CHAPTER 2

PUBLIC FINANCE

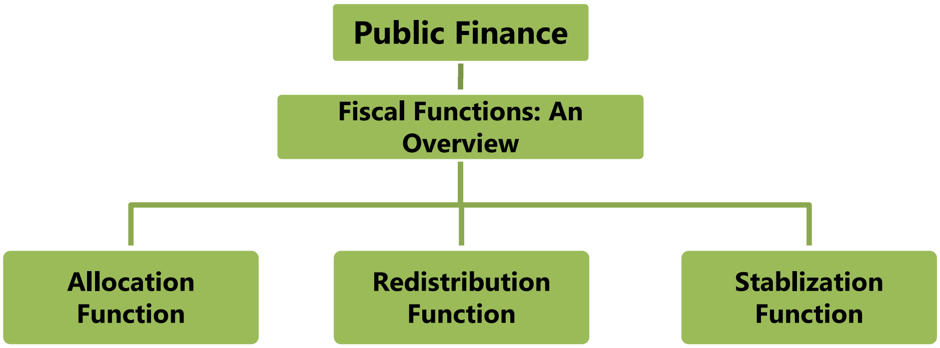
UNIT I: FISCAL FUNCTIONS: AN OVERVIEW

LEARNING OUTCOMES

At the end of this unit, you will be able to:

- Enumerate the rationale of government intervention in markets
- Explain the three branch taxonomy of the role of government in a market economy
- Describe the various interventionist measures adopted by the government
- Analyze the governmental economic actions and classify them according to the economic functions of the government

UNIT OVERVIEW



1.1 INTRODUCTION

The following are a few headlines which appeared recently in the leading business dailies:

1. Crop worry: Centre scraps import duty on wheat to ease supply and check prices
2. Monetary Policy panel members voted unanimously for a rate cut
3. A fortified mid -day meal gets underway at Karnataka's government schools
4. Government to spend ₹ 60,000 crores more on rural jobs
5. Government looking at subsidizing Smart phones to boost digital payments
6. No service tax on credit, debit card transactions up to ₹ 2,000

Each of the above statements represents a proactive response on the part of the government to achieve certain objectives in the interest of the economy and the society.

What exactly is the government planning to accomplish by the above measures? On close examination, we can find that the first two steps are intended to control potential rise in prices; the next two seek to bring in welfare to the underprivileged sections of the society by ensuring equity and fairness and the remaining two are meant to provide incentives to promote the production/ use of resources in a socially desirable direction. The government does not expect the economic variables underlying the above mentioned phenomena 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.

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 certain goods and services are provided exclusively by the government. For a variety of reasons, we believe that governments should accomplish some activities and should not do others. 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 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. Therefore, 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. 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.

Adam Smith is often described as a bold advocate of free markets and minimal governmental activity. However, Smith saw an important resource allocation role for government when he underlined the role of government in national defence, maintenance of justice and the rule of law, establishment and maintenance of highly beneficial public institutions and public works which the market may fail to produce on account of lack of sufficient profits. 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 as described above, 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 to the nature and extent of government intervention in economies, all governments are still expected to play a major role. This comes out of the belief that government intervention will invariably 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 government are to be separated into three, namely, resource allocation, (efficiency), income redistribution (fairness) and macroeconomic stabilization. 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 policy, the problems of macroeconomic stability, maintenance of high levels of employment and price stability etc fall under the stabilization function. We shall now discuss in detail this 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 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. 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.

As we know, 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 both market determined and government determined.

A market economy is subject to serious malfunctioning in several basic respects. There is also the problem of nonexistence of markets in a variety of situations. While private goods will be sufficiently provided by the market, public goods will not be produced in sufficient quantities by the market. Why do markets fail to give right answers to the question as to what goods should be produced and in what quantities? In other words, why do markets generate misallocation of resources?

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:

- Imperfect competition and presence of monopoly power in different degrees leading to under-production and higher prices than would exist under conditions of competition. These distort the choices available to consumers and reduce their welfare.
- Markets typically fail to provide collective goods which are, by their very nature, consumed in common by all the people.
- Externalities which arise when the production and consumption of a good or service affects people and they cannot influence through markets the decision about how much of the good or service should be produced e.g. pollution.
- Factor immobility which causes unemployment and inefficiency
- Imperfect information, 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 and 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 by too much production of certain goods or too little production of certain other 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.

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. Goods which involve externalities that are not met by the market require intervention by the government for corrective measures. Merit goods which are greatly beneficial to the society also fall under the purview of provision by the government. 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 fiscal policy focuses on the potential for the government to improve economic performance through its expenditure and tax policies. The allocative function in budgeting determines who and what will be taxed as well as how and on what the government revenue will be spent. It is concerned with the provision of public goods and the process by which the total resources of the economy are divided among various uses and an optimum mix of various social goods (both public goods and merit goods). The allocation function also involves 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,

- government may directly produce the economic good(for example, electricity and public transportation services)
- government may influence private 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)
- government may influence allocation through its competition policies, merger policies etc which will 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
- any of a mixture of intermediate techniques may be adopted by governments

Maximizing social welfare is one of the primary and most commonly manifest reasons for government intervention in the market. However, it is also possible that instead of eliminating market distortions, sometimes governments may contribute to generate them. The possible sources of this type of government failures are inadequate information, conflicting objectives and administrative costs involved in government intervention.

1.4 REDISTRIBUTION FUNCTION

You might have noticed that over the past decades there has been tremendous expansion in economic activities which has generated enormous increase in aggregate output and wealth. However, the outcomes of this growth have not spread evenly across the households. A major function of present-day governments therefore involves changing the pattern of distribution of income from what the market would offer to a more egalitarian one. 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 desirable and just distribution.

The distributive function of budget is related to the basic question of for whom should an economy produce goods and services. As such, 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.

The distribution function of the government aims at:

- redistribution of income to achieve an equitable distribution of societal output among households
- advancing the well-being of those members of the society who suffer from deprivations of different types
- providing equality in income, wealth and opportunities
- providing security for people who have hardships, and
- ensuring that everyone enjoys a minimal 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 (example, supply of essential food grains at highly subsidized prices to BPL households)

- employment reservations and preferences to protect certain segments of the population,
- regulation of the 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 exists 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 work, and discourage people from savings and investments and risk taking. This in turn will have negative consequences for productivity and growth of the economy. Consequently, the potential tax revenue may be reduced 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

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. Business cycles are natural phenomena in any economy and they tend to occur periodically. 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. In the absence of appropriate corrective intervention by the 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 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 intricate.

The stabilization issue also becomes more complex as the increased international interdependence causes forces of instability to get easily transmitted from one country to other countries This is also known as contagion effect".

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 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.

Government's fiscal policy has two major components which are important in stabilizing the economy:

1. an overall effect generated by the balance between the resources the government puts into the economy through expenditures and the resources it takes out through taxation, charges, borrowing etc.
2. a microeconomic effect generated by the specific policies it adopts.

Government's stabilization intervention may be through monetary policy as well as fiscal policy. Monetary policy has a singular objective of 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. On the expenditure side, Government can choose to spend in such a way that it stimulates other economic activities. For example, government expenditure on building infrastructure may initiate a series of productive activities. Production decisions, investments, savings etc can be influenced by its tax policies.

We know that government expenditure injects more money into the economy and stimulates demand. On the other hand, taxes reduce the income of people and therefore, reduce effective demand. 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. On the other hand, to control high inflation the government cuts down its expenditure or raises taxes. In other words, expansionary fiscal policy is adopted to alleviate recession and 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 are thought to slow down economic activity. 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.

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.

1.6 CONCLUSION

We have discussed the need for and rationale of government intervention to improve social welfare by enhancing stability, efficiency and fairness. However, we should also understand that when we say that the market-generated allocation of resources is imperfect, it does not necessarily imply that the government is always infallible and at all times capable of correcting the failures of the market. Governments are likely to commit serious errors in its attempt to correct market failure. For example, 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. Moreover, just as individuals, governments too have only imperfect information, and hence can commit mistakes. It is also possible that individuals may use government as a mechanism for maximizing their self-interest. Moreover, governments may not always be unbiased and benevolent.

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 to set apart to ensure growth of productive capacity
- Since the 1930s, the traditional functions of the state have been supplemented with the economic functions (also called the fiscal functions or the public finance function)
- 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 whom should an economy produce goods and services
- The distribution function 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 has a singular objective of 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.
- There is often conflict between the different goals and functions of budgetary policy. The challenge before any government is how to design its budgetary policy so that the pursuit of one goal does not jeopardize the other.
- Government intervention does not necessarily imply that the government is always capable of correcting the market failures. Government failures occur due to the imperfect information, high administrative costs and tendency of bureaucracy and the politicians to promote vested self- interest using government mechanisms

TEST YOUR KNOWLEDGE

I Multiple Choice Type Questions

1. Macroeconomic stabilization may be achieved through
   (a) Free market economy
   (b) Fiscal policy
   (c) Monetary policy
   (d) (b) and (c) above

2. Which of the following policies of the government fulfills the redistribution function
   (a) Parking the army on the northern borders of the country
   (b) Supply of medicines at subsidized prices to the poor people
   (c) Controlling the supply of money through monetary policy
   (d) None of the above

3. 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.

4. 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

5. When the government decides to produce fertilizers and supply them to the agriculturists, it aims

   (a) to achieve equity and fairness to the agriculturists

   (b) to influence the way resources are allocated in the economy

   (c) to ensure higher profits to agriculturists

   (d) to make greater profits for the public sector

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. The allocation and distribution functions are primarily :

   (a) Micro-economic functions

   (b) Macro-economic functions

   (c) both micro as well as macro-economic functions

   (d) aimed at bringing in price stability and economic growth

II. Short Answer Type Questions

1. Describe why governments should perform the allocation function in an economy?

2. How does monopoly power affect efficiency of markets?

3. Explain how government can get domestic producers produce more pulses?

4. Enumerate the circumstances which necessitate redistribution by government.

5. Illustrate with an example the redistribution effect of a tax and transfer policy

6. What is the objective of government subsidy?

7. Why do private producers hesitate to produce public parks, bridges and highways?

8. What reason would you assign for employment reservations to socially backward communities?

9. What would be the objective of a government when it declares special schemes for backward regions?

10. What should be the public revenue and expenditure policy of the government during recession?

11. Describe the rationale for the stabilization function of government policy.

III. Long Answer Type Questions

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

2. Illustrate four cases which provide justification for government intervention in markets.

3. Describe the various interventional measures adopted by the government.

4. What are the different instruments available to the government to improve allocation efficiency in an economy?

5. Explain how economic stability can be achieved through fiscal policy.

IV. Application Oriented Questions

1. 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.

2. The government decides to levy up to ₹ 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.

ANSWERS/HINTS

I Multiple Choice Type Questions

1.(d) 2.(b) 3.(c) 4.(d) 5(b) 6.(b) 7(a)

IV Hints to Application Oriented Questions

1. (a) (i) Public good – Merit good- Positive externalities – Inefficient market outcomes - Possible market failure –scope for market intervention to improve social welfare - Adam Smith's proposition of resource allocation role of government i.e establishment and maintenance of highly beneficial public institutions and public works which the market may fail to produce on account of lack of sufficient profits. Define the resource allocation role of government's policy - the potential for the government to improve economic performance through its expenditure to provide an optimum mix of various social goods.

(ii) Nature and characteristics of the programme of government action – Policy of Expenditure - Purpose- Welfare outcomes of programmes for eradication of mosquito-borne diseases –Possibility of government failure.

(iii) Substantiate with examples from recent policy propositions of government.

(b) (i) The distributive function of budget related to the basic question of for whom should an economy produce goods and services. Left to the market, only private benefits and private costs would be reflected in the price paid by consumers. This means, through the market mechanism, people would consume inadequate quantities compared to what is socially desirable. Outcome: social welfare will not be maximized. *Therefore* - Government Intervention in the case of Merit Goods eg Healthcare - government deems that its consumption should be encouraged - Price intervention- setting price ceilings - to influence the outcomes of a market on grounds of fairness and equity - price floor for ensuring minimum price and price ceiling for making a resource or commodity available to all at reasonable prices - May illustrate with diagram.

(ii) Nature and characteristics of the programme of government action - Purpose- Welfare outcomes of the policy – Negative outcomes - Possible disincentives to producers- diversion of resources away from regulated products- black marketing- etc.

(iii) Substantiate with examples

2. Theory of Government intervention for redistribution to ensure fairness and equity (As discussed in the above two questions)

   (i) Price intervention - a market-based policy - contributing airlines may experience cost escalation – possible fare hikes – changes in equilibrium quantities – disincentives to fly aircrafts in taxed routes - possible exit from market by low profit margin airlines- Regional connectivity and other welfare outcomes as subsidies to producers would lower their cost of production increase output- substantial positive externalities.

   (ii) Another possibility: 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 - cannot be sure that the government interventions would be effective – possibility of government failure.