

Ch-7

Public Finance

* Unit-1 :- Fiscal Function

* Central Economic Problems:

→ Scarcity: Lionel Robbins

What to produce
& How much to
produce?How to
produce?For Whom to
Produce?

(Who solves these problems?)

Depends on Nature of Economic System

Capitalist Economy

Socialist Economy

Mixed Economy

↓
Firms↓
Government↓
Firms + Govt

*

2 Economists

Adam Smith

Richard Musgrave

→ Believes in free market
[No govt interference]

→ "Theory of Public Finance
[1959]"

→ In following areas as per
Smith Govt interference
necessary:- [Pvt X]

→ 3 roles of Govt in
a market economy

a) National Defense

a) Allocation function

b) Justice, Law

b) Redistribution function

c) Beneficial Public
Institutions

c) Stabilization function

Ex:- ISRO, Railways,
NABARD.

*

Allocation Function [Govt]

⇒ It refers to the way in which factors of
production are allocated among various uses.

*

Q) What is Govt objective in Allocating Resources?

1) Optimal Allocation of scarce resources to minimise
wastage.

2) Maximise Social Welfare

3) Correct Market Failure, i.e - Misallocation of resources

4) To focus on Merit goods

*

Goods

↓
Merit Goods

↓
De-merit Goods

↓
Healthcare, Crops
(for society)

↓
Alcohol, Cigarettes.

* Q) Scope of Govt Intervention in Resource Allocation?

1) The allocation function determines what will be taxed (demerit), how and on what the govt revenue will spent (Subsidy → Merit)

2) It is concerned with process by which Total Resources, are divided among various public & private goods.

3) Reallocation of resources from Private use to Public use.

4) Govt → Complement to Market System
→ Not Substitute to Market System

* Q) What are instruments of Govt Intervention in allocation?

1) Directly Producing Economic Goods
[Eg- Electricity, Public Transportation]

2) Influencing private allocation through incentives (like subsidy) and disincentive (like tax at higher rate on cig + AlC)

3) Corruption Policies, Merger Policies

4) Regulatory activities such as licensing, controls, minimum wages, etc.

5) Legal & Administrative frameworks
[Penalty for Non Compliance]

*

Redistribution - Function

⇒ It is concerned with distribution of Income & wealth to ensure equity and fairness.

*

a) Objectives of Govt interference in Redistribution function?

1) Equitable distribution of society output among households

2) Advancing well being of members of society

3) Equality in distribution of Income & Wealth

4) Providing security to people who have hardships
[Rough kind]

5) Ensuring everyone enjoys atleast a minimum standard of living.

* Q) Scope of Govt Intervention in Redistribution function?

1) Redistribution policies are likely to have efficiency costs or deadweight losses due to conflict between efficiency & equity

2) Ex :- Greater equity can be achieved through increasing the tax rates on the rich. But this increase tax may act as a disincentive to work & discourage people from saving and investment and risk taking.

3) Consequently potential revenue may reduce.

4) Redistribution should be accomplished with minimal efficiency costs by carefully balancing equity & efficiency.

* Instruments of Redistribution :-

1) Taxation policies of the govt [Progressive Taxation]

2) Food Grain security

3) Employment Reservations

4) Schemes for backward regional development.

* Stabilization Function

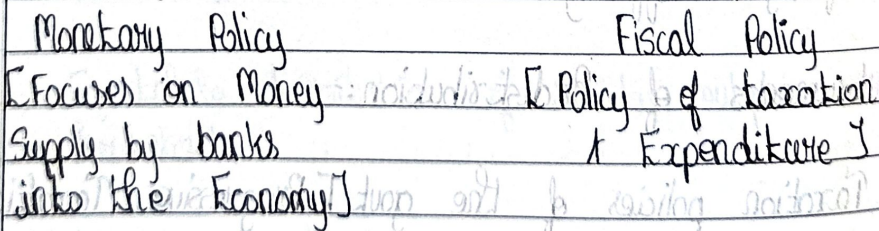
⇒ Stabilization Function aims at eliminating Macro-Economic fluctuations arising from suboptimal allocation.

* Objectives of Govt under Stabilization Function

- 1) Labour employment and Capital Utilization [PE(G+)] BOP]
- 2) General price levels
- 3) Balance of Payment
- 4) Rate of Economic Growth

* Scope of Govt Intervention:-

Stabilization may be through



* Methods of Govt Intervention [Instruments]:

a) Expansionary Fiscal Policy [Govt increases its expenditure & cuts down taxes] to overcome recession.

b) Contracting Fiscal Policy [Govt cuts down expenditure & raises taxes] to control inflation.

c) Deficit budgets are expected to stimulate (Increase) Economic Activity.

d) Surplus budgets slow down Economic Activity.

* Contagion Effect :-

=> Increased International Interdependence causes forces of instilling to get easily transmitted from one country to other country which is also known as Contagion Effect.

=> Example :

i) If today is the birthday of classmate we all will receive chocolates.

ii) If our classmate has Covid-19 we all have to suffer too.

* Ch - 7

=> Unit - 2

Market Failure

-> Situation in which free market tends lead to misallocation of resources such that there is:-

i) Under production or

ii) Over production

-> Leading to a less than optimal outcome.

* Reasons for market failure:-

-> Market Power [Monopoly]

-> Externalities

-> Public Goods

-> Incomplete Information

* i) Market Power [Monopoly Power]:

=> The ability of a firm to raise the price of a good or service over its Marginal Cost.

* $\Rightarrow$ Adverse Impacts, [Negative Impacts]

① Higher Prices

② Low Output [Single Producer]

③ Nonexistence of markets.

$\rightarrow$ Various goods & services are lacking

* Outcome Effect :-

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

* ii) Externalities :

$\Rightarrow$ When the actions of either consumers or producers results in costs or benefits that do not reflect in Market Prices.

$\Rightarrow$ It is not compensated by parties.

$\Rightarrow$ Other terms for Externalities :-

i) Spillover effects

ii) Neighbourhood effects

iii) Third Party effects

iv) Side effects.

✱

Externalities

Unidirectional
[One sided]

Reciprocal
[Two sided]

→ Originator imposes costs or benefits on the other party

→ Both parties imposes costs or benefits on each other

Ex- Students making noise

Ex- Students making noise and teacher imposing penalty

✱

Externalities

Positive [Benefit]

Negative [Cost]

Production

Consumption

Production

Consumption

Social costs less than private cost

Social benefit is more than private benefit

Social cost is more than private cost

Social benefit is less than private benefit

Firm providing housing to its workers benefits other firms when train them

Individual raising a cute attractive garden makes passers happy

Aluminium factory discharges waste into nearby water body

Students are disturbing class will prevent teacher from teaching efficiently

Producer

Consumer

Fishes Dead

Water Polluted

* Private Cost :-
 → Cost faced by producer or consumer directly involved in transactions.

→ Private cost comprises direct cost of labour, materials and other indirect overheads.

* Social Cost = Private Cost + External Cost

⇒ Smoking — { £100 [Cigarette] → Pvt cost
 → Neighbours [Passively] → Health → £500

$$\Rightarrow SC = 100 + 500 = \text{£}600$$

* iii) Public Goods :

Basis	Private / Market Goods	Public / Consumption / Social Goods
Concept	Yields utility to people who purchase them	Goods which all people enjoy in common
Ex-	Food items, clothing, Mobile phones, Cars, etc	Defense, Education, Highways, Law Enforcement, etc
Consideration	One has to purchase the private goods directly	No direct payment for Public Goods

Value / Benefit	Yields utility to people individually	Yields utility to people collectively
Simultaneous Consumption	Impossible	Possible Ex - Defense
Excludable Vs Non-Excludable	Excludable	Non-excludable
Rivalrous Vs Non Rival	Rivalrous	Non-Rival

	Excludable	Non-excludable
Rivalrous	Food, Clothing, Cars	Fish, forest resources
Non-Rival	Cinema, Club,	National defense, Knowledge

* Free Rider Problem

⇒ Free riding is benefitting from actions of others without paying.

■ Outcome / Effects :-

1, No Public goods will be available

a, Private market will underproduce public goods.

* in Incomplete Information:-

→ Asymmetric Information

→ Adverse Selection

→ Moral Hazard

* a) Asymmetric Information:-

It occurs when there is imbalance in information between buyer & seller.

• Buyer knows more than seller:

→ Borrower knows more about their ability to repay the loan.

• When seller knows more than buyer:

→ Seller of used car knows more about the car. [Lemons Problem]

* b) Adverse Selection:-

It is a situation in which asymmetric information about quality eliminates good quality products from market.

* c) Moral Hazard :- It occurs when individuals know about his or her actions more than other people.

Ex :- Insured Consumer don't care if hospital doctor overcharges them.

* Impure Public Goods

a) What are impure public goods?

⇒ The one that possesses features of both public and private goods.

Ex :- Courts, Govt Hospitals.

1) If a case is going on of Mrs X → Mrs Y can't

a) Hospital → Bed → Patient A
Patient B X

∴ Impure :- Not Completely non rivalrous and non excludable.

* Unit - 2

Government Intervention in case of Market Failure

Public Finance

* Market Failure :-

⇒ Misallocation of Resources

→ Market Power

→ Externalities

→ Public & Private goods

→ Information failure

Monopoly
↑

I

* Government intervention in case of Market Power

Competition based Reg

Price based Regulations

Government establishes rules It involves :-

A regulations to :-

a) Promote Competition

b) Prohibit actions that curtail competition

c) Prohibit Collusions that restrain Competitions

d) Grant Patents, etc to someone

e) Eliminate Predatory Pricing

a) Setting maximum prices

that firms can charge

b) Setting Price Caps/Ceiling $\rightarrow$ MRP

c)

II

* Government Interventions to correct Externalities

Increase Positive Externalities

Subsidies

→ Subsidies given by govt reduces the cost of production leads to rise in output by firms

Production

→ Govt enters the market directly as an Entrepreneur to produce merit goods beneficial for all

Reduce Negative Externalities

Direct Control

→ Prohibit specific activity

Ex- No smoke zone

Indirect Control

→ a) Taxes

b) license / permits

* a) Direct Control over Negative Externalities
 ↳ Prohibits activities that create negative externalities.

i) Set limit for emissions

ii) The firms have to install pollution control equipments

iii) Penalty for exceeding the permissible limit for emissions.

iv)

* b) Indirect Control over Negative Externalities

i) Environmental / Pollution / Pigouvian Tax

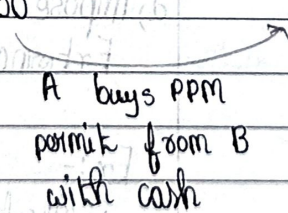
↳ Named after AC Pigou

↳ Make the Polluter Pay

↳ This increases firms cost of production

ii) Tradeable Emissions Permits

	A	B
Allowed	100 PPM	100 PPM
Used	150	40



 A buys PPM permit from B with cash

↳ Marketable licenses [Permits] to emit limited quantities of pollutants can be bought & sold by polluters

↳ These are transferable

↳ A firm exceeding the limit is penalized → fine or penalty

↳ High polluter have to pay; low polluter gets reward

Q

Tradeable Permits

Merits

- Records efficiency
- Encourages innovations
- Lower prices [Profits by selling PPM]

Demerits

- Monopoly
- Inelastic Demand
↓
Increase Prices to cover penalty, then charges.

Q

Government Intervention in case of merit & demerit goods :-

Merit Goods

- 1, Socially desirable
 - 2, Impose Positive Externalities
- Ex:-
- i, Healthcare,
 - ii, Library
 - iii, School, etc

Demerit Goods

- 1, Socially undesirable
 - 2, Impose Negative Externalities
- Ex:-
- i, Alcohol
 - ii, Drugs
 - iii, Guns, etc

* Abatement cost is the cost of removing the negative impacts of the byproducts that are produced during production.

* Methods of Govt Intervention

Merit Goods	Demerit Goods
1) Make consumption of some positive externalities compulsory Ex - Helmet (two wheelers) - Insurance - Sports or Yoga 2) Subsidies 3) Government provisions through	1) Ban :- In toxicating drugs 2) Persuasion through negative advertisement 3) Govt can impose high taxes → Luxury cars → Drugs

* Government Intervention in Other Areas

1) Information Failure

a) Mandatory to have certain content disclosures.

Ex - SEBI require accurate information to be provided to prospective buyers of new stocks

b) Regulation of Advertising and setting of advertising standards to make advertising more responsible & in format informative

2) Public Goods

- Certain goods are produced as public goods & services despite the fact that they can be produced as private goods.
- Left to the markets and profit motives, these may prove dangerous to the society.
- A common method is to grant licenses to private firms to build a good facility.

3) Price Controls

- Price controls may take the form of either a Price floor (minimum price buyer requires to pay) or price ceiling (maximum price sellers are allowed to charge for a good or service) Ex- Fixing of minimum wages & Rent controls

* Govt Intervention to manage price as :-

a) Initiation of Minimum Support Price [MSP] programme for crop production

b) This ensures steady income to farmers

4) Equitable Distribution [of Income & Wealth]

→ Progressive Taxation

→ Unemployment Compensation

→ Combat Black Economy → Corruption

Public Finance

* Unit - 4

Fiscal Policy

* Q₁) What is Fiscal Policy?

Ans: Fiscal Policy involves the use of government spending taxation and borrowing to influence the growth of Aggregate Demand, Output & Employment.

* Q₂) What are objectives of Fiscal Policy?

Ans:

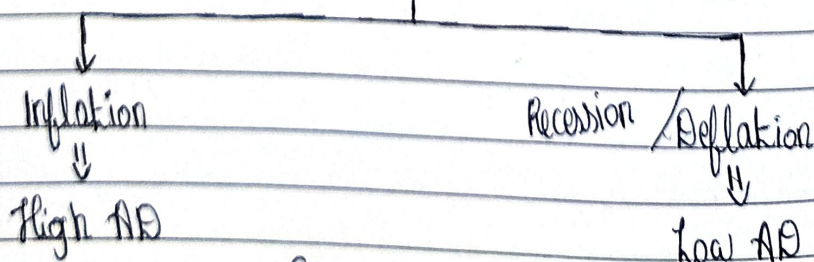
- Achievement & Maintenance of full employment
- Maintenance of Price stability
- Accelerate the rate of Economic development
- Equitable distribution of Income & Wealth

* Tools of Fiscal Policy:-

a) Taxes b) Government Expenditure

c) Public Debt d) Government Budget

a) * Taxes as an instrument of Fiscal Policy:



(See next pg)

⇓
Contractionary Fiscal Policy
[Reducing AD]
⇓

Increase Taxes
[To reduce purchasing power]

⇓
Expansionary Fiscal Policy
⇓

Reduce Taxes
[To increase purchasing power]

* Tax Multiplier = $\frac{-b}{1-b}$ $b = MPC$

* b) Government Expenditure as an instrument of Fiscal Policy:

Components of Govt Expenditure

⇓
Current Exp

⇓
Capital Exp

⇓
Transfer Payments

⇓
Day to day Exp
[Salaries of Govt Employee]

⇓
Infrastructure

⇓
One sided payment
[Pension]

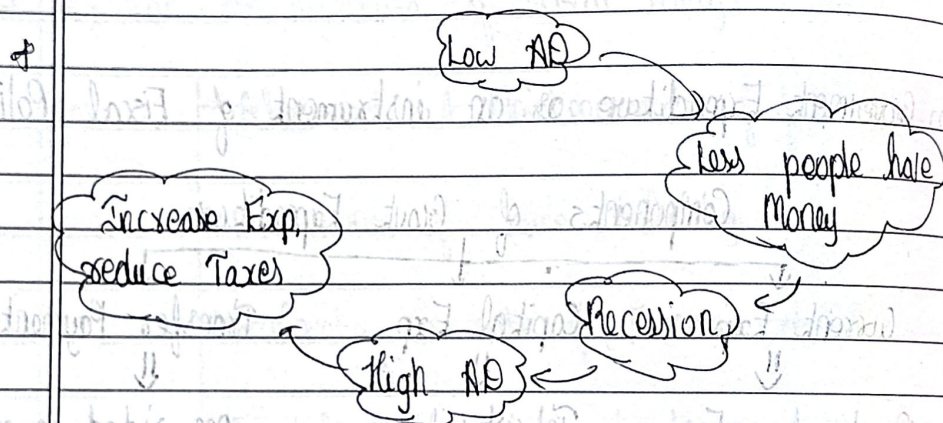
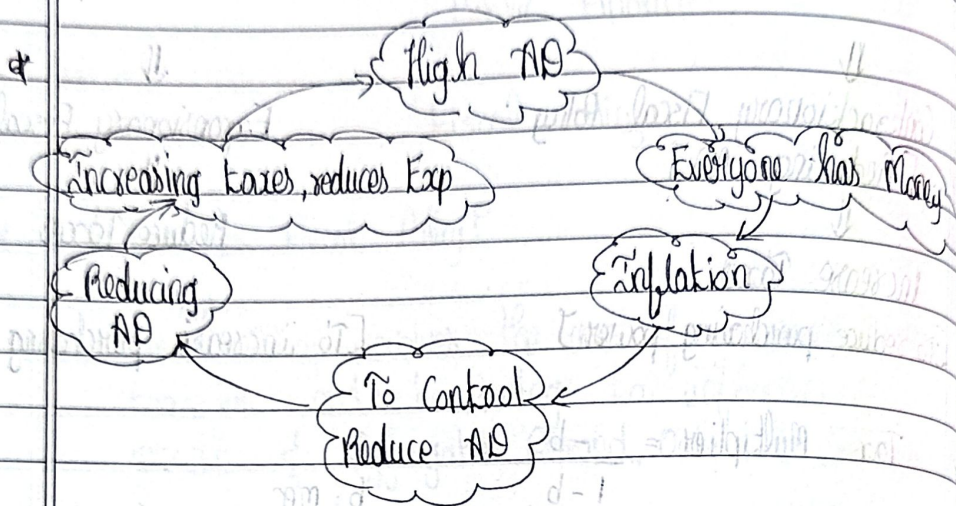
Action by Government

⇓
Inflation

⇓
Recession

⇓
Reduce Expenditure

⇓
Increase Expenditure



Government Spending Multiplier = $\frac{1}{1-b}$

[Investment Multiplier]

Balanced Budget Multiplier: $\Delta G = \Delta T$

Balance BM = 1

(Tax Multi) $TM + SM$ (Spending Multi)

$$\frac{-b}{1-b} + \frac{1}{1-b} = \frac{1-b}{1-b} = 1$$

* c) Public Debt as an instrument of Fiscal Policy:

Sources of Debt

Internal

External

[When Govt borrows from its own people in the country] [When Govt borrow from outside country]

Action by Govt

Inflation

Deflation / Recession

To reduce Money Supply

To increase Money Supply

Take debt from public

Repayment of old debt

* d) Budget as an instrument of Fiscal Policy:

Q.1) What is a Budget?

Ans: Budget is a statement of revenue earned from taxes and other sources and expenditure made by Govt in a year [Expected] [E]

Surplus Budget

Balanced Budget

Deficit Budget

$$R > E$$

$$R = E$$

$$E > R$$



Reduce AD

No impact AD

Increase AD



Inflation

Stability

Deflation / Recession

* Fiscal Policy for Reduction in Inequalities of Income & Wealth:

⇒ Meaning of Inequality:-

Rich gets richer
Poor becomes poorer.

* Grant Actions

Spending on Welfare

Progressive Direct Tax

Differential Indirect Tax

a) Poverty alleviation programmes

Ex- 0-5% xT

Ex- GST

b) Free or subsidised medical care

5-10% 10%
10+30% 30%.

Luxury - 28%
Essential - 0%

c) Infrastructure

10% + 40%

or 5%

d) Social security benefits like pensions

Ex- Income tax

e) Grant subsidies for essential commodities

Budget

R = E

R > E

↓

↓

Impact

Impact

↓

↓

Stability

Stability

* Limitations / Disadvantages of Fiscal Policy:

1, Lags [Delays]:

a) Recognition lag :- Delay in recognizing the economic problem

b) Decision lag :- When Govt delays to decide apt policies

c) Implementation lag :- Policy decision taken on time but delay in implementing them.

d) Impact lag :- Outcomes of a policy not visible for sometime.

2) Difficulty in Govt Spending - (It is practically difficult to reduce spending at various items such as defense, social security, etc.)

3) Gestation Period:

Public works cannot be adjusted easily because many huge projects such as highways, dams have long gestation period.

↑ Govt → Developing

4) Policy Conflicts:

When a policy designed to achieve one objective, adversely affects another.

⇒ Ex: - Spending on health care ↑
Reduces on Education ↓

5) Govt Borrowings:
Loans become a burden for future generations.

* Crowding Out Effect:

→ When Govt spending replaces private spending the private spending is said to be crowding out.

→ Crowding out effect is the negative effect, fiscal policy may generate when money from 'private sector' is crowded out to public sector.

* Effect on Consumption:

→ Recession:-

Economy's ability to recover will reduce if crowding out takes place [Long term]

→ Investment:- Govt Spending ↑
Govt Borrowing ↑ Int. Rates ↑
Private Spending ↓

{

{
{
{
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Types of Fiscal Policy

Expansionary Policy

1) Deflation situation

2) Tools - Taxes ↓
Spending ↑
Borrowing ↓
Budget deficit

3) Increases PP
(Purchasing Power)

Contractionary Policy

Inflation situation

Tools - Taxes ↑
Spending ↓
Borrowing ↑
Budget surplus

Decreases PP