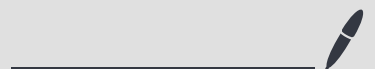


# UNIT – 1: FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

CA Hardik Manchanda



## Introduction

The governments of all nations have important economic functions even where markets constitute the basic resource allocation mechanism.

The primary goal of the state is to promote the general welfare of the society.

What governments do, or do not do, will obviously have an important impact on the economic performance of an economy and the quality of life of its citizens.

As we know, Macroeconomics is the study of the economy as a whole.

There are three main macroeconomic goals for any nation:

- 1) The first is economic growth: If the real gross domestic product grows at a faster rate than population, then people can enjoy higher standard of living.
- 2) The second goal is high levels of employment: This will ensure higher income and higher output. When unemployment occurs, it harms not only the unemployed, but the society as a whole because there is loss of output that could have been produced
- 3) The third macroeconomic goal is stable price levels: Inflation reduces real incomes and purchasing power of some people, and disproportionately affects lower income families.  
On the contrary, deflation signals a downturn in economic activity which may cause recession or even depression and large scale unemployment. By ensuring stable prices, an economy can avoid prolonged inflation and deflation and achieve high levels of economic activity and employment.

The purpose of this lesson is to examine the economic functions of the govt. and to understand why the government should invariably perform them.

## THE ROLE OF GOVERNMENT IN AN ECONOMIC SYSTEM

We shall first consider why an **'economic system'** should be in place?

The basic economic problem of **scarcity** arises from the fact that **wants are unlimited and the resources available to any society are limited.**

Consequently an economy cannot produce all economic goods and services that its members desire to have.

➔ Therefore, an economic system by which a society (households, businesses, and government) makes decisions about allocating resources to produce products and about distributing those products should exist to answer the basic questions such as:

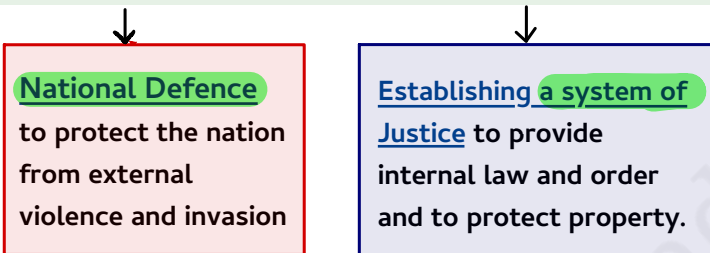
**What, How and for Whom to produce and how much resources should be set apart to ensure growth of productive capacity?**

**There are three alternative Economic systems:**

- 1) **Market or Capitalism**
- 2) **Government or Socialism**
- 3) **Mixed**

Each with different degrees of state intervention in economic activities.

Adam Smith is often described as a bold advocate of free markets and minimal governmental activity. However, Smith saw an important resource allocation role for the government when he underlined the role of government in:



Establishment and maintenance of highly beneficial public institutions and public works such as roads, bridges, canals, harbours, and postal system that profit-seeking individuals may not be able to efficiently build and operate.

Since the 1930s, more specifically, as a consequence of the great depression, the state's role in the economy has been distinctly gaining in importance, and therefore, the traditional functions of the state have been supplemented with what is referred to as economic functions (also called fiscal functions or public finance function)

Richard Musgrave, in his classic treatise 'The Theory of Public Finance' (1959), introduced the three-branch taxonomy of the role of government in a market economy. Musgrave believed that the functions of the government are to be separated into three, namely,

- (a) Resource allocation (to ensure efficiency), - Microeconomic functions
- (b) Income redistribution (to guarantee fairness), Microeconomic functions
- (c) Macroeconomic stabilization (to ensure price stability) - Macroeconomic

The National budget, in general, reflects the economic policy of a government and the government exercises its economic functions partly through the budget.

# THE ALLOCATION FUNCTION

☞ **Resource allocation refers to the way in which the available resources or factors of production are allocated among the various uses to which they might be put.** It determines how much of the various kinds of goods and services will actually be produced in an economy.

Resource allocation is a critical problem because the **resources of a society are limited in supply**, whereas the wants of the members of the society are unlimited. In addition, any given resource can have many alternative uses.

☞ **One of the most important functions of an economic system is the optimal or efficient allocation of scarce resources** so that the available resources are put to their best use and no wastages are there. **Economic efficiency** indicates a situation in which all resources are allocated to serve each person in the best way possible, minimising waste and inefficiency.

↓

**Private sector resource allocation** is characterized by **market supply and demand and price mechanism as determined by consumer sovereignty and producer profit motives**

↓

**State allocation** is accomplished through the **revenue and expenditure activities of governmental budgeting**. In the real world, resource allocation is determined by both market and the government.

↓

A market economy is subject to **serious malfunctioning in several basic respects**. While private goods will be sufficiently provided by the market, public goods and merit goods will not be produced in sufficient quantities by the market.

**why do markets generate misallocation of resources?**

## What is Allocative efficiency?

Allocative efficiency is concerned with utilizing limited resources to produce goods and services that would maximize value to the society. Allocative efficiency achieves the largest possible output of goods and services from the existing stock of resources and technology.

Efficient allocation of available resources in an economy is assumed to take place only when the markets are perfectly competitive and economic agents make rational choices and decisions. In reality, markets are never perfectly competitive.

**Market failures** which hinder efficient allocation of resources occur mainly due to the following reasons:

- 1) **Imperfect competition** and **presence of monopoly** power in different degrees leading to **under-production and higher prices** than would exist under conditions of competition. Markets may fail to control the abuses of monopoly power.
- 2) Markets typically **fail to provide collective public goods** such as **defence** which are, by their very nature, **consumed in common by all people**.
- 3) **Incomplete markets**; markets may fail to produce the right quantity **merit goods**, such as education and healthcare
- 4) **Common property resources (e.g. environment)** are **overused and exhausted** in individual pursuit of self-interest.
- 5) **Externalities** which arise when the production and consumption of a good or service affect third parties (e.g. pollution).
- 6) **Factor immobility** which causes unemployment and inefficiency.
- 7) **Imperfect information** because it may not be in the interests of one party to provide full information to the other party, and
- 8) **Inequalities in the distribution of income and wealth**

According to **Musgrave**, the state is the instrument by which the needs and concerns of the citizens are fulfilled. Therefore, Public finance is connected with economic mechanisms that should ideally lead to the effective and optimal allocation of limited resources.

In the absence of appropriate government intervention, **market failures may occur** and the resources are likely to be misallocated with too much production of certain goods or too little production of certain other goods.



The allocation responsibility of the governments involves suitable **corrective action** when private markets fail to provide the right and desirable combination of goods and services. Briefly put, **market failures provide the rationale for government's allocative function.**

Few of many examples of government intervention in resource allocation:

- 1) Government can provide us with goods and services that we cannot produce on our own or buy at a price from the market. For example, the government **establishes property rights** and makes the necessary arrangements for **enforcing contracts** through provision of law enforcement and courts.
- 2) When externalities are involved in the production and consumption of goods and services, **prices do not reflect the true costs** and benefits and government intervenes with appropriate corrective measures.
- 3) **Merit goods** which are greatly beneficial to the society are by and large provided by the government.

These interventions do not imply that markets are replaced by government action. In its allocation role, **the government acts as a complement rather than as a substitute** to the market system in an economy.

The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its **expenditure and tax policies**. The allocative function in budgeting determines:



- who and what will be taxed
- how much and on what the government revenue will be spent
- the process by which the total resources of the economy are divided among various uses
- the optimum mix of various social goods (both public goods and merit goods).
- the level of involvement of the public sector in the national economy
- the reallocation of society's resources from private use to public use.

A variety of **allocation instruments** are available by which governments can influence resource allocation in the economy. For example:

- The government may **directly produce an economic good** (for example, electricity and public transportation services)
- The government may use the **price mechanism** (i.e. altering the market prices determined by demand and supply through taxes and subsidies) to influence private allocation by policies that change the behaviour of consumers and producers. In other words, the government may **direct resource allocation** through **incentives and disincentives** (for example, tax concessions and subsidies may be given for the production of goods that promote social welfare and higher taxes may be imposed on goods such as cigarettes and alcohol so that their prices are higher)
- The government may influence allocation through **legislation and force**. For example, ban of single use plastic goods.

- d) The **competition policies, merger policies** etc. affect the structure of industry and commerce (for example, the Competition Act in India promotes competition and prevents anti-competitive activities)
- e) Government's **'regulatory activities'** such as licensing, controls, **minimum wages**, and directives on location of industry influence resource allocation.
- f) government sets **legal and administrative frameworks**, and
- h) governments may adopt any combination of possible remedies

## THE REDISTRIBUTION FUNCTION

**Socialist ideology** which emphasized **equality** created strong pressure on the redistributive role of governments. **The distribution responsibility of the government arises from the fact that, left to the market, the distribution of income and wealth among individuals in the society is likely to be skewed and therefore, the government has to intervene to ensure a more socially optimal and egalitarian distribution.**

The distributive function of budget is related to the basic question of **'for whom'** should an economy produce goods and services. Governments can redistribute income and wealth either through the **expenditure side** or through the **revenue side of the budget**

### Revenue

Redistribution is done through **progressive taxation**

### Expenditure

Governments may provide **free or subsidised education, healthcare, housing, food and basic goods** etc. to **deserving people**

Effective demand is determined by the level of income of the households and this, in turn determines the distribution of real output among people. Therefore, the **distribution function** also relates to the manner in which the effective demand over the economic goods is divided among the various individual and family spending units of the society.

The distribution function of the government **Aims** at:

- Redistribution of income to achieve an **equitable distribution of societal output** among households ensuring **increased overall social welfare**.
- **Advancing the well-being** of those members of the society who suffer from deprivations of different types
- Providing **equality of income, wealth and opportunities**
- **Providing security** (in terms of fulfillment of basic needs) for people who have **hardships**, and ensuring that **everyone enjoys a minimum standard of living**



A few examples of the redistribution function (or market intervention for socio-economic reasons) performed by governments are:

- **Taxation policies** of the government whereby **progressive taxation** of the rich is combined with **provision of subsidy** to the poor households
- Proceeds from progressive taxes used for **financing public services**, especially those that **benefit low-income households** (for example, supply of essential food grains at highly subsidized prices to BPL households)
- **Employment reservations and preferences** to protect certain segments of the population, **minimum wages** and **minimum support prices** for farmers for their output

- **Unemployment benefits and transfer payments** to provide support to the underprivileged, dependent, physically handicapped, the older citizens and the unemployed.
- Families below the poverty line are provided with **monetary aid and aid in kind**
- **Regulation of manufacture and sale** of certain products to ensure the health and well-being of consumers, and
- **Special schemes for backward regions** and for the vulnerable sections of the population.

### Conflict between Equity & Efficiency

Governments' redistribution policies which interfere with producer choices or consumer choices are likely to have **efficiency costs or deadweight losses**. For example, greater equity can be achieved through **high rates of taxes** on the rich; but **high rates of taxes** could also act as a **disincentive to entrepreneurship and work**, and **discourage people from making savings and investments and taking risks**. This in turn will have negative consequences for economic output, productivity and growth of the economy. Consequently, **the potential tax revenue may be reduced** in future and the scope for government's welfare activities would get seriously limited.

As such, an optimal budgetary policy towards any distributional change should **reconcile the conflicting goals of efficiency and equity by exercising an appropriate trade-off between them**. In other words, redistribution measures should be accomplished with **minimal efficiency costs** by **carefully balancing equity and efficiency objectives**.

# STABILIZATION FUNCTION

Macroeconomic stability is said to exist when:

- an economy's output matches its production capacity,
- the economy's total spending matches its total output - <sup>AD</sup> <sup>AS</sup> Equilibrium
- the economy's labour resources are fully employed, and
- Inflation is low and stable.

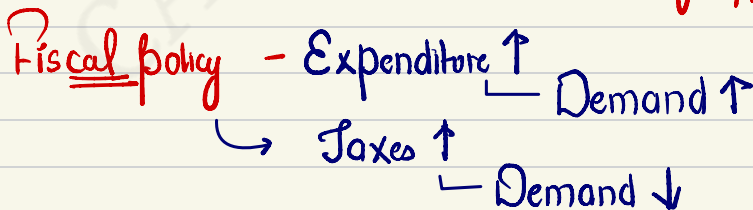
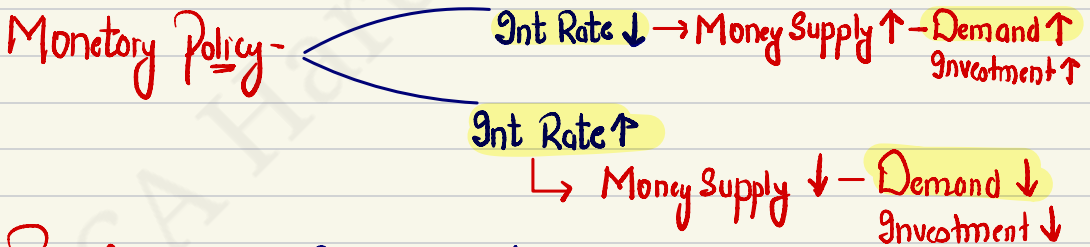
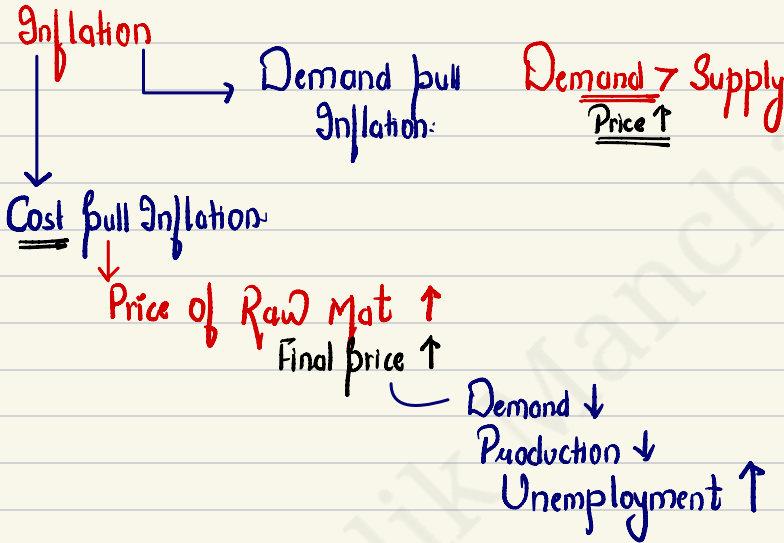
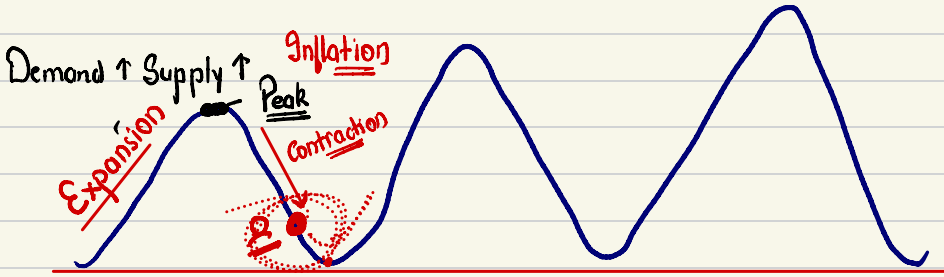
## Rationale for STABILIZATION Function:

The theoretical rationale for the stabilization function of the government is derived from the Keynesian proposition that a market economy does not automatically generate full employment and price stability and therefore, the governments should pursue deliberate stabilization policies.

■ The market mechanism is limited in its capacity to prevent or to resolve the disruptions caused by the fluctuations in economic activity. The government and the country's central bank promote full employment and price stability through prudent fiscal policy and monetary policy. - RBI  
<sub>Govt</sub>

■ In the absence of appropriate corrective intervention by government, the instabilities that occur in the economy in the form of recessions, inflation etc. may be prolonged for longer periods causing enormous hardships to people, especially the poorer sections of the society. It is also possible that a situation of stagflation (a state of affairs in which inflation and unemployment exist side by side) may set in and make the problem more complex.

■ The stabilization issue also becomes more complex due to 'contagion effect' whereby the increased international interdependence and financial integration causes forces of instability to get easily transmitted from one country to other countries.



The stabilization function is concerned with the performance of the aggregate economy in terms of:

- labour employment and capital utilization,
- overall output and income,
- general price levels,
- balance of international payments, and
- the rate of economic growth.

Government's stabilization intervention may be through monetary policy as well as fiscal policy.

**Monetary policy** : Controlling the size of money supply and interest rate in the economy which in turn would affect consumption, investment and prices.

**Fiscal Policy** : Attempts to direct the actions of individuals and organizations by means of its expenditure and taxation decisions

- Government expenditure injects more money into the economy and stimulates demand.
- On the other hand, taxes reduce the disposable income of people and therefore, reduce effective demand.

**Expansionary fiscal policy**: adopted to alleviate recession

- During recession, in order to ensure income protection, the government increases its expenditure or cuts down taxes or adopts a combination of both so that aggregate demand is kept stable or even boosted up with more money put into the hands of the people

$Demand > Supply$

**Contractionary fiscal policy** : resorted to for controlling high inflation.

- To control high inflation the government cuts down its expenditure or raises taxes.

# Fiscal Policy

Expansionary

Exp ↑

Taxes ↓

To Boost demand

Contractionary

Currently, Demand > Supply  
Inflation ↑

Taxes ↑

Expenditure ↓

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The nature of the budget (surplus or deficit) also has important implications on a country's economic activity.

- Deficit budgets ( Expenditure > Revenue) are expected to stimulate economic activity. Expansion-
- Surplus budgets tend to slow down economic activity. Rev. > Exp — Contractionary

There is often a conflict between the different goals and functions of budgetary policy. Effective policy design to meet the diverse goals of government is very difficult to conceive and to implement.

The challenge before any government is how to design its budgetary policy so that the pursuit of one goal does not jeopardize the other.



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**Fundamental matter in a Federation** - Allocation of revenue and expenditure responsibilities to different levels of governments.


Sources of revenue for both the centre and states are clearly demarcated with regard to the financial relationship and the responsibilities between them.

### Taxes levied by Centre & State:

The **central government** has greater revenue raising powers.

 The union government can levy taxes such as :

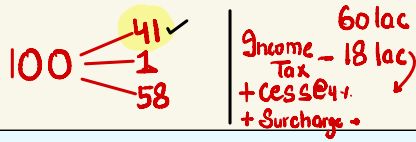
- a) tax on income, other than agricultural income,
- b) customs and export duties,
- c) excise duties on certain goods, → Terminal,
- d) corporation tax, Wealth Tax Tax
- e) tax on capital value of assets excluding agricultural land,
- f) security transaction tax,
- g) central GST,
- h) ~~union excise duty~~, taxes other than stamp duties etc.

 The state governments can levy taxes on:

- a) agricultural income,
- b) lands and buildings,
- c) mineral rights,
- d) electricity,
- e) vehicles,
- f) tolls,
- g) professions,
- h) collect land revenue and
- l) impose excise duties on certain items.

■ The property of the union is exempt from state taxation.

■ The property and income of the states are not liable to be taxed by the centre.



A significant element of fiscal federalism is **inter-governmental transfers** and **revenue-sharing** to fulfill diverse national objectives. There is substantial dependence of states on the union for securing necessary revenues.

**Articles 268 to 281** of the constitution contain specific provisions in respect of **distribution of finances among states**.

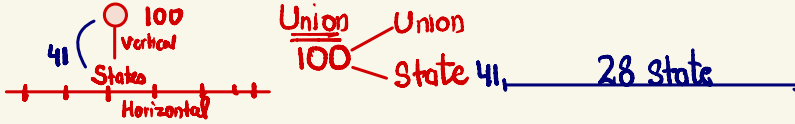
Distribution of revenue between the union and states is based on the constitutional provisions as follows:

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 2 and the States.
Article 271 →	Surcharge on certain duties and taxes for purposes of the union
Article 275 <sup>+4</sup> →	Statutory Grants – in-aid from the union to certain states.
Article 282 <sup>+7</sup>	Grants for any public purpose. <i>Discretionary</i>
Article 293 <sup>+11</sup>	Loans for any public purpose

**Article 280** provides for an **institutional mechanism**, namely the **Finance Commission**, to facilitate such transfers.

**Finance Commission** is a **constitutionally** mandated body that is at the **centre of fiscal federalism**. It is responsible for **evaluating the state of finances** of the union and state governments, **recommending the sharing of taxes** between them and **laying down the principles** determining the distribution of these taxes among states

CFI → Total amt by union  
 CFS → " " by state



## Functions of Finance Commission:

- The **distribution** between the **union** and the **states** of the **net proceeds of taxes** which are to be divided between them and **the allocation** between the **states** of the **respective shares** of such proceeds.
- Determination of principles and quantum of grants-in-aid to states which are in need of such assistance.
- To make recommendations to the President on measures needed to <sup>Increase</sup> augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.
- Any other matter referred to the Commission by the President in the interests of sound finance.

While recommending transfers, the Finance Commission considers issues related to:

**Vertical equity**- deciding about the share of all states in the revenue collected by centre and

**Horizontal equity**- allocation among states their share of central revenue.

The Finance Commission broadly assesses the overall gross tax revenues of the union; cesses, surcharges and non-tax revenue are netted out from gross tax revenue to arrive at the **net divisible pool (NDP)**.

**NET Divisible Pool : Gross Tax Revenue of Union - cess - surcharge - Non tax revenue**

Considering the needs of the central and the state governments, the <sup>Finance</sup> Commission determines what percentage out of the net divisible pool should be assigned to the state governments. The balance remains with the central government.

Gross Tax Revenue - cess - surcharge - Non Tax Revenue  
Total

- The **Fifteenth Finance Commission** was constituted on **27, November 2017**
- The commission recommended the share of states in the **central taxes (vertical devolution)** for the **2021-26 to be 41%**, which is the same as that for **2020-21**.
- This is less than the **42%** share recommended by the **14th Finance Commission** for 2015-20. The adjustment of 1% is to provide for the **newly formed union territories of Jammu and Kashmir, and Ladakh** from the resources of the centre.

The **criteria for distribution** of central taxes among states for **2021-26** period are same as that for **2020-21**. They are:

- (a) **Income Distance** i.e the distance of a state's income from the state with the highest income.
- (b) **Area**
- (c) **Population (2011)**
- (d) **Demographic performance** (to reward efforts made by states in controlling their population)
- (e) **Forest and ecology:**
- (f) **Tax and fiscal efforts:**

$$\frac{A}{60}$$

$$\frac{D}{57}$$

$$\frac{G}{10}$$

$$\frac{H}{12}$$

$$\frac{I}{18}$$

## GST

- The **introduction** of GST- on **1 July 2017**
- Significantly changed the **state** of affairs of financial relations between the centre and **states**.
- The GST **subsumes** the majority of indirect taxes – excise, services tax, sales tax, octroi (entry tax). The GST has made India's indirect tax regime **unitary in nature**.

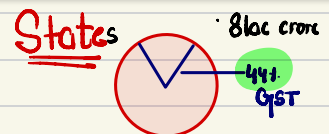
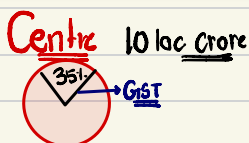
### Types of Taxes:

- 👉 **SGST** - levied and collected by state
  - 👉 **CGST** - levied and collected by centre
  - 👉 **IGST** - administered and collected by central government.
- } Intra-state  
- Inter-state

Applied on inter-state movement of goods and services and on imports and exports. IGST is simply a combination of SGST and CGST, kept in a separate account, and distributed between the union and states **after settlement of input tax credit and verification of the destination of the goods and services**.

■ With many taxes **subsumed under it**, **GST accounts for 35 per cent of the gross tax revenue of the union** and around **44 per cent of own tax revenue of the states**.

■ As per the **supreme court verdict in May 2022**, the **Union and state legislatures** have “*equal, simultaneous and unique powers*” to make laws on Goods and Services Tax (GST) and the **recommendations of the GST Council are not binding on them**



## Specific Reason

### Concept of GST Cess:

- The GST system replaced the then prevailing production-based taxation system with a consumption based one.
- Since the manufacturing states had apprehension about loss of revenue, it was decided to provide compensation to states for loss of revenue arising on account of implementation of the Goods and Services Tax for a period of five years from the date of its implementation.
- For providing compensation to states, a cess is levied on some luxury goods and demerit goods and the proceeds are credited to the compensation fund.
- GST compensation was extended beyond five years to enable states to tide over the pandemic induced economic slowdown.
- During the five-year transition period, the top five GST compensation-receiving states were Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Punjab. The total amount of compensation released to the states and union territories during the year 2022-23 is Rs. 1,15,662 crore

### In so far as expenditure decentralization is concerned:

- The Central Government is entrusted with the responsibilities of nationally important areas like defence, foreign affairs, foreign trade and exchange management, money and banking, cross-state transport and communication.
- The State governments are entrusted with the responsibility of facilitating agriculture and industry, providing social sector services such as health and education, police protection, state roads and infrastructure.
- The Local self governments such as municipalities and panchayats are entrusted with the responsibility of providing public utility services such as water supply and sanitation, local roads, electricity etc.

## Borrowings

Borrowing by the government of India and borrowing by states are defined under **Article 292 and 293** of Constitution of India.

- **Borrowing by Centre:** The centre may borrow within the limits fixed by parliament by law upon the **security of the Consolidated Fund of India** or give **guarantees within such limits**, if any.
- **Borrowing by State:** The state governments may borrow **within the territory of India** upon the **security of the Consolidated Fund of the State** within such limits, if any, as may from time to time be fixed by the Legislature of such state by law, or give guarantees within such limits.
- **The centre may give loans to the states within limits fixed under article 292 and **give guarantees** in respect of loans raised by the states.**
- **States need to obtain the centre's consent in order to borrow in case the state is indebted to the centre over a previous loan.**



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