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Chapter - 7 Public Finance

UNIT-1 Fiscal functions : An overview, Centre & State Finance.

Micro — Allocation; Micro — Redistribution; Macro — Stabilization

* Adam Smith is often described as bold advocate of Free Market (Capitalist), thus minimal Govt Activity.

MCQ

* Richard Musgrave in his Classical Theory "The Theory of Public Finance" introduce three Functions of Govt.

Govt Act as Compliment → Allocation } microeconomic — Efficiency
redistribution }
Stabilization } Macroeconomic

The Allocation Function (ensure Efficiency)

* Market Failure Hinder efficient Allocation of resources.

Market fails Due to ÷

MCQ

a) Imperfect Competition & Presence of Monopoly (Market Power)
b) Market Fails to Provide Public Goods
c) Common Property like environment is over used for self interest.
d) Externalities
e) Imperfect Information

* Appropriate Govt Intervention is needed to cover market Failure.

* In Allocation Role, Govt acts as a (complement) rather Than as a substitute to the market.

* Allocation Function Determine the mix of both Public & Merit Goods.

(to guarantee Fairness) The Redistribution Function ("For whom")

* Govt had to intervein for equitable Distribution

* Redistribute either through Expenditure or Revenue Side

* How to Redistribute:
  - Progressive Taxation ☆ MCQ
  - Employment Reservation
  - MSP & Many ~~More~~ More....

* While Redistribution Conflict arise between efficiency & Equity.

* Developing Country May choose — Efficiency
  Developed Country May Choose — Equity

Macro

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Stabilization Function (to ensure Price stability)

* Keynesian Says that, Market Donot automatically generate Full Employment & Price stability, Govt must intervein to pursue stabilization Policies.

* Stablisation Through Fiscal (Govt) & Monetary (By RBI) Policies.

* Stagflation (Inflation + Unemployment)

* Contagion Effect (Impact of one country on other)
  Like Inflation of one country effect other.

* COVID - highlighted the Imp of Macroeconomic Stability

* Fiscal Policy
  - Govt Exp
  - Taxation Policy
  - Budget
    - surplus (Slow downs economy)
    - Deficit (Fasten economic activity)

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UNIT - 2 Market Failure / Govt Intervention to correct Market failure.

* Market failure occurs due to Inefficient Allocation of Resources.

1) Complete Market Failure ÷ ("Missing Market"). It occurs when market does not supply Goods, even when goods are demanded.

2) Partial Market Failure ÷ Producing "wrong Quantity" or at "wrong Price".

* Major reasons of Market Failure.
  - Market Power (Monopoly)
  - Externalities
  - Public Goods
  - Incomplete Information

Market Power

* Ability to raise Price over its Marginal Cost.

* In this Market, Profits are not achieved due to operating Efficiency, but due to Market power and Dominance.

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Externalities

* It can't be reflected directly in "Monetary Terms".

Negative
- Production
  - Untreated waste
  - Poppulation of River ...
- Consumption
  - Smoking
  - Undisciplined student talking

Positive
- Production
  - Training Employee
- Consumption
  - Immunisation
  - health Club
  - Parks

* Social Cost = Private Cost + Externalities Cost

  Private Cost → Firms Monetary Cost

* Externality cost are not included while taking ~~estima~~ decisions, Thus leads to sending of Incorect singnals to producer & Consumer.

*

Public Good

MCQ

* Paul A. Samuelson introduce the concept of "Collective Consumption".

Free Rider

* Consumption by one individual Does not lead to Subtraction of goods for others.
  — These are Non-Excludable + Non Rivalrous *Imp

Non Rival - Good that can be consumed by Many People
Rival - By Only one

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* Private goods are "Excludable" and "Non-Rivalrous" ?

Incomplete Information

- Complexity of Product (Mutual Fund)
- Misinformation by Parties

* Asymmetric Information

MCQ
- Imbalance in Information, ~~when~~ b/w buyer & seller
* when buyer Knows more than seller & Vice Versa

— Asymmetric Info, leads to Adverse selection

~~Ex- Insurance Policy~~, while Purchasing Second hand Car.

"George Akerlof" Developed 'Lemon Problem'

- Here in respect to Cars, Poor Quality cars are defined as Lemon.

* Thus, asymetric information Leads to elimination of High Quality Goods from the Market & Economic agent end up either selecting a Sub standar product or leave the Market.

MCQ * Moral Hazard, it arises when Someone can shift its cost to another.

Ex- Insurance

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Informed Person Taking Advantage of less-informed Person.

Govt Intervention To Minimize Market Power

MCQ * Influence Competition, by law such as Competition Act 2007.
amended from " " 2002

— Also, Controls Mergers

Govt Intervention to Correct Externalities

— Direct Control [Govt Make strict rules to avoid Negative Externality]
— Market based Policies

Pollution Tax
(or)
Pigouvian Tax by A.C. Pigou

Cap & Trade (People Can Trade their Emission Rights)

Govt Intervention in Case of Merit Goods.

* Direct Govt Provisions, or Combination of Govt & Market

* Govt Set $\boxed{\text{minimum}}$ Retail Price for De-Merit Goods

other _ is Just GK

UNIT-3 The Process of Budget Making:

* Budget is Made by Ministry of Finance with Consulation of NITI Aayog & other ministries

* It is then approved by both the house of parliament

MCQ

* Budget word is not used in Constitution, but Article 112 of Constitution, says President shall provide "Annual Financial Statement".

Process Mainly Consist of Two things

1) Administrative Process, Prepared in Consulatation with Various ministries.

2) Legislative Process, Passed by Parliament after Discussion.

* Prepration Commences in $\boxed{\text{August-September}}$

* Budget Depicts info relating to Receipt & Exp of $\boxed{\text{two}}$ years.

$\boxed{\text{Budget}}$ Speech is usually in Two Parts ÷

- PART-A, Prevailing Macro Eco situation of Country and also reveal Priority of Govt.

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PART B, Progress Made by Govt in Various development Sector.

"Annual Financial Statement" is shown in 3 Parts

- Consolidated Fund of India
- Contingency Fund of India
- PF Public Account

List of Budget Document Presented to Parliament

- Annual Financial statement
- MCQ * Demands for Grants
- * Finance Bill
- Statement Mandated under FRBM Act
  - ~~1) Macro Eco statement~~
  - 2) Medium Term Fiscal Policy

9 other Explanatory Doc are submitted

* * In Election year, budget is Presented twice

Lok Sabha [can accept or reject the Grant demands]

↓

within 14 days → Rajya Sabha [Do not vote on Demanded Grants, only a General Discussion]

* Total ~~withing~~ Bill Pass withing 75 days.

* On last Day, Demand for Grants are Voted not Discusesd, it is known as "Guillotine".

MCQ

MCQ

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* ~~For~~ From the budget of $\boxed{2017-18}$ A new budgetary reform was the $\boxed{\text{merger}}$ of railway & Budget with General Budget.

Sources of Revenue

- Department of Revenue exercise control
  1) The Central Board of Direct Tax (CBDT) – Income Tax
  2) The Central Board of Indirect Tax & Customs – GST (CBIC)

Receipts

Revenue Receipts

- Tax Receipts
  - Corporate Tax
  - Income Tax
  - Wealth Tax – Now Abolish
  - Custom Duty
  - Union Exise Duty = on Petrol & Liquor
  - GST
- Non Tax
  - Interest Receipt ☆
  - Dividend & Profits
  - Fines & Challans

Capital Receipts

- Non Debt
  - Recovery of Loan
  - Disinvestment & other
- Debt
  - Treasury Bill

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Public Expenditure Management

* The Department of Expenditure of the Ministry of Finance is the nodal Department for overseeing the public Financial Management System in the Central Govt & Matters Connected with State Finance.

Public Debt Management

MCQ • Institute Responsible for Debt Management
- RBI
- Ministry of Finance

Important Terms

Balanced Budget = (R = E)
UNbalanced "
Surplus (R > E) — Deficit (E > R)

• Capital Receipt ÷ Reduction in Asset
Inc in Liability

Ex - Recovery of Loan

• Revenue Receipt ÷ No Dec in Asset
No Inc in Liability

	Rec	Exp
Cap	A ↓ L ↑	A ↑ L ↓
Revenue	A No ↓ L No ↑	A No ↑ L No ↓

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- Revenue Exp ÷ Not Create Asset
  Nor Dec Dliability

- Capital Exp ÷ Create Asset &
  Decrease Liability

Revenue Deficit

- Revenue Exp > Revenue Receipt

Fiscal Deficit

- Total Exp > Total Receipt (Excluding Borrowing)

Primary Deficit

Int Paymen - Int Receipts

Fiscal Deficit - Net Interest Liability

* Int Liability is a Revenue Exp & Thus does not account while Finding Fiscal Deficit. Imp

- Consolidation Fund ÷ All Govt Money through Receipts is stored In this Fund & all Govt Exp are incurred From this Fund.

- Contingency Fund ÷ To meet Unforseen Expenditure

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- Public Account ÷ Provident Fund or Small Savings
  This Money doesn't belong to govt.

- Cut Motions ÷ Reduction in various demand for Grants.

- Guillotine ÷ Parliament has limited Time to check all demand for Grants.
  So, Lok sabha Put all grants to Vote house. and thus decided by voting.

- Outcome Budget ÷ It is Link between the allocation of grant and its annual usage & performance.

- Finance Bill

5mrks UNIT-4 Fiscal Policy

* Fiscal Policy is $\boxed{\text{instrument}}$ of Taxation, Expenditure and Borrowing etc to influence AD.

* "Classic Economist" Adam Smith Says, Govt should Minimum intervene, because Market has capacity to make economy self Adjusting. Thus, Govt should have balanced budget & fiscal Policies are unnecessary.

* In '1936' the British economist 'John Maynard Keynes' in his book 'The General Theory of Employment, Interest & Money' advocate inc in Govt spending to combat recession & Unemployment.

* Objective of Fiscal Policy

  - It vary from Country to Country & Time to Time
  - Stability & Equality is $\boxed{\text{Priority}}$ for Developed Nation.
  - Growth & Employment are Priority of developing Nation.

* Types of Fiscal Policy

1) Expansionary (used when economy is in recession)

* while resorting to Expansionary Fiscal Policy, Govt may run into Budget Deficit

2) Contractionary Fiscal Policy

* It leads to a smaller govt budget defict or large budget surplus

* Instruments of Fiscal Policy

- Govt Expenditure
- Taxes < Inflation Tax ↑ / Deflation Tax ↓
- Public Debt
- Budget

* Fiscal Policy for Long-run Economic Growth

Demand side Fiscal Policy cannot Produce Long Run Economic Growth.

MCQ

- Long Run Economic Growth is influenced through its effects on the incentive ÷

Long Run
- Infrastructure Spending
- Public Good, health, Edu etc Provide long term eco Growth through human Capital Formation.

Inc in human Capital makes Physical capital more productive

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Redistribution

* Fiscal Policy for Reduction in Inequalities, of Income & wealth.

- Progressive Taxation System ☆ MCQ

* Limitations of Fiscal Policy

Lags

- Recognition Lag - Delay to Recognise Need for Policy
- Decision Lag - Decision on most Appropriate policy
- Implementation lag -
- Impact Lag

* Crowding Out ☆ MCQ

- If the govt compete with Private sector to borrow money for spending, it is likely that Interest rates will go up & Firms willingness to invest may be reduced.

- As a result, the effectiveness of expansionary policy in increasing AD will diminished.