

# 18KP3EC09 – Fiscal Economics

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## FISCAL ECONOMICS

COURSE CODE: 18KP3EC09

Credit : 5

Hours / Week : 6

Medium of Instruction : English

### UNIT – I Theory of Public Goods and Public Choice:

The Economic Role of Government allocation of Resources- Private goods, public and merit goods – Market failure –Causes and Measures.

### UNIT – II Public Expenditure:

Wagner's law of increasing state activities. Musgrave's views on public Expenditure - principles of public expenditure.

### UNIT – III Taxation and Public Debt:

Characteristics of a Good Tax system. Principles of Taxation. Factors determining Taxable capacity- Definition and classification of public Debt. Causes for the Growth of public Debt.

### UNIT – IV Fiscal Policy

Definition of Fiscal Policy - Objectives of Fiscal policy-Techniques of fiscal policy – Deficit financing, Fiscal policy in India.

### UNIT – V Fiscal Federalism

Meaning of Federal finance – principles of federal finance. Evolution of federal finance in India. Balancing factors in federal finance .

### REFERENCE BOOKS

1. S. Sankaran - Fiscal Economics
2. B.P. Iyage - Public Finance
3. A. Koutsoyiannis - Modern Economics

# Fiscal Economics

Unit 1 – Theory of Public goods and Public Choice

# Private Good

- Private good have been defined as good yielding utility or satisfaction only to the person consuming the good and it is denied to others.
- E.g. consumption of a cup of milk

# Public Good

- Public good is defined as the good one person consumption will not reduce the amount available to the others in other words consumption of public good is non-rival
- E.g.. Benefit of a Dam controlling flood

# Allocation of Resources

- Allocation of resources and distribution of income
- Allocation of resources in market and decreasing cost
- Allocation of resources in perfect and imperfect market condition
- Allocation of resources in market and Public wants
- Profit system Emphasises short term profit at the expense of long term profit
- Profit system fails to achieve the social goal of economic stability
- Market failure due to external externalities
- Market failure since marginal cost of a pure public good is zero
- Market failure due to non-rival consumption
- Market Failure due to non-excludability

# Allocation of Resources

- Allocation Of Resources And Distribution Of Income

Efficient allocation of resources is how resources are distributed among individuals. If income of the rich is transferred to poor the demand for X is increased and the demand for Y falls. Unequal distribution of income will lead to distasteful pattern of demand and output

- Allocation Of Resources In Market And Decreasing Cost

Decreasing cost occurs when there are high overhead or fixed costs. E.g. transportation, Hospitals

# Allocation of Resources

- Allocation Of Resources In Perfect And Imperfect Market Condition

Market economy may fail to achieve allocation of resources due to imperfect conditions of market, for instance imperfect knowledge of market.

- Allocation Of Resources In Market And Public Wants

Allocation of resources may not be efficient in case of certain public wants. E.g. National Defence



# Allocation of Resources

- Profit System Emphasises Short Term Profit At The Expense Of Long Term Profit

Private enterprise can effectively develop hydroelectric power resources or even provide water irrigation purpose

- Profit System Fails To Achieve The Social Goal Of Economic Stability

The reaction of individual to prospective decline in demand is normally to reduce investment in plant and inventory which leads to instability in the economy. Government should modify by Grant and subsidy

# Allocation of Resources

- Market Failure Due To External Externalities

Externalities refer to economic effect which occurs from the production or use of the goods by other parties or economic units. External benefits that occur to the members of the community and the nation in which members reside. E.g. education, road

- Market Failure Since Marginal Cost Of A Pure Public Good Is Zero

Pure Public good which possess the characteristic i.e. marginal cost is zero.

# Allocation of Resources

- Market Failure Due To Non-rival Consumption

Public good is a Non Rival good. The consumption of public good will lead to the utility and satisfaction to all.

- Market Failure Due To Non-excludability

Market failure may arise where commodity is rival but exclusion is not feasible. Social goods should be provided and furnished it which the fiscal resources needs to pay for them

# Public Wants

- Public wants can be classified into two categories
  - Social Wants
  - Merit wants
- Social Wants:

Social wants are those wants which are satisfied by services that must be consumed in equal amounts by all. He is excluded from the enjoyment of any particular commodity or services unless he is willing to pay the stipulated price to the owner.

# Public Wants

- Merit wants:

Some goods or wants are considered meritorious while others are held undesirable. E.g. Low cost housing with the subsidies given by the state is very desirable and meritorious

- Merit Goods:

Good whose consumption is to be encouraged should be called merit good. E.g. starting a primary school

- Demerit good

Good whose consumption is to not encouraged is non-merit good or demerit good

- E.g.: liquor

# Market Failure

- Market Failure

This is available market mechanism in the economy could not work efficiently to allocate the resources of the economy and produce the commodities required in optimal quantities

# Causes and Effect of market failure

- Distribution of Income:

Efficient allocation of resources is possible only where there are minimal inequalities of income and wealth E.g. Production of luxury goods demanded by rich will not be produced for poor because private sector is not willing to produce goods for poor. It will produce the profit good only. The government allocates adequate resources in the budget to produce essential goods under public sector

# Causes and Effect of market failure

- Allocation of resources under decreasing cost:

Production at law of decreasing costs in the case of transportation power generation and postal services

- Allocation of resources and imperfect market conditions

Individual consumption decisions are inferior because of inadequate knowledge and the market principal result in allocation of resources to other than the best uses



# Causes and Effect of market failure

- Market failure in the case of public wants

All the people in the economy may not be capable of paying the price for the commodity or services which are classified as public wants. It becomes inevitable on the part of the government to provide the necessary public want to all the people whether they are capable of paying the price for the same or not. E.g. National Defence, Protection against health Hazard

# Causes and Effect of market failure

- Profit system and failure of economic stability

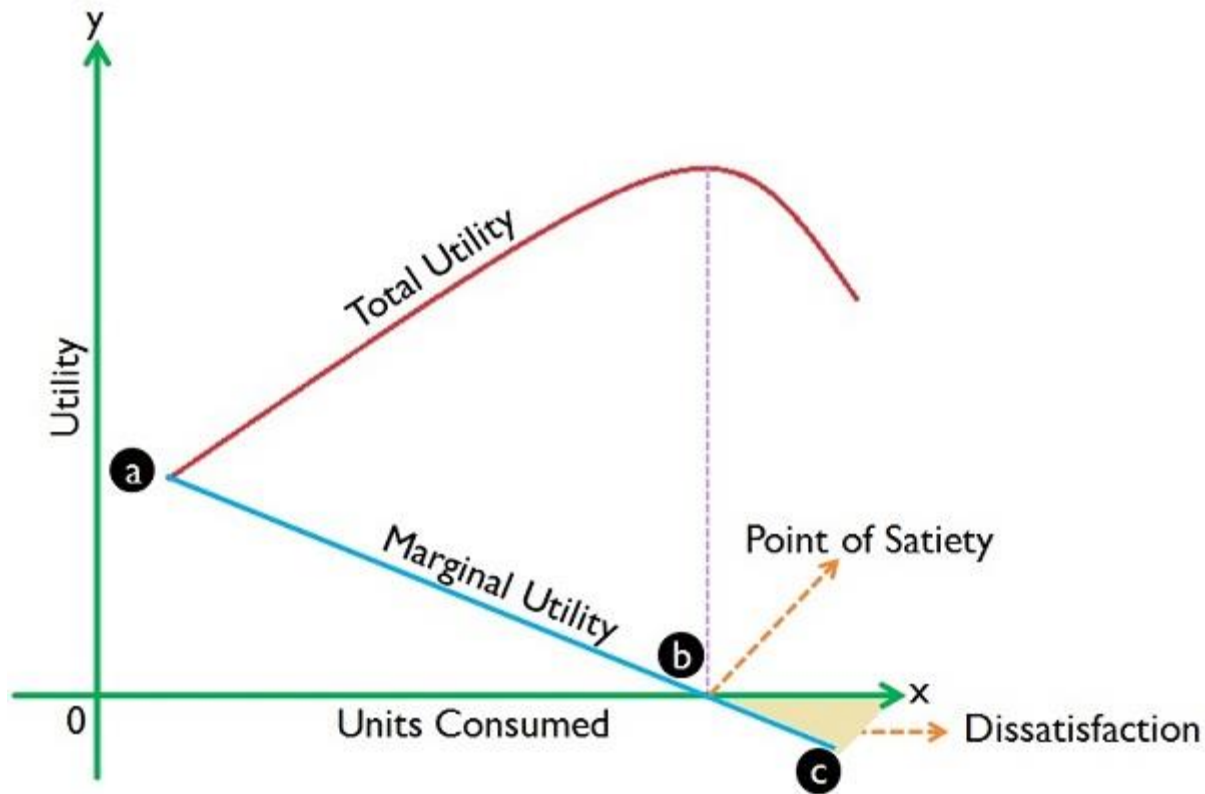
Market system works on the basis of profit and the resources will be exploited to those channels where the profit will be high and also immediate. The short term profit would be looked after in production rather than long term profit. At that time grants and subsidies will be given by the government

- Market failure due to externalities

Government expenditure on social wants like education and road will lead to market failure. It will be rectified by the equalities of income.

# Causes and Effect of market failure

- Marginal cost of pure goods are zero



# Causes and Effect of market failure

- Market failure due to non-rival consumption

Public goods produced for the social wants will be called a non-rival consumption goods.

# Fiscal Economics

## Unit 2 - Public Expenditure

# Wagner Law Of Increasing State Activity

- Wagner law of increasing state activity

Public expenditure is the expenditure incurred by public authorities –central state and local governments either for the satisfaction of collective needs of the citizen or for promoting their economic and social welfare

- Wagner's Law

Economic growth of public expenditure in modern days compared to the olden days because of the increased activities and responsibilities of the state.

# Wagner Law Of Increasing State Activity

- “policy state “ is replaced by “ welfare state “ Growth of Economy is necessarily associated with the growth of the Govt. activities
- There is a positive correlation between the growth of the economy and the growth of the Govt. activities . It is stated by Wagner that in this process the Govt. sector grows faster than the economy
- Wagner emphasised the long term forces of economic development rather than short term changes in the public expenditure.

# Wagner Law Of Increasing State Activity

- The tendency of increasing public expenditure, which means growing role of the state.
  1. Increasing population and also increasing complexities of modern life i.e. extra need of the population with more school Hospitals water supply transport etc.
  2. Prices have a secular tendency to go up
  3. It is not merely increase the quantity of public service that matters the quantity of service should be increased



# Wagner Law Of Increasing State Activity

4. Modern govt. have the duty to protect the economy from the evils of market mechanism i.e. price regulatory measures have to be adopted
5. Modern Govt. have a tendency to run into depts. An this leads to a subsequent increase in public expenditure in the form of debt servicing and repayment of loan
6. Periodical General Election, maintain thousands of legislators, a Cabinet Ministers besides a host of civil servants etc. is very expensive and these expenditures have to be met from the public treasury.

# Wagner Law Of Increasing State Activity

7. Both central and State Government Are providing firm subsidies on a large scale so as to become popular to win election. Schemes like supply of subsidised rice, free water to farmers, free electricity for tube wells in rural areas, free channel water for irrigation , free electricity to farmers to etc.

# Wagner Law Of Increasing State Activity

- Increase in public expenditure can be justified on the following grounds
  1. Assist in increasing state activity
  2. Increase in welfare activities to make the poor stronger in due course with a time bound programme.
  3. Reducing disparities between rich and poor
  4. Helping the growth of economy with stability

# Wagner Law Of Increasing State Activity

- Limitations

The quality of democracy or quality of administration, as well as political culture, integrity of the people go long way in establishing relationship between public expenditure and economic development.

# Mugrewe's Views On Public Expenditure

- The traditional objectives of public expenditure in developed economies are as follows
  1. Increasing income of the people and also employment opportunities
  2. Better distribution of income of economy
  3. Judicious allocation of resources in the economy into socially desirable channel etc.
  4. Maximising economic welfare through allocation of resources.
  5. Achieving full employment and economic stability.
  6. Ensuring equitable distribution of income.
  7. Accelerating economy group.

# Mugrewe's Views On Public Expenditure

- Functions of public expenditure
  1. Activity to secure reallocation of resources
  2. Redistributive activities
  3. Stabilising activities
  4. Commercial activity

# Public Expenditure In Developed Countries

Reasons for the increasing trends of public expenditure in developed countries

1. Activities to secure reallocation of resources
  - a) Government has to check Monopolies and also monopolistic tendencies preventing collusion and also price discrimination
  - b) Government has to encourage on expansion of output by various means such as subsidy to the producer with a view to making it available in large quantity to the masses. Public utility like railways electricity etc. has to provide at a low cost.

# Public Expenditure In Developed Countries

- c) Production of cigars and liquors is not only harmful to society but also increases cost of administration. Government should restrict it by imposing high taxes on the production and sale of those goods.
- d) Government should take steps to increase supply of services and activities like education or medical aid.
- e) Defence must be provided by the government and they cannot be provided by private producers, as the benefit arising out of these is social.



# Public Expenditure In Developed Countries

## 2. Redistributive activities

- a) Inequalities in income should be reduced by means of taxation and transfer of resources from rich to poor. These ensure minimum standard of living of the poor people and there by attempts to reduce the gap between the haves and have-nots.

## 3. Stabilising activities

- a) Government should take adequate measures to avoid business fluctuations and also to maintain economic stability and there by ensure high level of employment and price stability. During depression government expenditure must be increased with constant taxation.

# Public Expenditure In Developed Countries

## 4. Commercial activities

- a) Commercial services like transport can be efficiently provided by means of government monopoly than by private enterprise. Government may also invest project which are highly beneficial from the social point of view and also poor returns in the project

- Conclusion

- Public expenditure occupies a very important position in the economic development of the country as it plays a vital role in production, distribution and also in maintaining economic stability.

# Principles Of Public Expenditure

- First principle indicates the extent to which the total expenditure should be pushed
- Second refers to the distribution of resources on different heads to maximise the net social benefit.
- Public expenditure in every direction should be carried out so far that the advantage to the commodity of a further small increase in any direction. It is balanced by disadvantage of corresponding small increase in taxation or in receipts from any other source of public income

# Principles Of Public Expenditure

- This gives the ideal to both of public expenditure and public income.
- Public expenditure should be pushed in all directions up to the point at which the satisfaction obtained from the last shilling expended is equal to the satisfaction lost in respect of last shilling called upon Govt. service.
- Expenditure should be in the marginal social benefit obtained from the last rupee spent is equal to the marginal sacrifice imposed by the last rupee realised by way of taxation.

# Principles Of Public Expenditure

- Difficulties In Following Public Expenditure
  - Public expenditure should promote the welfare of the society
  - Careful judgement should be exercised by public officials.
  - The services which will be the best to promote the social welfare should be undertaken first and those which will promote the least social welfare should be undertaken at last.

# Principles Of Public Expenditure

- CONCLUSION
  - Principles of public expenditure are only ideals and are theoretically true but practically it is very difficult to follow them.

# Reference Materials

- Public Finance - B.P Tyage
- Fiscal Economics – S Sankaran
- Modern Economics – A.Koutsoyiannis