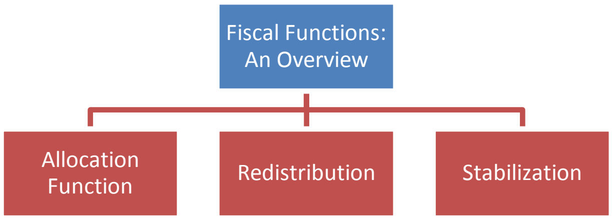
PUBLIC FINANCE

- Fiscal Functions
- Market Failure
- Government Interventions to Correct Market Failure
- Fiscal Policy



THE ALLOCATION FUNCTION

It determines how much of the various kinds of goods and services will actually be produced in an economy. 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.

A market economy is subject to serious malfunctioning in several basic respects.

Efficient allocation of resources is assumed to take place only in perfectly competitive markets. In reality, markets are never perfectly competitive. Market failures which hold back the efficient allocation of resources occur mainly due to the following reasons:

REASON FOR GOVERNMENT'S ALLOCATIVE FUNCTION.

1. Imperfect competition and presence of monopoly power in different degrees
2. Markets typically fail to provide collective goods which are, by their very nature, consumed in common by all the people.
3. Externalities which arise when the production and consumption of a good or service affects people ***e.g. pollution.***
4. Factor immobility which causes unemployment and inefficiency
5. Imperfect information
6. Inequalities in the distribution of income and wealth.

DIFFERENT INSTRUMENTS AVAILABLE TO THE GOVERNMENT TO IMPROVE ALLOCATION EFFICIENCY

1. Government May Directly Produce The Economic Good ***(Electricity, Public Transport)***
2. Government may influence private allocation through incentives and disincentives ***(subsidies)***
3. Competition policies, merger policies etc. ***(the Competition Act)***
4. Licensing, controls, minimum wages, and directives on location of industry
5. Legal and ***administrative frameworks***
6. Any of a mixture of intermediate techniques may be adopted by governments

REDISTRIBUTION FUNCTION

The distribution function 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.

The distribution function of the government aims at:

- To achieve an equitable distribution of societal output
- The well-being of those people who suffer from deprivations
- Providing equality in income, wealth and opportunities
- Security for people who have hardships
- Minimal standard of living

The Redistribution Effect of a Tax and Transfer Policy

- Taxation policies of the government whereby progressive taxation of the rich is combined with provision of subsidy to the poor households
- Collection of taxes are then used to low-income households *(supply of essential food for low price to BPL)*
- Employment reservations and preferences

Objective of government subsidy

- to ensure the health and well-being of consumers, and
- special schemes for backward regions and for the vulnerable sections of the population

There should be an optimal balance between efficiency and equity, so that both the elements of the society are encouraged and the redistribution process is neutral for both.

STABILIZATION FUNCTION

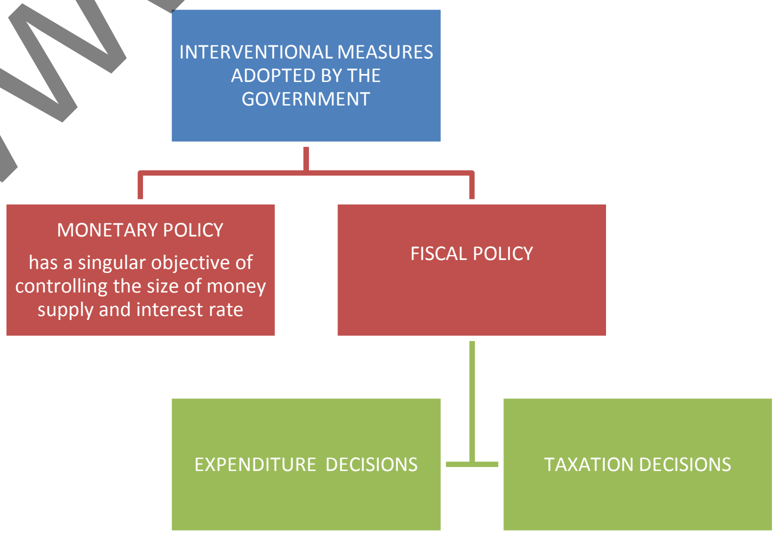
The stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation. As you might recall, the economic crisis that engulfed the world in 2008 and the more recent euro area crisis have highlighted the importance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

The stabilization function

- Labour employment and capital utilization,
- Overall output and income,
- General price levels,
- Balance of international payments, and
- The rate of economic growth.

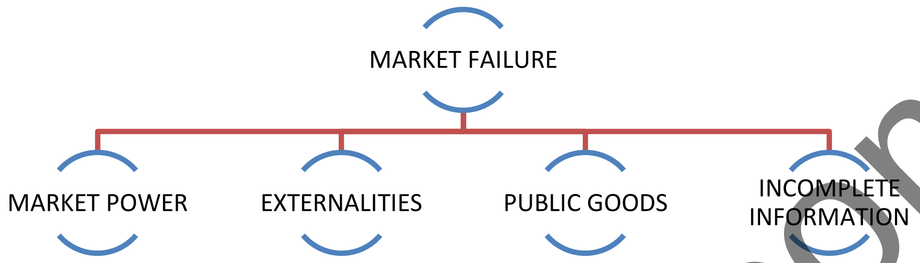
Government's fiscal policy

- The resources the government puts into the economy through taxation, charges, borrowing etc.
- A microeconomic effect generated by the specific policies it adopts.



Generally government's fiscal policy has a strong influence on the performance of the macro economy in terms of employment, price stability, economic growth and external balance.

- **During recession, the government increases its expenditure or cuts down taxes or adopts a combination of both so that aggregate demand is boosted up with more money put into the hands of the people.**
- **To control high inflation the government cuts down its expenditure or raises taxes.**
- **The nature of the budget (surplus or deficit) also has important implications on a country's economic activity.**



THE CONCEPT OF MARKET FAILURE

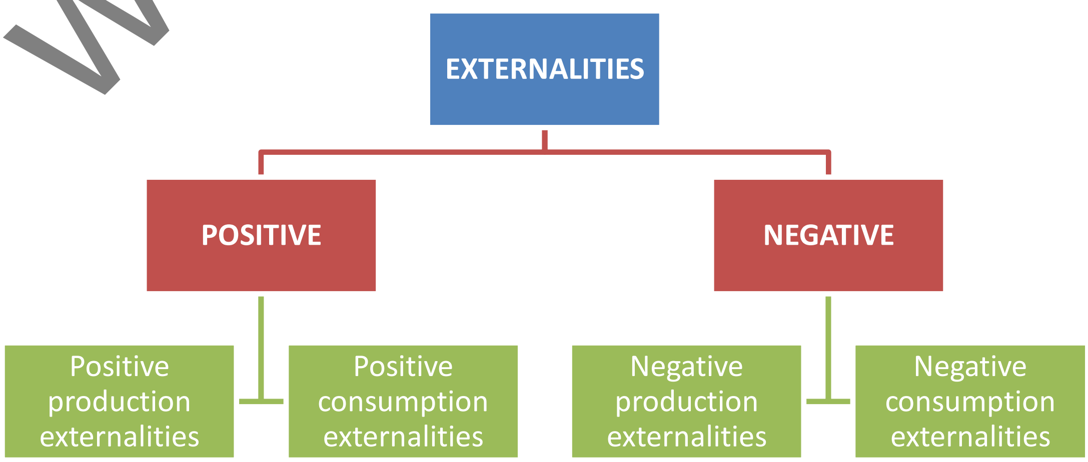
Market failure is a situation in which the free market leads to misallocation of society's scarce resources in the sense that there is either overproduction or underproduction of particular goods and services leading to a less than optimal outcome.

We need to appreciate the fact that there are two aspects of market failures namely:

1. Demand-side market failures
2. Supply-side market failures

MARKET POWER

- It creates monopoly power.
- Can charge unfair price
- Output lower than the outcome of equilibrium of supply and demand.
- Nonexistence of markets
- Failure to produce various goods and services
- The markets for pure public goods do not exist



Private cost is the cost faced by the producer or consumer directly involved in a transaction. If we take the case of a producer, his private cost includes direct cost of labour, materials, energy and other indirect overheads.	**Social costs** are private costs borne by individuals directly involved in a transaction together with the external costs borne by third parties not directly involved in the transaction. ***Social Cost = Private Cost + External Cost***

PUBLIC GOODS

A public good (also referred to as collective consumption good or social good) is defined as one which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individuals' consumption of that good.

Characteristics of Private Goods

- goods that yield utility to people. Anyone who wants to consume them must purchase them.
  - Owners of private goods can exercise private property rights.
- simultaneous consumption of a rivalrous good by more than one person is impossible.
- those who want to consume private goods must buy them at a price from its sellers
- All private goods and services can be rejected by the consumers if their needs, preferences or budgets change.
- *Example: Loaf of bread, butter etc*

Characteristics of Public Goods

- No direct payment by the consumer is involved in the case of pure public goods.
- Public good is non-rival in consumption.
- Public goods are non-excludable.
- Public goods are characterized by indivisibility
- Public goods are generally more vulnerable to issues such as externalities, inadequate property rights, and free rider problems.
- Example: Law enforcement, national defense, parks

Classification of Public Goods

Pure Private goods

↑

	Excludable	Non-excludable
Rivalrous	A Private goods food, clothing, cars	B Common resources such as fish stocks, forest resources, coal
Non-rivalrous	C Club goods, cinemas, private parks, satellite television	D Pure public goods such as national defence

↓

Pure Public Goods

Quasi Public Goods (Mixed Goods)

The quasi-public goods or services, also called a near public good (for e.g. education, health services) possess nearly all of the qualities of the private goods and some of the benefits of public good.

Markets for the quasi public goods are considered to be incomplete markets and their lack of provision by free markets would be considered as inefficiency and market failure.

Global Public Goods

These goods have widespread impact on different countries and regions, population groups and generations. These are goods whose impacts are indivisibly spread throughout the entire globe.

The distinctive characteristic of global public goods is that there is no mechanism (either market or government) to ensure an efficient outcome.

The Free Rider Problem

Free riding is 'benefiting from the actions of others without paying'. A free rider is a consumer or producer who does not pay for a nonexclusive good in the expectation that others will pay.

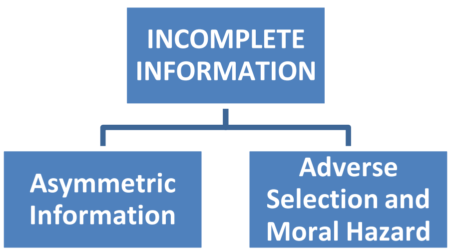
If the free-rider problem cannot be solved, the following two outcomes are possible:

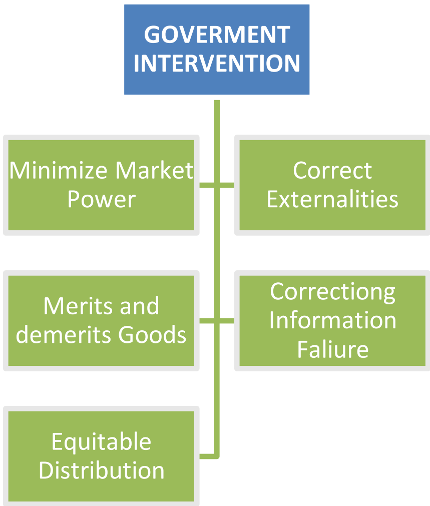
1. No public good will be provided in private markets
2. Private markets will seriously under produce public goods even though these goods provide valuable service to the society.

INCOMPLETE INFORMATION

Complete information is an important element of competitive market. Perfect information implies that both buyers and sellers have complete information about anything that may influence their decision making. However, this assumption is not fully satisfied in real markets due to the following reasons:

- High complexity
- Consumers are unable to quickly / cheaply find sufficient information on the best prices as well as quality for different products.
- inaccurate or incomplete data and consequently make potentially 'wrong' choices / decisions.





MINIMIZE MARKET POWER

- Designed to promote competition and prohibit actions that are likely to restrain competition.
- To promote and sustain competition in markets.
- aim at prohibiting contracts, combinations and collusions among producers or traders which are in restraint of trade
- Elimination of anticompetitive actions such as predatory pricing.
- Protection of unique innovations for E.g. patent and copyright laws.
- Price Regulation

GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

1. Direct controls that openly regulate the actions of those involved in generating negative externalities.

   For E.g. Smoking is completely banned in many public places. Stringent rules are in place in respect of tobacco advertising, packaging and labeling etc.

2. Charge an emissions fee which is levied on each unit of a firm's emissions.
3. Governments may also form special bodies/ boards to specifically address the problem. *For E.g. Ministry of Environment & Forest, the Pollution Control Board of India*

The market-based approaches–environmental taxes and cap-and-trade – operate through price mechanism to create an incentive for change. In other words, they rely on economic incentives to accomplish environmental goals at lesser costs. The market based approaches focus on generation of a market price for pollution. This is achieved by:

1. Setting the price directly through a pollution tax
2. Setting the price indirectly through the establishment of a cap-and-trade system.

Account for the difficulties in determination of level of taxes to solve the problems associated with market failure?

- Pollution taxes are difficult to determine and administer.
- difficult to discover the right level of taxation
- the tax may only have an insignificant effect in reducing demand.
- complex and costly administrative procedures for monitoring the polluters.
- It only establishes an incentive system for use of methods which are less polluting. Less genuine.
- Inflation may effect the consumer welfare.
- Pollution taxes also have potential negative consequences on employment and investments

What are the relative advantages of market based interventions?

- Flexibility and reward efficiency
- Cheap and simple to implement.
- Pollution is minimized in the most cost-effective way
- Strong incentives for innovation.
- Consumers are benefited by low prices.

GOVERNMENT INTERVENTION IN THE CASE OF MERIT GOODS

- Merit goods are goods and services the government deems/feels that people will under consume, and which might be subsidized or provided free at the point of use.
- Both the state and the private sector provide merit goods.
- With merit goods individuals may not act in their own interest because of imperfect information.
- Unlike pure public goods, merit goods can be rival, excludable and rejectable.
- The social benefit from consumption exceeds the private benefit.
- A merit good is a product that society values and judges that people should have regardless their ability to pay.

OPTIONS FOR GOVERNMENT

- Regulations.
- Subsidies.
- Direct government provisions
- Combination of government provision and market provision.
- Compulsory immunization
- Legislation to enforce the consumption of a good which generates positive externalities.

GOVERNMENT INTERVENTION IN THE CASE OF DEMERIT GOODS

Demerit goods are goods which are believed to be socially undesirable. *Examples of demerit goods are cigarettes, alcohol, intoxicating drugs etc.*

OPTIONS FOR GOVERNMENT

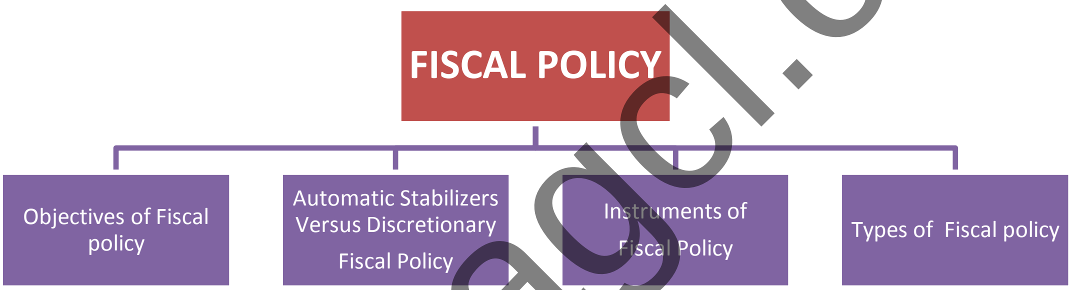
- Complete ban on a demerit good.
- Negative advertising campaigns
- Legislations that prohibit the advertising or promotion of demerit goods
- Limit access to the good, especially by vulnerable groups such as children and adolescents.
- Spatial restrictions *e.g. smoking in public places, sale of tobacco to be away from schools*
- high taxes on producing or purchasing the good

GOVERNMENT INTERVENTION FOR CORRECTING INFORMATION FAILURE

- Mandatory to have accurate labeling and content disclosures by producers. *For E.g.: SEBI requires that accurate information be provided to prospective buyers of new stocks.*
- Public dissemination of information
- Regulation of advertising >> *informative and less persuasive.*

GOVERNMENT INTERVENTION FOR EQUITABLE DISTRIBUTION

- Progressive income tax
- Targeted budgetary allocations
- Unemployment compensation
- Transfer payments
- Subsidies
- Social security schemes
- Job reservations
- Land reforms
- Gender sensitive budgeting



FISCAL POLICY

- Fiscal policy involves the use of government spending, taxation and borrowing to influence:-
  - economic activity
  - growth of aggregate demand
  - output
  - employment
- fiscal policy is designed to influence the pattern and level of economic activity in a country
- Fiscal policy is in the nature of a demand-side policy
- An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

OBJECTIVES OF FISCAL POLICY

- Achievement and maintenance of full employment
- maintenance of price stability

→ *For Developed Countries*

- acceleration of the rate of economic development
- equitable distribution of income and wealth

→ *For Developing Countries*

AUTOMATIC STABILIZERS/NON- DISCRETIONARY FISCAL POLICY

Part of the structure of the economy

'Built-in' fiscal mechanisms

Operates automatically to reduce the expansions and contractions of the business cycle.

Changes in fiscal policy do not require action by government.

Depend on the level of aggregate production and income

Aggregate Demand ↑ during recession.

Aggregate Demand ↓ during inflation

E.g. :-

Personal income taxes

Corporate income taxes

Transfer payments

NON- DISCRETIONARY FISCAL POLICY

deliberate policy actions on the part of government

changing the level and types of taxes

the extent and composition of spending

the quantity and form of borrowing

INSTRUMENTS OF FISCAL POLICY

Government Expenditure as an Instrument of Fiscal Policy

- Capital expenditure
  - Investment in capital equipment
  - Infrastructures
- Current expenditures to meet the day to day running of the government
- Public works
- Relief expenditures
- Subsidy payments
- Transfer payments

Taxes as an Instrument of Fiscal Policy

- encouraging or restricting private expenditures on consumption and investment.
- Taxes determine the size of disposable income in the hands of the general public
- Determines aggregate demand during recession or inflation

Public Debt as an Instrument of Fiscal Policy

- Internal Debt >> borrowing from its own people in the country
- External debt >> borrowing from outside sources
- Public debt >>
  - Market loans >> treasury bills, government securities, long- term capital bonds
  - Small savings >> National Savings Certificates, National Development Certificates

Budget as an Instrument of Fiscal Policy

BALANCED BUDGET

Expenditure = Revenue

No effect on aggregate demand

SURPLUS BUDGET

Expenditure < Revenue

Negative impact on aggregate demand

DEFECIT BUDGET

Expenditure > Revenue

Positive net effect on aggregate demand

TYPES OF FISCAL POLICY

Expansionary fiscal policy

is designed to stimulate the economy during the contractionary phase of a business cycle

accomplished by increasing aggregate expenditures and aggregate demand through spending or decresing in taxes

Contractionary fiscal policy

is designed to restrain the levels of economic activity of the economy during an inflationary phase,

carried out by decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/ or an increase in taxes.

Contractionary fiscal policy

(eliminating an inflationary gap)

1. Decrease in government spending

2. Increase in personal income taxes and/or business taxes

3. A combination of the above 2 methods

FISCAL POLICY FOR REDUCTION IN INEQUALITIES OF INCOME AND WEALTH

MEASURES

- A progressive direct tax system
- Indirect taxes can be differential >> luxuires goods are taxed heavily and necessaties goods are taxed ligher.
- Poverty alleviation programmes
- Free or subsidized medical care, education, housing, essential commodities etc
- Infrastructure provision on a selective basis
- Various social security schemes for e.g. *old-age pensions, unemployment relief, sickness allowance etc.*
- Strengthening of human capital for enhancing employability etc.
- Public production and/ or grant of subsidies
- Subsidized production of products of mass consumption

LIMITATIONS OF FISCAL POLICY

1. **Discretionary Fiscal Policy**
    - Recognition lag
    - Decision lag
    - Implementation lag
    - Impact lag
2. changing governments' spending and taxation policies.
3. Difficult to reduce government spending on defence and social security or huge capital projects on midway.
4. difficulties of forecasting of inflation or recession.
5. Big projects cannot be adjusted due to long gestation period.
6. conflicts between different objectives of fiscal policy
7. fiscal measures may cause disincentives
8. prices spiraling beyond control.
9. perpetual burden on internal and external debts
10. **CROWDING OUT**

↓

If the government runs a big budget defecit, it will have to sell debt → The demand for loans increases and this pushes the interest rates up → This squeezes spending and investment by the private sector

Private investments will be reduced. → Therefore, Fiscal policy becomes ineffective as the decline in private spending partially or completely offset the expansion in demand resulting from an increase in government expenditure.