

# 1. FISCAL FUNCTIONS

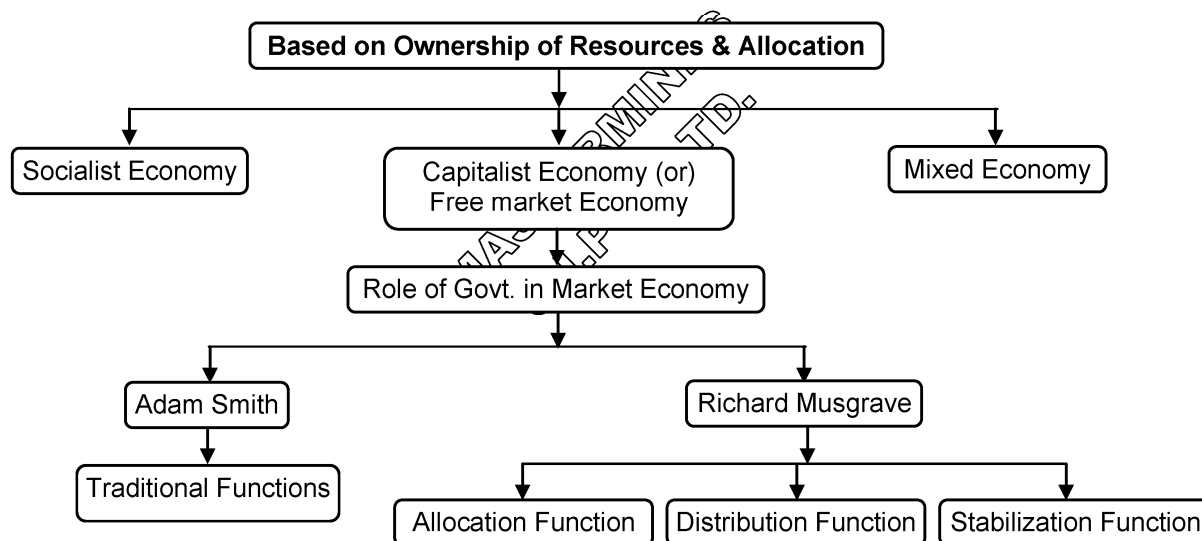
## QUESTION WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	M18 (N)	N18 (N)	M19 (N)	N19 (N)
3.	3	-	-	-
6.	-	2	3	-

## CHAPTER OVERVIEW

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## SECTION 1: THEORY FOR CLASSROOM DISCUSSION



**Q.No.1. What is the common Economic Problem being faced by different Economic systems and what are the basic questions faced by each of these economies due to Economic problem? (B) (SM)**

**TYPES OF ECONOMIC SYSTEMS:** Based on the ownership of economic resources and their allocation, economists recognized three economic systems. These are 1) Capitalist Economy or Free Market Economy or Laissez-faire Economy; 2) Socialist Economy and 3) Mixed Economy.

**ECONOMIC PROBLEM:** The basic economic problem being faced by all economic systems is scarcity of resources. This scarcity may arise on account of qualitative as well as quantitative constraints.

The resources available to any society cannot produce all economic goods and services that its members desire to have. Hence the following basic questions arise for any economic system such as:

- What to produce?
- How to produce?

- For whom to produce? and
- How much resources should be set apart to ensure growth of productive capacity?

**SIMILAR QUESTION:**

1) What are the central economic problems faces by every economy

A) Refer above answer

**Q.No.2. Explain the role of government in a market economy in the words of Adam Smith (A) (SM)**

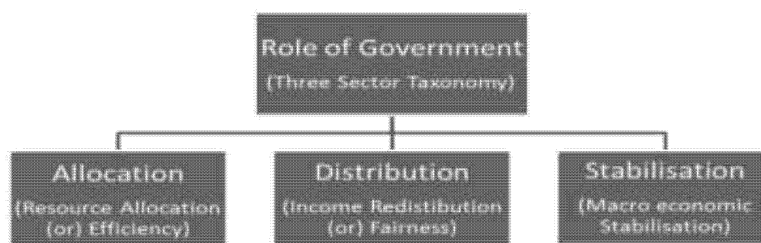
**Role of Government in the words of Adam Smith:** According to Adam Smith, government needs to play the following role in a Market economy;

- Adam Smith is often described as a bold advocate of free markets and minimal governmental activity.
- According to Smith the resource allocation role of government lies in traditional functions such as:
  - National Defence,
  - Maintenance of Justice and the Rule of Law,
  - Establishment and Maintenance of Highly Beneficial Public Institutions (**Ex:** Government schools, hospitals etc.)
  - Establishment and maintenance of Public works which the market may fail to produce on account of lack of sufficient profits. (**Ex:** Roads, Bridges, Canals and Harbours etc.)
- Since the 1930s, as a consequence of the great depression, the state's role in the economy has gained its importance. The traditional functions of the state have been supplemented with economic functions (also called fiscal functions or public finance function).
  - Allocative, Distributive and Stabilisation functions are termed as Fiscal functions.

**Q.No.3. Explain the role of Government in a market economy as stated by "Richard Musgrave" (A) (SM, M18 - 3M)**

**Role of Government in the words of Richard Musgrave:** According to Richard Musgrave, government needs to play the following role in a Market economy:

- 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 for conceptual purposes.



- 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.
- The distribution function ensures that the distribution of wealth and income is fair.
- Monetary and fiscal policy, the problems of macroeconomic stability, maintenance of high levels of employment and price stability etc. fall under the stabilization function.

**SIMILAR QUESTION:**

1) Explain the role of government in a market economy.

A) Refer answers of 2<sup>nd</sup> and 3<sup>rd</sup> questions (i.e. you need to state the opinions of both Adam smith and Richard Musgrave).

**Q.No.4. What is meant by resource allocation? Explain Private sector resource allocation and State's resource allocation. (A) (SM)**

**Resource allocation:**

- a) It refers to the way in which the available factors of production are allocated among the various uses to which they might be used.
- b) Every economic system aims at optimal or efficient allocation of scarce resources so that the available resources are put to their best use and no wastages are there.
- c) Efficient allocation of resources is assumed to take place only in perfectly competitive markets. But in reality, markets are never perfectly competitive.
- d) In the real world, resource allocation is both market determined and government determined.
  - **PRIVATE SECTOR RESOURCE ALLOCATION:** It is characterized by market supply, demand and price mechanism as determined by consumer sovereignty and producer profit motives.
  - **STATE'S RESOURCE ALLOCATION:** It is accomplished through the revenue and expenditure activities of governmental budgeting.

**SIMILAR QUESTION:**

- 1) Differentiate Private sector and State's resource allocation. (RTP M20)
- A) Refer two bullets of point d)

**Q.No.5. Why do markets generate misallocation of resources? (A) (SM)**

1. **Misallocation of resources in a market:** If a free market fails to allocate the society's scarce resources efficiently then it results in either underproduction or overproduction of particular goods and services. Thus market outcome becomes inefficient and leads to market failure.
2. **Reasons for the misallocation of resources (or) Reasons for market failure:** Misallocation of resources occurs when:
  - a) **Imperfect Competition and Monopoly Power:** It leads to under-production and higher prices than perfect competition. This reduces consumer's choice and their welfare.
  - b) **Public Goods:** Goods consumed in common by all the people Ex: Roads, bridges, dams etc. Markets fail to provide public goods or under produce as people use them without paying.
  - c) **Externalities:** The costs or benefits which are not included in market price. Ex: Pollution.
  - d) Imperfect information
  - e) Inequalities in distribution of income and wealth.
  - f) **Factor Immobility:** It causes unemployment and inefficiency in the economy

**SIMILAR QUESTIONS:**

- 1) What are the reasons for the misallocation of resources?
  - A) Refer side heading 2
- 2) Provide the reasons for market failure.
  - A) Refer side heading 2
- 3) Define the market failure. Why do markets fail? (RTP M19 -3 M)
  - A) Refer the above answer
- 4) How do the markets fail in an economy? What are the main reasons behind this market failure and economic inefficiency?
  - A) Refer the above answer (MTP M20)

**Q.No.6. Describe why governments should perform the allocation function in an economy? (A) (SM)**

- a) According to Musgrave, in the absence of appropriate government intervention, market failures may occur and the resources are likely to be misallocated by too much production of certain goods or too little production of certain other goods.
- b) Also 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.

**Rationale for government intervention in Resource Allocation (or) The Allocative functions of government aims:**

- a) To improve economic performance through its expenditure and tax policies.
- b) To determine who and what will be taxed as well as how and on what the public revenue will be spent.
- c) It is concerned with the provision of an optimum mix of both public goods and merit goods.
- d) Reallocation of society's resources from private use to public use.

**SIMILAR QUESTIONS:**

- 1) Support the sentence 'market failures provide the rationale for government's allocative function in the words of Musgrave  
A) Refer the introduction
- 2) What is the rationale for government intervention in allocation of resources? (MTP M18 - 3M)  
A) Refer the above answer
- 3) What is allocation function of Fiscal Policy? (N18 - 2M)  
A) Refer the 4 points of Side heading Role of government in resource allocation.
- 4) Why is there a need for the government to resort to resource allocation? (M19 - 3M)  
A) Refer the above answer
- 5) What are the aims of the Allocative Functions of Government?  
A) Refer the above answer

**Q.No.7. Name the allocative instruments of government that can influence the resource allocation in the economy? (A) (SM)****Allocation instruments by which governments can influence resource allocation in the economy:**

- a) Government may directly produce the economic goods (EX: *Electricity and public transportation services*).
- b) Government may influence private allocation through incentives and disincentives (EX: *Subsidies on production of goods that promote social welfare and higher taxes on cigarettes and alcohol*).
- c) Through its competition policies, merger policies etc. (Ex; *Competition Act, 2002 in India*).
- d) Governments' regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.
- e) Government sets legal and administrative frameworks.
- f) A mixture of intermediate techniques.
- g) Maximizing social welfare.

**'In its allocation role the government acts as a complement rather than as a substitute to the market system in an economy'.** However, it is also possible that instead of eliminating market distortions, sometimes governments may further create market failures.

**SIMILAR QUESTIONS:**

- 1) What are the different instruments available to the government to improve allocation efficiency in an economy?
- A) Refer the above answer
- 2) How can the government influence the resource allocation in an economy? (RTP N19)
- A) Refer the above answer

**Q.No.8. Define distributive function of government. What are the aims of distributive function of the government? (A) (SM)**

- 1) **Distributive Function:** The distributive function of budget is related to the basic question of “for whom should an economy produce goods and services”.  
It is concerned with the adjustment of the distribution of income and wealth so as to ensure distributive justice namely, equity and fairness.  
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.  
(Effective demand is determined by the level of income of the households and this in turn determines the distribution of real output among the population.)
- 2) **The distribution function of the government aims at:**
  - a) Redistribution of income to achieve an equitable distribution of societal output among households.
  - b) Advancing the well-being of members who suffer from various types of deficiencies.
  - c) Providing equality in income, wealth and opportunities.
  - d) Providing security for people who have hardships.
  - e) Ensuring that everyone enjoys a minimal standard of living.

**SIMILAR QUESTIONS:**

- 1) What are the aims of distributive function?
- A) Refer the 2<sup>nd</sup> point

**Q.No.9. Give some examples of redistributive function performed by the government. (B) (SM)**

Redistribution of income is essential to achieve an equitable distribution of societal output among households.

**Examples of the redistribution function performed by governments are:**

- a) Taxation policies of the government whereby progressive taxation of the rich is combined with provision of subsidy to the poor households
- b) Proceeds from progressive taxes used for financing public services, especially those that benefit low-income households (*example, supply of essential food grains at highly subsidized prices to BPL households*)
- c) Employment reservations and preferences to protect certain segments of the population
- d) Regulation of the manufacture and sale of certain products to ensure the health and well-being of consumers.
- e) Special schemes for backward regions and for the vulnerable sections of the population
- f) In most of the egalitarian welfare states provide free or subsidized education and health-care system, unemployment benefits, pensions and such other social security measures.

**SIMILAR QUESTION:**

- 1) List out the examples of Government intervention for socio- economic reasons in an economy?
- A) Refer any 5 points in the above topic.

**Q.No.10. Does redistributive function can balance both efficiency and equity simultaneously? Support the question with an example 'Greater equity can be achieved through high rates of taxes on the rich' .** (B) (SM)

**Equity and Efficiency:** Equal distribution of economic scarce resources and opportunities among the different sectors of society through productive efficiency.

**Equity - Efficiency trade off:** Of the redistributive function of government, there exists a conflict in achieving both efficiency and equity simultaneously. Redistribution policies of government interfere either with producer choices or consumer choices which have efficiency costs or deadweight losses.

**EX: 'Greater equity can be achieved through high rates of taxes on the rich':** The sentence may not be true because

- High rates of taxes could also act as a disincentive to work,
- It discourages people from savings and investments and risk taking.
- It will have negative consequences for productivity and growth of the economy.
- The potential tax revenue may be reduced
- The scope for government's welfare activities would get seriously limited.

**Conclusion:** Thus an optimal budgetary policy towards any distributional change should reconcile the conflicting goals of efficiency and equity by exercising an appropriate tradeoff between them.

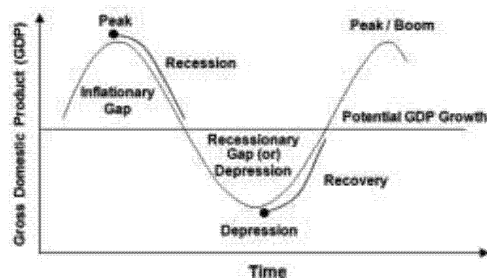
**SIMILAR QUESTIONS:**

- Does the redistributive function balance the conflict between efficiency and equity?  
A) Refer above answer.
- Why redistribution measures should be accomplished with minimal efficiency costs by carefully balancing equity and efficiency objectives?  
A) Refer above answer.

**Q.No.11. What is the basis for stabilization function of government? What is the need for Stabilization function of government in the market economy?** (A) (SM)

**1) Basis or theoretical rationale for the stabilization function of the government:**

- According to Keynes, a market economy does not automatically generate full employment and price stability and therefore the governments should pursue deliberate stabilization policies.
- Business cycles are natural phenomena in any economy and they tend to occur periodically.
- 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



**2) Need for Stabilization function in the market economy:** Market mechanism can neither prevent nor resolve the fluctuations caused by business cycle.

- In the absence of government intervention, the instabilities may be prolonged for longer periods causing hardships especially to the poorer sections of society.

- b) Stagflation (inflation and unemployment exist side by side) may set in and make the problem more complicated.
- c) It implies contagion effect (*The increased international interdependence causes forces of instability to get easily transmitted from one country to other countries*).

**Conclusion:** Not only the economic crisis of 2008 but also the more recent euro area crisis have highlighted the importance of macroeconomic stability

**SIMILAR QUESTIONS:**

- 1) What is the theoretical rationale for the stabilization function of the government? (or) Describe the rationale for the stabilization function of government policy.
  - A) Refer side heading 1
- 2) Which situations create need for Stabilization function in the market economy?
  - A) Refer side heading 2
- 3) As far as stabilization function is concerned what are the terms to be considered for the performance of the aggregate economy?
  - A) Refer point 'c' side heading 1

**Q.No.12. Mention the two major components through which government's fiscal policy can influence the performance of the macro economy in stabilizing it. (B) (SM)**

Government's fiscal policy can influence the performance of the macro economy in terms of employment, price stability, economic growth and external balance.

**The two major components which are important in stabilizing the economy:**

- a) An overall effect generated by the balance between government expenditures and public revenue through taxation, charges, borrowing etc.
- b) A microeconomic effect generated by the specific policies it adopts.

**SIMILAR QUESTION:**

- 1) What are the two major important components in stabilizing the economy?
  - A) Refer the above answer

**Q.No.13. Explain how Economic Stability can be achieved through fiscal policy. (A) (SM)**

**Role of fiscal policy in stabilizing the economy by its expenditure, taxation and budget decisions:**

- a) **On the Expenditure Side:** Government expenditure injects more money into the economy and stimulates demand. For example, government expenditure on building infrastructure may initiate a series of productive activities.
- b) **Tax policies:** Production decisions, investments, savings etc. can be influenced by tax policies. Taxes reduce the income of people and therefore, reduce effective demand.
- c) **Budget:** Deficit budgets are expected to stimulate economic activity, surplus budgets are thought to slow down economic activity.
- d) **Action during recession:** The government increases its expenditure or cuts down taxes or adopts a combination of both to boost up the aggregate demand. Expansionary fiscal policy is adopted to alleviate recession.
- e) **Action during Inflation:** The government cuts down its expenditure or raises taxes. Contractionary fiscal policy is adopted to control high inflation. Contractionary fiscal policy is adopted to alleviate inflation.

Phases of Business Cycle	Stage of Business Cycle	Availability of money or money supply	Fiscal Instruments				Effect of fiscal policy on economic activity, aggregate demand, output and employment	Discretionary Fiscal policy
			Taxes	GE	Public debt	Budget		
Expansion	Inflation	↑	↑	↓	Borrows from public	Surplus	↓	Contractionary Fiscal policy
Contraction	Recession	↓	↓	↑	Repays to public	Deficit	↑	Expansionary Fiscal policy

**SIMILAR QUESTION:**

- 1) Explain the role of fiscal policy in terms of macroeconomic fluctuations through stabilization function.
- A) Refer points c) & d)

**SECTION 2: QUESTIONS FOR ACADEMIC INTEREST - FOR STUDENTS SELF STUDY**

**Q.No.14. 'In its allocation role the government acts as a complement rather than as a substitute to the market system in an economy'. Support the sentence with suitable examples? (C) (SM)**

The following government interventions do not imply that markets are replaced by government action:

- a) The government can provide us with goods and services that we cannot produce on our own or buy at a price from the market.
- b) The government establishes property rights and makes the necessary arrangements for enforcing contracts through provision of law enforcement and courts.
- c) Goods which involve externalities that are not met by the market require intervention by the government for corrective measures.
- d) Merit goods which are greatly beneficial to the society also fall under the purview of provision by the government.

**Q.No.15. 'It does not necessarily imply that the government is always infallible and at all times capable of correcting the failures of the market'. Support the sentence with suitable examples? (C) (SM)**

The following examples depicts that sometimes Governments are likely to commit serious errors in its attempt to correct market failure:

- a) In certain cases the costs incurred by government to deal with some market failure could be greater than the cost of the market failure itself.
- b) Just as individuals, governments too have only imperfect information, and hence can commit mistakes.
- c) It is also possible that individuals may use government as a mechanism for maximizing their self-interest.
- d) Moreover, governments may not always be unbiased and benevolent.

**SECTION 3: TEST YOUR KNOWLEDGE**

- 1) The following are a few headlines which appeared recently in the leading business dailies. Comment on each in your own words.
  - a) Crop worry: Centre scraps import duty on wheat to ease supply and check prices
  - b) Monetary Policy panel members voted unanimously for a rate cut



- c) A fortified mid-day meal gets underway at Karnataka's government schools
  - d) Government to spend Rs.60,000 crores more on rural jobs
  - e) Government looking at subsidizing Smart phones to boost digital payments
  - f) No service tax on credit, debit card transactions up to Rs.2,000
- 2) List any two statements that meant to provide incentives to promote the production/ use of resources in a socially desirable direction.
- 3) What is meant by Contagion effect?
- 4) Elucidate the nature of economic function performed by the government in the following cases:
- a) The government initiates a massive programme for eradication of mosquito-borne diseases in coastal areas.
  - b) The government fixes the prices of 377 essential medicines listed in the National List of Essential Medicine, 2015.
- 5) The Government decides to levy up to Rs. 20, 500 per flight from private airlines on major routes in order to fund an ambitious regional connectivity scheme which seeks to connect small cities by air and to make flying more affordable for the masses. Critically examine the implications of this policy on the airlines market.
- 6) What is the objective of government subsidy?
- 7) What would be the objective of a government when it declares special schemes for backward regions?
- 8) Illustrate with an example the redistribution effect of a tax and transfer policy
- 9) Why do private producers hesitate to produce public parks, bridges and highways?
- 10) What are the basic questions should every economic system answer?
- 11) What are the other terms known for Economic functions?
- 12) Who introduced the three branch taxonomy of the role of government in a market economy?
- 13) What is the three branch taxonomy as the role of government in a market economy introduced by Richard Musgrave?
- 14) Do the allocation and distribution functions are primarily microeconomic functions or macroeconomic functions?
- 15) Do the stabilization function is primarily microeconomic function or macroeconomic function?
- 16) Enumerate the circumstances which necessitate redistribution by government.
- 17) What reason would you assign for employment reservations to socially backward communities?
- 18) Name the function of budget that is related to the basic question of for whom should an economy produce goods and services?
- 19) What are the policies involved in Government's stabilization intervention?
- 20) What is the objective of monetary policy as a part of Government's stabilization intervention?
- 21) What is the aim of fiscal policy as a part of Government's stabilization intervention?
- 22) Government's stabilization intervention may be through monetary policy as well as fiscal policy. How? (RTP M20)
- 23) Describe any few interventional measures adopted by the government.
- 24) What is the major determinant of the economic functions of a government? (RTP M19)
- 25) Why classical economists do believed that fiscal policy is unnecessary for an economy?
- 26) What is the consequence of excessive taxation that will have on business?
- 27) Well designed and timely fiscal responses are necessary for an economy which is either going through stages of recession or inflation or on a drive to achieve economic growth and/ or equitable distribution of income. Explain.

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