CHAPTER 7

PUBLIC FINANCE

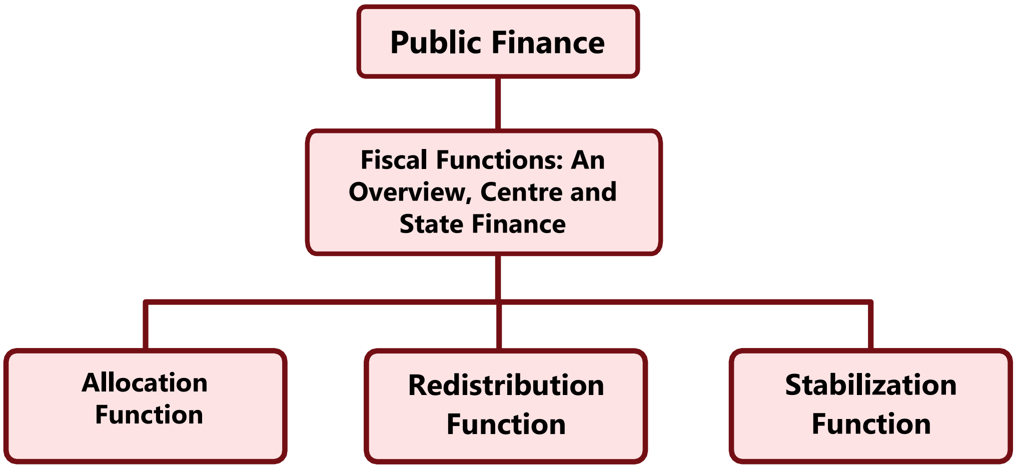
UNIT – 1: FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

LEARNING OUTCOMES

After studying this Chapter, you will be able to –

- Explain the three-branch taxonomy of the role of government in a market economy
- Analyze the governmental economic actions and classify them according to the economic functions of the government
- Elucidate the nature of finances and responsibilities of the centre and state governments
- Describe the mode of division of resources between the union and the states

CHAPTER OVERVIEW



1.1 INTRODUCTION

The governments of all nations have important economic functions even where markets constitute the basic resource allocation mechanism. The size and scope of government in market economies have grown much larger over the past few decades. 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.

Governments at various levels involve in several operations for running the state. For example; the government raises money from various sources, incurs expenditures, consumes goods and services, borrows money, employs people, and provides key institutions such as property rights. The governments also establish and administer rules and regulations and puts in place policies concerning all aspects of life of people. We have experienced in our day-to-day life that though governments at various levels impose many rules and regulations in the economy, some matters still go unregulated. Similarly, most of the goods and services that we consume are provided to us by private producers, but there is broad agreement that certain goods and services should be provided exclusively by the government. For a variety of reasons, we believe that governments should accomplish some activities and should not do others.

As we know, Macroeconomics is the study of the economy as a whole. There are three main macroeconomic goals for any nation. 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. The second goal is high levels of employment which 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. 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 government does not expect the economy to function automatically; rather it intervenes to direct them to function in particular directions. Such intervention on the part of the government is based on the belief that the objective of the economic system and the role of government is to improve the wellbeing of individuals and households. The purpose of this lesson is to examine the economic functions of the government and to understand why the government should invariably perform them.

1.2 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.

The modern society, in general, offers three alternate economic systems through which the decisions of resource reallocation may be made namely, the market, the government and a mixed system where both markets and governments simultaneously determine resource allocation. Correspondingly, we have three economic systems namely, capitalism, socialism and mixed economy, 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. Smith believed that government's roles in society should be limited, but well defined

However, Smith saw an important resource allocation role for the government when he underlined the role of government in:

(a) national defence to protect the nation from external violence and invasion,

(b) establishing a system of justice to provide internal law and order and to protect property

(c) 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). While there are differences among different countries in respect of the nature and extent of government intervention in economies, all of them agree on one point that the governments are expected to play a major role in the economy. This comes out of the belief that government intervention will always influence the performance of the economy in a positive way.

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, for conceptual purposes, the functions of the government are to be separated into three, namely,

(a) resource allocation (to ensure efficiency),

(b) income redistribution (to guarantee fairness), and

(c) macroeconomic stabilization (to ensure price stability).

The allocation and distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function. The allocation function aims to correct the sources of inefficiency in the economic system, while the distribution role ensures that the distribution of wealth and income is fair. Monetary and fiscal policies, the problems of macroeconomic stability, economic growth and maintenance of high levels of employment and price stability etc. fall under the stabilization function.

The national budget, in general, reflects the economic policy of a government and the government exercises its economic functions partly through the budget. We shall now discuss in detail the conceptual three-function framework of the responsibilities of the government.

1.3 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.

The private sector resource allocation is characterized by market supply and demand and price mechanism as determined by consumer sovereignty and producer profit motives. The state's allocation, on the other hand, 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. Missing markets or nonexistence of markets occur in a variety of situations. Why do markets fail to give the right answers to the questions as to how the resources can be efficiently utilised and what goods should be produced and in what quantities? In other words, why do markets generate misallocation of resources?

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:

- 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.
- Markets typically fail to provide collective public goods such as defence which are, by their very nature, consumed in common by all people.
- Incomplete markets; markets may fail to produce the right quantity merit goods, such

as education and healthcare

- Common property resources (e.g. environment) are overused and exhausted in individual pursuit of self-interest.
- Externalities which arise when the production and consumption of a good or service affect third parties (e.g. pollution).
- Factor immobility which causes unemployment and inefficiency.
- Imperfect information because it may not be in the interests of one party to provide full information to the other party, and
- 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. This logic, in effect, makes it necessary for the government to intervene in the market to bring about improvement in social welfare.

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. For example, the society may produce too much of demerit goods and too little of merit 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.

Let us see a few of many examples of government intervention in resource allocation. You might have noticed that in many cases, the 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. 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. Merit goods which are greatly beneficial to the society are by and large provided by the government. Production and consumption of demerit goods are controlled with appropriate policies. 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:

(a) who and what will be taxed

(b) how much and on what the government revenue will be spent

(c) the process by which the total resources of the economy are divided among various uses

(d) the optimum mix of various social goods (both public goods and merit goods).

(e) the level of involvement of the public sector in the national economy

(f) 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 prevent resources moving into their production.
- 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)
- governments' regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.
- government sets legal and administrative frameworks, and
- governments may adopt any combination of possible remedies

1.4 THE REDISTRIBUTION FUNCTION

You might have noticed that over the past decades there has been tremendous expansion in economic activities resulting in enormous increase in aggregate output and wealth. However, the outcomes of such economic growth have not spread evenly across the households. 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. On the expenditure side, governments may provide free or subsidised education, healthcare, housing, food and basic goods etc. to deserving people. On the revenue side, redistribution is done through progressive taxation.

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.

In modern times, most of the egalitarian welfare states provide free or subsidized education and health-care system, unemployment benefits, pensions and such other social security measures. There is, nevertheless, an argument that in exercising the redistributive function, there would be a conflict between efficiency and equity. In other words, 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.

1.5 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
- the economy's labour resources are fully employed, and
- Inflation is low and stable.

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 system has inherent tendencies to create business cycles. 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. 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.

The stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation of resources. As you might recall, the economic crisis that engulfed the world in 2008 and the more recent global phenomenon of COVID pandemic-induced economic crisis have highlighted the importance of macroeconomic stability and have, therefore, revived immense interest in countercyclical fiscal policy.

Government's stabilization intervention may be through monetary policy as well as fiscal policy. Monetary policy works through controlling the size of money supply and interest rate in the economy which in turn would affect consumption, investment and prices.

Fiscal policy for stabilization purposes attempts to direct the actions of individuals and organizations by means of its expenditure and taxation decisions. We know that 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.

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. On the other hand, to control high inflation the government cuts down its expenditure or raises taxes. In other words, an expansionary fiscal policy is adopted to alleviate recession and a contractionary fiscal policy is resorted to for controlling high inflation.

The nature of the budget (surplus or deficit) also has important implications on a country's economic activity. While deficit budgets are expected to stimulate economic activity, surplus budgets tend to slow down economic activity.

To sum up;

- If there is high inflation the government may decrease government spending, raise taxes, and/or reduce the money supply
- If there is high unemployment the government might increase government spending, reduce taxes, and/or increase the money supply

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.

Centre and State Finance

Fiscal federalism, a term introduced by Richard Musgrave, deals with the division of governmental functions and financial relations among the different levels of government. Musgrave argued that the federal or central government should be responsible for performing functions related to economic stabilization and income redistribution, and the allocation of resources should be the responsibility of the state and local governments.

India is a federation of 28 states and 8 union territories. Fundamentally, federalism is an institutional arrangement to accommodate two sets of government — one at the national level and the other at the regional level. Each government is autonomous in its own sphere. An independent judiciary is established to resolve disputes between the central government and the states on issues related to division of power.

The constitution of India has provided for the division of powers between the central and the state governments. Article 246 of the Constitution demarcates the powers of the union and the state by classifying their powers into three lists, namely union list, state list and the concurrent list. The union list contains items on which the union parliament alone can legislate, the state list has items on which the state legislative assemblies alone can legislate, and the concurrent list, on which both the parliament and the legislative assemblies can legislate. In the event of conflicting legislation in concurrent list, the law passed by the centre prevails.

Allocation of revenue and expenditure responsibilities to different levels of governments is a fundamental matter in a federation. Sources of revenue for both the centre and states are clearly demarcated with regard to the financial relationship and the responsibilities between them.

Taxes are levied by the centre and the states. The central government has greater revenue raising powers. The union government can levy taxes such as tax on income, other than agricultural income, customs and export duties, excise duties on certain goods, corporation tax, tax on capital value of assets excluding agricultural land, terminal taxes, security transaction tax, central GST, union excise duty, taxes other than stamp duties etc.

The state governments can levy taxes on agricultural income, lands and buildings, mineral rights, electricity, vehicles, tolls, professions, collect land revenue and 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. Since the states have comparatively less sources of income, their revenues may not be sufficient to meet their expenditure responsibilities. 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 2and the States.
Article271	Surcharge on certain duties and taxes for purposes of the union
Article275	Statutory Grants – in–aid from the union to certain states.
Article 282	Grants for any public purpose
Article 293	Loans for any public purpose

Besides the above provisions enabling transfer of resources from the centre to the states, a unique feature of the Indian Constitution is that Article 280 provides for an institutional mechanism, namely the Finance Commission, to facilitate such transfers. The 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.

The Finance Commission helps in maintaining fiscal federalism in India by performing following functions:

(a) 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.

(b) Determination of principles and quantum of grants-in-aid to states which are in need of such assistance.

(c) To make recommendations to the President on measures needed to 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.

(d) 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). Following a constitutional amendment in year 2000, the divisible pool now consists of all taxes of the union. Considering the needs of the central and the state governments, the Commission determines what percentage out of the net divisible pool should be assigned to the state governments. The balance remains with the central government.

The Fifteenth Finance Commission was constituted on 27, November 2017 against the background of the abolition of Planning Commission (as also of the distinction between Plan and non-Plan expenditure) and the introduction of the goods and services tax (GST). 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 is:

(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:

The introduction of GST, which was rolled out across the country on 1 July 2017, has 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.

The states levy and collect state GST (SGST) and the union levies and collects the central GST (CGST). For any particular good or service or a combination of the two, the SGST and CGST rates are equal. An integrated GST (IGST) is applied on inter-state movement of goods and services and on imports and exports. IGST is simply a combination of SGST and CGST administered and collected by the union government, 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.

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 ₹ 1,15,662 crore.

In so far as expenditure decentralization is concerned, the central government is entrusted with the responsibilities of provision 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. For items that fall in the concurrent list, both central and state governments are responsible for providing services.

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

SUMMARY

- Government intervention to direct the functioning of the economy is based on the belief that the objective of the economic system and the role of government is to improve the wellbeing of individuals and households.
- An economic system 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.
- Richard Musgrave (1959) introduced the three-branch taxonomy of the role of government in a market economy namely, resource allocation, income redistribution and macroeconomic stabilization.
- The allocation and distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function.
- One of the most important functions of an economic system is the optimal or efficient allocation of scare resources so that the available resources are put to their best use and no wastages are there.

- Market failures, which hold back the efficient allocation of resources, occur mainly due to imperfect competition, presence of monopoly power, collectively consumed public goods, externalities, factor immobility, imperfect information, and inequalities in the distribution of income and wealth.
- The allocation responsibility of the governments involves appropriate corrective action when private markets fail to provide the right and desirable combination of goods and services.
- A variety of allocation instruments are available by which governments can influence resource allocation in the economy such as, direct production, provision of incentives and disincentives, regulatory and discretionary policies etc.,
- The distributive function of budget is related to the basic question of for who should an economy produce goods and services and aims at redistribution of income so as to ensure equity and fairness to promote the wellbeing of all sections of people and is achieved through taxation, public expenditure, regulation and preferential treatment of target populations.
- Redistribution policies are likely to have efficiency costs or deadweight losses and therefore redistribution measures should be accomplished with minimal efficiency cost by carefully balancing equity and efficiency objectives.
- A market economy does not automatically generate full employment and price stability and therefore the governments should pursue deliberate stabilization policies.
- Stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation.
- 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, economic growth and balance of international payments.
- Government's stabilization intervention may be through monetary policy as well as fiscal policy. Monetary policy works through controlling the size of money supply and interest rate in the economy, while fiscal policy aims at changing aggregate demand by suitable changes in government spending and taxes.

Centre and state Finance

- Fiscal federalism deals with the division of governmental functions and financial relations among the different levels of government.
- The central government should be responsible for the economic stabilization and income redistribution, but the allocation of resources should be the responsibility of state and local governments.

- Article 246 of the Constitution demarcates the powers of the union and the state by classifying their powers into 3 lists, namely union list (on which the union parliament alone can legislate) state list (on which the state legislative assemblies alone can legislate) and the concurrent list on which both, the parliament and the legislative assemblies can legislate.
- The union government can levy taxes such as tax on income, other than agricultural income, customs and export duties, excise duties on certain goods, corporation tax, tax on capital value of assets, excluding agricultural land, terminal taxes, security transaction tax, Central GST, Union Excise Duty, taxes other than stamp duties etc.
- The state governments can levy taxes on agricultural income, lands and buildings, mineral rights, electricity, vehicles, tolls, professions, as well as collect land revenue, and impose excise duties on certain items.
- Articles 268 to 281 of the constitution contain specific provisions in respect of distribution of finances among states.
- Article 280, provides for an institutional mechanism, namely the Finance Commission, to facilitate such transfers. 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
- 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 Fifteenth Finance Commission recommended the share of states in the central taxes (vertical devolution) for the 2021-26 to be 41%.
- The criteria for distribution of central taxes among states for 2021-26 are income distance i.e the distance of a state's income from the state with the highest income, area, population (2011), demographic performance (to reward efforts made by states in controlling their population), forest and ecology and tax and fiscal efforts.
- States levy and collect state GST (SGST) and the union levies and collects the central GST (CGST). An integrated GST (IGST) is applied on inter-state movement of goods and services and on imports and exports.
- For providing compensation to states, a cess is levied on 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.

- The central government is entrusted with the responsibilities of provision 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. For items that fall in the concurrent list, both central and state governments are responsible for providing services.

TEST YOUR KNOWLEDGE

Multiple Choice Type Questions

1. *Redistribution policies are likely to have efficiency costs because*
   - *(a) They will reduce the efficiency of governments*
   - *(b) They may create disincentives to work and save*
   - *(c) Governments have to forego taxes*
   - *(d) They are likely to make the poor people dependent on the rich*
2. *Macroeconomic stabilization may be achieved through*
   - *(a) Free market economy*
   - *(b) Fiscal policy*
   - *(c) Monetary policy*
   - *(d) (b) and (c) above*
3. *Which of the following policies of the government fulfils the redistribution function*
   - *(a) Parking the army on the northern borders of the country*
   - *(b) Supply of food grains at subsidized prices to the poor people*
   - *(c) Controlling the supply of money through monetary policy*
   - *(d) All of the above*
4. *Choose the correct statement*
   - *(a) Fiscal policy involves the use of changes in taxation and government spending;*

while monetary policy involves the use of price and profit controls.

(b) *Fiscal policy involves the use of price and profit controls; while monetary policy involves the use of taxation and government spending.*

(c) *Fiscal policy involves the use of changes in taxation and government spending; while monetary policy involves the use of changes in the supply of money and interest rates.*

(d) *Fiscal policy involves the use of changes in the supply of money and interest rates; while monetary policy involves the use of changes in taxation and government spending.*

5. *The justification for government intervention is best described by*

   (a) *The need to prevent recession and inflation in the economy*

   (b) *The need to modify the outcomes of private market actions*

   (c) *The need to bring in justice in distribution of income and wealth*

   (d) *All the above*

6. *Read the following statements:*

   1. *The market-generated allocation of resources is usually imperfect and leads to inefficient allocation of resources in the economy*

   2. *Market failures can at all times be corrected through government intervention*

   3. *Public goods will not be produced in sufficient quantities in a market economy*

   Of the three statements above:

   (a) *1,2 and 3 are correct*

   (b) *1 and 3 are correct*

   (c) *2 and 3 are correct*

   (d) *3 alone is correct*

7. *When a government offers unemployment benefits and also resorts to progressive taxation which function does it seem to fulfill?*

   (a) *It is trying to establish stability in an economy*

   (b) *It is trying to redistribute income and wealth*

   (c) *It is trying to allocate resources to their most efficient use*

   (d) *It is creating a source of market failure*

8. *Government of Emeline Land decides to provide most modern road infrastructure throughout the nation. This can be classified as*

   (a) *Distribution function*

   (b) *Allocation function*

   (c) *Stabilization function*

   (d) *None of the above*

9. *Which function does the government perform when it provides transfer payments to offer support to the underprivileged*

   (a) *Allocation*

   (b) *Efficiency*

   (c) *Distribution*

   (d) *None of the above*

10. *Which of the following is true in respect of centre and state government finances?*

   (a) *The centre can tax agricultural income and mineral rights*

   (b) *Finance commission recommends distribution of taxes between the centre and states*

   (c) *GST subsumes majority of direct taxes and a few indirect taxes*

   (d) *IGST is collected by the state governments*

11. *GST compensation is given to*

   (a) *to the industries which have made losses due to the introduction of GST*

   (b) *to compensate for the lower rates of GST on essential items*

   (c) *to the states to compensate for the loss of revenue due to the introduction of GST*

   (d) *to compensate for the loss of input tax credit in manufacturing*

12. *Which of the following is true in respect of the role of Finance Commissions in India?*

   I. *The distribution between the union and the states of the net proceeds of taxes*

   II. *Allocation between the states of the respective shares of such proceeds.*

   III. *Make Recommendations on integrated GST on inter-state movement of goods and services*

   IV. *To recommend expenditure decentralization among different states*

(a) I and II are correct

(b) II and III are correct

(c) I, II and III are correct

(d) All the above are correct

13. In a federal set up, the stabilization function can be effectively performed by

(a) Respective state governments

(b) Ministry of taxes

(c) The government at the centre

(d) None of the above

14. Which of the following is concerned with division of economic responsibilities between the central and state Government of India?

(a) NITI Aayog

(b) central bank

(c) Finance Commission

(d) Parliament

15. Fiscal Federalism refers to _____________.

(a) Organizing and implementing development plans

(b) Sharing of political power between centers and states

(c) The management of fiscal policy by a nation

(d) Division of economic functions and resources among different layers of the government

16. Which one of the following taxes is levied by the state government only?

(a) Corporation tax

(b) Wealth tax

(c) Income tax

(d) None of the above

17. The percentage of share of states in central taxes for the period 2021-26 recommended by the Fifteenth Finance Commission is

(a) 38 percent

(b) *41 percent*

(c) *42 percent*

(d) *The commission has not submitted its report*

18. *Which of the following is not a criterion for determining distribution of central taxes among states for 2021-26 period*

    (a) *Demographic performance*

    (b) *Forest and ecology*

    (c) *Infrastructure performance*

    (d) *Tax and fiscal efforts*

19. *As per the supreme court verdict in May 2022*

    (a) *The union has greater powers than the states for enacting GST laws*

    (b) *The union and state legislatures have "equal, simultaneous powers "to make laws on Goods and Services Tax*

    (c) *The union legislature's enactments will prevail in case of a conflict between those of union and states*

    (d) *The state legislatures can make rules only with the permission of central government*

20. *Providing social sector services such as health and education is*

    (a) *the responsibility of the central government*

    (b) *the responsibility of the respective state governments*

    (c) *the responsibility of local administrative bodies*

    (d) *none of the above*

ANSWERS

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