of certain products to ensure well-being **7) Special schemes** for **backward** & vulnerable sections
8	**Stabilization Function** **Macroeconomic stability** is said to exist when: 1) economy's output = production capacity, 2) economy's total spending = total output 3) economy's labour resources are fully employed, and 4) Inflation is low and stable. **Rationale** ➢ A market economy **does not automatically** generate full employment and price stability on its own. ➢ **Recessions**, **inflation** etc.- **prolonged for longer periods** ➢ Becomes complex due to '**contagion effect**' (**increased international interdependence**)→ **instability** get **transmitted** from one country to other.
9	**Deficit budget (Exp > Rev)** - **stimulate** economic activity **Surplus budget (Rev>Exp)**- **slow down** economic activity.
10	**Fiscal federalism-** Given by **Richard Musgrave**, deals with the division of **govt functions & financial relations** among the different levels of govt. As per Musgrave, responsibility of- ➢ central (union/federal) govt → **economic stabilization & income redistribution**, and ➢ state govt → **allocation of resources**
11	India is a federation of **28 states** & **8 union territories**.
12	**Article 246** of Constitution→ demarcates powers of union & state into three lists- **1) Union list**- items where **union parliament** can legislate **2) State list-** items for **state legislative assemblies** **3) Concurrent list-** for **both**. **Conflicting legislation** in concurrent list→ **centre** prevails.
13	**Taxes levied by central (union) government** **income tax** (**other than agricultural income**), customs duties, excise duties, corporation tax, tax on capital value of assets, **security transaction tax**, central GST, taxes other than stamp duties etc

CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

16	**Taxes levied by state government** **taxes on agricultural income**, lands & buildings, mineral rights, **electricity**, **vehicles**, **tolls**, professions, land revenue
17	**Property of the union** is **exempt** from **state taxation**, & vice versa. (ek dusre pe tax nahi lagate)
18	**Articles 268 to 281** of constitution→ provisions in respect of **distribution of finances among states**.
19	**Finance Commission (Article 280)-** Responsible for: ➢ evaluating **state of finances** of union & state govt, ➢ **recommending the sharing of taxes** between them ➢ **lay down principles determining distribution** of taxes among states
20	**Vertical Equity** (deciding about **share of all states** in revenue collected by centre)→ **41%** for 2021-26 **Horizontal Equity** (**allocation among states** their share of central revenue). **Criteria for distribution (horizontal equity)-** **(a)Income Distance** **(d)Demographic performance** **(b)Area** **(e)Forest** and **ecology** **(c)Population** (2011) **(f)Tax** & **fiscal efforts**
21	**GST** came on **1 July 2017**- subsumes majority of indirect tax. For any particular G/S, SGST & CGST rates are **equal**. **Integrated GST** (IGST) on **inter-state movement**
22	GST accounts for- **35%** of tax revenue of **union** & **44%** of tax revenue of **states.**
23	Supreme court verdict in **May 2022**, **Union & state** legislatures have "**equal, simultaneous and unique powers**" to make laws on GST
24	GST system **replaced old production-based** taxation system with a **consumption based** one. For **loss of revenue** of **manufacturing states→** provide **compensation** by levying **cess on luxury goods & demerit goods** → proceeds are credited to **compensation fund.** Top five GST compensation receiving states were **Maharashtra, Karnataka, Gujarat, Tamil Nadu, & Punjab**
25	**Expenditure Decentralization** **Central govt** ✓ **defence**, ✓ **foreign affairs**, ✓ foreign trade ✓ Foreign exch mgt, ✓ money & banking, ✓ cross-state transport, ✓ communication. **State govt** ✓ **agriculture** & **industry**, ✓ **social sector services-** • health & education, • **police protection**, • **state roads** **& infrastructure**. **Local self govts -municipalities & panchayats** ➢ **public utility services** like- ✓ **water supply** ✓ **sanitation**, ✓ **local roads**, ✓ **electricity**
26	Borrowing by Govt of India & borrowing by states → **Article 292 & 293** of Constitution

CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

1	**Market failure** A situation in where **free market→ misallocation of society's scarce resources** leading to- **overproduction** or **underproduction** of particular G/S leading to a **less than optimal outcome**.
2	**Two types of market failure** a) **Complete market failure-** "**Missing markets**" - when market **does not supply products at all** b) **Partial market failure-** occurs when **market does actually function**, but it **produces** either- **wrong quantity** or at **wrong price**.
3	**Why do markets fail ? OR Reasons for market failure** I) Market Power , II) Externalities III) Public Goods , IV) Incomplete Information
3 (a)	**Market power** or monopoly power→ **ability of firm** to **raise market price over its marginal cost.** (Price > MC) Here producers **restrict output,** & keep **price high**
3 (b)	**Externalities** are **costs or benefits** that **do not reflect as part of market price**. They are also referred to as **'spillover effects'**, OR **'neighbourhood effects'** **'third-party effects'** OR **'side-effects'**, as **originator** of externality **imposes costs or benefits on others** who are **not responsible for initiating** effect.
3 (b)	**Externalities can be-** **i) NPE** (initiated in production confers external cost) • Received in production **Eg-** Factory **discharges untreated waste into a nearby river→ affects fish output→** less catch for **fishermen** • **Received in consumption** **Eg-** Factory **discharges untreated waste into a nearby river-** causing **health hazards** while **drinking & bathing** **ii) NCE**(initiated in consumption confers external cost) • Received in production **Eg-** act of **undisciplined students talking & creating disturbance** in a class • **Received in consumption** **Eg- smoking cigarettes in public** place causing **passive smoking by others** **iii) PPE** (initiated in production confers external benefit) • **Received in production** **Eg- Firm offers training** to employees - generates **+ve benefits for other firms** while they hire same workers. • **Received in consumption** **Eg-** When an **individual raises an attractive garden** & **persons walking by enjoy** the garden

4	**iv) PCE (initiated in prod. confers external benefit)** • **Received in production** Eg- Consumption of **services health club by employees → external benefit to firm** • **Received in consumption** **Eg-** If people **get immunized against contagious diseases→ benefit to others**
4	**How externalities cause inefficiency and market failure ?** ➢ **Private cost** is **cost** incurred by producer directly involved in production→ **appears in accounts**. ➢ **Supply curve** → shows only **private marginal costs**. ➢ **External costs** are borne by third parties not directly involved in transaction. **Social costs→ total costs to society** on account of **production or consumption**. **Social Cost = Private cost + External Cost** ➢ Each **firm's cost** considers **only private cost** & do **not incorporate externalities** ➢ Goods having **–ve** externality→ **over-produced** ➢ Goods having **+ve** externality→ **under-produced**
5	**Public Goods** ➢ Aka. '**collective consumption good**' or social good ➢ Given by **Paul A. Samuelson** **Characteristics of Public Goods** 1) Consumption is **collective** in nature. **2) Non-Rivalrous** :Simultaneous consumption is possible. **3) Non-excludable** : One individual **cannot deny other individuals'** consumption, **even if** they have **not paid** for it. **4) Indivisibility** **5) Additional resource cost** of another person is '**zero**' **6) No direct payment** by the consumer is involved **7) More vulnerable** to issues → **externalities**, **inadequate property rights**, & **free rider** problem. Public goods will **not be produced** at all or will be **under-produced**.
6	**Private goods** are **scarce** & anyone who wants to consume them **must purchase** them at a **price**. ➢ Do **not** face **free-rider problem**. ➢ **Excludable**→ payment is must to access ➢ **Rivalrous**→ Simultaneous consumption is possible. Normally markets **efficiently allocate resources** for private goods.

7	**Incomplete Information** **Perfect information** → both **buyers & sellers have complete information** Information failure leads to – **a) asymmetric information,** **b) adverse selection and** **c) moral hazard**
7.1	**a) Asymmetric Information** Means **imbalance in information**, i.e when **seller knows more than buyer or vice versa**→ **distort choices** & thus market failure.
7.2	**b) Adverse Selection** Asymmetric information **generates adverse selection**. When **one party**, say X, **has some information** that other party **Y does not**→ the **value** of **transaction** is **known more accurately to X** → and X may **take advantage** of Y's ignorance Eg- **Health insurers** know less about health conditions of buyers → **unable to differentiate** between **high-risk** and **low-risk** persons.

7.3	**Lemons Problem (given by George Akerlof)** Lemons- **Both** poor & good quality used cars Generally used **car on sale is 'lemon'**→ **buyers' willingness to pay** will be based on '**average quality**' of used cars. **Asymmetric info leads to elimination of high-quality goods** from market. People end up either- • selecting a **sub-standard product** or • **leaving the market** altogether.
7.4	**c) Moral Hazards** It is about **informed person's taking advantage** of a **less-informed person** through an **unobserved action**. Eg- deliberately risk-taking due to comprehensive insurance cover.
8	**Minimize Market Power** **Establishing regulations** designed to **promote competition** & prohibit actions restraining competition.

9	**Government intervention to correct Negative Externalities** **i) Direct Controls** Direct controls, (aka **command solutions**), **prohibit activities that create negative externalities** or require that negative externality be **limited** to a certain level. **ii) Market Based Policies** Market-based policies **provide economic incentives** so that **self interest** of market participants would **achieve socially optimal solution.** Market based approaches affect market price by- > **Setting price directly**- by pollution tax > **Setting price indirectly**- by cap-&-trade system
10	**Pollution Tax** ➢ This tax **depends on amount of pollution** firm produces. ➢ Aka. **Pigouvian taxes** after A.C. Pigou ➢ **Making the polluter pay**→ tax **increases private cost** & thus **decreases output** of good which creates negative externality. ➢ **Proceeds from tax**→ used for **projects** that **protect environment**.
11	**Problems in pollution tax** 1) Difficult to determine → **complex & costly administrative procedures**. 2) If **demand for good** is **inelastic**→ tax have **less effect in reducing demand**. 3) Tax have **negative consequences** on **employment** & **investments** → producers shift their factories to other countries.
12	**Tradable Emission Permits** ➢ Use of **tradable permits to limit emissions** is called '**cap and trade**'. ➢ Tradable permit → license that allows to release a unit of pollution into environment over a period of time. ➢ A firm that generates emissions above what is allowed → penalized with fines. ➢ A firm which **produces less pollution** can **sell their permits & earn money.** ➢ **High polluters** have to **buy more permits**→ which increases their costs & makes them less competitive & less profitable.
13	**Government intervention to correct Positive Externalities** Govt provides (Pigouvian subsidy)– **a) corrective subsidies to producers**-to increase supply **b) Corrective subsidies to consumers** - to increase demand

14	**Government intervention in case of merit goods** ➢ **Merit goods** → have **positive externalities** & are **socially desirable.** ➢ But are **under-produced** & **under-consumed** ➢ **Eg-** education, health care, waste management etc ➢ **Govt can provide-** **1) Regulation**→ how private activity may be conducted. **2) Prohibit** some activities, set standards & issue mandates. 3) Use **legislation to enforce consumption** (Eg helmets) **4) Compel individuals** to consume such good. (Eg- Right of Children to Free & Compulsory Education Act, 2009) 5) Ultimate encouragement → make the good **completely free** → leads to substantial demand.
14.1	**Government intervention in case of demerit goods** ➢ Demerit goods are **socially undesirable**. Eg- cigarettes, alcohol etc. ➢ Its **consumption** → imposes **negative externalities**. (over-prod. & over-cons.) ➢ All goods with **negative externalities are not essentially demerit goods**; e.g. **steel**.
14.2	**How do governments correct market failure resulting from demerit goods ?** 1) Enforce **complete ban** → but still can be **secretly driven underground** & traded in **hidden market** 2) Imposing **unusually high taxes**→ But, if **demand** is **inelastic**→ sellers can **shift tax burden to consumers**. 3) Fix **minimum price** below which **demerit good should not be sold**. (price floor) 4) Through **persuasion**, achieved by **negative advertising campaigns** 5) Through **legislations** that **prohibit advertising or promotion** 6) Strict regulations- to **limit access** to children **7) Spatial restrictions**
15	**Government intervention in case of Public goods** ➢ Important public goods- Eg- **defence**, **establishment** & **maintenance of legal system**→ are directly provided by govt. ➢ **Excludable public goods**→ provided by govt & can be **financed through entry fees**. ➢ Some public goods are provided by **voluntary contributions** and private donations by corporate entities and NGOs.

CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

16	**Price Intervention: Non-Market Pricing** Price intervention → **legal restrictions on price.** **a) Price Floor** (minimum price buyers are required to pay) or ✓ Price set **above** the equilibrium price ✓ Eg- **MSP, minimum wages, making demerit goods expensive** etc **b) Price Ceiling** (a maximum price sellers are allowed to charge) ✓ Price set **below** the equilibrium price ✓ Eg- **rent controls, black marketing, Shortages in market, problem of allocation of limited supplies among large no. of consumers etc**
17	**Correcting Information Failure** 1) Mandatory **labelling** & **content disclosures**. **2) Mandatory disclosure** of information. **3) Public dissemination of information** to improve knowledge **4) Regulation of advertising** and setting of advt **standards**
18	**Equitable Distribution** **Govt can provide-** **1) progressive** income tax, **2) targeted budgetary allocations** **3) unemployment** compensation **4) transfer payments**, **subsidies**, job **reservations**, etc.
19	➢ **Government Failure** ➢ When govt intervention to correct a market failure→ creates **inefficiency** & **misallocation of resources**. ➢ Also can **produce fresh & more serious problems**

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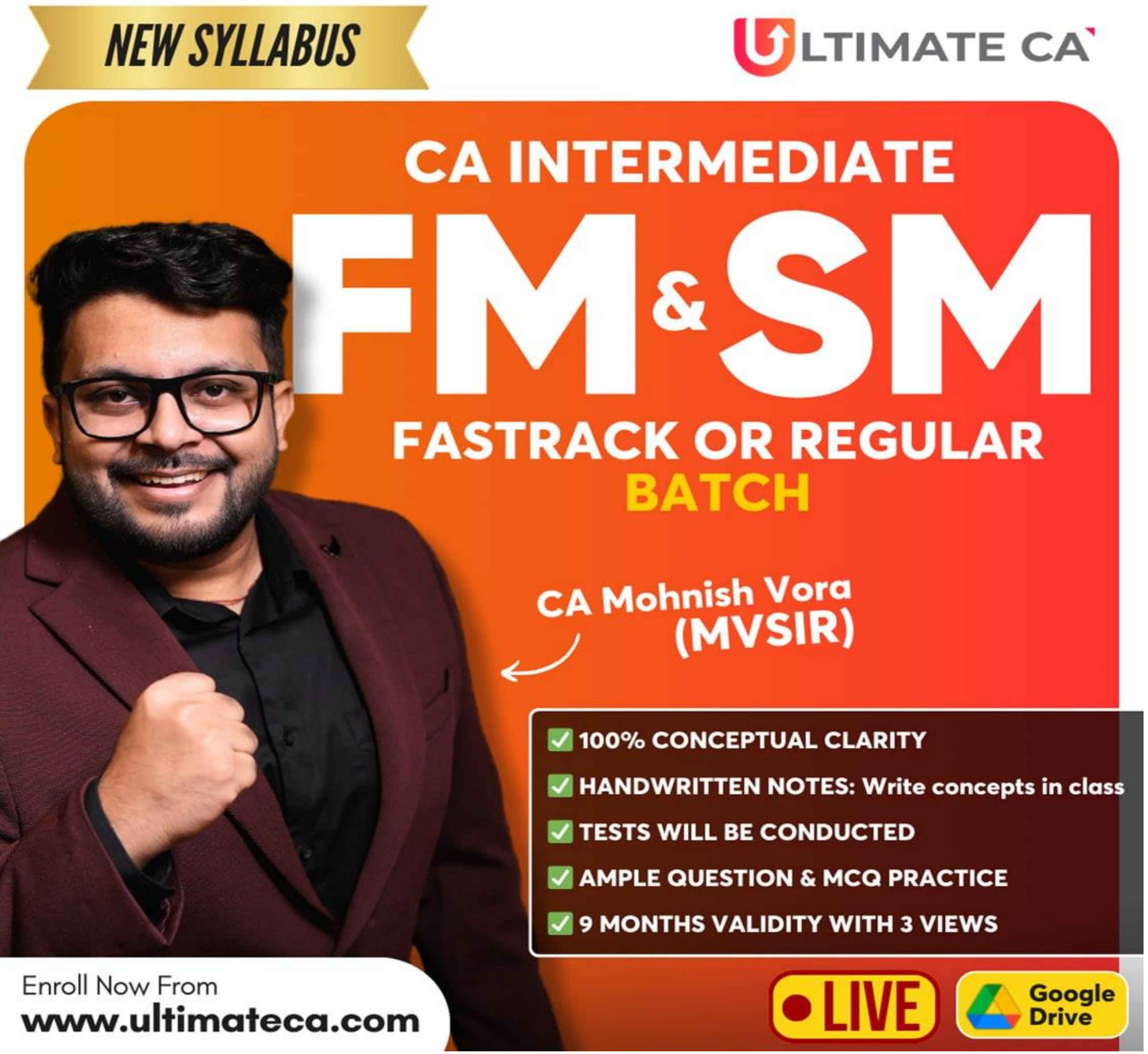

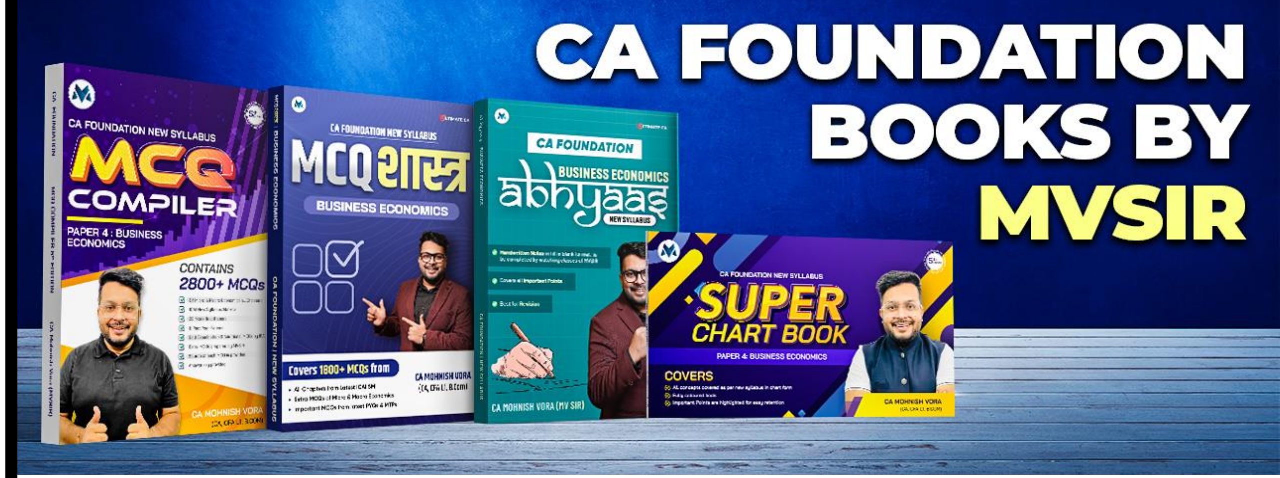

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