1. FISCAL FUNCTIONS

ANSWERS FOR TEST YOUR KNOWLEDGE QUESTIONS

QUESTION NO. 1

The following are the incentives to promote the production/ use of resources in a socially desirable direction:

a) 100% Income Tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for next 5 years. (**Sunset Clause for Units will become effective from 01.04.2020).**

b) Sector specific initiatives: The government of India provides sector specific subsidies for promoting manufacturing for example in order to boost manufacturing of electronics, the Govt. of India provides capital subsidy of up to 25% for 10 years.

c) Area based incentives: Incentives are provided for units in SEZ/NIMZ as specified in respective acts or setting up project in special areas like North East Region, Jammu & Kashmir, and Himachal Pradesh & Uttarakhand.

QUESTION NO. 2

Contagion effect: The **contagion effect** explains the possibility of spread of economic crisis or boom across countries or regions. When stabilization issue becomes more complex, the increased international interdependence causes forces of instability to get easily transmitted from one country to other countries. This effect is known as contagion effect.

Ex: Great economic depression 1930, Global financial crisis 2007-08 etc.

QUESTION NO. 3

a) The government initiates a massive programme for eradication of mosquito-borne diseases in coastal areas.

Type of good: Public good and Merit good

Features of a good: Collective consumption good, Non rivalrous and Non-excludable. (But at the time of congestion it becomes rivalrous)

Type of externality: Positive externalities

Market outcome: Inefficient or under produced if provided by the market alone. Hence people would consume inadequate quantities than socially desirable.

Resource allocation role of government's policy: To correct market failure.

Example: In India, National Vector Borne Disease Control Program provides medicine and diagnostic facilities for dengue, chikungunya and Japanese encephalitis from as many as 542 places, at free of cost.

Purpose: To maximise social welfare by maintaining good health of the society with the slogan I.e., Prevention is better than cure.

Welfare outcomes: Public can effectively participate in economic activities and earn a better standard of living.

Possibility of government failure:

- Information failure is widely prevalent with merit goods
- Equity considerations demand that merit goods (health and education) should be provided free.
- There is a lot of uncertainty as to the need for merit goods E.g. health care.

b) **Type of good:** Merit Good

Market outcome: Left to the market alone private benefits and private costs would be included in the price paid by consumers. Hence people would consume inadequate quantities than socially desirable and thus social welfare will not be maximized.

Role of government: Distribution function. This function refers to the basic question of for whom should an economy produce goods and services on grounds of fairness and equity

Price intervention: Government levies price ceilings for making commodity available to all at reasonable prices

Purpose: The government deems that its consumption should be encouraged and to maximise social welfare by maintaining good health of the society.

Possibility of government failure:

- Negative outcomes
- Possible disincentives to producers
- Diversion of resources away from regulated products
- Black marketing- etc.

QUESTION NO. 4

Market outcome: Airlines with cost escalation - possible fare hikes - disincentives to fly aircrafts in taxed routes - possible exit from market by low profit margin airlines.

Government intervention: Redistribution to ensure fairness and equity. Regional connectivity and other welfare outcomes as subsidies to producers would lower their cost of production increase output-substantial positive externalities.

Possibility of government failure:

- Government intervention in the economy to correct a market failure creates inefficiency and leads to a misallocation of scarce resources - social welfare will not be maximized
- Uncertainty as to the need for merit goods
- Disincentives to existing players

QUESTION NO. 5

A subsidy is a benefit given to an individual, business or institution, usually by the government.

The twin objectives of Subsidies: Growth and equity of nation

QUESTION NO. 6

To achieve Balanced Regional Development through its distribution function on the grounds of fairness and equity that must be applicable to all the regions.

QUESTION NO. 7

Market power or monopoly power is the ability of a firm to profitably raise the market price of a good or service over its marginal cost.

Market power can cause markets to be inefficient because it keeps price higher and output lower than the outcome of equilibrium of supply and demand.

QUESTION NO. 8

Government through its Minimum support prices, Subsidies on required inputs, demonstration of improved technology, distribution of quality seeds of new varieties, integrated pest management, water saving devices and capacity building of farmers can encourage domestic producers to produce more pulses.

QUESTION NO. 9

Taxation (Direct and Indirect) and income transfers to the poorest segment of society are the most direct way to keep inequality in check and reduce poverty in the short term

Progressive taxation (Direct taxes): A higher and more effective income tax in the upper part of the income scale could help raise the necessary funds. The generalized use of bank accounts, credit cards, and debit cards by higher-income people makes easier to monitor personal incomes and reduce tax evasion.

Regressive taxation (Indirect taxes): Lowering taxes on goods such as food that weigh more in the budget of poor people achieves relatively little redistribution because wealthier people also consume these goods, perhaps as a lower proportion of their budget but possibly in larger quantity.

Income transfers: Subsidies on necessaries through fair ration shops, old age and disability benefits, sickness and maternity benefits, work injury transfers, unemployment benefits, free education up to the age of 14 years children, mid-day meal schemes, free health care to the poor etc.

QUESTION NO. 10

The production of public parks, bridges and highways requires high capital requirement, long gestation period but can acquire only low rate of returns. Hence private producers hesitate to produce public parks, bridges and highways.

QUESTION NO. 11

The basic questions that arise for any economic system are 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?

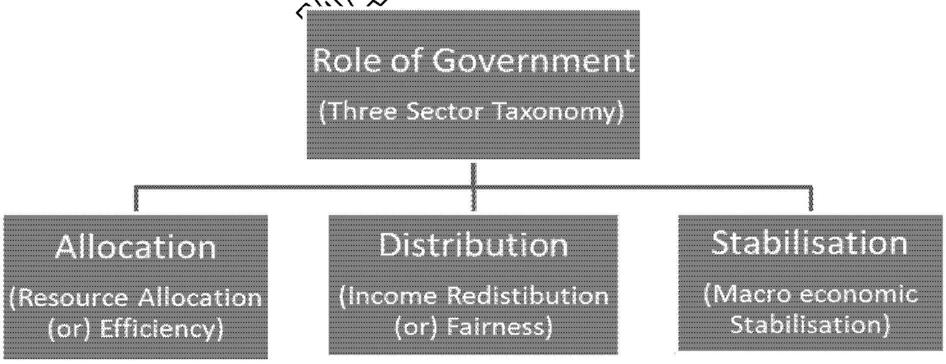
QUESTION NO. 12

Fiscal functions or Public Finance functions

QUESTION NO. 13

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.

QUESTION NO. 14



QUESTION NO. 15

The allocation and distribution functions are primarily microeconomic functions as they consider from individual point of view.

QUESTION NO. 16

The stabilization function is primarily macroeconomic function as it is concerned with the performance of the aggregate economy.

Monetary and fiscal policy, the problems of macroeconomic stability, maintenance of high levels of employment and price stability etc. fall under the stabilization function.

QUESTION NO. 17

Distribution function

QUESTION NO. 18

Government through its Discretionary fiscal policy brings stability by controlling fluctuations in the business cycle.

Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of business cycle.

Contractionary fiscal policy is designed during an inflationary phase to restrain the levels of economic activity of the economy.

QUESTION NO. 19

Maintaining price stability as a necessary precondition for sustainable growth is the objective of monetary policy as a part of Government's stabilization intervention.

QUESTION NO. 20

Discretionary fiscal policy for stabilization: It refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment and prices. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the quantity and form of borrowing.

QUESTION NO. 21

Interventional measures adopted by the government are:

- Competition Act, 2002 to control Monopoly power
- Progressive taxation to reduce income inequalities
- High taxes, special restrictions, penalties etc. to control negative externalities
- Subsidies, tax holidays, tax rebates, etc. to encourage production of merit goods or the goods which provides positive externalities.

QUESTION NO. 22

The fundamental principle of **the classical theory** is that the economy is self-regulating. Classical economists maintain that the economy is always capable of achieving the natural level of real GDP or output, which is the level of real GDP that is obtained when the economy's resources are fully employed. While circumstances arise from time to time that cause the economy to fall below or to exceed the natural level of real GDP, **self-adjustment mechanisms** exist within the market system.

Classical economists supported Automatic stabilisers rather than Discretionary fiscal policies. Hence classical economists believed that fiscal policy is unnecessary for an economy.

QUESTION NO. 23

Less potential profits - disincentives- suppresses new investments - less economic growth

THE END