18KP3EC09 – Fiscal Economics

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FISCAL ECONOMICS

COURSE CODE: 18KP3EC09

Credit : 5
Hours / Week : 6
Medium of Instruction : English

UNIT – I Theory of Public Goods and Public Choice:

The Economic Role of Government allocation of Resources- Private goods, public and merit goods – Market failure –Causes and Measures.

UNIT – II Public Expenditure:

Wagner's law of increasing state activities. Musgrave's views on public Expenditure - principles of public expenditure.

UNIT – III Taxation and Public Debt:

Characteristics of a Good Tax system. Principles of Taxation. Factors determining Taxable capacity- Definition and classification of public Debt. Causes for the Growth of public Debt.

UNIT – IV Fiscal Policy

Definition of Fiscal Policy - Objectives of Fiscal policy-Techniques of fiscal policy – Deficit financing, Fiscal policy in India.

UNIT – V Fiscal Federalism

Meaning of Federal finance – principles of federal finance. Evolution of federal finance in India. Balancing factors in federal finance .

REFERENCE BOOKS

1. S. Sankaran - Fiscal Economics
2. B.P. Tyage - Public Finance
3. A. Koutsoyiannis - Modern Economics

Fiscal Economics

Unit 1 – Theory of Public goods and Public Choice

Private Good

- Private good have been defined as good yielding utility or satisfaction only to the person consuming the good and it is denied to others.

- E.g. consumption of a cup of milk

Public Good

- Public good is defined as the good one person consumption will not reduce the amount available to the others in other words consumption of public good is non-rival
- E.g.. Benefit of a Dam controlling flood

Allocation of Resources

- Allocation of resources and distribution of income
- Allocation of resources in market and decreasing cost
- Allocation of resources in perfect and imperfect market condition
- Allocation of resources n market and Public wants
- Profit system Emphasises short term profit at the expense of long term profit
- Profit system fails to achieve the social goal of economic stability
- Market failure due to external externalities
- Market failure since marginal cost of a pure public good is zero
- Market failure due to non-rival consumption
- Market Failure due to non-excludability

Allocation of Resources

- Allocation Of Resources And Distribution Of Income

Efficient allocation of resources is how resources are distributed of among individuals. If income of the rich is transferred to poor the demand for X is increased and the demand for Y falls. Unequal distribution of income will lead to distasteful pattern of demand and output

- Allocation Of Resources In Market And Decreasing Cost

Decreasing cost occurs when there are high overhead or fixed costs. E.g. transportation, Hospitals

Allocation of Resources

- Allocation Of Resources In Perfect And Imperfect Market Condition

Market economy may fail to achieve allocation of resources due to imperfect conditions of market, for instance imperfect knowledge of market.

- Allocation Of Resources In Market And Public Wants

Allocation of resources may not be efficient in case of certain public wants. E.g. National Defence

Allocation of Resources

- Profit System Emphasises Short Term Profit At The Expense Of Long Term Profit

Private enterprise can effectively develop hydroelectric power resources or even provide water irrigation purpose

- Profit System Fails To Achieve The Social Goal Of Economic Stability

The reaction of individual to prospective decline in demand is normally to reduce investment in plant and inventory which leads to instability in the economy. Government should modify by Grand and subsidy

Allocation of Resources

- Market Failure Due To External Externalities

Externalities refer to economic effect which occurs from the production or use of the goods by other parties or economic units. External benefits that occur to the members of the community and the nation in which members reside. E.g. education, road

- Market Failure Since Marginal Cost Of A Pure Public Good Is Zero

Pure Public good which possess the characteristic i.e. marginal cost is zero.

Allocation of Resources

- Market Failure Due To Non-rival Consumption

Public good is a Non Rival good. The consumption of public good will lead to the utility and satisfaction to all.

- Market Failure Due To Non-excludability

Market failure may arise where commodity is rival but exclusion is not feasible. Social goods should be provided and furnished it which the fiscal resources needs to pay for them

Public Wants

- Public wants can be classified into two categories
  - Social Wants
  - Merit wants
- Social Wants:

Social wants are those wants which are satisfied by services that must be consumed in equal amounts by all. He is excluded from the enjoyment of any particular commodity or services unless he is willing to pay the stipulated price to the owner.

Public Wants

- Merit wants:

Some goods or wants are considered meritorious while others are held undesirable. E.g. Low cost housing with the subsidies given by the state is very desirable and meritorious

- Merit Goods:

Good whose consumption is to be encouraged should be called merit good. E.g. starting a primary school

- Demerit good

Good whose consumption is to not encouraged is non-merit good or demerit good

- E.g.: liquor

Market Failure

- Market Failure

This is available market mechanism in the economy could not work efficiently to allocate the resources of the economy and produce the commodities required in optimal quantities

Causes and Effect of market failure

- <u>Distribution of Income:</u>

Efficient allocation of resources is possible only where there are minimal inequalities of income and wealth E.g. Production of luxury goods demanded by rick will not be produced for poor because private sector is not willing to produce goods for poor. It will produce the profit good only. The government allocates adequate resources in the budget to produce essential goods under public sector

Causes and Effect of market failure

- Allocation of resources under decreasing cost:

Production at law of decreasing costs in the case of transportation power generation and postal services

- Allocation of resources and imperfect market conditions

Individual consumption decisions are inferior because of inadequate knowledge and the market principal result in allocation of resources to other than the best uses

Causes and Effect of market failure

- Market failure in the case of public wants

All the people in the economy may not be capable of paying the price for the commodity or services which are classified as public wants. It becomes inevitable on the part of the government to provide the necessary public want to all the people whether they are capable of paying the price for the same or not. E.g. National Defence, Protection against health Hazard

Causes and Effect of market failure

- Profit system and failure of economic stability

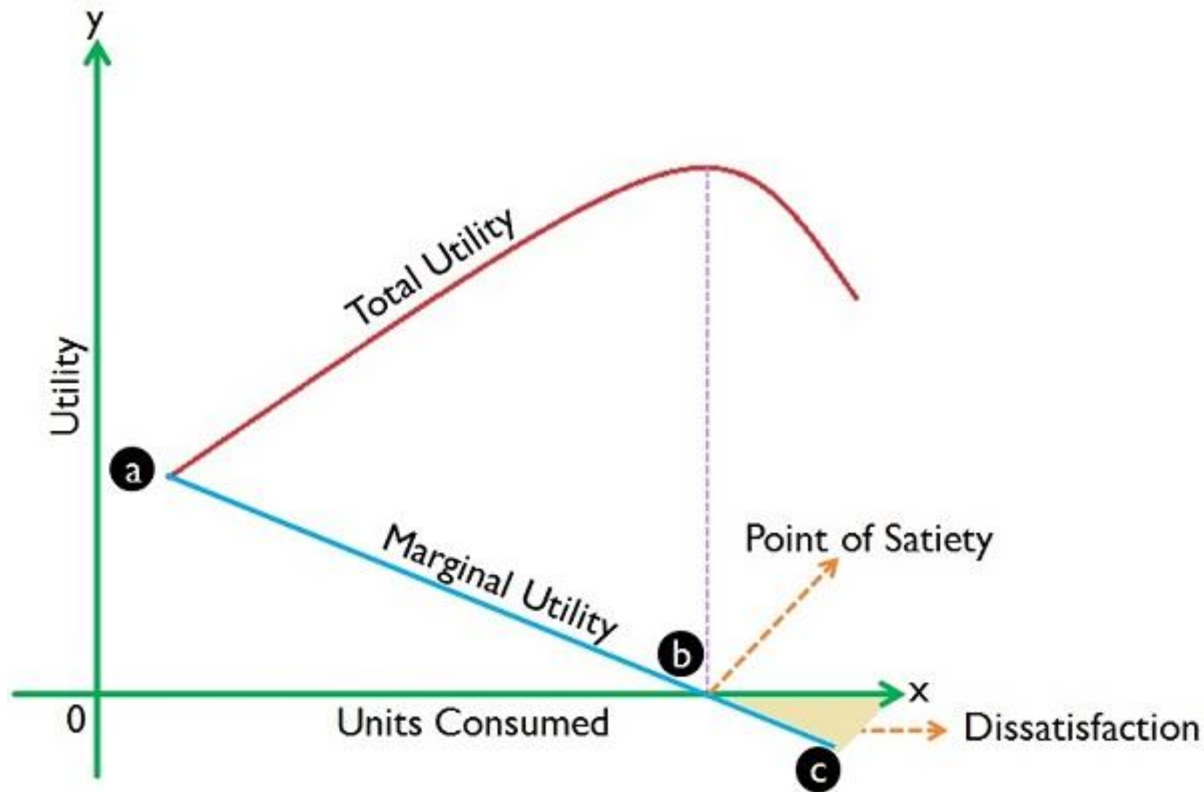
Market system works on the basis of profit and the resources will be exploited to those channels where the profit will be high and also immediate. The short term profit would be looked after in production rather than long term profit. At that time grants and subsidies will be given by the government

- Market failure due to externalities

Government expenditure on social wants like education and road will lead to market failure. It will be rectified by the equalities of income.

Causes and Effect of market failure

- Marginal cost of pure goods are zero



Causes and Effect of market failure

- Market failure due to non-rival consumption

Public goods produced for the social wants will be called a non-rival consumption goods.

Fiscal Economics

Unit 2 - Public Expenditure

Wagner Law Of Increasing State Activity

- Wagner law of increasing state activity

Public expenditure is the expenditure incurred by public authorities –central state and local governments either for the satisfaction of collective needs of the citizen or for promoting their economic and social welfare

- Wagner's Law

Economic growth of public expenditure in modern days compared to the olden days because of the increased activities and responsibilities of the state.

Wagner Law Of Increasing State Activity

- “policy state “ is replaced by “ welfare state “ Growth of Economy is necessarily associated with the growth of the Govt. activities
- There is a positive correlation between the growth of the economy and the growth of the Govt. activities . It is stated by Wagner that in this process the Govt. sector grows faster than the economy
- Wagner emphasised the long term forces of economic development rather than short term changes in the public expenditure.

Wagner Law Of Increasing State Activity

- The tendency of increasing public expenditure, which means growing role of the state.
  1. Increasing population and also increasing complexities of modern life i.e. extra need of the population with more school Hospitals water supply transport etc.
  2. Prices have a secular tendency to go up
  3. It is not merely increase the quantity of public service that matters the quantity of service should be increased

Wagner Law Of Increasing State Activity

4. Modern govt. have the duty to protect the economy from the evils of market mechanism i.e. price regulatory measures have to be adopted
5. Modern Govt. have a tendency to run into depts. An this leads to a subsequent increase in public expenditure in the form of debt servicing and repayment of loan
6. Periodical General Election, maintain thousands of legislators, a Cabinet Ministers besides a host of civil servants etc. is very expensive and these expenditures have to be met from the public treasury.

Wagner Law Of Increasing State Activity

7. Both central and State Government Are providing firm subsidies on a large scale so as to become popular to win election. Schemes like supply of subsidised rice, free water to farmers, free electricity for tube wells in rural areas, free channel water for irrigation , free electricity to farmers to etc.

Wagner Law Of Increasing State Activity

- Increase in public expenditure can be justified on the following grounds
  1. Assist in increasing state activity
  2. Increase in welfare activities to make the poor stronger in due course with a time bound programme.
  3. Reducing disparities between rich and poor
  4. Helping the growth of economy with stability

Wagner Law Of Increasing State Activity

- Limitations

The quality of democracy or quality of administration, as well as political culture, integrity of the people go long way in establishing relationship between public expenditure and economic development.

Mugrewe's Views On Public Expenditure

- The traditional objectives of public expenditure in developed economies are as follows
  1. Increasing income of the people and also employment opportunities
  2. Better distribution of income of economy
  3. Judicious allocation of resources in the economy into socially desirable channel etc.
  4. Maximising economic welfare through allocation of resources.
  5. Achieving full employment and economic stability.
  6. Ensuring equitable distribution of income.
  7. Accelerating economy group.

Mugrewe's Views On Public Expenditure

- Functions of public expenditure
  1. Activity to secure reallocation of resources
  2. Redistributive activities
  3. Stabilising activities
  4. Commercial activity

Public Expenditure In Developed Countries

Reasons for the increasing trends of public expenditure in developed countries

1. Activities to secure reallocation of resources
   a) Government has to check Monopolies and also monopolistic tendencies preventing collusion and also price discrimination
   b) Government has to encourage on expansion of output by various means such as subsidy to the producer with a view to making it available in large quantity to the masses. Public utility like railways electricity etc. has to provide at a low cost.

Public Expenditure In Developed Countries

c) Production of cigars and liquors is not only harmful to society but also increases cost of administration. Government should restrict it by imposing high taxes on the production and sale of those goods.

d) Government should take steps to increase supply of services and activities like education or medical aid.

e) Defence must be provided by the government and they cannot be provided by private producers, as the benefit arising out of these is social.

Public Expenditure In Developed Countries

2. Redistributive activities
   a) Inequalities in income should be reduced by means of taxation and transfer of resources from rich to poor. These ensure minimum standard of living of the poor people and there by attempts to reduce the gap between the haves and have-nots.
3. Stabilising activities
   a) Government should take adequate measures to avoid business fluctuations and also to maintain economic stability and there by ensure high level of employment and price stability. During depression government expenditure must be increased with constant taxation.

Public Expenditure In Developed Countries

4. Commercial activities
   a) Commercial services like transport can be efficiently provided by means of government monopoly than by private enterprise. Government may also invest project which are highly beneficial from the social point of view and also poor returns in the project

- Conclusion
  - Public expenditure occupies a very important position in the economic development of the country as it plays a vital role in production, distribution and also in maintaining economic stability.

Principles Of Public Expenditure

- First principle indicates the extent to which the total expenditure should be pushed
- Second refers to the distribution of resources on different heads to maximise the net social benefit.
- Public expenditure in every direction should be carried out so far that the advantage to the commodity of a further small increase in any direction. It is balanced by disadvantage of corresponding small increase in taxation or in receipts from any other source of public income

Principles Of Public Expenditure

- This gives the ideal to both of public expenditure and public income.
- Public expenditure should be pushed in all directions up to the point at which the satisfaction obtained from the last shilling expanded is equal to the satisfaction lost in respect of last shilling called upon Govt. service.
- Expenditure should be in the marginal social benefit obtained from the last rupee spent is equal to the marginal sacrifice imposed by the last rupee realised by way of taxation.

Principles Of Public Expenditure

- Difficulties In Following Public Expenditure
  - Public expenditure should promote the welfare of the society
  - Careful judgement should be exercised by public officials.
  - The services which will be the best to promote the social welfare should be undertaken first and those which will promote the least social welfare should be undertaken at last.

Principles Of Public Expenditure

- CONCLUSION
  - Principles of public expenditure are only ideals and are theoretically true but practically it is very difficult to follow them.

Fiscal Economics

Unit 3 - TAXATION AND PUBLIC DEBT

Characteristics of a good tax system

- The 10 Characteristics of a good tax system
  1. Canon Of Equality
  2. Canon Certainty
  3. Canon Of Convenience
  4. Canon Of Economy
  5. Canon Of Productivity
  6. Canon Of Elasticity
  7. Canon Of Diversity
  8. Canon Of Simplicity
  9. Canon Of Expediency
  10. Cannon Of Co-ordination

Characteristics of a good tax system

1. Canon Of Equality

It implies that the income which a person enjoys under the protection of the state should be taxed on the proportional rate of taxation

2. Canon Certainty

The time of payment, the manner of payment, the quality to be paid, ought to be clear and plain and simple to the contributor and to every other person. There are genuine difficulties in the assessment of a tax, and the canon of certainty aims at removing all these difficulties so that the Revenues to the govt. may become certain.

Characteristics of a good tax system

3. Canon Of Convenience

Every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it. It implies that taxes should be imposed in such a manner and at the time which is most convenient for the tax payer e.g. Tax at the harvest time [direct and indirect tax]

4. Canon Of Economy

Canon aims as keeping the administrative cost of tax collection minimum, i.e. the difference between the money which comes out of the pockets of the people at that which deposited in the public treasury should be as small as possible.

Characteristics of a good tax system

5. Canon Of Productivity

A tax should yield a satisfactory amount for the maintenance of a govt. To put it in the words the very object for which the revenue system exists is to provide for the maintenance of the state. The tax should not obstruct and discourage production in the short as well as in the long run.

6. Canon Of Elasticity

The yields of the taxes may be increased or decreased according to the needs of the govt. The Govt. may need more funds to face drought and flood or to finance war or for development purposes and other unforeseen reasons also. Taxes on property and commodities are not as elastic as income tax.

Characteristics of a good tax system

7. Canon Of Diversity
   i. Single tax System and
   ii. Multiple tax system
   - Single tax System
     - Revenue is not sufficient,
     - Burden may not be satisfactory
     - Expensive to collect and
     - Evading may be large.
   - Multiple tax system

   Burden of taxation should be widely distributed on the entire economy without causing much harm to anyone.

Characteristics of a good tax system

8. Canon Of Simplicity

Tax should be easily understood by the tax payer i.e. its nature, its aim, time of payment, method and basis of estimation should all be easily followed by each tax payer.

9. Canon Of Expediency

It implies that the possibility of imposing a tax should be taken into account from different angles i.e. its reaction upon the tax payers sometimes seen that a tax may be desirable and may have most of the characteristic of good tax, but the Govt. may not find it expedient to impose it. E.g. Progressive agricultural income tax.

Characteristics of a good tax system

10. Cannon Of Co-ordination

In democratic country taxes are imposed by central, state and local Govt. It is therefore very much desirable that there must be co-ordination between different taxes that are imposed by different taxing authorities. It is very much needed considering the interest of tax payers and the Govt. both especially in democratic countries.

Principles of taxation

- If the payment of tax is considered as a burden, it might seem that a simplest way of distribution would be, to make each member of the community to make an equal contribution.
- Several theories have been advanced from time to time for achieving the principle of justice in taxation.
  a) Physiocratic theory
  b) Financial theory
  c) Principle of equity
  d) Cost of service theory
  e) Benefit principle
  f) Ability to pay theory

Principles of taxation

1. Physiocratic theory
    - Physiocratics maintained the agriculture alone could yield a net return and could add to the wealth of the country and hence recommended that revenue of the state should be derived from a single direct tax levied upon land.
    - Objections of this theory
        - Industrial magnates in every country have got a better paying capacity than the well-to-do agriculturists.
        - Only tax on land revenue will not bring enough income to meet the large expenditure of a modern govt.
        - Canon of ability is not operated.
        - Land owners cannot foresight effort of land revenue.

Principles of taxation

2. Financial theory

    It aims at obtaining the maximum amount of revenue rather than on proper distribution of burden of taxation. The greatest danger in following this theory is that the burden of taxation may fall mainly on weak and voiceless people rather than on rich and vocal. Hence this theory is rejected by the economist.

Principles of taxation

3. Principle of equity

Equity generally means fairness or justice in the distribution of burden of taxation. Equity involves two aspects

a) Horizontal equity

People in like circumstances implies that those who are equally well off from the economic point of view should pay equal amounts as taxes.

b) Vertical equity

People in unlike circumstances implies that the people in dissimilar circumstances should be subjected to dissimilar treatment i.e. the persons who are “better off” should pay more as taxes than others

Principles of taxation

- Direct Burden Of Taxation:

It refers to the amount of sacrifice involve in parting with the purchasing power of the people by way of taxes. It can be expressed in two ways

a) Objective

The volume of goods and services raised from the community by way of taxes is an objective approach to measures sacrifice.

b) Subjective

The amount of sacrifice imposed upon the community in parting with the purchasing power in payment of taxes is a subjective approach to measure sacrifice.

- Indirect Burden Of Taxation:

Indirect burden of taxation refers to its effects on the price level, income, output and employment.

Principles of taxation

4. Cost of service theory

The basis of taxation should be the cost incurred by the govt. on different services for the benefit of the individual tax payers. Each tax-payer has to pay the tax equal to the cost of service to him. Higher the tax, the higher should be tax-vice versa.

This principle cannot be accepted because

- It is very difficult to estimate the cost of service to every individual e.g. defence expenditure cannot be calculated by the individual
- If cost is taken as basis of taxation, the government may not perform various functions which may be very much desirable for the welfare of the country as a whole e.g. Relief in times of drought, flood and earthquake, free education and free medical facility etc.

Principles of taxation

5. Benefit principle

The burden of taxation should be divided among the people in proportion to the benefits received from the state. The persons receiving equal benefits from the state should pay equal amount as taxes and those who received greater benefit should pay more as taxes than those getting less benefit.

Principles of taxation

6. Ability To Pay Theory
   - This theory is based on the principle that the govt. expenditure incurred for the general good of the society should be met by the society rather than by any class of individual.
   - The problem arises as the term "ability to pay" it is solved by three concepts
     a) Equal sacrifice
     b) Proportional sacrifice
     c) Least aggregate sacrifice

Principles of taxation

- Equal sacrifice
  - Burden of taxation should be distributed that the direct real burden on all tax payer is equal
- Proportional sacrifice
  - An individual with higher income will pay more as tax than those who have lower income
  - $\frac{Sacrifice\ made\ by\ A}{Income\ of\ A} = \frac{Sacrifice\ made\ by\ B}{Income\ of\ B} = \frac{Sacrifice\ made\ by\ C}{Income\ of\ C}$
- Least aggregate sacrifice
  - The total direct real burden on the tax payers as a whole is as small as possible

Taxable Capacity

- Taxable capacity refers to the maximum capacity of a community to bear taxes without much hardship and loss of economic welfare.
- Factors Determining Taxable capacity:
  a) National Income
  b) Population
  c) Attitude f the people
  d) Standard of living of the people
  e) Administrative efficiency
  f) Character of public expenditure
  g) Patter of taxation

Taxable Capacity

1. National Income:

Taxable capacity depends on the volume of national income. The larger the size of the national income the greater is the taxable capacity. The citizen of the rich countries can contribute a larger amount as taxes towards the public expenditure of the government as their taxable capacity is large. The taxable capacity is affected not only by the Quantum of national income, but also by the distribution of income and wealth in the community

Taxable Capacity

2. Population

   Taxable capacity depends on the size of the population of the country and also on the growth of population. If the population is large everybody will have smaller share in the national income so the taxable capacity will be low. If the growth rate of the population is higher than the national income, the country will become poorer and poorer and the taxable capacity will be reduced.

3. Attitude Of The People

   Taxable capacity depends on the psychological attitude of the people. If the people of the country are highly patriotic and sentimental, they could bear heavy burden of tax quiet willingly. If people confidence in the government is high by utilizing tax for public expenditure people will pay taxes thus it depend on the psychology.

Taxable Capacity

4. Standard of living of people
   - Higher the consumption Expenditure, higher would be the standard of living. But, high consumption is possible only in the high income group. Hence, rich people with high standard of living will have a higher capacity to pay taxes.
5. Administrative Efficiency
   - If the tax collecting machinery is efficient, the tax evasion may be reduced. Taxable capacity will get reduced due to corrupt and ineffective machinery.

Taxable Capacity

6. Character of Public expenditure
   - Taxable capacity will increase if the govt. spends money on the social and economic overheads or on the economic development of the people i.e. on the development of agriculture, industry, trade and transport. But if the public expenditure incurred on war and perpetration of war, the taxable capacity will get reduced as it is a unproductive expenditure.
   - If the money is spent on paying interest on the internal debt or in repaying the internal debt, the taxable capacity will be greater because the taxed amount is returned to the citizens in the form of interest.

Taxable Capacity

7. Pattern of Taxation
   - If the number of productive revenue resources is high, the taxable capacity is higher. While some taxes are highly productive, other are not. Therefore a carefully framed tax system will increase the taxable capacity.

- Conclusion:
  - The taxable capacity depends on the political condition of the country, the monetary and fiscal policies of the govt. and policies related to foreign trade and capital movement.

Public Debt

- Public Debt
  - Public Debt refers to all type of borrowings by the government form the central bank, commercial bank, business organizations and individuals.
- Classification of Public Debt:
  a) Redeemable And Irredeemable Debt
  b) Funded And Unfunded Debt
  c) Voluntary And Compulsory Debt
  d) Internal And External Debt
  e) Productive And Unproductive Debt

Public Debt

1. Redeemable And Irredeemable Debt

- Redeemable Debt:

  Redeemable loans are those loans for which the govt. promises to pay off at some future date. It has to pay the interest and capital on some future date.

- Irredeemable Debt:

  Irredeemable loans are those loans for which no promises are made by the govt. to pay at some future. The govt. has to pay only interest regularly.

Public Debt

2. Funded And Unfunded Debt

- Funded Debt:

  Funded Debt may be redeemed after a year or they may not be redeemed at all. The govt. Obligation is paying a fixed sum of interest to the creditor. It is left to the option of the govt. to repay the principal. Hence the bond holder shave no right to the principal but they have right to get the payment of interest regularly

- Unfunded Debt:

  Unfunded debt may be those that are paid off within a year. Treasury Bonds are unfunded debt because they are for 3-6 months and are never for a longer period than a year.

Public Debt

3. Voluntary And Compulsory Debt
   - Voluntary Debt:

     Govt. debt is voluntary nature and it is up to the citizens or the institutions to purchase govt. bonds
   - Compulsory Debt:

     Compulsory debt is made during war period or period of emergency. The govt. may exercise some compulsion to subscribe the govt. bonds.

Public Debt

4. Internal and External Debt

- Internal Debt:

  Internal Debt refers to loads floated within the country. The net income will not get reduced. This does not affect the productivity of the nation.

- External Debt:

  External Debt refers to the debt Obligations due to foreign govt. and their nationals. Foreign loans can be incurred for Development Purposes. During war period many countries would be forced to take foreign loans.

Public Debt

- Productive And Unproductive Debt
  - Productive Debt:

    Debt incurred for development purposes may be considered as productive. Loans may be floated for construction of railways, dams or power projects etc. these loans are utilized for projects and they in turn create income to the govt. and the people. Income derived from these projects is not enough to pay off yearly interest on the loans. It should not be considered as burden to the govt. or tax payers.
  - Unproductive Debt:

    It is those which do not yield any return for the govt. E.g. War, flood relief, drought relief, cyclone relief and refugee relief. This expenditure no not creates any assets hence these types of debts are called dead weight debt.

Public Debt

- Causes of the growth of public debt:
  a) War and preparation of war
  b) Social obligations
  c) Economic development and deficit budget
  d) Employment and economic stability

1. War and preparation of war

Expenditure on war and nuclear defence program take away the major share of the govt. revenue and at times the govt. find it difficult to meet the defence budget and they have to incur debts.

Public Debt

2. Social Obligations

   Modern welfare states have to undertake many social obligations like public health, Sanitization, education, transport and communications.

3. Economic development and deficit budget

   Govt. has to undertake many projects for economic development of the country like construction of railways, power projects, irrigational projects, heavy industry. It could be done only by means of mobilizing enormous resources in the form of public debt. Due to heavy public expenditure, the govt. always face deficit budget. Such deficit has to be financed only through borrowings.

Public Debt

4. Employment And Economic Stability

To solve the unemployment problem and to fight rescission the govt. has to make massive expenditure. During inflation govt. has to reduce the purchasing power through taxes and floating public don’ts. To maintain economic stability the state have to resort to public debt.

Fiscal Economics

Unit 4 - Fiscal Policy

Fiscal Policy

- Fiscal policy means the use of taxation, public borrowing and public expenditure by the govt. for the purpose of stabilization or development.
- Objectives of Fiscal Policy:
    - To increase the rate of investment
    - To encourage social optimal investment
    - To increase employment opportunities
    - To counter act inflation
    - To increase and redistribute national income

Fiscal Policy

- To increase the rate of investment:

It can be achieved by checking actual and potential consumption and by raising the saving ratio, mobilizing the resource by increasing rate of taxation, imposing new taxes, mobilizing the surplus from public sector undertakings and public borrowings of non-inflationary nature and deficit financing

- To encourage social optimal investment

The pattern should lead to optimum investment into those channels which are socially desirable like education, health etc.

- To increase employment opportunities

The state expenditure should be directed towards proving social and economic overheads. The state should undertake local public works of community development involving more labour and less capital per head.

Fiscal Policy

- To counter act inflation

The purchasing power of the community will be large while the supply remains inelastic due to structural rigidities and market imperfections. Consequently the price will rise which will lead to inflationary spiral. The inflationary condition should be smoothened by removing the excess money income through direct and indirect taxation as well as borrowings.

- To increase and redistribute national income

The fiscal policy should aim at increasing national income and redistribute it in such a manner that the extreme inequalities of income and wealth are reduced in the economy.

Fiscal Policy

- Techniques of Fiscal policy:

Fiscal policy can be implemented by anyone or a combination of the following measures.

  - Controlling the economy through public expenditure
  - Influencing the economy through tax measures
  - Influence the economy through public debt measures

Public Expenditure

- Public Expenditure:

Increase in public expenditure will add to purchasing power of the community and decrease in public expenditure reduces the purchasing power of the community. The public expenditure will have multiplier effect. This means that a certain amount spent or invested will get magnified in due course.

The following three types of public expenditure are

- Expenditure on public works
- Expenditure on Social Relief
- Certain type of Govt. Expenditure which get automatically adjusted according to the condition of the economy

Public Expenditure

- Expenditure on public works

It is considered to be very important as well as significant and if these works are properly timed, that can counter act the adverse effect of business cycle. This Programming is called counter cycle policy under this the public work authorities are expected to put though their program of expenditure to offset the bad effect of depression. During the boom period the expenditure on public good should be kept at minimum

- Expenditure on Social Relief

It is absolutely indispensible during the period of depression particularly giving unemployment relief is a must. The advantage is social relief expenditure is that there is already a machinery in existence to take up the relief work in proper time. There may not be any time lag, benefit will be immediate.

Public Expenditure

- Expenditure which automatically adjust itself:

It will relate to the expenditure out of unemployment insurance fund which exist when there is depression. Money will flow out of this fund when recovery starts the flow of money from this fund will slowly reduce.

- Tax Measures

Taxation is a highly powerful instrument which influences the economy. Taxation is highly powerful in the heads of public authorities to effect changes indispensible income, consumption and investment. Tax reduction will leave larger funds with the community leading to greater economic activity and the tax increase will reduce the purchasing power of community.

Public Debt and Fiscal Policy

Public Debt and Fiscal Policy:

- Govt. borrowings are generally made to cover budget deficits
  - Borrowings from non-bank public
  - Borrowings from banking system
  - Drawing from treasury
- Borrowings from non-bank public

When the govt. borrows from public through sale of bonds, money may flow either out of consumption or saving or private investment or hoarding. If the bonds are attractive enough to induce the people to curtail their consumption the borrowing are likely to be non-inflammatory in nature.

Public Debt

- Borrowings from banking system

The govt. may also borrow from the banking institutions. Such borrowings are inflammatory in nature. This type of borrowing is suitable only in times of depression.

- Drawing from treasury

The govt. may also draw upon the cash balances held in the treasury for financing a budgetary deficit. As this amount to dishoarding, it causes a net addition to the supply of money and it is likely to be inflationary in nature.

Deficit Financing

- Deficit Financing:
- The term deficit financing refers to expenditure of govt. in excess of the income whenever the govt. expenditure exceed the receipts such as taxes, fees, profits from public undertaking and borrowings from Public etc.
- The deficit is met by drawing from cash balance of the govt. held in Reserve Bank treasuries or by borrowing from the RBI which issues more notes to give them to the government against the rupee securities of the govt.

Deficit Financing

- Limitations:
  1. Deficit financing will not lead to an inflammatory raise in prices during the rising trend in production
  2. It depends on the extent of unutilized capacity in the economy
  3. It depends on the balance of trade position and the inflow of foreign aid.
  4. It depends on the extent to which people prefer to hoard their savings in cash balance
  5. If trend of private investment is expanding the deficit financing will increase in demand on current resource and tend to push up price.
  6. It depends upon the effectiveness of regulatory device in the economic system
  7. Judicious increase in money supply
  8. Efficient mobilization of additional income
  9. Enormous sacrifice on the part of people which in a democratic setup is rarely fulfilled

Deficit Financing

- Fiscal Policy in India:

After attaining independence efforts have been made to achieve rapid economic development through 5 year plan. The plan documents envision full employment, reduction of inequalities of income & wealth and rate of growth of the economy at 5.5% per annum.

The central and state govt. used their annual budgets to mobilise resources for rapid economic development. Market borrowings form the significant part of the internal debt as the rupee loans. These loans are generally long term loans and dated loans

Deficit Financing

- Classification of loans by Govt. of India:
  - Market loans
  - Market loans in course of repayment
  - 91 days treasury bills
  - 91 days treasury bills funded into securities
  - Other special securities issued by RBI
  - 364 days treasury bills
  - Compensation and other bonds
  - Special bearer bonds
  - Securities issued by international financing institutions
  - Ways and means of advance
  - 14 days treasury bills
  - Small savings

Deficit Financing

- The deficit financing tempts to distribute income and wealth in favour of profiteering classes hence the inequalities in the distribution and wealth wider as a result of deficit financing or rising prices.
- Fiscal policy in India has miserably failed to reduce inequalities of income and wealth in spite of steeply progressive taxes and indirect taxes. While inflation has cut the consumption standards of middle class and lower class the rich have become richer
- Checking the adverse effect of deficit financing:

The adverse effect of deficit financing can be minimized by increasing the receipts of govt. by additional tax revenue or net return from the goods & services sold by the govt. or increasing the govt. drafts on domestic savings or by raising more domestic loans. The best method is to reduce the magnitude of deficit financing.

Fiscal Economics

Unit 5 – Fiscal Federalism

Federal Finance

- Meaning Of Federal Finance:
  - The federal finance refers to the finance of the federal as well as of the state government and the relationship between the two.

Principles of Federal Finance

Principles of Federal Finance

- Principle of Autonomy
- Principle of Uniformity
- Principle of Adequacy and Flexibility
- Administrative Economy and Efficiency
- Principle of Equity
- Principle of integrations and coordination
- Principle of transferences
- Principle of accountability
- Principle of federations supervision
- Principle of fiscal assets

Principles of Federal Finance

- Principle of Autonomy
  - Central and state government should be financially independent with their own spheres.
  - Central should not interfere in the matters which are exclusively the responsibility of the state and similarly the state also should not interfere in the matters which are exclusively the responsibility of the Centre
- Principle of Uniformity
  - Federal government should discharge its responsibilities towards the state in a way that its treatment with all the states will be uniform. There should be equitable and just allocation of benefits and sacrifices between different state

Principles of Federal Finance

- Principle of Adequacy and Flexibility
  - There should be adequate means at the disposal of the federal, state and local governments for their requirements as determined by the allocation of functions at any given time
- Administrative Economy and Efficiency
  - For the success of the central and state financial relations the administrative cost should be minimum and there should be no fraud and evasion in the matter of finance

Principles of Federal Finance

- Principle of Equity
  - Equity is an important cannon of taxation said by Adam smith
  - Equity can be viewed from two points
    - The resources should be so distributed among the components as to give each a fair share of revenue
    - Allocation of resources should be so done as to give equitable treatment to individuals and business firms in different places

Principles of Federal Finance

- Principle of integrations and coordination
  - Whole financial system of a federation should be well integrated and coordinated. This should be done in a way that promotes economic development.
- Principle of transferences
  - In a federation all the states are not equal as to resource and economic development. Some states are strong and some are weak in the availability of resources and economic development so it is essential that the federation provided specific financial assistance and grand's to backward and poor state
  - This can be achieved thorough transferences from rich areas to poor areas in a federal state

Principles of Federal Finance

- Principle of accountability
  - The government should be accountable to its own legislator for its spending decisions further the decisions should be made with due regards for their on effect on other government
- Principle of federation supervision
  - Federation supervision is essential for the regulation of financial control. The integrity of federal finance required that the state govt. should follow those rules and regulations which are laid down by the federal govt. with regards to taxation and expenditure

Principles of Federal Finance

- Principle of fiscal assets
  - There should be no bar on central and state govt. in developing new sources of revenue within their own prescribed field to meet their growing financial needs

Evolution of Federal finance in India

Before 1871 the central govt. of India had complete control over all revenues and expenditure of the country. The provinces were given only fixed grand's to meet their expenses. These was uncertainty in finance and wasteful expenditure by provinces hence some decentralization was attempted in 1871.

This was done under provincial settlement by which expenditure of local character wise Police, Jail, road, civil works were transferred to provinces and there were given limited taxation power with some grand's by the centre

Evolution of Federal finance in India

- This led to the abolition of fixed grand and there was division of revenue sources into 3 types
  1. Imperial head
     - Profits from commercial dept. . Revenue from opium, salts and customs
  2. Provincial Heads
     - Civil dept. and provincial work
  3. Divided heads
     - Excise tax , assisted tax, stamps , forest and registration

Mountford reforms Act 1919

- Mountford reforms act 1919:
  - This act provided partial responsible govt. to provinces and this necessitated in providing partial financial autonomy
  - According to this act the central govt. retained the following heads of revenue i.e. salt, opium, customs, income tax, railways, postal telegraph, currency and mint.
  - The provincial govt. were give land revenue, stamps registrations, excise and forest

Government of India Act 1935

- There were three list of subjects in the sphere of finance. They are the
  - Federal list
  - Provincial list and
  - Concurrent list

1. Federal list
   - federal list consisted of import duties, salt, excise on tobacco , corporation tax, taxes on non agricultural income, duties on properties succession other than land, stamp duties on bills and taxes on railways fare

Government of India Act 1935

2. Provincial list
   - It consisted of land revenue, excise on alcohol, taxes on agricultural income, sales tax
3. Concurrent list
   - It consisted of income tax on personnel incomes and the inheritance tax on property other that agricultural land.

Sir Otto Niemeyers Award

- This was the starting point of federal finance and the sharing of revenue between the centre and the provinces
- The financial allocation between the centre and the province before the inauguration of provincial autonomy under the act of 1935.

Deshmuk Award 1950

- After independence and partition of the country lead to fix the provincial share of the divisible pool of income tax
- When India became a republic the financial relationship between the state and the centre was determined on the basis of the recommendations made by financial commissions setup according to the constitution of India

Balancing factor in Federal Finance

- The method by which the deficits in the state budgets and central budgets could be made good by means of financial help to the state as well as to the central. There are different devices adopted in various federations. Some of them are explained below.
  - Assignment
  - Supplementary levies
  - Federal Supervision
  - Federal Subsidy

Balancing factor in Federal Finance

- Assignment
  - Central government enacts the tax measures, levies the tax and collect it But the proceeds of taxes are distributed on agreed basis between the federal government i.e. Central and the state
  - The distribution is done on the basis of actual collection or on the basis of origin or on the basis of population etc.
- Supplementary levies
  - The principal tax maybe levied by the centre and a supplementary tax maybe levied by the states or the principal tax maybe levied by the states and the supplementary tax maybe levied by the Centre.

Balancing factor in Federal Finance

- Federal Supervision
  - It will reduce the inequalities between the states in the matter of resources after the initial allocation has been made
- Federal Subsidy
  - There are payments made to the state for the loss of revenue sustained by the states on account of transfer of some resources such as customs, excise etc. from the state to the centre

Conclusion

- The main problem in federal finance is the allocation or distribution of taxes between the centre and the state. The distribution of resources between the centre and states is not based upon pure theory but determined by the special circumstances governing the formation of each federation.

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