

$$FTM = \frac{1}{1 - b + m} \quad \left[\begin{array}{l} b = 2 \\ m = 4 \end{array} \right]$$

$$= \frac{1}{1 - 2 + 4} = \frac{1}{3} = 0.3\bar{3}$$

Now $m = 6$

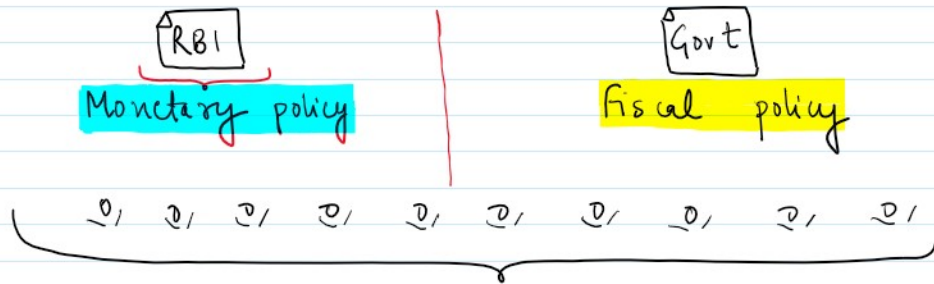
$$FTM = \frac{1}{1 - 2 + 6} = \frac{1}{5} = 0.2$$

x ————— x ————— x ————— x ————— x

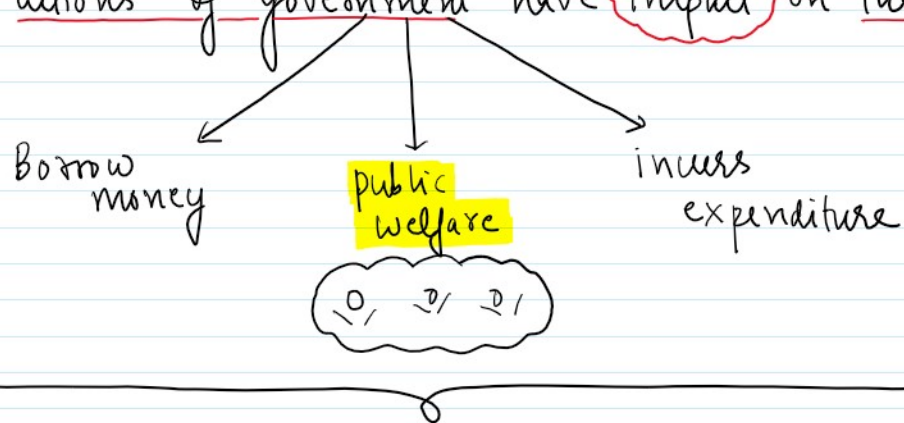
CH-7 : PUBLIC FINANCE (8 Marks)

(Unit 1 : Fiscal functions : Overview)

① Introduction



→ The actions of government have impact on the economy



Three Main Macro Economic goals for any nation

- Economic "Growth"
- High level of "employment"
- "Stable" Price levels.

* Government has to intervene in all above matters

* Government has to intervene in all above matters and take decisions.

② Role of Government in Economic System

Economic System

(It is a system which provides means to work + earn a living)

SCARCITY

(unlimited human wants with limited resources)

Problems

What to produce

How to produce

For whom to produce

Three types of economic system

Capitalist
(Refer CH 1)

Socialist
(Refer CH 1)

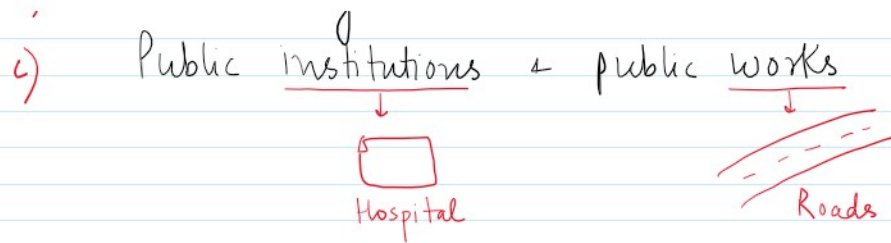
Mixed
(Refer CH 1)

* ADAM SMITH

Favoured FREE MARKET (i.e. Capitalist)

but role of Government should be in :-

- National Defense
- Justice system
- Public institutions + public works



* 1930 - "Great Depression"

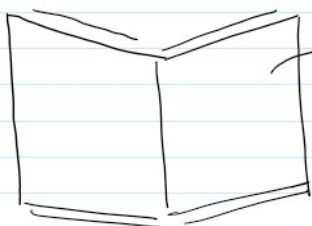
After this government's role in economy gained importance.

Government performs economic functions

Fiscal functions or Public Finance functions

* Richard Musgrave

1959



Theory of Public Finance

introduced three branch taxonomy of the role of government in market economy

Resource allocation

to ensure efficiency

Income redistribution

to guarantee "fairness"

Macro economic stabilization

to ensure price stability

③ " THE ALLOCATION FUNCTION "

- Optional allocation of resources for MAXIMUM SATISFACTION
- Minimum waste

- Minimum waste
- Minimum inefficiency

Private Sector (Market economy)	State (Socialist economy)
<ul style="list-style-type: none"> • Role of demand & Supply • Consumer Sovereignty • Public goods (↓) • Merit goods (↓) 	<ul style="list-style-type: none"> • Government decides • Public goods (↑) • Merit goods (↑)

- Efficient allocation takes place in **Perfectly competitive market**, but in reality markets are never perfectly competitive.
- Some reasons for inefficient allocation :-
 - a) Imperfect competition
 - b) Lack of public goods
 - c) Incomplete market - i.e. **lack of merit goods**
 - d) Over use of resources (environment)
 - e) Externalities (eg. Pollution)
 - f) Factor immobility
 - g) Inequalities of income

- According to Richard, government should intervene in market to bring about improvement in social welfare

(eg. production & consumption of demerit goods are controlled by government)

- The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its

- The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its expenditure & tax policies. It determines :-

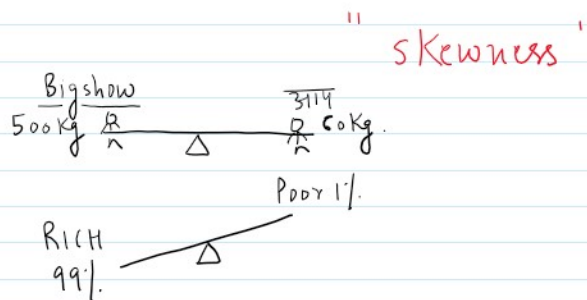
- who and what will be taxed
 - how much and on what government revenue will be revenue
 - optimum mix of various social goods
- etc
- Public goods + Merit Goods

- A variety of allocation instruments are available by which government can influence resource allocation in the economy. For eg :-

- government may directly produce an economic good like electricity
- government may influence allocation through "legislation" & force
↳ ban on single use plastic
- government's regulatory activities eg licensing

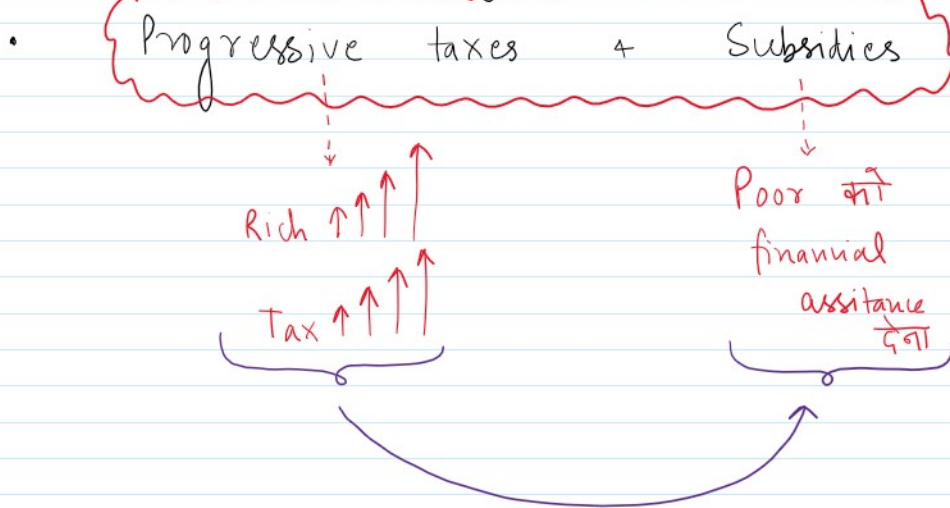
④ REDISTRIBUTION FUNCTION

- Generally distribution of income & wealth is **SKEWED**



- This function relates to the basic question of **FOR WHOM TO produce**
- This function also relates to the manner in which effective demand over the economic goods is divided among the various individuals

is divided among the various individuals

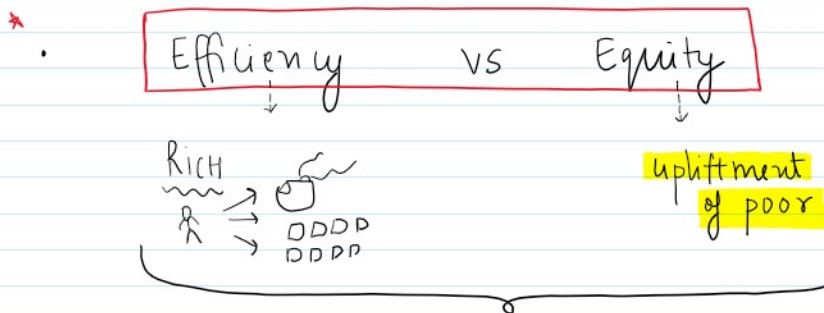


This function aims at :-

- redistribution of income
- Social welfare
- provide equality of income
- provide security (in terms of fulfilment of basic needs)

few examples :-

- Progressive taxes
- food grains at subsidised prices to BPL households
- Employment reservations
- Unemployment benefits etc



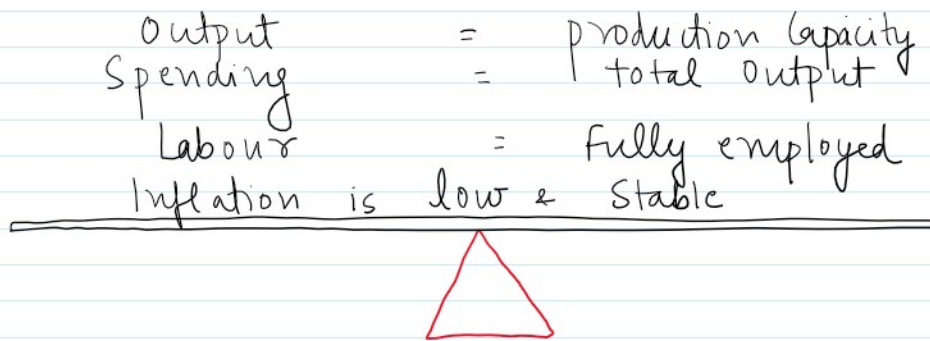
→ Greater equity can be achieved through high taxes on Rich; but this could act as disincentive to entrepreneurship & discourage people from making savings + investments.

disincentive to entrepreneurship & discourage people from making savings & investments.

→ Therefore redistribution measures should be accomplished with minimal efficiency costs.

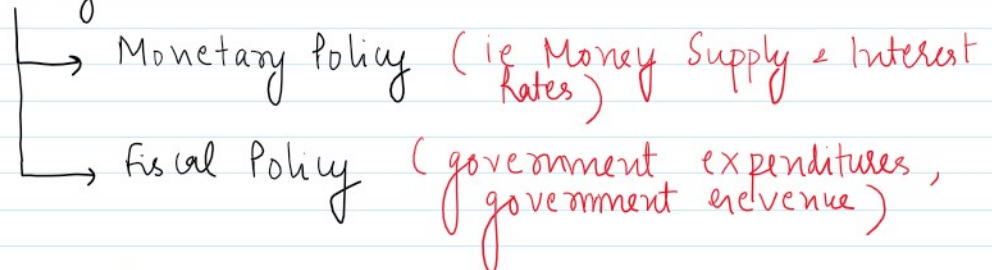
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STABILIZATION FUNCTION

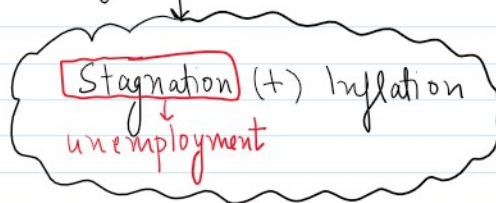


• Keynes believed that economy does not automatically generate full employment, therefore government has to interfere.

• for stability

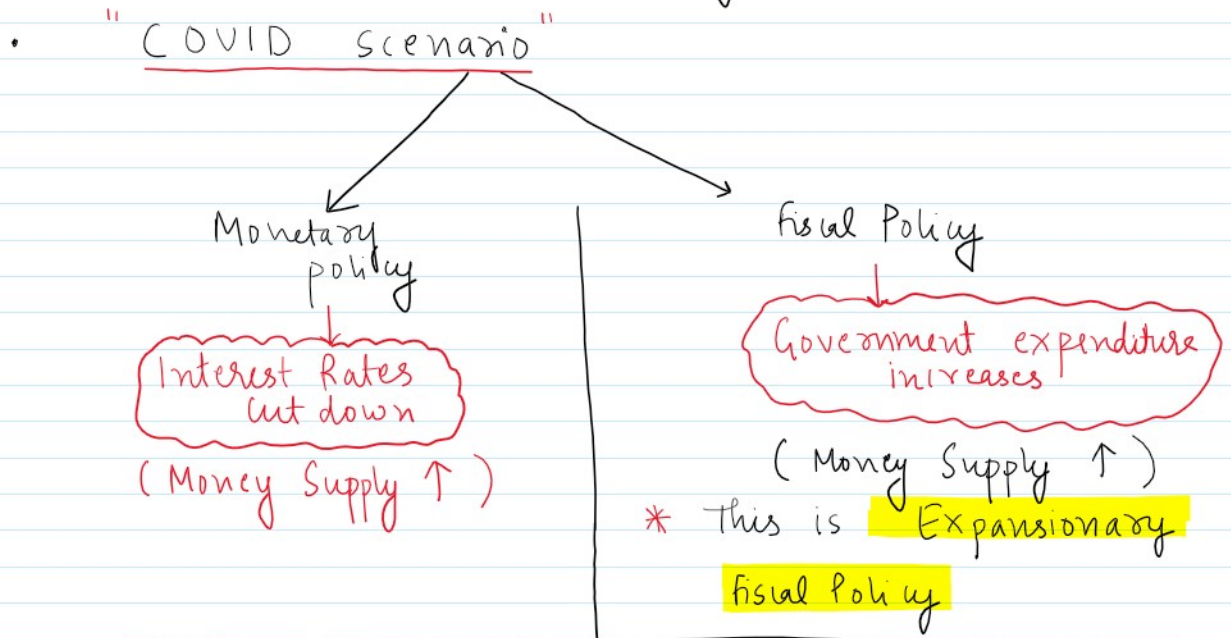


• **Stagflation** is also problem



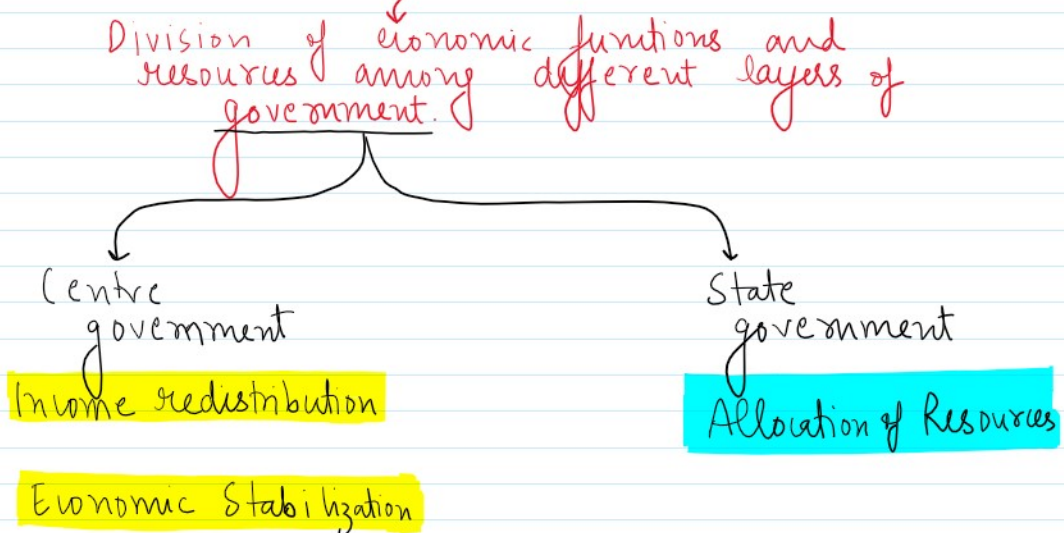
• Stabilization issue also become more complex due to **CONTAGION EFFECT** (ie increased international interdependence & financial integration causes forces of instability)

- Stabilization function is concerned with :-
labour employment, capital utilisation, overall output, general price level, balance of international payments and rate of economic growth.



* To control inflation, government adopts **Contractionary fiscal Policy**

- Richard introduced a term "**FISCAL FEDERALISM**"



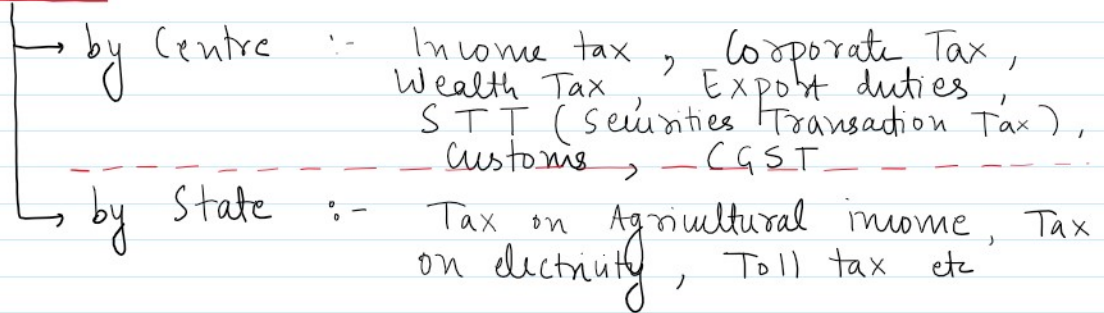
- * In India, Article 246 of Constitution demarcates the powers of the union & the state by classifying their powers into three lists :-
a) Union list

- a) Union list
- b) State list
- c) Concurrent list

* In case of conflicting legislation in concurrent list, the law passed by centre prevails.

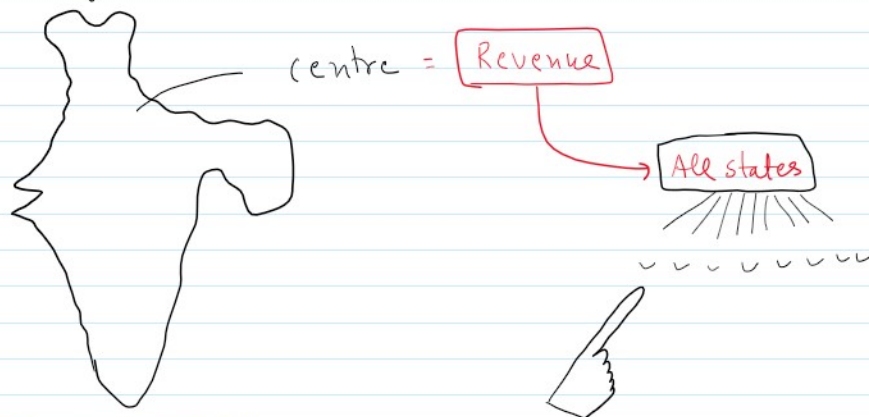
*

TAXES



*

Article 268 to 281 of Constitution contain specific provision in respect of distribution of finances among state



*

Finance Commission facilitate such transfers

- It makes recommendations to **President** as well
- 15th finance commission was constituted on **27 Nov 2017**
- Finance Commission also consider issues related to :-

- a) Vertical equity - share of **all states** in revenue collected by centre
- b) Horizontal equity - allocation among

b) Horizontal equity - ^{by centre} allocation among states

* Gross Tax Revenue (of Union)	xxx
(-) <u>Cesses</u>	(xxx)
(-) <u>Surcharges</u> ^{Tax F.}	(xxx)
(-) <u>Non Tax Revenues</u>	(xxx)
Net Divisible Pool (<u>NDP</u>)	<u>xxx</u>

Some share to States ~~~~~

Remaining with Centre ~~~~~



GST compensation is given to State to compensate for loss of revenue due to introduction of GST

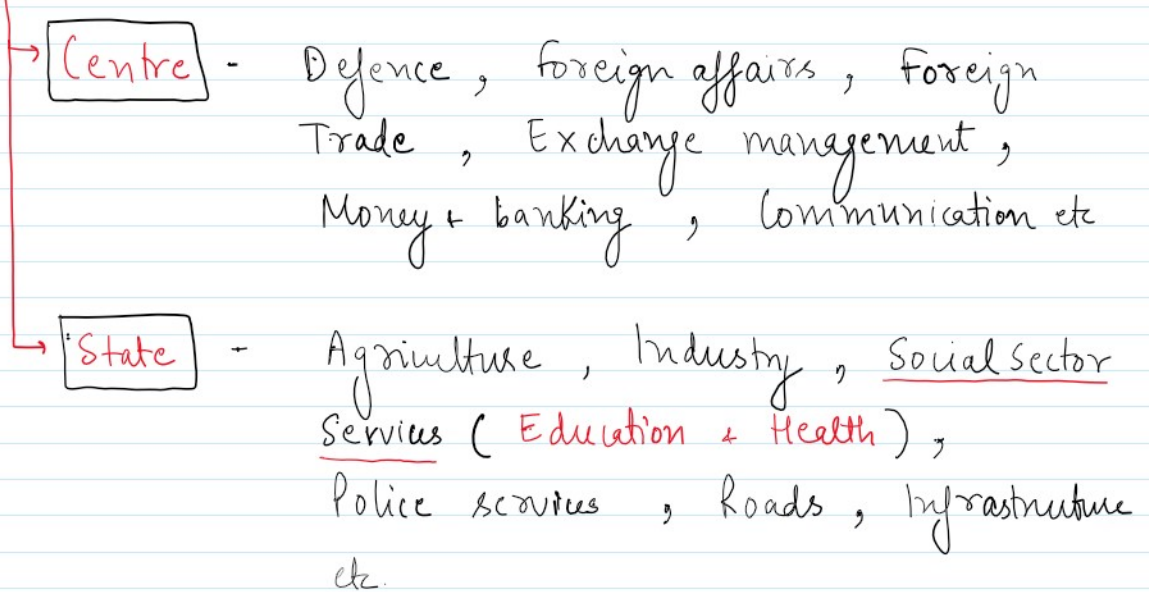
* In May 2022, Supreme Court said that Union & State government have "EQUAL Simultaneous & unique powers" to make laws on GST

* For 2021-26, % share of states in central taxes is 41%. Criteria for determining this distribution includes :-

- 1) Income distance
- 2) Population

- 1) Income distance
- 2) Population
- 3) Area
- 4) Demographic performance
- 5) Forest & ecology
- 6) Tax & fiscal efforts.

* Responsibilities



CH 7 Unit 2

MARKET FAILURE

(inefficient allocation of resources)

Complete Market failure

↓

This is a case of " missing markets " and occurs when the market does not supply products at all despite the fact that such product or service are wanted by the people eg pure public goods.

Partial Market failure

↓

Failure occurs when the market does actually function, but it produces either the wrong quantity or at the wrong price. This results in loss of economic welfare