CHAPTER

7

Public Finance

- **Unit 1:** Fiscal Functions: An Overview, Centre and State Finance
- **Unit 2:** Market Failure/Government Intervention to Correct Market Failure
- **Unit 3:** The Process Of Budget-Making : Source of Revenue, Expenditure Management and Management of Public Debt
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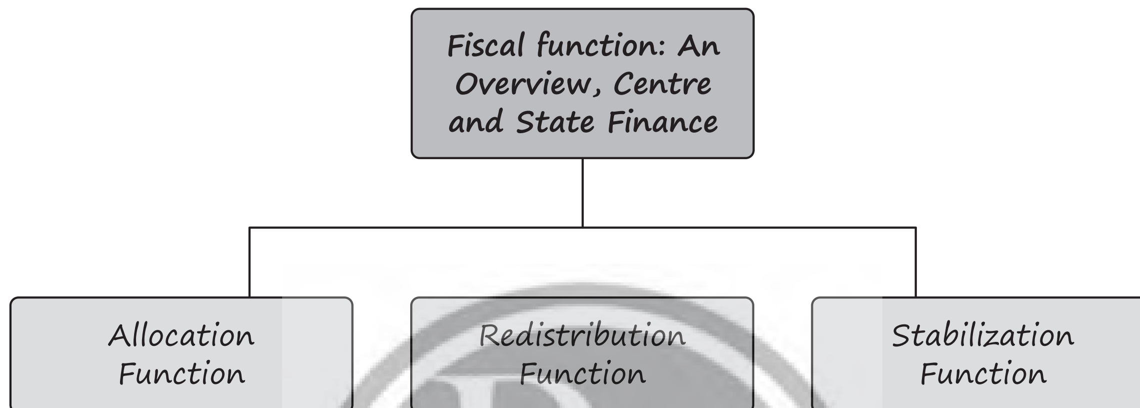
UNIT 1

Fiscal Functions: An Overview, Centre and State Finance



INTRODUCTION

1. Governments of all nations have important economic functions even in market-based economies, and their role has grown in size and scope in recent decades.
2. The primary goal of the state is to promote the general welfare of society, and government actions significantly impact economic performance and citizens' quality of life.
3. Governments engage in various operations, including raising funds, incurring expenditures, consuming goods and services, borrowing money, employing people, and establishing key institutions like property rights.
4. Governments also create and enforce rules and regulations, and formulate policies that affect many aspects of people's lives.
5. While governments impose rules and regulations, some areas remain unregulated, and most goods and services are provided by private producers. However, certain goods and services are considered appropriate for exclusive government provision due to various reasons.

THE ROLE OF GOVERNMENT IN AN ECONOMIC SYSTEM

INTRODUCTION

- Economic systems address the problem of scarcity due to unlimited wants and limited resources.
- An economic system allocates resources, answers what, how, and for whom to produce, and supports growth of productive capacity.

- Three main economic systems: market, government, and mixed system (capitalism, socialism, mixed economy).

ADAM SMITH'S PERSPECTIVE

- Adam Smith advocated for free markets and minimal government intervention.
- Acknowledged government's roles in:
  (a) National defense against external threats.
  (b) Establishing a system of justice for internal law and order and property protection.
  (c) Developing and maintaining public institutions and works that profit-seeking individuals may not efficiently provide.

GOVERNMENT'S EVOLVING ROLE

- Since the 1930s, government's role in the economy has increased, especially after the Great Depression.
- Traditional government functions expanded to include economic functions or fiscal functions.
- Different countries vary in the nature and extent of government intervention, but all agree on the government's significant role in the economy.

RICHARD MUSGRAVE'S THREE-BRANCH TAXONOMY

- Musgrave's taxonomy separates government functions into three branches:
  (a) Resource allocation (efficiency).
  (b) Income redistribution (fairness).
  (c) Macroeconomic stabilization (price stability).

FUNCTIONS IN DETAIL

- Allocation function aims to correct economic inefficiencies.
- Distribution function ensures fair distribution of wealth and income.
- Stabilization function addresses macroeconomic stability, economic growth, high employment, and price stability.

GOVERNMENT'S ECONOMIC POLICY

- The national budget reflects the government's economic policy.
- Government exercises its economic functions partly through the budget.

Conclusion

- The government's role in an economic system encompasses resource allocation, income redistribution, and macroeconomic stabilization.
- Government's involvement in the economy has evolved over time and plays a crucial role in modern economies.

THE ALLOCATION FUNCTION IN RESOURCE ECONOMICS

INTRODUCTION

- Resource allocation is the distribution of limited resources among various uses.
- This function determines what goods and services are produced in an economy.
- The challenge lies in addressing unlimited wants with finite resources.

ECONOMIC EFFICIENCY

- Economic efficiency seeks to use resources optimally, minimizing waste and inefficiency.
- It ensures that resources are allocated to benefit each person as much as possible.
- Private sector allocation relies on market supply, demand, prices, consumer sovereignty, and profit motives.
- The government also plays a significant role in resource allocation through its budgeting activities.

MARKET FAILURES

- Market economies experience several malfunctions:
  - Private goods are adequately provided by the market.
  - Public goods and merit goods often lack sufficient production in the market.
  - Missing markets or nonexistence of markets is common.
- Markets fail in providing efficient allocation due to:
  - Imperfect competition and monopoly power leading to under-production and higher prices.
  - Inability to provide public goods consumed by all.
  - Incomplete markets, leading to inadequate production of merit goods.
  - Overuse of common property resources.
  - Externalities affecting third parties (e.g., pollution).
  - Factor immobility causing unemployment and inefficiency.
  - Imperfect information.
  - Income and wealth inequalities.

GOVERNMENT INTERVENTION

- Public finance aims to achieve the optimal allocation of limited resources.
- Government intervention becomes necessary when market failures occur.
- Government intervention doesn't replace markets but complements them.

EXAMPLES OF GOVERNMENT INTERVENTION

- Government establishes property rights and enforces contracts through law enforcement and courts.
- Corrective measures are taken when externalities affect production and consumption.
- Government provides merit goods beneficial to society.

- Demerit goods are controlled through policies.
- Government acts as a complement to the market system.

RESOURCE ALLOCATION IN GOVERNMENT POLICY

- Government's budgeting determines:
    - Who and what will be taxed.
    - How government revenue will be spent.
    - Division of resources among various uses.
    - Optimum mix of social goods (public and merit goods).
    - Level of public sector involvement in the economy.
    - Reallocation of resources from private to public use.

INSTRUMENTS OF ALLOCATION

- Governments use various instruments to influence resource allocation:
    - Direct production of economic goods (e.g., electricity, public transportation).
    - Altering market prices through taxes and subsidies.
    - Influence through incentives and disincentives.
    - Legislation, bans, competition, and merger policies.
    - Regulatory activities (licensing, minimum wages).
    - Legal and administrative frameworks.
    - A combination of remedies.

Conclusion

- The allocation function in resource economics is critical for optimizing resource use.
- Governments play a key role in correcting market failures and ensuring efficient resource allocation.
- A combination of instruments and policies is used to achieve allocative efficiency and enhance social welfare.

THE REDISTRIBUTION FUNCTION IN GOVERNMENT ECONOMICS

INTRODUCTION

- Economic growth has expanded wealth and output, but benefits are not evenly distributed.
- Socialist ideology emphasizes government's redistributive role.
- Government intervenes to ensure a more socially optimal and egalitarian distribution of income and wealth.

DISTRIBUTION FUNCTION OF THE GOVERNMENT

- Addresses the question of 'for whom' goods and services should be produced.
- Redistribution occurs through the expenditure and revenue sides of the budget.
- Expenditure side: Provides free or subsidized education, healthcare, housing, food, and basic goods to deserving individuals.
- Revenue side: Achieves redistribution through progressive taxation.

EFFECT ON EFFECTIVE DEMAND

- Household income determines effective demand, which, in turn, influences the distribution of real output among individuals.
- The distribution function divides effective demand for economic goods among society's individual and family units.

AIMS OF THE DISTRIBUTION FUNCTION

- Redistribute income for an equitable distribution of societal output among households.
- Enhance overall social welfare.
- Improve the well-being of individuals facing different types of deprivations.
- Promote equality in income, wealth, and opportunities.
- Provide security for those in hardship, ensuring a minimum standard of living.

EXAMPLES OF REDISTRIBUTION FUNCTION

- Progressive taxation with subsidies for low-income households.
- Financing public services that benefit low-income households.
- Employment reservations and preferences, minimum wages, and support prices for farmers.
- Unemployment benefits and transfer payments for underprivileged, dependent, physically handicapped, older citizens, and the unemployed.
- Monetary aid and aid in kind for families below the poverty line.
- Regulation of certain product manufacturing and sales for consumer health and well-being.
- Special schemes for backward regions and vulnerable population segments.

TRADE-OFF BETWEEN EFFICIENCY AND EQUITY

- Conflict may arise between efficiency and equity in redistribution policies.
- High tax rates on the rich can achieve greater equity but might discourage entrepreneurship, work, savings, investments, and risk-taking.
- This can negatively impact economic output, productivity, and growth.
- Balancing equity and efficiency objectives is crucial to minimize efficiency costs and ensure optimal budgetary policy.
- Redistribution measures should carefully reconcile equity and efficiency goals to avoid adverse consequences for the economy.

THE STABILIZATION FUNCTION IN GOVERNMENT ECONOMICS

INTRODUCTION

- Macroeconomic stability involves matching an economy's output with its production capacity, aligning total spending with total output, achieving full employment, and maintaining low and stable inflation.

- The government's stabilization function is based on Keynesian principles, which argue that a market economy doesn't automatically achieve full employment and price stability, necessitating government intervention.
- Market economies exhibit inherent tendencies for business cycles, and government policies are essential for promoting full employment and price stability.

CHALLENGES IN MACROECONOMIC STABILITY

- Market mechanisms may not prevent or resolve economic disruptions caused by fluctuations in economic activity.
- In the absence of government intervention, economic instabilities such as recessions and inflation can persist, leading to hardships, particularly for the poorer sections of society.
- Stagflation (simultaneous inflation and unemployment) can further complicate the issue.
- The "contagion effect" from international interdependence and financial integration can transmit instability across countries.

KEY AREAS OF CONCERN IN STABILIZATION

- Labor employment and capital utilization.
- Overall output and income.
- General price levels.
- Balance of international payments.
- The rate of economic growth.

ROLE OF FISCAL AND MONETARY POLICY

- Fiscal policy aims to eliminate macroeconomic fluctuations through expenditure and taxation decisions.
- Government expenditure injects money into the economy, stimulating demand.
- Taxes reduce disposable income and, consequently, effective demand.
- To combat recession, the government increases expenditure or reduces taxes, maintaining or boosting aggregate demand.
- To control inflation, the government cuts expenditure or raises taxes, adopting an expansionary or contractionary fiscal policy.

BUDGET SURPLUSES AND DEFICITS

- Budget surplus stimulates economic activity.
- Budget deficit can slow down economic activity.

CONFLICTS IN POLICY GOALS

- Conflicts often arise among the various goals and functions of budgetary policy.
- Effective policy design must balance multiple government objectives without jeopardizing one for the sake of another.

Conclusion

- The stabilization function of government economics plays a crucial role in ensuring macroeconomic stability.
- It addresses labor and capital utilization, output and income, price levels, international balance, and economic growth.
- Effective policy design is challenging, as governments must strike a balance between competing goals to promote economic stability and welfare.

TRY YOUR UNDERSTANDING 7.1.1

1. Macroeconomic stabilization may be achieved through
   (a) Free market economy
   (b) Monetary policy
   (c) Fiscal policy
   (d) (b) and (c) above
2. Which of the following policies of the government fulfils the redistribution function
   (a) Parking the army on the northern borders of the country
   (b) Supply of medicines at subsidized prices to the poor people
   (c) Controlling the supply of money through monetary policy
   (d) None of the above
3. The justification for government intervention is best described by
   (a) The need to prevent recession and inflation in the economy
   (b) The need to modify the outcomes of private market actions
   (c) The need to bring in justice in distribution of income and wealth
   (d) All the above
4. When the government decides to produce fertilizers and supply them to the agriculturists, it aims
   (a) To achieve equity and fairness to the agriculturists
   (b) To influence the way resources are allocated in the economy
   (c) To ensure higher profits to agriculturists
   (d) To make greater profits for the public sector
5. The allocation and distribution functions are primarily:
   (a) Micro-economic functions
   (b) Macro-economic functions
   (c) Both micro as well as macro-economic functions
   (d) Aimed at bringing in price stability and economic growth

Answer Key

1. (a) 2. (b) 3. (d) 4. (b) 5. (a)

CENTRE AND STATE FINANCE IN INDIA

FISCAL FEDERALISM

- Fiscal federalism, introduced by Richard Musgrave, deals with the division of governmental functions and financial relations among different levels of government.Musgrave's concept suggests that central governments should focus on economic stabilization and income redistribution, while allocation of resources should be the responsibility of state and local governments.

INDIA'S FEDERAL STRUCTURE

- India is a federal nation comprising 28 states and 8 union territories.
- Federalism accommodates two levels of government: national and regional, each autonomous in its sphere.
- An independent judiciary resolves disputes between the central government and states regarding the division of power.

CONSTITUTIONAL DIVISION OF POWERS

- India's Constitution divides powers between the central and state governments.
- Article 246 classifies powers into three lists: the Union List, State List, and Concurrent List.
- The Union List is for exclusive central legislation, the State List is for exclusive state legislation, and the Concurrent List allows both central and state legislatures to make laws.
- In case of conflicting legislation in the Concurrent List, the central law prevails.

REVENUE AND EXPENDITURE ALLOCATION

- Allocation of revenue and expenditure responsibilities is crucial in a federation.
- Revenue sources and responsibilities between the center and states are clearly demarcated.
- Both the center and states can levy taxes, but the central government has broader revenue-raising powers.

CENTRAL GOVERNMENT TAXES

- The central government can levy taxes including income tax (excluding agricultural income), customs and export duties, excise duties on specific goods, corporation tax, and more.

STATE GOVERNMENT TAXES

- State governments can levy taxes on agricultural income, lands, buildings, mineral rights, electricity, vehicles, tolls, professions, and collect land revenue.
- The property of the central government is exempt from state taxation, and the property and income of states are not subject to central taxation.

INTER-GOVERNMENTAL TRANSFERS

- Fiscal federalism involves inter-governmental transfers and revenue-sharing to achieve national objectives.
- States often rely on the central government for necessary revenues due to limited income sources.
- The Constitution (Articles 268 to 281) includes provisions for the distribution of finances among states.

Distribution of revenue between the union and states is based on the constitutional provisions 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	Statutory Grants-in-aid from the union to certain states.
Article 282	Grants for any public purpose.
Article 293	Loans for any public purpose.

CENTRE AND STATE FINANCE AND FISCAL FEDERALISM IN INDIA

FISCAL FEDERALISM AND THE FINANCE COMMISSION

- Fiscal federalism involves the division of functions and financial relations between different levels of government.
- Article 280 of the Indian Constitution establishes the Finance Commission, responsible for assessing the finances of the union and states, recommending tax sharing, and defining principles for tax distribution among states.
- The Finance Commission supports fiscal federalism through several functions, including tax sharing, grants-in-aid, and resource allocation.

TAX DISTRIBUTION

- The Finance Commission evaluates vertical equity (share of all states in central revenue) and horizontal equity (allocation of central revenue among states).
- The Commission assesses the gross tax revenues of the union, deducting cesses, surcharges, and non-tax revenue to determine the net divisible pool (NDP).
- A constitutional amendment in 2000 expanded the divisible pool to include all central taxes.
- The Commission decides what percentage of the NDP is assigned to state governments, while the balance remains with the central government.

THE FIFTEENTH FINANCE COMMISSION

- The Fifteenth Finance Commission, formed in November 2017, recommended that states receive 41% of central taxes for 2021-26, the same as for 2020-21.
- An additional 1% adjustment was made for newly formed union territories, Jammu and Kashmir, and Ladakh.
- Distribution criteria for central taxes remain consistent for 2020-21 and 2021-26, considering income distance, area, population, demographic performance, forest and ecology, tax and fiscal efforts.

INTRODUCTION OF GST

- The Goods and Services Tax (GST), introduced on July 1, 2017, significantly impacted financial relations between the center and states.
- GST consolidated various indirect taxes into a unitary indirect tax regime.
- States levy and collect state GST (SGST), while the union levies and collects central GST (CGST), both at equal rates.
- An integrated GST (IGST) applies to inter-state transactions, imports, and exports, collected and distributed by the central government.
- GST contributes a substantial portion of gross tax revenue for the union and own tax revenue for states.
- A Supreme Court verdict in May 2022 confirmed that Union and state legislatures have equal powers to make laws on GST, and GST Council recommendations are not binding on them.

GST COMPENSATION

- To compensate states for revenue losses due to GST implementation, a cess was imposed on luxury and demerit goods, with proceeds credited to a compensation fund.
- GST compensation was extended beyond the initial five-year period to support states during economic slowdowns.
- During the transition period, top compensation-receiving states included Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Punjab.
- In 2022-23, the total compensation released to states and union territories amounted to ₹1,15,662 crore.

EXPENDITURE DECENTRALIZATION

- Responsibilities for expenditure decentralization are divided among central, state, and local governments.
- The central government handles national areas like defense, foreign affairs, trade, finance, transportation, and communication.
- State governments manage agriculture, industry, social services (health, education), police protection, state infrastructure, and local roads.
- Local self-governments (municipalities and panchayats) provide public utilities like water supply, sanitation, local roads, and electricity.
- For items on the concurrent list, both central and state governments share responsibility.

BORROWING AND ARTICLE 292/293

- Borrowing by the central government and state governments is defined under Articles 292 and 293 of the Indian Constitution.
- The central government may borrow within limits set by Parliament and give guarantees upon the security of the Consolidated Fund of India.
- State governments may borrow within limits set by state legislatures and provide guarantees, while obtaining the center's consent if indebted to the center for a previous loan.

TRY YOUR UNDERSTANDING 7.1.2

1. Redistribution policies are likely to have efficiency costs because
   (a) They will reduce the efficiency of governments
   (b) They may create disincentives to work and save
   (c) Governments have to forego taxes
   (d) They are likely to make the poor people dependent on the rich
2. Macroeconomic stabilization may be achieved through
   (a) Free market economy
   (b) Fiscal policy
   (c) Monetary policy
   (d) (b) and (c) above
3. Which of the following policies of the government fulfils the redistribution function
   (a) Parking the army on the northern borders of the country
   (b) Supply of food grains at subsidized prices to the poor people
   (c) Controlling the supply of money through monetary policy
   (d) All of the above
4. Choose the correct statement
   (a) Fiscal policy involves the use of changes in taxation and government spending; while monetary policy involves the use of price and profit controls.
   (b) Fiscal policy involves the use of price and profit controls; while monetary policy involves the use of taxation and government spending.
   (c) Fiscal policy involves the use of changes in taxation and government spending; while monetary policy involves the use of changes in the supply of money and interest rates.
   (d) Fiscal policy involves the use of changes in the supply of money and interest rates; while monetary policy involves the use of changes in taxation and government spending.
5. The justification for government intervention is best described by
   (a) The need to prevent recession and inflation in the economy
   (b) The need to modify the outcomes of private market actions
   (c) The need to bring in justice in distribution of income and wealth
   (d) All the above

6. Read the following statements:
   1. The market-generated allocation of resources is usually imperfect and leads to inefficient allocation of resources in the economy
   2. Market failures can at all times be corrected through government intervention
   3. Public goods will not be produced in sufficient quantities in a market economy of the three statements above:

   (a) 1,2 and 3 are correct (b) 1 and 3 are correct
   (c) 2 and 3 are correct (d) 3 alone is correct

7. When a government offers unemployment benefits and also resorts to progressive taxation which function does it seem to fulfill?
   (a) It is trying to establish stability in an economy
   (b) It is trying to redistribute income and wealth
   (c) It is trying to allocate resources to their most efficient use
   (d) It is creating a source of market failure

8. Government of Emeline Land decides to provide most modern road infrastructure throughout the nation. This can be classified as
   (a) Distribution function (b) Allocation function
   (c) Stabilization function (d) None of the above

9. Which function does the government perform when it provides transfer payments to offer support to the underprivileged
   (a) Allocation (b) Efficiency (c) Distribution (d) None of the above

10. Which of the following is true in respect of centre and state government finances?
    (a) The centre can tax agricultural income and mineral rights
    (b) Finance commission recommends distribution of taxes between the centre and states
    (c) GST subsumes majority of direct taxes and a few indirect taxes
    (d) IGST is collected by the state governments

11. GST compensation is given to
    (a) To the industries which have made losses due to the introduction of GST
    (b) To compensate for the lower rates of GST on essential items
    (c) To the states to compensate for the loss of revenue due to the introduction of GST
    (d) To compensate for the loss of input tax credit in manufacturing

12. Which of the following is true in respect of the role of Finance Commissions in India?
    I. The distribution between the union and the states of the net proceeds of taxes
    II. Allocation between the states of the respective shares of such proceeds.
    III. Make Recommendations on integrated GST on inter-state movement of goods and services
    IV. To recommend expenditure decentralization among different states

    (a) I and II are correct (b) II and III are correct
    (c) I, II and III are correct (d) All the above are correct

13. In a federal set up, the stabilization function can be effectively performed by
(a) Respective state governments (b) Ministry of taxes
(c) The government at the centre (d) None of the above

14. Which of the following is concerned with division of economic responsibilities between the central and state Government of India?
(a) NITI Aayog (b) central bank
(c) Finance Commission (d) Parliament

15. Fiscal Federalism refers to _______.
(a) Organizing and implementing development plans
(b) Sharing of political power between centers and states
(c) The management of fiscal policy by a nation
(d) Division of economic functions and resources among different layers of the government

16. Which one of the following taxes is levied by the state government only?
(a) Corporation tax (b) Wealth tax
(c) Income tax (d) None of the above

17. The percentage of share of states in central taxes for the period 2021-26 recommended by the Fifteenth Finance Commission is
(a) 38 percent (b) 41 percent
(c) 42 percent (d) The commission has not submitted its report

18. Which of the following is not a criterion for determining distribution of central taxes among states for 2021-26 period
(a) Demographic performance (b) Forest and ecology
(c) Infrastructure performance (d) Tax and fiscal efforts

19. As per the supreme court verdict in May 2022
(a) The union has greater powers than the states for enacting GST laws
(b) The union and state legislatures have "equal, simultaneous powers "to make laws on Goods and Services Tax
(c) The union legislature's enactments will prevail in case of a conflict between those of union and states
(d) The state legislatures can make rules only with the permission of central government

20. Providing social sector services such as health and education is
(a) The responsibility of the central government
(b) The responsibility of the respective state governments
(c) The responsibility of local administrative bodies
(d) None of the above

Answer Key

1. (b)	**2.** (d)	**3.** (b)	**4.** (c)	**5.** (d)	**6.** (b)	**7.** (b)	**8.** (b)	**9.** (c)	**10.** (b)
11. (c)	**12.** (a)	**13.** (c)	**14.** (c)	**15.** (d)	**16.** (d)	**17.** (b)	**18.** (c)	**19.** (b)	**20.** (b)

UNIT 2

Market Failure/Government Intervention to Correct Market Failure

INTRODUCTION

- **Market Definition:** A space where buyers and sellers engage in transactions for goods and services.
- **Economic Assumption:** Economists presume individuals act in their own self-interest, making rational choices for personal benefit.
- **Rational Behavior:** Individuals choose things that provide the greatest personal benefit and avoid those not valuable.
- **Market Efficiency Belief:** The belief that a perfectly working market system, driven by rational individuals, efficiently allocates scarce economic resources.
- **Market Signals:** In a well-functioning market, prices act as accurate signals to producers and consumers.
- **Allocation of Resources:** The expectation is that the right quantity of goods and services will be produced and supplied at the right price.
- **Market Failure:** Circumstances where the market fails to allocate resources efficiently, leading to inefficient outcomes.

THE CONCEPT OF MARKET FAILURE

- **Definition:** Inefficient allocation of resources in an economy is termed as market failure.
- **Misallocation in Free Market:** Market failure does not imply the market is non-functional but indicates it does not function optimally.
- **Types of Market Failure:**
  1. **Complete Market Failure:**
     - **Definition:** "Missing markets" where the market fails to supply products despite demand.
     - **Example:** Pure public goods like national defense.
  2. **Partial Market Failure:**
     - Definition: Market functions but produces the wrong quantity or at the wrong price, leading to economic welfare loss.

WHY DO MARKETS FAIL?

FOUR MAJOR REASONS FOR MARKET FAILURE

1. **Market Power:**
   - Definition: Ability of a firm to profitably raise the market price above its marginal cost.
2. **Externalities:**
   - Definition: Indirect effects on others due to production or consumption activities.
3. **Public Goods:**
   - Definition: Goods consumed collectively, non-excludable and non-rivalrous.
4. **Incomplete Information:**
   - Definition: Lack of complete information in markets due to complexity, misinformation, or difficulty in obtaining accurate information.

MARKET POWER

- **Definition:** 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.
- **Price Makers:** Firms with market power act as price makers, allowing them to set prices that yield positive economic profits.
- **Effects of Excessive Market Power**: Excessive market power leads to a single producer or a small number of producers restricting output compared to competitive markets.
- **Price Distortion:** Market power enables charging prices higher than those under perfect competition, resulting in economic inefficiency.
- **Profit Source**: Profits derived from market power and dominance, not from operating efficiency.
- **Outcome of Market Power**: Market fails to produce the right quantity of goods and services at the right price due to the distortion caused by excessive market power.

TRY YOUR UNDERSTANDING 7.2.1

1. 'Market failure' occurs
   (a) When public goods are not sufficiently provided by public sector
   (b) The market fails to allocate resources efficiently and therefore market outcomes become inefficient
   (c) People are not willing to pay and want to free ride
   (d) (a) and (b) above
2. Markets fail because
   (a) Externalities are not accounted for in pricing and quantity decisions of firms
   (b) Most often the prerequisites of competition are unlikely to be present in an economy
   (c) Prices fail to reflect the true costs and benefits to the society.
   (d) All the above

3. Market power
   (a) Makes price equal marginal cost and produce a positive external benefit on others
   (b) Can cause markets to be inefficient because it keeps price and output away from equilibrium of supply and demand
   (c) Makes the firms price makers and restrict output so as to make allocation inefficient
   (d) (b) and (c) above

Answer Key

1. (b) 2. (d) 3. (d)

EXTERNALITIES

- **Definition:** Externalities refer to the indirect effects of an individual's actions on others, either positively or negatively.
- **Nature of Externalities:** Actions of one individual may have marginal effects on others, influencing consumption or production activities.
- **Example:** If individuals switch from consuming ordinary vegetables to organic ones, it may increase the price of organic vegetables, affecting the welfare of existing consumers of organic vegetables.
- **Operation Through Price Mechanism:** Externalities operate through the price mechanism, causing changes in prices. However, when these effects are not directly reflected in market prices, they result in externalities.
- **Types of Externalities:** Externalities can be positive or negative.
  - **Negative Externalities:** Imposing costs on another party.
  - **Positive Externalities:** Conferring benefits on another party.

PRODUCTION EXTERNALITIES

- **Negative Production Externality:**
  - Definition: Imposes external costs on others, affecting consumption or production.
  - Example:
    - Factory discharging untreated wastewater into a river, causing health hazards for those using the water for drinking and bathing.
    - Pollution affecting fish output, reducing catch for fishermen.
- **Incentive Issue:** Firms have no incentive to account for external costs when making production decisions, leading to uninternalized costs not reflected in product prices.
- **Positive Production Externality:** Definition: Confers external benefits on others, affecting consumption or production.
- **Examples:**
  - Firms offering employee training, benefiting other firms when they hire skilled workers.
  - Individual creating an attractive garden, benefiting passersby.

- **Consideration in Decision Making:** External effects are often not considered when making production decisions, leading to uninternalized benefits not factored into production choices.

CONSUMPTION EXTERNALITIES

- **Definition:** Consumption externalities are indirect effects of an individual's consumption actions on others, either imposing costs or conferring benefits.

NEGATIVE CONSUMPTION EXTERNALITIES

- **Initiated in Consumption:** Definition: Produce external costs on others, affecting either consumption or production.
- **Examples:**
  - Smoking in public places causing passive smoking and litter.
  - Loud radio playing obstructing others from enjoying a concert.
- **Effects on Consumption and Production:**
  - Undisciplined students disrupting a class, affecting teachers' ability to instruct.
  - Excessive alcohol consumption causing efficiency impairment in work and production.

POSITIVE CONSUMPTION EXTERNALITIES

- **Initiated in Consumption:**
  - Definition: Confer external benefits on others, affecting either consumption or production.
  - Examples:
    - Immunization against contagious diseases preventing infection for others.
    - Employees of a firm consuming health club services, resulting in increased efficiency and productivity for the firm.
- **Actor Ignorance:** When externalities occur, the actors in a transaction tend to ignore external costs or benefits experienced by people outside the transaction.

IMPACT OF EXTERNALITIES ON EFFICIENCY AND MARKET FAILURE

- **Private Costs vs. Social Costs:**
  - Private costs: Money cost of production incurred by the firm, including wages, raw materials, etc.
  - Social costs: Total costs to society, including private costs and external costs borne by third parties not directly involved in the transaction.
- **Social Cost Formula:** Social Cost = Private Cost + External Cost
- **External Costs Ignored:** External costs, not included in firms' income statements or consumers' decisions, are real and significant for society.
- **Market Prices and Incorrect Signals:** Market prices without incorporating externalities send incorrect signals to producers and consumers, leading to either overproduction or underproduction.

- **Market Failure:** Competitive markets with externalities produce output levels that are not socially optimal, resulting in market failure.

PUBLIC GOODS

- **Definition:** A public good, also known as a collective consumption good or social good, is a product enjoyed collectively, where one individual's consumption does not subtract from others' consumption.

PRIVATE GOODS VS. PUBLIC GOODS

PRIVATE GOODS

- Definition: Scarce goods that individuals must purchase, excludable, and rivalrous in consumption.
- Examples: Food items, clothing, movie tickets, cars.

PUBLIC GOODS

- Characteristics:
  - Non-rival in consumption: One individual's consumption does not reduce availability for others.
  - Non-excludable: Consumers cannot be excluded from consumption benefits.
  - Indivisibility: Total consumption is the same for each individual.
- Examples: National defense, highways, public education, scientific research, law enforcement.

FREE RIDER PROBLEM

- **Definition:** The tendency of individuals to benefit from public goods without contributing to their costs, due to the non-excludable nature of public goods.

MARKET FAILURE IN PUBLIC GOODS

- **Free-Riding and Market Failure:**
  - Absence of excludability in public goods leads to free-rider problems.
  - Individuals have no incentive to pay for public goods as they can consume them without payment.
- **Profit-Maximizing Firms and Market Failure:**
  - If individuals don't offer to pay for public goods, profit-maximizing firms will not produce them.
  - Producers lack motivation to produce socially-optimal amounts without charging a positive price or making profits.
- **Under-Production of Public Goods:**
  - Left to the market, public goods may not be produced at all or will be grossly under-produced.
  - Despite their societal value, market failure occurs in the case of public goods.

INCOMPLETE INFORMATION AND MARKET FAILURE

- **Importance of Complete Information:**
  - Complete information is crucial for a competitive market.
  - Perfect information implies both buyers and sellers have all relevant information for decision-making.
- **Challenges in Real Markets:**
  - Complexity of products and services (e.g., cardiac surgery, financial products).
  - Difficulty in obtaining correct information.
  - Deliberate misinformation through persuasive advertisements.

TRY YOUR UNDERSTANDING 7.2.2

1. Markets do not exist
   (a) For pure public goods
   (b) For goods which have positive externalities
   (c) For goods which have negative externalities
   (d) None of the above
2. The unique feature of an externality is that it is
   (a) Initiated and experienced, not through the operation of the price system but affects an external agent.
   (b) Initiated and experienced, not through the operation of the price system, but outside the market.
   (c) Initiated and experienced by the same entity, but causes decrease in social welfare
   (d) Causes decreases in social welfare through the system of prices prevailing in the market
3. If a textile mill produces large amounts of negative externality, then which one of the following is possible?
   (a) The output of textile is too tittle when compared to the socially optimal quantity.
   (b) The output of textile is too large when compared to the socially optimal quantity.
   (c) The output of textile is not socially optimal as it is likely to be a regulated one
   (d) Any of the above
4. In case of a positive externality
   (a) The social marginal cost will exceed private marginal cost
   (b) The social marginal cost will be equal to private marginal cost
   (c) The social marginal cost will be less than private marginal cost
   (d) The social marginal cost has no relation to private marginal cost

Answer Key

1. (a) 2. (b) 3. (b) 4. (c)

The term 'foreign capital' encompasses any capital inflow into a home country from abroad. It's important to distinguish between the movement of capital and foreign investment. Foreign capital can enter an economy through various means. Some of the important components of foreign capital flows are:

ASYMMETRIC INFORMATION

- **Definition:** Asymmetric information occurs when there is an imbalance in information between the buyer and the seller.
- **Examples:** Landlords vs. tenants, borrowers vs. lenders, used-car sellers vs. buyers, health insurance buyers vs. insurance companies, traders with insider information.

ADVERSE SELECTION

- **Definition:** Asymmetric information leads to adverse selection, impacting transactions before they occur.
- **Example - Health Insurance**
  - Health insurance companies, if able to identify health risks costlessly, could offer low premiums to low-risk buyers and high premiums to high-risk buyers.
  - Insurance companies know less about the health conditions of buyers compared to the buyers themselves.
  - People with higher health risks are more likely to seek insurance coverage, increasing the proportion of unhealthy individuals in the insured pool.
  - Insurance companies may extend coverage to applicants with higher actual risks than known by the company, leading to "adverse" decisions on coverage or premium costs.
- **Consequences:**
  - Heavy insurance claims result in rising premiums.
  - Healthy individuals, aware of their low risks, choose not to be insured.
  - The proportion of unhealthy individuals among the insured increases, further raising insurance prices.
  - In extreme cases, insurance companies may stop selling insurance, creating "missing" markets.
- **Economic Impact:**
  - More unhealthy insurance buyers make insurance expensive.
  - Sellers may incur significant costs to identify the risk for different buyers, increasing insurance premiums.
  - The market faces challenges due to adverse selection, leading to potential inefficiencies.

THE "LEMONS PROBLEM" IN THE USED CAR MARKET

- **George Akerlof's Concept:** "Lemons problem" in the used car market illustrates asymmetric information.
- **Example:**
  - Second-hand cars can be good quality or poor quality ("lemons").

- Owners know more about the car's quality than potential buyers.
- Sellers may not disclose all information about mechanical defects.
- Buyers base their willingness to pay on the average quality of used cars, considering uncertainty.

- **Consequences:**
  - The price offered in the market is lower than the acceptable one.
  - Sellers of good quality cars avoid placing them in the used car market, keeping or selling only to relatives or friends.
  - The market becomes flooded with "lemons," offering lower prices and lower average quality.
- **Market Failure:**
  - Asymmetric information in the used car market leads to the elimination of high-quality cars.
  - Economic agents may choose sub-standard products or leave the market altogether.
  - Market failure occurs as low-quality cars dominate, driving out high-quality ones.

Conclusion

Asymmetric information in both insurance and used car markets results in adverse selection and the "lemons problem," leading to market inefficiencies, higher prices, and the elimination of high-quality goods. Economic agents face challenges in making informed decisions, contributing to market failures and potential disruptions in these markets.

MORAL HAZARD IN INSURANCE MARKETS

- **Definition:**
  - Moral hazard arises when an economic agent can shift some of its costs to others, leading to opportunistic actions after a market exchange.
  - It involves an informed person taking advantage of a less-informed person through unobserved actions, driven by the lack of information about future behavior.
- **Example - Driver with Comprehensive Insurance**
  - In the insurance market, moral hazard can lead to increased probabilities of losses or larger-than-normal losses.
  - For instance, a driver with comprehensive insurance might become less careful while driving, increasing the likelihood of insurance claims.
  - Protection from bearing the full costs of harmful actions can result in irresponsible behavior, making harmful consequences more likely.
- **Example - Medical Insurance**
  - In medical insurance, extensive coverage may lead individuals to care less about excessive fees or inefficient and costly procedures by healthcare providers.
  - The more one's costs are covered by insurance, the less concern about the financial impact of healthcare decisions.

- **Consequences:**
  - Moral hazard in insurance markets can contribute to a rise in insurance premiums for everyone.
  - When individuals are shielded from the full costs of their actions, they tend to act in ways that increase the overall risk and cost for insurers.
  - The inability to monitor post-sale actions makes it challenging for insurance companies to judge the genuine occurrence of accidents or the outcome of insured behavior.
- **Market Impact:**
  - The expected outflow in terms of insurance claims is higher due to moral hazard.
  - Insurance companies may be forced to increase premiums for everyone or, in extreme cases, refuse to sell insurance at all, resulting in missing markets.

GOVERNMENT INTERVENTION TO ADDRESS MARKET FAILURES

- **Infrastructure Development:** Government creates necessary physical infrastructure like roads, bridges, airports, and waterways to facilitate economic activities.
- **Institutional Infrastructure:** Provision of legal and regulatory frameworks, establishment of the rule of law, and protection of property rights ensure a conducive environment for fair market exchanges.
- **Competition and Consumer Law Framework:** Government ensures an appropriately framed competition and consumer law framework to regulate the activities of firms and individuals in market exchanges.
- **Intervention for Market Efficiency:**
  - While a free market exists, government intervention is crucial to correct specific market failures.
  - Government actions aim to ensure economic efficiency and greater welfare to society by addressing issues such as externalities, asymmetric information, and moral hazard.

Conclusion

Moral hazard in insurance markets poses challenges to fair market exchanges, impacting the behavior of economic agents. Government intervention becomes essential to address such market failures, creating an environment that promotes efficiency, fairness, and greater welfare for society.

GOVERNMENT INTERVENTION TO MINIMIZE MARKET POWER

1. **Legislation and Regulation:**
   - Governments establish rules and regulations, such as the Competition Act, to promote and sustain competition and prohibit actions that restrain competition.
   - Antitrust laws in the US and the Competition Act, 1998 in the UK aim to prevent contracts, combinations, and collusions that restrict trade.
2. **Market Liberalization:** Introducing competition in previously monopolistic sectors like energy and telecommunications helps reduce market power.

3. **Controls on Mergers and Acquisitions:** Governments impose controls on mergers and acquisitions to prevent possible market domination.
4. **Price Regulation:** Implementing price capping and regulation prevents monopolistic pricing practices.
5. **Profit or Rate of Return Regulation:** Governments may regulate the profit or rate of return to ensure fair practices.
6. **Consumer Patronage:** Supporting consumer associations empowers consumers and promotes fair market practices.
7. **Investigations into Unfair Practices:** Governments conduct thorough investigations into cartelization, collusion, and predatory pricing to ensure fair competition.
8. **Restrictions on Monopsony Power:** Measures are taken to restrict monopsony power, ensuring fair treatment of suppliers.
9. **Reduction in Import Controls:** Governments may reduce import controls to enhance competition in the market.
10. **Nationalization:** In certain cases, nationalization may be considered as a strategy to address market power.

GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

1. **Direct Controls or Regulations:**
   - Governments impose emission standards, licensing, production quotas, and mandates to control negative externalities like pollution.
   - Legislation and environmental standards, like the Environment (Protection) Act, regulate actions to protect the environment.
2. **Market-Based Policies:**
   - **Pollution Taxes:**
     - Taxes are imposed on firms based on the amount of pollution produced, creating economic incentives for reducing pollution.
     - Challenges include determining and administering efficient pollution taxes.
   - **Cap-and-Trade System:**
     - Tradable emissions permits, known as cap-and-trade, set a limit on total emissions, with permits tradable in the market.
     - This approach encourages firms to reduce pollution and is administratively simpler than direct controls.
   - **Government Schemes and Mechanisms:**
     - Various schemes like Perform, Achieve & Trade (PAT), carbon tax, Renewable Purchase Obligations (RPO), and Renewable Energy Certificates (REC) indirectly put a price on carbon in India.
     - Cap-and-trade systems are not explicitly present, but implicit carbon pricing mechanisms exist.

- **Positive Externalities:**
  - For positive externalities, governments implement corrective subsidies to producers or consumers to increase supply or demand for goods with external benefits.
  - Corrective production subsidies, like fertilizer subsidies, lower the cost for producers.
- **Direct Government Production:** For goods and services with significant positive externalities, governments may directly enter the market as producers, e.g., public education, healthcare, and environmental quality services.

Conclusion

Government intervention plays a crucial role in minimizing market power and correcting externalities. Through legislation, regulation, and market-based policies, governments aim to ensure fair competition, prevent market domination, and internalize external costs and benefits for the overall welfare of society.

GOVERNMENT INTERVENTION IN THE CASE OF MERIT GOODS

Merit goods have positive externalities, making them socially desirable but under-produced and under-consumed through the market. Government responses include:

1. **Regulation:**
   - Governments regulate the provision and consumption of merit goods to ensure quality and access.
   - Compulsory immunization, mandatory education, and legal standards for services are examples.
2. **Subsidies:**
   - Providing financial incentives to consumers or producers through subsidies to encourage consumption or production of merit goods.
   - Subsidies for education, healthcare, and other essential services fall into this category.
3. **Direct Government Provision:**
   - Governments may directly provide merit goods to ensure widespread access.
   - Offering free healthcare, education, and public services are examples of direct provision.
4. **Combination of Government and Market Provision:**
   - Governments may use a mix of direct provision and market mechanisms to ensure access.
   - Licensing private firms for public services with regulated entry fees is an example.
5. **Legislation to Enforce Consumption:**
   - Governments may enforce laws mandating the consumption of certain merit goods for the benefit of individuals and society.
   - The Right of Children to Free and Compulsory Education Act is an example.
6. **Free Provision:**
   - Making merit goods completely free at the point of consumption to encourage widespread use.
   - Free hospital treatment is an example.

GOVERNMENT INTERVENTION IN THE CASE OF DEMERIT GOODS

Demerit goods are socially undesirable, and government intervention aims to discourage their production and consumption:

1. **Complete Ban:** Governments may enforce a complete ban on demerit goods, making their possession, trade, or consumption illegal.
2. **Persuasion and Negative Advertising:** Negative advertising campaigns highlight the dangers associated with demerit goods to discourage consumption.
3. **Legislative Measures:** Legislation prohibiting the advertising or promotion of demerit goods to limit their appeal.
4. **Regulatory Controls:** Strict regulations on the market, spatial restrictions, and time restrictions to limit access, especially for vulnerable groups.
5. **High Taxes:** Imposing high taxes on demerit goods to increase their cost and make them unaffordable.
6. **Minimum Price Fixing:** Fixing a minimum price below which demerit goods should not be exchanged to discourage consumption.

GOVERNMENT INTERVENTION IN THE CASE OF PUBLIC GOODS

1. **Direct Provision:** Governments directly provide public goods such as defense, legal systems, fire protection, and disease prevention.
2. **Excludable Public Goods:** Governments may grant licenses to private firms for the provision of excludable public goods, regulating entry fees.
3. **Voluntary Contributions:** Some public goods are provided through voluntary contributions and private donations.
4. **Government as an Entrepreneur:** Government may enter the market as an entrepreneur to produce goods deemed dangerous to society if left to profit motives.

PRICE INTERVENTION: NON-MARKET PRICING

1. **Price Controls:**
   - Governments may implement price controls, including price floors (minimum prices) or price ceilings (maximum prices).
   - Examples include minimum wages and rent controls.
2. **Minimum Support Price (MSP):** Governments use programs like MSP to ensure steady and assured incomes for farmers by intervening in the pricing of agricultural crops.

GOVERNMENT INTERVENTION FOR CORRECTING INFORMATION FAILURE

1. **Mandatory Labeling and Disclosures:**
   - Governments mandate accurate labeling and content disclosures by producers to inform consumers.
   - Requirements for cigarette packet labels and nutritional information on food packages are examples.

2. **Disclosure of Information:** Governments mandate the disclosure of information, ensuring that accurate information is provided to buyers, as seen in regulations by SEBI.
3. **Public Dissemination of Information:** Governments disseminate information to improve public knowledge about products, services, or investments.
4. **Regulation of Advertising:** Governments regulate advertising and set standards to make advertising more responsible, informative, and less persuasive.

GOVERNMENT INTERVENTION FOR EQUITABLE DISTRIBUTION

1. **Redistribution Policies:** Progressive income tax, targeted budgetary allocations, unemployment compensation, transfer payments, subsidies, and social security schemes are used for income redistribution.
2. **Combatting Black Economy:** Governments intervene to combat the black economy and address market distortions associated with it.
3. **Ensuring Equity:** Interventions aim to ensure fairness and equity in society through various measures, including land reforms, job reservations, and gender-sensitive budgeting.

Conclusion

Government interventions in the market address various market failures and challenges, aiming to achieve economic efficiency, fairness, and overall societal welfare. The effectiveness of interventions depends on careful consideration of costs and benefits, and potential government failures should be minimized.

E ER ISE

1. 'Market failure' is a situation which occurs when
   (a) Private goods are not sufficiently provided by the market
   (b) Public goods are not sufficiently provided by public sector
   (c) The market fail to form or they allocate resources efficiently
   (d) (b) and (c) above
2. Which of the following is an example of market failure?
   (a) Prices of goods tend to rise because of shortages
   (b) Merit goods are not sufficiently produced and supplied
   (c) Prices fall leading to fall in profits and closure of firms
   (d) None of the above
3. Which of the following is an outcome of market power?
   (a) Makes price equal to marginal cost and produce a positive external benefit on others
   (b) Can cause markets to be efficient due to reduction in costs
   (c) Makes the firms price makers and restrict output so as to make allocation inefficient
   (d) (b) and(c) above

4. Markets do not exist
   (a) For goods which have positive externalities
   (b) For pure public goods
   (c) For goods which have negative externalities
   (d) None of the above
5. Which of the following is the right argument for provision of public good by government?
   (a) Governments have huge resources at their disposal
   (b) Public goods will never cause any type of externality
   (c) Markets are unlikely to produce sufficient quantity of public goods
   (d) Provision of public goods are very profitable for any government
6. Adequate amount of a pure public good will not be provided by the private market because of
   (a) The possibility of free riding
   (b) The existence of very low prices and low profits
   (c) Governments would any way produce them, so there will be overproduction
   (d) There are restrictions as well as taxes on production of public goods
7. The free rider problem arises because of
   (a) Ability of participants to produce goods at zero marginal cost
   (b) Marginal benefit cannot be calculated due to externalities present
   (c) The good or service is non excludable
   (d) General poverty and unemployment of people
8. A chemical factory has full information regarding the risks of a product, but continues to sell it. This is possible because of
   (a) Asymmetric information (b) Moral hazard
   (c) Free riding (d) (a) and (c) above
9. If an individual tends to drive his car in a dangerously high speed because he has a comprehensive insurance cover, it is a case of
   (a) Free riding (b) moral hazard
   (c) Poor upbringing (d) Inefficiency
10. Smoking in public is a case of
   (a) Negative consumption externality
   (b) Negative production externality
   (c) Internalising externality
   (d) None of the above
11. Read the following statements
   (i) The market-based approaches to control externalities operate through price cmechanism
   (ii) When externalities are present, the welfare loss would be eliminated

(iii) The key is to internalizing an externality is to ensure that those who create the externalities include them while making decisions

Of the above statements

(a) (ii) and (iii) are correct
(b) (i) only is correct
(c) (ii) only is correct
(d) (i) and (iii) are correct

12. Which of the following statements is false?

(a) Tradable permits provide incentive to innovate and reduce negative externalities
(b) A subsidy on a good which has substantial positive externalities would reduce its cost and consequently its price would be lower
(c) Substantial negative externalities are involved in the consumption of merit goods.
(d) Merit goods are likely to be under-produced and under consumed through the market mechanism

13. Which one of the following would you suggest for reducing negative externality?

(a) Production subsidies
(b) Excise duty
(c) Pigouvian taxes
(d) All of the above

14. A Pigouvian subsidy

(a) Cannot he present when externalities are present
(b) Is a good solution for negative externality as prices will increase
(c) Is not measurable in terms of money and therefore not practical
(d) May help production to he socially optimal when positive externalities are present

15. If governments make it compulsory to avail insurance protection, it is because

(a) Insurance companies need to he running profitably
(b) Insurance will generate moral hazard and adverse selection
(c) Insurance is a merit good and government wants people to consume it
(d) None of the above

16. The Competition Act, 2002 aims to -

(a) Protect monopoly positions of firms that have developed unique innovations
(b) To promote and sustain competition in markets
(c) To determine pricing under natural monopoly.
(d) None of the above

17. Rules regarding product labelling

(a) Seeks to correct market failure due to externalities
(b) Is a method of solving the problem of public good
(c) May help solve market failure due to information failure
(d) Reduce the problem of monopolies in the product market

18. Identify the incorrect statement

(a) A minimum support price for agricultural goods is a market intervention method to guarantee steady and assured incomes to farmers.

(b) An externality is internalised if the ones that generated the externality incorporate them into their private cost- benefit analysis

(c) The production and consumption of demerit goods are likely to be less than optimal under free markets

(d) Compared to pollution taxes, the cap and trade method is administratively cheap and simple to implement and ensures that pollution is minimised in the most cost-effective way.

19. The incentive to let other people pay for a good or service, the benefits of which are enjoyed by an individual

(a) Is a case of negative externality

(b) Is a case of market efficiency

(c) Is a case of free riding

(d) is inappropiate and warrant action

20. A Government subsidy

(a) Is a market-based policy

(b) Involves the government paying part of the cost to the firms in order to promote the production of goods having positive externalities

(c) Is generally provided for merit goods

(d) all the above

21. The production and consumption of demerit goods are

(a) Likely to be more than optimal under free markets.

(b) Likely to be less than optimal under free markets

(c) Likely to be subjected to price intervention by government

(d) (a) and (c) above

22. The argument for education subsidy is based on

(a) Education is costly

(b) The ground that education is merit good

(c) Education creates positive externalities

(d) (b) and (c) above

23. Read the following statements

(i) Social costs are the total costs incurred by the society when a good is consumed or produced.

(ii) The external costs are not included in firms' income statements or consumers' decisions

(iii) Each firm's cost which is considered for determining output would be only private cost or direct cost of production which does not include external costs

(iv) Production and consumption decisions are efficient only when private costs are considered

Of the above

(a) Statements (i) and (iii) are correct

(b) Statements (i), (ii) and (iii) are correct

(c) Statement (i) only is correct

(d) All the above are correct

24. Government failure occurs when

(a) Government fails to implement its election promises on policies

(b) A government is unable to get reelected

(c) Government intervention is ineffective and produces fresh and more serious problems

(d) None of the above

Answer Key

1. (c)	**2.** (b)	**3.** (c)	**4.** (b)	**5.** (c)	**6.** (a)	**7.** (c)	**8.** (a)	**9.** (b)	**10.** (a)
11. (d)	**12.** (c)	**13.** (c)	**14.** (d)	**15.** (c)	**16.** (b)	**17.** (c)	**18.** (c)	**19.** (c)	**20.** (d)
21. (d)	**22.** (d)	**23.** (b)	**24.** (c)						

UNIT 3

The Process of Budget-Making: Source of Revenue, Expenditure Management and Management of Public Debt

INTRODUCTION

UNITING FINANCES: THE POWER OF BUDGETS

Governments worldwide bear the responsibility of diverse functions, from safeguarding their territories to upholding law and order, providing public goods, and devising comprehensive plans for citizens' economic and social welfare. For these endeavors, financial resources are a governmental necessity, and the budget emerges as a potent policy tool to regulate and reshape a country's economic priorities.

The essence of budgeting lies in the judicious allocation of limited resources, aiming for the maximal social welfare possible. The government, in executing its functions, must reallocate resources in alignment with declared priorities. Through effective budgeting, the government achieves not only the redistribution of income and wealth but also addresses broader objectives such as stabilizing the economy, sustaining real GDP growth, and mitigating regional disparities.

At its core, a budget serves as a detailed statement answering the fundamental questions of 'where the money comes from' and 'where the money goes.' Presented for approval and legislation, a government budget encompasses estimates of proposed expenditures for a specific period and the means of financing them. It acts as a roadmap for the government's fiscal plans, projecting revenues and expenditures across sectors like agriculture, industry, and services. This comprehensive financial report, known as budgeted estimates, stands as a crucial document consolidating revenues from various sources and outlays for all governmental activities.

While state and local bodies conduct their budgetary processes, this exploration centers on the union budget, examining the intricate financial blueprint that steers a nation's course.

BUDGET MAKING PROCESS

CRAFTING THE FINANCIAL BLUEPRINT: THE BUDGETARY JOURNEY

The budgetary process is the collaborative effort of the executive and legislative branches to formulate a cohesive set of taxing and spending proposals. Traditionally overseen by the Ministry of Finance, the government's finances in India are carefully crafted through a series of steps involving planning, presentation, and execution.

Despite the absence of the term 'budget' in the Indian Constitution, Article 112 outlines the requirement for an 'Annual Financial Statement.' This statement, commonly referred to as the budget, is presented before both houses of parliament annually, detailing the estimated receipts and expenditures of the government for the upcoming fiscal year.

THE BUDGETARY PROCESS ENCOMPASSES 3 KEY STAGES:

1. Preparation of the Budget: The Ministry of Finance initiates the process in August-September of the preceding year. A comprehensive schedule is prepared, and a budget circular is issued to all relevant entities. Ministries and departments then prepare detailed estimates of receipts and expenditures.
2. Presentation and Enactment of the Budget: The Union Finance Minister conducts pre-budget consultations with various stakeholders, including state finance ministers, chief ministers, and representatives from different sectors. The budget, presented in Parliament, includes estimates for the current and upcoming financial years, as well as actuals from the preceding year. The Finance Minister's budget speech provides a detailed overview of proposed policies, taxation, borrowings, and government expenditure plans.
3. Execution of the Budget: The budget undergoes discussions in two stages in the Lok Sabha. The first involves a general discussion on the budget as a whole, followed by a period of adjournment. During this break, standing committees review demands for grants of various ministries. The Lok Sabha then proceeds with discussion and voting on demands for grants. The Parliament has the authority to concur, refuse demands, or adjust grant amounts. The Rajya Sabha, while having a general discussion on the budget, does not vote on demands for grants. The government introduces the Appropriation Bill, providing authority to incur expenditures from the Consolidated Fund of India. The Finance Bill, aligning with taxation proposals, is introduced and must be passed within 75 days of its introduction.

The process culminates in 'Guillotine,' a mechanism to conclude the debate on financial proposals within a set timeframe. The Finance Bill, once passed by the Lok Sabha, undergoes consideration in the Rajya Sabha, with recommendations returned within 14 days.

Since the financial year 2017-18, the budget's presentation date has been advanced to February 1st. An integral reform was the merger of the railway budget with the general budget from the financial year 2017-18 onward.

SOURCES OF REVENUE

In the complex web of fiscal management, the Department of Revenue under the Ministry of Finance takes the reins, overseeing direct and indirect union taxes. Two statutory boards, the Central Board of Direct Taxes (CBDT) and the Central Board of Indirect Taxes and Customs (CBIC), play pivotal roles in managing matters related to these taxes.

Government receipts, vital for sustaining its functions, are categorized into revenue receipts and capital receipts. Revenue receipts encompass tax revenue and non-tax revenue, while capital receipts include debt receipts and non-debt capital receipts.

TAXING MATTERS: A GLIMPSE AT REVENUE STREAMS

1. **Corporation Tax:** Levied on corporate entities, this tax contributes significantly to the government's revenue.
2. **Taxes on Income:** Individual income taxes form a substantial part of the revenue, ensuring a diversified income stream.
3. **Wealth Tax:** A tax on the wealth possessed by individuals, contributing to the government's financial pool.

4. **Customs Duties:** Income generated from duties imposed on imports and exports, playing a crucial role in trade-related revenue.
5. **Union Excise Duties:** Levied on goods manufactured or produced in India, contributing to the government's indirect tax revenue.
6. **Goods and Services Tax (GST):** An indirect tax on the supply of goods and services, including the GST compensation cess.
7. **Taxes on Union Territories:** Revenue generated from taxation within union territories.

BEYOND TAXES: NON-TAX REVENUES

1. Interest Receipts: Income derived from interest on loans and other financial instruments.
2. Dividends and Profits: Revenue generated from public sector enterprises and transfers from the Reserve Bank of India.
3. Other Non-Tax Revenues: Diverse sources contributing to the government's income.
4. Receipts of Union Territories: Income generated from union territories.

SOCIAL SERVICES AND ECONOMIC CONTRIBUTIONS: A DUAL REVENUE STREAM

Government activities in various sectors, such as medical services, public health, education, sports, art and culture, housing, communication, energy, transport, science, technology, environment, railways, and general administrative services, yield revenue. These contributions are not only essential for societal well-being but also serve as revenue-generating avenues for the government.

CAPITAL RECEIPTS: BALANCING THE BOOKS

1. Non-Debt Capital Receipts: Includes recoveries of loans and advances, miscellaneous capital receipts (disinvestments, etc.).
2. Debt Capital Receipts: Involves market loans, short-term/treasury bill borrowings, securities issued against small savings, state provident fund (net), net external debts, and other receipts (net).

In essence, non-debt receipts encompass recoveries of loans, sale proceeds from divestments, and other capital transactions. Debt capital receipts involve various forms of borrowings, including market loans and short-term borrowings.

As the financial tapestry unfolds, the government strategically navigates various revenue sources, ensuring a delicate balance between taxation, non-tax revenue, and capital receipts to meet its multifaceted financial needs.

PUBLIC EXPENDITURE MANAGEMENT

In the realm of fiscal responsibility, effective public expenditure management is the compass that guides governments through the sea of limited resources. This management is crucial for aligning aggregate public expenditure with a sustainable macroeconomic framework. In economies like India, where substantial public spending is vital for fostering economic growth and creating employment opportunities, the need for prudent expenditure policies becomes paramount.

The Department of Expenditure under the Ministry of Finance shoulders the responsibility of overseeing the public financial management system in the central government. It plays a pivotal role in implementing the recommendations of entities like the Finance Commission and the Central Pay Commission, monitoring audit comments and observations, and preparing central government accounts. Additionally, it aids central ministries and departments in controlling costs, reviewing systems, and optimizing the outputs and outcomes of public expenditure.

As the government juggles various expenditure requirements, pre-budget meetings chaired by the Secretary (Expenditure) become essential forums for discussing funds needed for different programs and schemes. The Department of Expenditure finalizes expenditure estimates and communicates them to ministries and departments after Finance Minister approval. The 'Expenditure Profile,' a vital document in the budget, consolidates relevant data across all entities to provide a snapshot of the government's financial performance.

TRY YOUR UNDERSTANDING

1. The budgetry process includes following stages –
   (a) Preparation of the Budget
   (b) Presentation and Enactment of the Budget
   (c) Execution of the Budget
   (d) All of the above
2. Which of the following is not revenue receipt of the government
   (a) Corporation tax
   (b) House tax
   (c) Income tax
   (d) Borrowings from RBI

Answer Key

1. (d) 2. (d)

EXPENDITURE UNVEILED: CATEGORIZING THE FISCAL LANDSCAPE

The total expenditure through the budget encompasses both current and capital components, consisting of central expenditure and transfers. In the Expenditure Budget, central government expenditure falls into six broad categories:

A. Centre's Expenditure:

- **Establishment Expenditure of the Centre:** Encompassing costs related to ministries, departments, attached, and subordinate offices.
- **Central Sector Schemes:** Fully funded and implemented by central agencies under union government ministries/departments.
- **Other Central Expenditures:** Including those on CPSEs (Central Public Sector Enterprises) and Autonomous Bodies.

B. Centrally Sponsored Schemes and other Transfers:

- **Centrally Sponsored Schemes:** Programs where the center and states share funding and implementation responsibilities.
- **Finance Commission Transfers:** Allocations made by the Finance Commission.
- **Other Transfers to States:** Additional fund transfers to states.

Establishment expenditure focuses on the organizational and administrative costs of ministries, departments, and related offices. Central Sector Schemes are fully backed and managed by

central agencies, ensuring a centralized approach to certain initiatives. The categorization facilitates a nuanced understanding of how government expenditures are allocated and utilized, contributing to effective fiscal management.

PUBLIC EXPENDITURE MANAGEMENT

In the realm of fiscal responsibility, effective public expenditure management is the compass that guides governments through the sea of limited resources. This management is crucial for aligning aggregate public expenditure with a sustainable macroeconomic framework. In economies like India, where substantial public spending is vital for fostering economic growth and creating employment opportunities, the need for prudent expenditure policies becomes paramount.

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   - Establishment Expenditure of the Centre: Encompassing costs related to ministries, departments, attached, and subordinate offices.
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The sheer size of India's public debt can be understood from the following table:

Debt Position of the Government of India		(In ₹ Crores)
	As on 31st March 2023	As on 31st March 2024
Internal debt and other liabilities	147,77,724.43	164,23,983.04
External debt	4,83,397.69	5,22,683.81
Total	152,61,122.12	169,46,666.85
Source: Budget 2023–2024		

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.

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 does not fall short of expenditure. i.e., revenue is equal to expenditure (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. When the government spends less than the receipts the budget becomes surplus. Briefly put, 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.

CAPITAL RECEIPTS

Capital receipts are those receipts that lead to a reduction in the assets or an increase in the liabilities of the government. Examples include recoveries of loans, earnings from disinvestment and debt.

REVENUE RECEIPTS

Revenue receipts can be defined as those receipts which neither create any liability nor cause any reduction in the assets of the government. There are two sources of revenue receipts for the government – tax revenues and non-tax revenues.

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 (even though some of the grants may be meant for creation of assets).

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.

When a government spends more than it collects by way of revenue, it incurs a budget deficit. There are various measures that capture government deficit and they have their own implications for the economy.

BUDGETARY DEFICIT OR OVERALL DEFICIT

Budgetary Deficit is defined as the excess of total estimated expenditure over total estimated revenue is the difference between all receipts and expenditure, 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 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, or the government is diverting resources from other sectors to finance its current expenditure.

Revenue deficit = Revenue expenditure – Revenue receipts

FISCAL DEFICIT

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. In other words, fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing. 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)

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.

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. The goal of measuring primary deficit is to focus on present fiscal imbalances.

Primary deficit = Fiscal deficit – Net Interest liabilities

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

FINANCE BILL

The Bill produced immediately after the presentation of the union budget detailing the Imposition, abolition, alteration or regulation of taxes proposed in the budget.

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 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.

GUILLOTINE

The parliament has very limited time for examining the expenditure demands of all the ministries. So, once the prescribed period for the discussion on demands for grants is over, the speaker of Lok Sabha puts all the outstanding demands for grants, whether discussed or not, to the vote of the house. This process is popularly known as 'Guillotine'.

CUT MOTIONS

Motions for reduction to various demands for grants are made in the form of cut motions seeking to reduce the sums sought by government on grounds of economy or difference of opinion on matters of policy or just in order to voice a grievance.

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.

CONTINGENCY FUND OF INDIA

A fund placed at the disposal of the President to enable him/her to make advances to the executive/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 executive from the contingency fund which is subsequently reported to the Parliament for recoupment from the Consolidated Fund of India.

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.

EXERCISE

1. The difference between the budget deficit of a government and its debt service payments is

(a) Fiscal deficit
(b) Budget deficit
(c) Primary deficit
(d) None of the above

The following hypothetical figures relate to country A

	₹ Crores
Revenue receipts	20,000
Recovery of loans	7,500
Borrowing	75,000
Other Receipts	5,000
Expenditure on revenue account	24,500
Expenditure on capital account	26,000
Interest payments	2,000

2. The revenue deficit for country A is.

(a) 5,000 (b) 24,000 (c) 4,500 (d) None of these

3. Fisal deficit of country A is.

(a) 14,000 (b) 24,000 (c) 23,000 (d) None of these

4. Primary deficit of country A is

(a) 26,000 (b) 26,500 (c) 22,000 (d) 24,500

5. In NITI Aayog, NITI stands for

(a) National initiative for transforming India.
(b) National institution for transforming India.
(c) National institute for technology and innovation
(d) None of these

6. The appropriation bill is intended to

(a) reduce unnecessary expenditure on the part of the government
(b) give authority to government to incur expenditure from and out of the Consolidated Fund of India
(c) give authority to government to incur expenditure from the revenue receipts only
(d) be passed before the budget is taken for discussion

7. Public debt management aims at

(a) An efficient budgetary policy to avail of domestic debt facilities
(b) Raising loans from international agencies at lower rates of interest
(c) Raising the required amount of funding at the desired risk and cost levels
(d) Management of public expenditure to reduce public debt

8. The railway budget is

(a) Part of the general budget, but is presented by the railway minister
(b) Part of the general budget from the budget for financial year 2017-18.
(c) Part of the general budget from the budget for financial year 2021-22
(d) Part of the general budget but presented on the next day of the general budget

9. Outcome budgeting

(a) shares information about the money allocated for various purposes in a budget
(b) establishes a direct link between budgetary allocations and performance targets measured through output and outcome indicators
(c) establishes a direct link between budgetary performance targets and public account disbursals
(d) shares information about public policies and programmes under the budget

10. Corporate tax

(a) is collected by the union government and can be a capital receipt or revenue receipt
(b) may be collected by the respective states and fall under revenue receipts
(c) may be collected either by the centre or states and fall under revenue receipts
(d) is collected by the union government and is a revenue receipt

11. Government borrowings from foreign governments and institutions
(a) Capital receipt
(b) Revenue receipt
(c) Accounts for fiscal deficit
(d) Any of the above depending on the purpose of borrowing

The following table relates to the revenue and expenditure figures of a hypothetical economy

	In ₹ Lakh Crores
(a) Recovery of loans	5. 1
(b) Salaries of govt. servants	41.1
(c) Capital Expenditure	45.0
(d) Interest payments	1.3
(e) Payments towards subsidies	3.2
(f) Other receipts (mainly from disinvestment)	11.6
(g) Tax revenue (net of states' share)	26.3
(h) Non-tax revenue	12.3
(i) Borrowings and other liabilities	6.8
(j) States' share in tax revenue	11.9

12. The capital receipts are
(a) 23.5 (b) 19.7 (c) 11.3 (d) None of the above

13. Revenue deficit is
(a) 23.6 (b) 13.0 (c) 7.0 (d) 2.6

14. The non-debt capital receipts of this country is
(a) 45.1 (b) 16.7 (c) 15.8 (d) None of the above

15. A budget is said to be unbalanced when
(a) when government's revenue exceeds government's expenditure
(b) when government's expenditure exceeds government's revenue
(c) either budget surplus of budget deficit occurs
(d) All the above

16. Fiscal deficit refers to
(a) the excess of government's revenue expenditure over revenue receipts
(b) The excess of total expenditure over total receipts excluding borrowings
(c) Primary deficit - interest payments
(d) None of these

17. Budget of the government generally impacts

(a) the resource allocation in the economy

(b) redistribution of income and enhance equity

(c) stability in the economy by measures to control price fluctuations

(d) all the above

18. Which of the following is a statement submitted along with the budget as a requirement of FRBM Act

(a) Annual Financial Statement

(b) Macro -Economic Framework Statement

(c) Medium-Term Fiscal Policy cum Fiscal Policy Strategy Statement

(d) (b) and (c) above

19. Government borrowing is treated as capital receipt because

(a) It is mainly used for creating assets by government

(b) It creates a liability for the government

(c) Both (a) and (b) above are correct

(d) None of the above is correct

20. 'Retail Direct 'scheme is

(a) Initiated by the Reserve Bank of India

(b) facilitate investment in government securities by individual investors.

(c) Direct sale of goods and services by government departments

(d) Both (a) and (b) are correct

21. Non-debt capital receipts

(a) do not add to the assets of the government and therefore not treated as capital receipts

(b) are those that do not create any future repayment burden for the government

(c) are those that create future liabilities for the government

(d) facilitate capital investments at low cost

22. Which of the following is a capital receipt?

(a) Licence fee received

(b) Sale proceeds from disinvestment

(c) Assistance from Japan for covid vaccine

(d) Dividend from a public sector enterprise

23. Grants given by the central government to state governments is

(a) A revenue expenditure as it is meant to meet the current expenditure of the states

(b) A revenue expenditure as it does neither creates any asset, nor reduces any liability of the government

(c) A capital expenditure because it increase the capital base of the states

(d) It is a grant and so does not come under revenue expenditure or capital

24. Short-term credit from the Reserve Bank to state governments to bridge temporary mismatches in cash flows is known as

(a) RBI credit to states

(b) Commercial credit of RBI

(c) Ways and Means Advances (Wfv1A)

(d) Short term facility

Answer Key

1. (c)	**2.** (c)	**3.** (b)	**4.** (c)	**5.** (b)	**6.** (b)	**7.** (c)	**8.** (b)	**9.** (b)	**10.** (d)
11. (a)	**12.** (a)	**13.** (c)	**14.** (b)	**15.** (d)	**16.** (d)	**17.** (d)	**18.** (d)	**19.** (b)	**20.** (d)
21. (b)	**22.** (b)	**23.** (b)	**24.** (c)						

UNIT

4

Fiscal Policy

INTRODUCTION: GOVERNMENT BUDGET AND FISCAL POLICY

1. **Government Economic Goals:** Governments worldwide pursue various economic goals, including rapid economic growth, equitable distribution of wealth, poverty reduction, price stability, exchange rate stability, full employment, and balanced regional development.
2. **Role of Government Budget:**
   - The government budget emerges as a powerful instrument in achieving economic objectives.
   - The budgetary policy encompasses public revenue (taxation), public expenditure, public debt, and deficit financing to address the gap between public receipts and payments.
3. **Fiscal Policy Definition:**
   - Fiscal policy is a deliberate government strategy employing taxation, public expenditure, and public borrowing to influence economic activity's pattern, aggregate demand, output, and employment levels.
   - It is essentially a demand-side policy, intervening in the economy to shape its trajectory.
4. **Tools of Fiscal Policy:**
   - **Taxation:** Governments use taxes to regulate income distribution and control spending power.
   - **Public Expenditure:** The government spends money to stimulate economic activity, create jobs, and address societal needs.
   - **Public Debt:** Governments may borrow to fund projects or cover deficits, impacting overall economic health.
   - **Deficit Financing:** Bridging the gap between public receipts and payments by borrowing money.
5. **Objective of Fiscal Policy:** Fiscal policy aims to influence economic variables like aggregate demand, output, and employment to achieve broader socio-economic goals.
6. **Classical Economists' Perspective:**
   - Classical economists argued against government intervention, believing in the self-adjusting nature of the market mechanism.
   - They contended that markets maintain stability, ensuring full employment without the need for deliberate fiscal policies.
   - Advocated for a balanced budget, asserting that active fiscal policies were unnecessary.

7. **Keynesian Revolution:**
   - The significance of fiscal policy gained recognition after the Great Depression of the 1930s.
   - John Maynard Keynes, in "The General Theory of Employment, Interest, and Money" (1936), proposed increased government spending to combat recession and unemployment.
   - Keynesian economics challenged the laissez-faire approach and advocated for an active role for the government in managing the economy.
8. **Modern Context:**
   - Recent global financial crises prompted many countries to adopt a more active fiscal policy.
   - Governments use fiscal tools to address economic challenges, demonstrating the evolving role of fiscal policy in modern economic governance.

OBJECTIVES OF FISCAL POLICY

1. **Derived from Societal Goals:** The objectives of fiscal policy, akin to other government economic policies, stem from societal aspirations. Government responsibility includes providing goods and services for social welfare, such as highways, education, and healthcare.
2. **Varied Objectives Across Nations:**
   - Nations exhibit diversity, leading to variations in fiscal policy objectives.
   - Common objectives include:
     - Achievement and maintenance of full employment.
     - Maintenance of price stability.
     - Acceleration of economic development.
     - Equitable distribution of income and wealth.
3. **Priority Variations:**
   - The importance and priority order of these objectives differ among countries and change over time.
   - Developed nations may prioritize stability and equality, while developing countries may emphasize economic growth, employment, and equity.
4. **Government Influence on Resource Allocation:**
   - Governments wield direct and indirect influence on resource utilization.
   - Fiscal policy emerges as a potent tool due to its impact on the total output, i.e., gross domestic product (GDP).
5. **Stabilization Role of Fiscal Policy:**
   - Fiscal policy's influence on aggregate demand positions it as a key instrument for economic stabilization.
   - The fundamental equation of national income accounting illustrates this relationship: $GDP = C + I + G + N_x$

- The equation breaks down aggregate spending or demand into components like private consumption (C), investment (I), government expenditure (G), and net exports (NX).

6. **Government's Direct Control:** Governments directly control the level of economic activity (GDP) by managing government expenditure (G), which includes purchases of goods and services.
7. **Indirect Influence:** Indirectly, governments affect private consumption (C), investment (I), and net exports (NX) by altering tax rates, transfer payments, and public expenditure.
8. **Stabilizing the Economy:**
   - By strategically using fiscal tools, governments aim to stabilize the economy by moderating fluctuations in aggregate demand.
   - For instance, during economic downturns, increased government spending can stimulate demand, supporting overall economic activity.

TYPES OF FISCAL POLICY

1. **Introduction to Fiscal Policy Adjustments:** Fiscal policy involves intentional adjustments in government revenues, expenditures, and public debt to address economic challenges such as unemployment during a recession and achieve price stability during inflation.
2. **Contra Cyclical Fiscal Policy:** Contra cyclical fiscal policy aims to correct business-cycle instability and comes in two basic types: expansionary fiscal policy and contractionary fiscal policy.

   (a) **Expansionary Fiscal Policy:**
   - **Objective:** Stimulate the economy during a contractionary phase or an anticipated contraction in the business cycle.
   - **Indicators:** Occurs during a recession marked by falling real GDP, low aggregate demand, reduced consumer spending, and rising unemployment.
   - **Measures:**
     - **Tax Cuts:** Reduce all types of taxes (direct and indirect) to boost purchasing power and increase demand for goods and services.
     - **Government Expenditure Increase:** Pump money into the economy to raise aggregate demand, output, and employment.
     - **Combination Approach:** Often involves a mix of increased government spending and decreased personal or business taxes.
   - **Budget Impact:** May lead to budget deficits as tax cuts reduce government income while expenditures exceed tax revenues.

   (b) **Contractionary Fiscal Policy:**
   - **Objective:** Restrain economic activity during an inflationary phase or in anticipation of business-cycle expansion likely to induce inflation.
   - **Indicators:** Implemented when the economy experiences high growth rates, leading to inflation and asset bubbles.
   - **Measures:**
     - **Decrease in Government Spending:** Reduce total money available in the economy, lowering aggregate demand.

- **Increase in Taxes:** Raise personal or business taxes to reduce disposable incomes, curbing consumption spending and aggregate demand.
- **Combination Approach:** Involves both reduced government spending and increased taxes.

- **Budget Impact:** Ideally results in a smaller budget deficit or a larger budget surplus.

3. **Fiscal Policy and Economic Conditions:**
   - Fiscal policy aims to:
     - Control excessive aggregate spending during inflation.
     - Compensate for deficient effective demand during deflation or sluggish economic activity.

4. **Instruments of Fiscal Policy:**

(a) **Government Expenditure:**
- **Role:** An essential instrument influencing consumption and investment to achieve full employment.
- **Categories:** Includes current expenditures, capital expenditures, and transfer payments.
- **Impact during Recession:** Increased public works and infrastructure projects stimulate employment and economic activity.

(b) **Taxes:**
- **Role:** Most significant revenue source for governments, used to establish economic stability.
- **During Recession:** Income tax reduction and low corporate taxes encourage consumption and investment.
- **During Inflation:** New taxes and increased tax rates reduce disposable incomes to control inflationary gaps.

(c) **Public Debt:**
- **Types:** Internal (borrowing from own people) and external (borrowing from outside sources).
- **Forms:** Market loans (treasury bills, government securities) and small savings (non-negotiable, not traded).
- **Impact:** Borrowing curtails aggregate demand, debt repayment increases money availability, boosting aggregate demand.

(d) **Budget:**
- **Types:** Balanced, surplus, deficit.
- **Impact:** Balanced budgets have no net effect on aggregate demand; surpluses may have negative effects, deficits positive effects.
- **Role:** Deliberate changes in revenue and expenditure components influence economic variables like growth, inflation, unemployment, and external stability.

TRY YOUR UNDERSTANDING

1. Fiscal policy refers to
   (a) Use of government spending, taxation and borrowing to influence the level of economic activity
   (b) Government activities related to use of government spending for supply of essential goods
   (c) Use of government spending, taxation and borrowing for reducing the fiscal deficits
   (d) (a) and (b) above
2. During recession fiscal policy of the government should be directed towards
   (a) Increasing the taxes and reducing the aggregate demand
   (b) Decreasing taxes to ensure higher disposable income
   (c) Increasing government expenditure and increasing taxes
   (d) None of the above
3. Name the policy that accords with expenditure and taxation policies decisions of the government?
   (a) Monetary Policy (b) Fiscal Policy
   (c) Labor Market Policies (d) Trade Policy
4. Which one among the following is a tool of Fiscal Policy?
   (a) Government Research (b) Election
   (c) Taxation (d) None of the above

Answer Key

1. (a) 2. (b) 3. (b) 4. (?)

FISCAL POLICY FOR LONG-RUN ECONOMIC GROWTH

1. **Introduction:** Fiscal policy has been discussed mainly in the context of managing short-term aggregate demand. However, for sustained development, long-run economic growth is crucial. Fiscal policies need to extend beyond demand-side measures to stimulate aggregate supply for sustainable growth.
2. **Incentive Effects of Fiscal Policy:**
   - **Infrastructure Spending:** Positive supply-side effects occur when governments invest in infrastructure, providing necessary overheads for private sector development.
   - **Public Goods Provision:** Government investment in public goods like education, healthcare, and research fosters long-run growth by enhancing human capital formation, making physical capital more productive.
   - **Tax Impacts:** Tax policies can influence economic growth positively or negatively, depending on their impact on saving and investment.
   - **Well-Designed Tax Policies:** Reward innovation and entrepreneurship without discouraging incentives, promoting private business investments.
   - **Example:** Corporate tax increases may hinder incentives and output.

3. **Market Failure Correction:**
   - **Taxes and Subsidies:** Effective use of taxes and spending policies can correct market failures resulting from externalities.
   - **Environment Taxes:** Increase firm costs, reducing output.
   - **Subsidies:** Boost output, e.g., subsidies for farmers.

FISCAL POLICY FOR REDUCTION IN INEQUALITIES OF INCOME AND WEALTH

1. **Introduction:** Fiscal policy serves as a chief instrument for governments to influence income distribution and address rising inequality in developed and developing economies.
2. **Direct and Indirect Income Distribution Measures:**
   - **Progressive Direct Tax System:** Ensures those with greater ability to pay contribute more fairly, distributing the tax burden equitably.
   - **Differential Indirect Taxes:** Tax luxury goods heavily (consumed by the rich) and necessities lightly or not at all (consumed by the poor).
3. **Redistribution through Public Expenditure:**
   - **Carefully Planned Expenditure:** Redistributes income from the rich to the poorer sections through targeted spending programs.
   - **Examples:** Poverty alleviation programs, subsidized healthcare, education, and housing, infrastructure for disadvantaged areas, social security schemes.
4. **Challenges in Designing Tax Structure:**
   - **Progressive Tax System Challenges:** Must be carefully framed to avoid deterring work, saving, and investment.
   - **Redistributive Policy Challenges:** Overly generous social programs may reduce incentives to work and save.

LIMITATIONS OF FISCAL POLICY

1. **Lag Issues:**
   - **Recognition Lag:** Difficulty in recognizing the need for a policy change due to complex economic variables and data collection challenges.
   - **Decision Lag:** Delays in evaluating alternative policies once the need for intervention is recognized.
   - **Implementation Lag:** Bureaucratic delays in enacting and implementing chosen policies.
   - **Impact Lag:** Outcomes of a policy may not be visible immediately.
2. **Timing Challenges:**
   - **Badly Timed Policies:** Fiscal policy changes may be poorly timed, initiated when the economy is already recovering or vice versa.
3. **Implementation Difficulties:**
   - **Instant Policy Changes:** Challenges in instantly changing government spending and taxation policies.

- **Unalterable Expenditures:** Difficulties in reducing spending on items like defense and ongoing capital projects.

4. **Supply-Side Concerns:**
   - **Disincentives:** Certain fiscal measures may create disincentives, such as increased profits tax affecting investment incentives.
5. **Deficit Financing Issues:**
   - **Purchasing Power Increase:** Deficit financing may increase purchasing power faster than production can catch up, leading to uncontrollable inflation.
6. **Borrowing and Debt Challenges:**
   - **Burden on Future Generations:** Government borrowing creates a burden on future generations if debts are not productively utilized.
   - **Interest Rate Impact:** Competition for borrowing may raise interest rates, reducing private sector investment and borrowing.

CROWDING OUT

1. **Introduction:**
   - Discussing the secondary effects of fiscal policy on the economy, particularly the concept of crowding out.
   - Some economists argue that government spending might substitute private spending, potentially diminishing the impact of government spending on aggregate demand.
2. **Expansionary Fiscal Policy and Budget Deficit:**
   - During a recession, the government implements an expansionary fiscal policy by increasing spending and/or reducing taxes.
   - This leads to a budget deficit as government expenditure rises while income decreases.
   - The deficit is financed by government borrowing from the credit market through the issuance of long-term, interest-bearing bonds.
3. **Crowding Out Effect:**
   - **Definition:** Substantial government borrowing in the credit market can reduce available funds and drive interest rates up.
   - **Impact:** Higher interest rates can slow down business investment and consumption expenditures sensitive to interest rates.
   - **Result:** Private spending is crowded out when government spending replaces it.
   - **Effectiveness Diminished:** The effectiveness of expansionary fiscal policy in stimulating aggregate demand is diminished as a result.
4. **Crowding Out and Economic Growth:**
   - **Long-Run Impact:** Crowding out may reduce the economy's prospects for long-run economic growth.
   - **Interest Rate Influence:** Government borrowing increasing interest rates may discourage private sector investments.

5. **Exceptions During Recessions:**
   - **Less Likely Crowding Out:** In deep recessions, crowding out is less likely as private sector investment is already minimal.
   - **Borrowing in Recessions:** During a recession, the government may borrow from the market without significantly increasing interest rates.

CONCLUSION

1. **Necessity of Well-Designed Fiscal Responses:** Well-designed and timely fiscal responses are crucial for managing different economic stages, be it recession, inflation, economic growth, or income distribution.
2. **Impact during Recession and Full Employment:**
   - **Recessionary Phase:** In times of recession, increasing aggregate demand can boost total output without causing price changes.
   - **Full Employment:** In a fully employed economy, an expansionary fiscal policy may pressure prices to rise without impacting total output.
3. **Fiscal Policy for Economic Growth and Equality:**
   - **Potent Instrument:** Fiscal policy serves as a potent instrument for fostering economic growth and achieving a more equitable distribution of income.

In conclusion, crowding out highlights the potential limitations of expansionary fiscal policy, especially when substantial government borrowing influences interest rates and hinders private sector spending. Well-designed fiscal policies remain essential for navigating economic challenges and promoting long-term growth and income equality.

E ER ISE

1. Fiscal policy refers to the
   (a) Use of government spending, taxation and borrowing to influence the level of economic activity
   (b) Government activities related to use of government spending for supply of essential goods
   (c) Use of government spending, taxation and borrowing for reducing the fiscal deficits
   (d) (a) and (b) above
2. If real GOP is continuously declining and the rate of unemployment in the economy is increasing, the appropriate policy should be to
   (a) Increase taxes and decrease government spending
   (b) Decrease both taxes and government spending
   (c) Decrease taxes and increase government spending
   (d) Either (a) or (c)
3. Which of the following are likely to occur when an economy is in an expansionary phase of a business cycle?

(A) Rising unemployment rate
(B) Falling unemployment rate
(C) Rising inflation rate
(D) Deflation
(E) Falling or stagnant wage for workers
(F) Increasing tax revenue
(G) Falling tax revenue

(a) A, B and F are most likely to occur
(b) B, C and F are most likely to occur
(c) O, E and F are most likely to occur
(d) A, E and G are most likely to occur

4. During recession the fiscal policy of the government should be directed towards
(a) Increasing the taxes and reducing the aggregate demand
(b) Decreasing taxes to ensure higher disposable income
(c) Increasing government expenditure and increasing taxes
(d) None of the above

5. According to Keynesian economics, when we have inflation an effective fiscal policy should not include
(a) Increase corporate taxes.
(b) Decrease aggregate demand.
(c) Increase government purchases.
(d) None of the above is correct

6. Keynesian economists believe that
(a) Fiscal policy can have very powerful effects in altering aggregate demand, employment and output in an economy
(b) When the economy is operating at less than full employment levels and when there is a need to offer stimulus to demand fiscal policy is of great use
(c) Wages are flexible and therefore business fluctuations would be automatically adjusted
(d) (a) and (b) above

7. Which of the following may ensure a decrease in aggregate demand during inflation?
(a) Decrease in all types of government spending and/ or an increase in taxes
(b) Increase in government spending and/ or a decrease in taxes
(c) Decrease in government spending and/ or a decrease in taxes
(d) All the above

8. A recession is characterized by
(a) Declining prices and rising employment
(b) Declining unemployment and rising prices
(c) Declining real income and rising unemployment.
(d) Rising real income and rising prices

9. Which one of the following is an example of fiscal policy?
(a) A tax cut aimed at increasing the disposable income and spending
(b) A reduction in government expenditure to contain inflation
(c) An increase in taxes and decrease in government expenditure to control inflation
(d) All the above

10. Which of the following would illustrate a recognition lag?

(a) The time required to identify the appropriate policy

(b) The time required to identify to pass a legislation

(c) The time required to identify the need for a policy change

(d) The time required to establish the outcomes of fiscal policy

11. An expansionary fiscal policy, taking everything else constant, would in the short-run have the effect of

(a) A relative large increase in GOP and a smaller increase in price

(b) A relative large increase in price, a relatively smaller increase in GOP

(c) Both GOP and price will be increasing in the same proportion

(d) Both GOP and price will be increasing in a smaller proportion

12. Which statement (s) is (are) correct about crowding out?

I. A decline in private spending may be partially or completely offset by the expansion of demand resulting from an increase in government expenditure.

II. Crowding out effect is the negative effect fiscal policy may generate when money from the private sector is 'crowded out' to the public sector

III. When spending by government in an economy increases government spending would be crowded out.

IV. Private investments, especially the ones which are interest - sensitive, will be reduced if interest rates rise due to increased spending by government

(a) I and III only

(b) I, II, and III

(c) I, II, and IV

(d) III only

13. Which of the following policies is likely to shift an economy's aggregate demand curve to the right?

(a) Increase in government spending

(b) Decrease in taxes

(c) A tax cut along with increase in public expenditure

(d) All the above

14. Identify the incorrect statement

(a) A progressive direct tax system ensures economic growth with stability because it distributes the burden of taxes unequally

(b) A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society.

(c) There are possible conflicts between different objectives of fiscal policy such that a policy designed to achieve one goal may adversely affect another

(d) An increase in the size of government spending during recessions may possibly 'crowd-out' private spending in on economy.

15. Read the following statements

I. Fiscal policy is said to be contractionary when revenue is higher than spending i.e., the government budget is in surplus

II. Other things constant, a fiscal expansion will raise interest rates and "crowd out" some private investment

III. During inflation new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes

IV. Classical economists advocated contractionary fiscal policy to solve the problem of inflation

Of the above statements

(a) I and II are correct
(b) I, II and III are correct
(c) Only III is correct
(d) All are correct

16. While resorting to expansionary fiscal policy

(a) The government may possibly have a budget surplus as increased expenditure will bring more output and more tax revenue
(b) The government may run into budget deficits because tax cuts reduce government income and the government expenditures exceed tax revenues in a given year
(c) It is important to have a balanced budget to avoid inflation and bring in stability
(d) None of the above will happen

17. Contractionary fiscal policy

(a) Is resorted to when government expenditure is greater than tax revenues of any particular year
(b) Increase the aggregate demand to sustain the economy
(c) To increase the disposable income of people through tax cuts and to enable greater demand
(d) Is designed to restrain the levels of economic activity of the economy during an inflationary phase

18. When government spending is deliberately reduced to bring in stability

(a) The government is resorting to contractionary fiscal policy
(b) The government is resorting to expansionary fiscal policy
(c) Trying to limit aggregate demand to sustainable levels
(d) (a) and (c) above

19. An increase in personal income taxes

(a) Reduces disposable incomes leading to fall in consumption spending and aggregate demand
(b) Is desirable during inflation or when there is excessive levels of aggregate demand
(c) Is to compensate the deficiency in effective demand by boosting aggregate spending
(d) Both (a) and (b) are correct

20. While the government resorts to deliberate fiscal policy it may not attempt to manipulate

(a) Government expenditures on public works
(b) The rates of personal income taxes and corporate taxes
(c) Government expenditures on goods and services purchased by government
(d) The rate of interest prevailing in the economy

21. Which of the following fiscal remedy would you advice when an economy is facing recession

(a) The government may cut interest rates to encourage consumption and investment

(b) The government may cut taxes to increase aggregate demand

(c) The government may follow a policy of balanced the budget.

(d) None of the above will work

22. While if governments compete with the private sector to borrow money for securing resources for expansionary fiscal policy

(a) It is likely that interest rates will go up and firms may not be willing to invest

(b) It is likely that interest rates will go up and the individuals too may be reluctant to borrow and spend

(c) It is likely that interest rates will go up and the desired increase in aggregate demand may not be realized

(d) All the above are possible.

Answer Key

1. (a)	**2.** (c)	**3.** (b)	**4.** (b)	**5.** (c)	**6.** (d)	**7.** (a)	**8.** (c)	**9.** (d)	**10.** (c)
11. (a)	**12.** (c)	**13.** (d)	**14.** (a)	**15.** (b)	**16.** (b)	**17.** (d)	**18.** (d)	**19.** (d)	**20.** (d)
21. (b)	**22.** (d)								

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