PUNJABI UNIVERSITY PATIALA

M.A. (ECONOMICS) PART-II **PAPER - ECO-303**

SEMESTER-III **PAPER-III : PUBLIC ECONOMICS**

UNIT NO. A

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Lesson No. :

Section-A

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1.2 : Changing Perspectives about the Role of the Government

1.3 : Government as an Agent for Economic Planning and Development

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An Introduction to Public Economics

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1.1.1 Introduction

In this lesson, first, a brief history of the growth of the subject, i.e., Public Economics is given. Then its scope, coverage and its inter- disciplinary approach encompassing many disciplines of social sciences, have been explained. The importance of public economics and also how the study of public economics can be used to achieve the objectives of aggregating social demand for public goods have also been explained. The importance of public economics to achieve some other objectives like economic stability, distribution of income, pricing of public goods, etc has also been explained.

1.1.2 Objectives

In this lesson, the students would know about the meaning history and importance of Public Economics. They would also understand how the study of Public Economics is distinct from the study of Public Finance.

1.1.3 Public Economics : Meaning, Nature and Scope

Public Economics has a short history of 40-50 years. Although it is an off shoot of Public Finance, yet its scope and coverage is much wider and it encompasses many disciplines of social sciences like Political Science (voting behaviour), Public Administration (devolution of functions and powers between different layers of the government, i.e., Centre, States and Local Bodies) bureaucratic behaviour, (i.e., theory of choice), law (enforcement of tax laws and tax evasion), Ethics and Philosophy (welfare and equity questions). Whereas Public Finance grew out of the market failures to maximize social welfare, but Public Economics deals with the issues relating to government failure also. Traditionally, Public Finance deals with the finances of the state, i.e. how the resources are raised and how these are spent, which basically deals with the government budgets only from the financial point of view. On the other hand, Public Economics deals with total allocation of resources in the public sector from all its perspectives, besides the optimum level of resource allocation in the private and public sector. And once the optimum level of resources is decided for the public sector, what forces push up the limit of public sector. How the vested interest of bureaucracy and politicians, is responsible for the ever increasing limits of the public sector (theory of choice). If confronted with peak and off-peak demands for public goods, how the theory of price discrimination developed for private monopolist can be used by public sector (club theory) also form the core of Public Economics. Then the issue of trade off between equity and efficiency, in a policy framework, is a continuing and central theme of Public Economics. Some economists prefer to call Public Economics as Public Sector Economics.

Further, the role and functions of the Government in an economy have been changing with the passage of time. Traditionally, the term 'Public Finance' has been applied to the package of those policies and operations which involve the use of tax and expenditure measures, while budgetary policy is an important part to understand the basic problems of use of resources, distribution of income, etc. There are vast array of fiscal institutions—tax systems, expenditure programmers, budgetary procedures, stabilization instruments, debt issues, levels of government, etc., which raise a spectrum of issues arising from the operation of these institutions. Further, the existence of externalities, concern for adjustment in the distribution of income and wealth, removal of poverty, etc., require political process for their solutions in a manner which combines individual freedom and justice. The problem of allocation of resources between public goods and private goods is a perennial problem. Then in a democracy there is a political process of voting to decide about the budgetary policy to be adopted. Therefore, now more attention is paid to a wider coverage of government activities relating to financial aspects and the subject is known as 'Public Economics'. Thus the subject is very vast and as already said it is also related with other branches of social sciences. Public economics focuses on answering how do government policies affect the economy and how should policies be designed to maximum welfare.

Thus we define Public Economics as a science which deals with economic activities of the government, which have grown out of not only the market failures but also from the failures of the government, though its involvement with the former is far stronger than the latter, which is still in initial stages.

Broad methods and topics of public economics include :

- analysis and design of public policy.
- public finance theory and its application.
- distributional effects of taxation and government expenditure.
- analysis of market failure and government failure.

Public Economics as an antonym of private economics, deals with the economics of the Public or Government Sector. Private economics basically deals with the operation of private sector to satisfy the private wants. An individual has private wants, social wants and merit wants. So public economics builds on the theory of welfare economics and is ultimately used as a tool to improve social welfare.

Self-Check Exercise-I
Q. Discuss the nature and scope of Public Economics.
Ans ....
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1.1.4 Importance of Public Economics

1. Satisfaction of Social and Merit Wants:

In a welfare state, the satisfaction of social/collective wants and merit wants is another reason for the growing importance of Public Economics. All the wants of the community can be divided into three categories:

(i) Private wants;
(ii) Social wants;
(iii) Merit wants

Private wants are those wants which are satisfied by the people on their own depending upon their affordable capacity. Here market forces have their full say. A rich person may satisfy more of his demands than the poor person. Social wants are those wants on which all people have the equal rights. Maintenance of law and order, internal and external security (defence) and even some minimum amount of sanitation and other health measures are such examples from which all have to be benefited .Technically speaking, we can say that here the principle of exclusion does not apply . That is, we cannot exclude or deprive any person from availing of such facilities. Those have to be provided by the state by incurring public expenditure on these items, for which the government can levy taxes and thereby satisfy these wants. Merit wants, on the other hand, though are the private wants yet these have to be satisfied by the government. Musgrave defines 'Merit' wants as those wants of the poor like minimum housing, food and clothing and even social security which the state, must provide. The poor people, because of their poverty, cannot afford a minimum desirable level of these merit wants out of their own income. Therefore, the state must either itself satisfy or subsidize partially or wholly such wants.

While satisfying social and merit wants government has to encounter many problems. Firstly what to produce? This is very difficult for the government to decide in view of the fact that for pure public goods, which are lumpy and non-excludable, people do not reveal their preferences. Secondly, decision regarding how much to produce again is difficult to be taken. Although many attempts have been made in the past to give answer to such vexed question, yet no satisfactory answer has been found. For example, pure theory of public expenditure has been developed to analyze the determination of optimum public expenditure and the optimum allocation of resources for public goods. The theory essentially rests upon the benefit approach as developed by the continental writers, like Mazzola, Pataleoni, Wagner and Eric Lindahl and the ability approach as developed by the Anglo-Saxon writers including Pigou, Mill, Dalton and Samuelson.

The benefit approach poses the issue of optimum public expenditure on the market principle: just as private spending optimally meets the subjective wants of individual consumers, the same principle should be applied to the wants satisfied by the government. But the proponents of this school immediately recognized that market rule is not applicable to public goods as these are indivisible and are consumed in equal amounts by all. The existence of externalities – positive and negative, also exposes the failure of the market mechanism to determine accurately the optimum public expenditure. The way-out suggested was that the consumer's equilibrium condition in case of public goods may be fulfilled by the consumption of equal quantities of the commodity at different prices such that there is equi-proportionality between the utility to every individual and the price paid by him. No doubt, in this way, the optimum distribution of the consumer expenditure between public and private goods can be distributed but it fails to provide answer to the question as to how much resources should be provided by the government for the provision of public goods. Lindahl attempted to determine simultaneously the optimum amount of public spending and the optimum distribution of tax burden on the cost of benefit principle. The Lindahl model, however, encounters some difficulties. Firstly, the individuals will not readily reveal their true preferences for public goods. Secondly, even when they reveal their true preferences, the optimum quantity of public goods to be provided cannot be determined without first determining the optimum distribution of income.

The Anglo-Saxon writers, in contrast with the simultaneous determination of optimum public expenditure and optimum distribution of tax burden – the approach followed by the continental writers, maintained that the primacy should be given to the determination of optimum public expenditure . Once the government expenditure is determined, the optimum distribution of tax burden can be determined by an equitable tax formula based on the ability–to-pay principle. However, the ability-to-pay approach is considered as one-sided and deficient because it seeks to determine the magnitude and pattern of public spending without in any way trying to link the same to the preference pattern of the individuals and also to the contribution that the individuals are required to make for the provision of such goods. By the proponents of ability to pay approach – Pigou and Dalton, an attempt was made to determine simultaneously the optimum expenditure and tax revenues through the principle of least aggregate sacrifice and the break even point is sought to be established at a point where the social benefit derived from an additional dose of government expenditure becomes equal to the social cost of additional amount of taxation required for financing the expenditure. The Pigou-Dalton approach emphasizes that the public expenditure should be optimally planned. But there are serious difficulties in the planning of optimum public expenditure. Firstly, the optimum size of government spending cannot be determined without knowing the true preference pattern of individuals for public goods. Secondly, the optimum tax pattern cannot be devised without making inter-personal comparisons of utility. The new welfare economics has highlighted the practical problems in knowing the true preferences of individuals and the inter-personal comparisons of utility. Unless there is prior determination of the optimum distribution of income of the community, there can be no hope for the determination of optimum level of public spending and the optimum distribution of tax burden. Neither the benefit approach nor the ability-to-pay approach, from this angle, has succeeded in providing a satisfactory solution for the determination of optimum public expenditure and the optimum distribution of tax burden. Moreover, modern state does not incur public expenditure on providing 'pure' public goods alone but on innumerable services also with a view to improve the economic life of a country. Hence, attempts to develop a 'pure' theory of public expenditure have not been very successful.

2.Correcting Inter-personal and Inter-regional Inequalities

Then there is the problem of distribution of income both in developed and developing countries. The policy of non-government intervention, as recommended by classical economists, assumed the distribution of income is equal, which is not. The important feature witnessed by the developed countries in their initial stages of economic development was the growing economic disparities. In free enterprise economies such disparities were tolerated as they provided incentives to the propertied and entrepreneurial class. In fact the main reason for the growing economic inequalities has been the right to own private property. But no society can tolerate such disparities beyond a certain point. A combination of tax and expenditure policies has to be evolved to keep these inequalities under check. Beside inter-personal inequalities as discussed above inter-regional inequalities is another essential feature of under-developed countries like India. Through fiscal incentives (like subsidies and tax holidays) and disincentives (like heavy taxes) the dispersal of private enterprises over the vast areas particularly backward areas can be ensured.

3.To Promote and Stabilize the Economic Growth:

Then there is the problem of economic stabilization. Some of modern thinkers feel that since this problem basically deals with macro-economics, therefore, it may now be left out from the study of Public Economics. Therefore, Public Economics now relies more on micro-economic behaviour of the government than on macro-economics. That is how to satisfy individual preferences for social goods.

However the problems of economic stability and promoting economic growth are the chronicle issues with which the government is confronted with both in developed and developing countries.

The concepts of 'Functional Finance' and 'Development Finance' have been developed in this context. While the former, as advocated by A.P. Lerner is applicable in the context of developed countries, the latter conforms to the needs of under-developed or developing countries.

Thus we can conclude that the importance of Public Economics cannot be belittled. The subject has travelled a long path before reaching the present state of affairs. The state is no longer a police state and the days of laissez-faire are gone. The state has undergone a fundamental change today. From a protector of its citizens against internal disorder and external aggression, it has grown into a welfare state. Its basic objective now is to maximize social welfare. It has to adjust and extend its tax and expenditure programmes so as to maximize total social advantage. According to Pigou-Dalton approach, this point is reached when marginal benefits from public expenditure are equal to marginal sacrifice. And insofar as the allocation of resources between the private sector and public sector goods is concerned, there should be a 'social balance' as advocated by Professor Galbraith.

Self-Check Exercise-2

Q. **Discuss some important objectives of studying Public Economics.**

Ans. ....

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4. Problem of Revealing Preferences and Their Aggregation

As already stated the most important problem which we have to face in Public Economics as distinct from private economics, is the problem of revelation of preferences/ demand for pure public goods. Whereas, individual preferences for goods and services differ, but there is no problem of reconciliation of varying preferences in the market sector of the economy because effective demands are summed up by the market and production adjusts accordingly. But in the case of public goods, automatic summation does not take place because amounts to be produced are determined by a single non-market decision. In case of identical preference patterns, there is no difficulty. But the individual preferences for public goods also differ while the quantity available to each individual may be the same as the principle of exclusion is not applicable. Because of the indivisible nature of public goods, amounts cannot be adjusted to each individual's wants. To resolve this conflict and to attain optimal societal allocation of resources, the political process of voting is extremely important. In other words, budget determination involves a political rather than a market process. Individual preferences may now be known and translated into budgetary decision through a political process which involves the individual's preferences as recorded by his vote.

If the value judgment of the society prefers a political process of the democratic type, the revelation of true preferences is importantly dependent on the institutional set-up. The situation differs in accordance with the voting rules applicable. In a modern democratic political set-up, it is normally agreed that each person should be given one vote, i.e., one person, one vote. The principle of uniform vote distribution is widely accepted these days. But particular voting rule must be chosen, i.e., complete unanimity rule (where 100 per cent voters agree to a particular government proposal), majority rule (i.e., where at least 50 per cent voters agree), qualified majority rule (say where two-third, three-fourth, nine-tenth, etc. voters agree), etc. etc.

It may also be mentioned that Public Economics deals with both pure public goods and impure public goods. Pure public goods are non-rivalrous in consumption (meaning that one person's consumption of any of these goods does not interfere with any other person's consumption of the same good). The clarity of radio reception, for example, is independent of the number of other listeners. So are the defence services. Private goods are rivalrous in consumption**,** meaning that only one person can consume each unit of these goods. Food and clothing are examples of goods in this category. But there are many other goods, including parks and recreational facilities, police and fire protection, and roads and bridges, that do not fit into either category. Consumption of these goods by one person reduces, but does not eliminate, the benefits that other people receive from the consumption of the same good. These goods are called **impure public goods,** and are said to be **partially rivalrous** or **congestible goods.**

Impure public goods also differ from pure public goods in that they are often excludable. Access to many recreational facilities may be controlled by imposing entry fees. Toll roads and toll bridges are very common these days. Fire and police protection are more problematic. Controlling access to these services is more difficult.

The possibility of controlling access to impure public goods has two important implications. First, provision by private firms or by governments on a "fee for service" basis becomes possible, because free riding can be eliminated. Second, the provider of the good can influence the degree of congestion by regulating either the number of people who use the good, or the frequency with which they use the good, or both.

The study of impure public goods has centered on two broad classes of goods; the club goods and the variable use public goods. Club goods include such facilities as swimming pools, tennis courts, etc. It is generally assumed that the number of users (members) of each facility is controlled, but that the frequency of each member's use is not. These goods are assumed to be replicable so that individuals who are excluded from one facility (or club) can become members of another equivalent club. Variable use public goods are goods such as road bridges and public transit systems. They can either be excludable or non-excludable, but if they are excludable, frequency of use rather than number of users is controlled. For example one has to pay tolls every time when passes through the toll road or toll bridge. Public Economics deals with all types of such goods the use of which creates congestions and for this we have Theory of Club Goods.

Theory of pricing of public goods also forms part of Public Economics. In case of private goods, under perfect market conditions, pricing depends upon marginal cost, where average cost is also minimum. Because of large number of small producers of an identical product, the above principle is in the interest of both consumer (who gets the product at the lowest average cost) and producer (who maximizes his profit). But in case of the non-congestible public goods (defence and justice services), where average cost is declining and marginal cost is zero, the above principle does not hold good. Problem of externalities in case of public goods further compound the problem of pricing public goods.

It should also be remembered that the subject of public economics is relevant where both private and public sector operate i.e., mixed economies. Then in mixed economies, planning is essential to move towards the desired direction. That is why planning form the core of Public Economics. Further since most of the consumer choices have now to be met at the local level, therefore, the study of local finance has also become an integral part of Public Economics.

Self-Check Exercise-3

Q. Discuss the problem of aggregation of social wants in Public Economics.

Ans. ....

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Lastly it must be observed that the science of Public Economics is both positive as well as normative. It is positive in the sense that it studies the activities (financial) of the government they actually occur. A study of tax structure and expenditure structure, as they are, falls in the realm of positive science. When we study the financial activities of the government as they should be according to set goals or norms of the society, we enter into normative aspect of Public Finance or Public Economics. Once the objective is given, or determined by the state in the light of socio-political theories that prevail in the community, there is only one way in which Public Economic activities can be planned so as to secure the maximum achievement of that ideal. The modern State is broad-based, no matter whether organized on a communist or a capitalist basis, and has as its objective to promote the welfare of the community as a whole. It is, thus, essentially a democratic state where the wishes of the people ultimately prevail. It is another thing that the voting behaviour of the people, sometimes, does not lead to any concrete proposal.

A state which is guided with the objective of the welfare of the entire people is a mere theoretical concept. In practice, the State tends to place greater emphasis on the welfare of some sections of people than that of others. The destinies of the State have to be guided by men, with all their human weaknesses, who may not always be able to clearly visualize the true interests of the entire people. They may sometimes exploit the people for their personal or party advantage. To the extent that they succeed in furthering personal interests at the cost of the interest of the community, the state fails in its objective of promoting the interests of the entire people, known as government failure. In Public Economics while analyzing various theories we, however, assume that the state play an important role for promoting the welfare of the people as a whole. This is the normative aspect of the science of Public Economics.

1.1.5 Summary

To summarize, Public Economics is based more on micro-economic principle than macro-economics, whereas traditional public finance relies more on macro economics, exception being the theory of tax and expenditure incidence, taxable capacity, etc. Further Public Economics also relies on other such disciplines as Political Science, Public Administration, Law, Ethics, Philosophy, etc. Thus the subject matter of Public Economics is much wider than Public Finance. Major areas of public economics include the economics of public expenditure, of taxation to pay for that expenditure and of policy and programs broadly defined.

1.1.6 Basic Concepts:

Congestible Public Goods: These are partially rivalrous (i.e., by imposing a fee, the users may become excludable).

Social Goods or Public Goods: Which are produced or provided by the government.

Pure Public Goods: Which are produced by the government but are totally non-rivalrous and non-excludable.

Private Wants: Which can be satisfied by the market.

Social Wants: Which are satisfied by the government.

Merit Wants: Which can be satisfied by the market but because of non availability of resources in the hands of a certain sections of the society, government must satisfy these wants.

Functional Finance: Use of the government finances i.e., tax and expenditure policies, for achieving the goal of economic stability, i.e., to avoid both depression and inflation.

1.1.7 Questions for your Practice

(i) Long Questions

1. Critically discuss the nature and scope of the subject 'Public Economics'.
2. Discuss the main problems with which the subject 'Public Economics' is confronted with.

(ii) Short Questions

Define

1. Social wants
2. Merit wants
3. Club goods
4. Is the study of Public Economics positive or normative?

1.1.8 References

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LESSON NO. 1.2 AUTHOR : PROF. J. R. GUPTA

CHANGING PERSPECTIVES ABOUT THE ROLE OF THE GOVERNMENT

1.2.1 Introduction
1.2.2 Objectives
1.2.3 Role of Public Finance in a Free Enterprise Economy
1.2.4 Role of Government in a Mixed Economy
1.2.5 Role of Government in Socialist Economies
1.2.6 Summary and Conclusion
1.2.7 Basic Concepts

1.2.1 Introduction

The very best of all plans of finance is to spend little and the best of all taxes is that which is the least in amount, remarked J.B. Say. For classical economists the 'best government was that which governed the least'. In the words of J.S. Mill, laissez-faire should be the general practice, every departure from it; unless required by some great need, is a certain evil. Classical economists believed in invisible hand. They were of the opinion that when every one maxmises his income—total income in the economy or country would also be maximised. To them, the government had to perform strictly three functions, viz, (i) protecting the country from foreign invasions, (ii) maintenance of internal law and order and (iii) constructing and maintaining certain public works such as roads, bridges and canals for promoting trade and commerce. To meet the expenditure needs of the state for above mentioned functions, Adam Smith laid down 4 maxims (canons) of taxation, viz., canon of equality, canon of convenience, canon of certainty and canon of economy. But no where they talked about canons or maxims of public expenditure. To classical economists, perhaps "Taxes were like hails which destroy the crops". They never considered the use pattern of taxes. According to classical economists, taxes kill the private initiative on the one hand and restrict the resource availability to the private sector on the other.

Professor R.N. Bhargava while tracing the history of origin of public finance says that the State came into existence primarily for the purpose of protecting a community. The functions of a state or the government were, therefore, very limited and narrow. It had to maintain law and order to protect the community from external aggression. It was primarily a police state. In the discharge of these protective functions, the government was forced to increase its role gradually. There was also the fear that autocratic rulers will misuse the funds placed at their disposal. Hence the people tried to restrict the availability of funds to the government. This restriction had its impact on the functions that the state could perform and acted as a check on their expansion. The classical economists, with their faith in laissez faire, also advocated minimum functions of government. However, there was a gradual change in the concept of the state and there was a steady increase in the functions of the state and these were extended to the fields of education, poor relief and then to sanitation, medical care etc. If the state protected against aggression or internal disorders then it has also to protect the community against diseases, ill health, poverty and ignorance, so that the concept of a welfare state gradually evolved. The objective of such a state is to maximize the welfare of the community as a whole. Such a view of the state, however, extended its functions and it had to take up certain public utility services also to increase the welfare of the community. The severe depression of the thirties and the recommended solution in the publication of Keynes 'General Theory' sounded the death knell of Laissze-faire policy. Keynes demonstrated that "it was possible through the fiscal activities of the state to increase employment and to maintain it at a high level. Since then, most governments are committed to the maintenance of economic stability at the full employment level as far as possible".

Keynes demonstrated that income has two sides, viz., income and expenditure. One man's expenditure is another man's income. His famous equations are :

$Y = C + S$ (Income side)

$Y = C + 1$ (Expenditure side)

That is income can either be consumed or saved; or alternatively income can be spent either for consumption purpose or for investment purpose. Consumption (C) being common in both the equations, therefore, savings will have to be equal to investment expenditure in order to maintain economic stability. But, as savings normally outstrip investment expenditure, therefore, a process of downswing, in the economy sets in. In order to maintain economic stability, governments expenditure must compensate the fall in private total expenditure. That is, the expenditure side equation should become $C + 1 + G$ where 'G' denotes government expenditure. Thus, the role of Public Finance was recognised as 'Compensatory Finance' for the first time and the role of government increased very fast after the world wide depression. But in the wake of inflationary trends during the second world war and post war-periods the role of the government to perform anti inflationary and rehabilitary functions was also recognised. And the role of government moved from 'Compensatory Finance' to 'Functional Finance', the concept propagated by A.P. Lerner.

While the concepts of Compensatory Finance and 'Functional Finance' were evolved in the context of developed countries, in the context of under developed countries considering that the government should be committed to a programme of accelerated economic development, a new concept of 'Development Finance' took place. Prof. R.N. Bhargava sums up 'Thus developed and developing states have both to play an increasing role in the economy and their functions have considerably expanded. In order to discharge these expanded functions the state has to increase its draft on the gross national product......This brings expansion in the functions and responsibilities of public finance and it now plays a vital role in the economic life of a community and its members." In this new era of globalised world, the state will have to play a more significant and intelligent regulatory role.

Briefly speaking, one can discuss the changing role of Public Finance in the context of three important economic systems, viz., capitalist or free enterprise economy, mixed economy and socialist economy.

1.2.2 Objectives:

After having gone though this lesson, you would be able to understand the role of public finance in a free enterprise economy, the role of government in a mixed economy and in the socialistic economies.

1.2.3. Role of Pubic Finance in a Free Enterprise Economy

In the context of free enterprise or capitalist economy, the following are some of the important factors, which have played a key role to popularise the science of Public Finance from time to time.

i. Breakdown of laissez-faire policy

As already stated that the laissez-faire policy failed miserably during the depression of thirties. Keynes demonstrated that in order to maintain the level of effective demand in order to achieve the objective of economic stability, the State must intervene actively. Whenever saving exceeds investment the total expenditure in the economy falls, then public expenditure must increase to compensate this fall. Even during inflation the active role of the government to maintain price stability cannot be denied. The government has to siphon off the excess purchasing power either in the form of taxes or loans to reduce the pressure on demand. Even when the economy is on even keel the extension in the role of government cannot be belittled. A German thinker, Mr. Wagner, projected as early as in the mid eighteenth century that there were secular tendencies of increasing state intervention (in the form of increasing public expenditure both intensively as well as extensively). Wiseman Peacock agreed with the basic observations of Wagner but they offered different interpretations for the increasing tendencies of public expenditure. Thus, although the failure of laissez faire policy during the depression gave a final blow to the doctrine of State non intervention, yet the increasing importance of the role of the government was being recognised much earlier.

ii. Lack of Common Goods and Provision of Public Utilities

Provision of common goods like parks, libraries, schools and other recreation facilities, is urgently required for ever-increasing population in urban areas. In the absence of such facilities the urban life would be very dull and drudgery. Therefore, the state (here urban local self government) must come forward to make provision for these goods so as to maximise social welfare. The private sector, being solely guided by profit motive, would be least interested in these economic activities. In fact, the concept of welfare state has further extended the field of Public Finance. Further, the provision of public utilities like public health including safe drinking water, transport and communication, electricity, sewerage system, etc. is another area of concern in a Welfare State. Because of the externalities of these goods they must be provided by the State. The private sector either will not undertake the production and distribution of these goods and services, or if it is asked to do so, two extreme economic tendencies, viz., excessive competition or monopoly would develop.

Either of these tendencies are not conducive to maximise the social welfare which is the main objective of Public Finance activities.

iii. To Bridge the gap between Private Interest and Social Interest

The goal of maximising social welfare brings us to another area of concern, i.e., perennial conflict between private welfare and social welfare. This divergence in interest arises due to many factors. While private interest is to maximise private profits, the social interest intends to maximise social welfare. Now profits depend on total revenue (price of the product) and total costs. Prices being determined by market forces, the producers usually try to minimise costs. The discharge of industrial wastes and affluents by industries in the nearby fields is an excellent example. No doubt the disposal of such toxic wastes costs nothing to indusry and, therefore, serves the purpose of private interest, but its social costs, in terms of its adverse affects on health would be unimaginable. A.C. Pigou, a classical economist but ardent believer in maximising social welfare, explains how Public Finance activities can be used to bridge this conflict between the two. During his times the paper manufacturing units were usually located near the running streams of water like rivers or canals so that the industrial wastes, produced during the manufacturing process are discharged in the water at no cost of the industry for this purpose. In the process, the water got contaminated. But that water was invariably used for irrigation, washing and even for drinking purposes. Thus, the people living alongside the polluted stream of water were the great sufferers. A.C. Pigou explained that a system of taxes and expenditure policies can partially correct this divergence by taxing the paper producing units and utilising the proceeds for the purification of water.

iv. Correcting Inter-Personal and Inter-Regional Inequalities

Another important feature witnessed by the developed countries in their initial stages of economic development was the growing economic disparities. In the free enterprise economies such disparities were tolerated as they provided incentives to the proprietor and entrepreneurial class. (See detailed explanation of this concept in lesson no.1).

v. Satisfaction of Social and Merit Wants

In a welfare state, the satisfaction of social/collective wants and merit wants is another point to the growing importance of Public Finance.(see detailed explanation of this concept in lesson no.1)

vi. To Promote and Stabilise the Economic Growth

Problems of economic stability and promoting economic growth are the major issues with which the government is confronted with in developed and developing countries, respectively.

As already stated the concepts of Functional Finance and Development Finance were developed in this context. While the former, as advocated by A.P. Lerner, is applicable in the context of developed countries, the latter conforms to the needs of under-developed or developing countries.

1.2.4.ROLE OF GOVERNMENT IN A MIXED ECONOMY

You have read that the role of the Government in a free enterprise economy is limited though various factors have played a key role in popularising the science of public finance. However, in a mixed economy the role of the Government is recognised. Here public sector has to operate along with the private sector in the decision-making processes covering economic activities in general and allocation of resources in particular. In fact, a mixed economy is one where both private and public sectors operate. The essential feature of such economies is that here the role of the government is increasingly recognised. Under the garb of nationalisation, the hold of the Government is being extended and this extension of the role of the Governmnet can take various forms such as :

(i) Direct participation;

(ii) Regulatory or indirect measures; and

(iii) Direct physical measures.

(i)Direct Participation

Government, in a mixed economy, directly participates in performing certain economic and social activities. Sometimes, both the public and the private sectors operate simultaneously to supplement their efforts. And sometimes their objectives may be different. The economics of india and even of United States of America and Britain have also become mixed economies but the nature of mixed economy of India is quite different from them, because in India, public sector is more active. Where as the economy in USA and England is biased towards capitalism the mixed econmy of India remained biased toward socialism for a long time. For example, in India, there has been an ever-increasing extension in the government activities. The proportion of total public expenditure (both of the Union and State Governments) to national income has increased to as much as 40 percent from meagre figure of about 20 percent when India embarked on the path of planned economic development. As already discussed in the previous lesson, German thinker, Mr. Wagner projected as early as in mid-18th century that there were secular tendencies of increasing state intervention. Today, there may be no country in the world which could be characterized as a free enterprise economy following purely laissez-faire policy. Take the case of India, Industrial policies of 1948 and 1956 recognise that both the private and public sectors have key roles to play for the economic development of the country. Through the Industrial policy of 1956 the commanding heights of the economy have been entrusted to the public sector. Even in the recent past when the government announced the introduction of New Economic Policy in 1991 and embarked upon drives of privatisation, liberalisation and globalisation, the role of the public sector did not get diluted. The government continued to have a monopoly of the social sector like education and public health. Even certain activities, particularly those directed towards poverty alleviation programmes remained the privilege of the public sector. The US Postal services is run by the government of US and is an example of the direct role the US government plays.

Many a times the direct participation by the Government necessitates the operation of indirect regulatory measures such as taxes and duties, tariffs, subsidies (Public expenditure) etc. Take the example of deficit financing, although deficit financing gives virtual confiscatory power to the Government to purchase whatever it likes without resorting to mobilisation of resources through taxes and non-tax measures, yet it disturbs the equilibrium in the monetary market, which necessitates the application of regulatory measures like credit regulation. Thus, the application of regulatory measures is another manifestation of Government intervention in mixed economy.

(ii) REGULATORY AND INDIRECT MEASURES

Sometimes, government can use indirect measures to achieve the planned targets in a mixed economy. Suppose, the Government wants to discourage imports and encourage exports. Then the government can resort to increasing import duties and giving export subsidies. Similarly, for affecting the desired changes in production pattern, tools of taxes and public expenditure can be employed, availability and restriction of bank credit is another form of regulatory mechanism to control the private sector in a mixed economy. Likewise regulatory pricing mechanism is another indirect form of limiting the role of private sector in mixed economy. Thus, the activities of the government do not only stop at having a proper and effective public sector. In a mixed economy the government also tries to regulate the working of the private sector so as to achieve the set social objectives and planned targets. Sometimes, the regulatory mechanism takes the shape of direct physical controls like licensing, quotas, etc. with which you are quite familiar (Industrial Policy). Similarly, the government mandates that almost all workers be paid minimum wage.

(iii) DIRECT PHYSICAL MEASURES

For the economic fields where the government itself does not want to enter or where even regulatory devices fail, the government resorts to direct physical controls. The Government may not issue licence for economic activities which need to be restricted. However, industrial licensing was abolished in India for almost all product categories but alocohol, tobacco, hazardous chemical, industrial explosives, electronics, aerospace and pharmacentical, in 1991.)Quota and rationing systems are other such manifestations through which the government tries to allocate the scarce resources in an efficient manner. Import and export restrictions also fall in this category. It is another thing that such physical controls often promote economic inefficiencies and breed corruption. This is the main reason that India is now bidding farewell to these regulatory mechanisms when we talk about privatisation and liberalisation of the Indian economy.

From the above discussion we can conclude that despite some shortcomings, the modern governments find that the need of state intervention has been constantly increasing.

You must remember that even when the economy is free enterprise economy and depends on price mechanism, there is a need to regulate its working. Left to itself, free market system would promote inequalities in the distribution of income and wealth on the one hand and monopolistic tendencies on the other. A free market economy is also subject to violent fluctuations from which the Government should protect actively participating in the economic system. We have already discussed this problem of ensuring economic stability. Besides, it is also contended that with the growth of industrialisation and urbanisation lot of economic problems emerge. The problems of health, education, recreation, housing, social security etc. increase automatically. These problems can be tackled only at the local level and the local self governments are important organs of the state in countries like India. With the 73rd and 74th Amendments of the constitution these problems have been tackled to some extent.

An essential feature which distinguishes the mixed economies from free enterprise economies is the incorporation of planning for economic development. The role of Government is all the more important to usher in a new era of economic development. Mixed economies are invariably to be set with numerous problems of under development. Raja. J. Chelliah explains how in such economies the government can supplement the private efforts and act as a catalytic agent to promote economic development. In these countries there is lack of savings because of wide spread poverty. And whatever little savings exist, these are channelised not into productive investment but in real estates and jewellery. The main stumbling block in productive investment is the lack of infrastructure. Private sector does not invest in social and economic infrastructure like education, public health, means of transport and communication, power, financial market, etc. This is mainly because of poor returns from cash investments. And also lack of initiatives on the part of private investors prohibits them to go for these investments in a big way. Raja J. Chelliah explains how the governments of developing countries can perform this gigantic task of promoting economic development.

Self-Check Exercise-I

Q. How the government can directly participate in a mixed economy?

Ans. ....

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The most important task before the developing countries who have opted for a mixed economic system is not only the lack of resources but is also their mobilisation for building capital assets. The main problem before the government is to find the economic surpluses and then mobilise these surpluses for economic development. Raja J. Chelliah in this regard distinguishes three forms of economic surplus :

(a) Existing Economic Surplus

(b) Potential Economic Surplus; and

(c) Additional Economic Surplus.

While the first two are static concepts, the third one is dynamic concept.

(a) Existing Economic Surplus : By existing economic surplus, we mean the excess of current income over current consumption provided it is not productively invested. At any given time the nationals of a country would be consuming less than their current income. If the difference is not productively invested, then it becomes the duty of the government to mobilise this existing economic surplus. The best channel of mobilisation is taxation. If this is not possible then the government must resort to borrowings to mobilise these surpluses. Symbolically, one can define the existing economic surplus as :

$$Y - (C + 1)$$

Where 'Y' is the current income and 'C' and 'I' are current consumption and investment respectively.

(b) Potential Economic Surplus : The current income, however, may be higher than minimum essential consumption required for maintaining good health and the higher income can be used for productive purposes up to that level so that efficiency for production is not adversely affected. In other words, there may be always such cases as enjoying non-functional consumption. And in their cases, there may be potentials to contribute still more resources for the economic development of a country. If these sections of the society are not allowed to consume more than what is absolutely essential for living so that excess is mobilised by the government and investing these surpluses in productive channels then the era of economic development can be ushered in more quickly.

Symbolically, potential surplus means :

$$Y - (Cm + I)$$

Where 'Y' and 'I' are current income and investment respectively as before and 'Cm' is minimum level of consumption as defined above.

It may be mentioned here that there may be some sections of the society whose actual consumption may be less than the minimum consumption. If these sections are allowed to continue with their existing consumption levels, then potential economic surplus may be little higher.

(c) Additional Economic Surplus : Coming lastly to the economic surplus in a dynamic sense or mobilisation of additional economic surplus. As these countries start development, their current income goes on increasing. Being poverty-ridden their marginal propensity to consume (ΔC / ΔY) is very high and in most of the cases it is close to unity, which implies that as they start experiencing increase in their incomes they tend to increase their consumption standards by the same levels. That is, left to themselves, every additional income, would be spent and nothing would be left for investment. Therefore, it becomes the duty of the government not to allow increase in consumption to the same level of additional increase in income. A substantial part of the additional increase in income must be mobilised by the government.

Another important function of mobilising additional economic surplus is to reduce economic inequalities. As the process of economic development starts in mixed economies there are in-built tendencies of increasing income inequalities. Since income and wealth inequalities are socially intolerable beyond a particular limit, it becomes the duty of the government to initiate some progressive tax and expenditure policies so as to contain them. It must be noted that since taxes adversely affect ability and willingness to work, save and invest, therefore, progressivity in their case should not be very steep. The Indian example bears testimony to this fact that over successive years we have reduced progressivity in our system without any adverse effect on the tax-yield. Rather public expenditure should be made more progressive so as to promote ability and incentives for increasing production.

Another essential characteristic of these economies is that they have adopted planning for development. The main difference in planning for socialist and mixed economies is that while in the former it is by command, in the latter, it is mostly by inducements. In socialist economies, planning for development has to be through command. There is no question of incentives or disincentives. But in a mixed economy to achieve planned targets particularly set for the private sector, planning has to be done through various incentive and disincentive measures. Planning for the public sector may be through command, but for the private sector planning has to be through inducements. Then the short-term (or annual) planning has to be integrated with long term planning and regional planning with national planning for which an apex planning machinery has to be constituted by the government.

Self-Check Exercise-II

Q. What do you mean by Potential Economic Surplus?

Ans. ....

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Co-operation or Competitions: Whether there should be co-operation or competition between public sector and private sector has become a debatable issue these days. Many countries are providing opportunities for the private sector to participate in the building of public infrastructure and on the other by opening up traditional government business monopolies to competition. Because of public sector reforms a more commercial and competitive approach in the delivery of public sector goods and service is adopted. Public Private Partnership (PPPs), Build, Operate and transfer (BOT) are forms of co-opeartion between the private sector and national governements. Energy and utilties network and servies, telecommunications and transport system, server and waste treatment facilities, health, education are such fields where public and private sector are co-operating. Sometimes, the government in mixed economies and that the private sector are not cooperating in achieving the set planned targets. In such circumstances the government may resort to nationalisation, i.e., take over of the private sector. These measures further expand the role of the government in a mixed economy. Although this measure is fraught with many difficulties yet it helps the State to achieve certain goals for the society. The famous measure of nationalisation of 14 major commercial banks in 1969 is a well-known example in India.

The increasing role of the government in mixed economies is also due to the lack of private initiatives. The private sector is always guided by the principle of profit maximisation. The private sector would not invest in activities which do not yield direct economic returns. The government sector, on the other hand, is guided by the long term objectives. There may be certain activities which do not yield any direct return yet in these cases externalities or external economies may be so much as to require immediate attention of the government. Investment in economic and social infrastructre is one such example. Power, means of transport and communication, education including technical education, medical and public health facilities, etc., have to be provided. Since the private sector may not be interested in these activities, therefore, it becomes the duty of the government to come forward and invest in these channels. But the new economic policy of 1991 in India has laid emphasis on liberalisation, privatisation and globalisation (LPG), and the role of public sector was reformulated. The private sector was supported to compete with public sector in the same area. The accountability for losses and profits on investment was also put on public sector units. In the case of public sector undertakings incurring losses repeatedly, it was referred to the Board of Industrial and Financial Reconstruction (BIFR) for improvement or close down.

2.5. Role of Government in Socialist Economies

Finally, before we conclude this lesson about the role of the government in a mixed economy, a few words about the role of the government in socialist economies seem to be important. As already discussed that even in free enterprise economy because of certain factors the government has to play a key role in the form of imposing taxes and incurring public expenditure. Similarly, in a mixed economy, by definition, public sector has to operate side by side with the private sector. But socialist economies are entirely different, hence, whole of the economy is under socialist control. Therefore, the government may not have to play the key role as it does in a capitalist or mixed economy. But this appears to be a misnomer. Because even in such economies taxes are levied and public expenditure incurred the same way as it is done in capitalist or mixed economies. For example, in the erstwhile USSR, turn over tax on commodities was levied whenever the state found that demand was likely to exceed supply. Therefore, in order to equate demand and supply, turnover tax was levied. Similarly, various fiscal incentives in the form of better living conditions were assured to encourage the workers to improve upon their productivity by receiving higher education.However, the truth is every developed country has some programs that are socialist.

Self-Check Exercise-III

Q. Write three sentences about the role of government in a mixed economy.

Ans. ....

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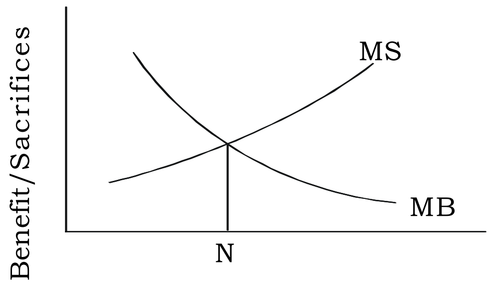
1.2.6 Conclusion

Thus, it can be concluded that the importance of public finance cannot be belittled. The subject has travelled a long path before reaching the present state of affairs. The state is no longer a police state and the days of laissez-faire are gone. The role of state has undergone a fundamental change today. From a protector of its citizens against internal disorders and external aggression, it has to adjust and extend its tax and expenditure programmes so as to maximise total social advantage. And this point is reached when marginal benefits from public expenditure are equal to marginal sacrifice imposed by taxation. This is clear through diagram 1.

Diagram-1



Amount of Taxation & Public Expenditure

In the diagram-I we measure amount of taxation and public expenditure on x-axis and benefits from public expenditure and sacrifices imposed by taxation on y-axis. The curve 'MB' stands for marginal benefits from public expenditure, which falls from left to right like marginal utility curve, indicating thereby that as more and more is spent, marginal benefits from public expenditure go on decreasing. Contrary to this, 'MS' curve stands for marginal sacrifices of taxation, which go on increasing as more and more taxes are levied on the people. In order to maximise total social welfare tax expenditure programme should be extended up to ON. Therefore, the government can add to the social welfare, by extending the taxation and expenditure levels. However, if tax expenditure programme is extended beyond ON, then marginal sacrifices of taxation on people would be more than marginal benefits derived from public expenditure and in the process, total social welfare would suffer. Thus, the public finance activities, viz., tax-expenditure programme should be extended up to ON in order to maximise total social welfare.

To conclude, the government has to play a key role in all forms of the economic system, though the objectives of government intervention may be different.

1.2.7 Short Concepts

Existing Economic Surplus: The excess of current income over current consumption provided it is not productively invested.

Additional Economic Surplus: Mobilisation of a substantional part of the additional increase in income of the people by government for investment.

1.2.8 Long Question:

1. Highlight the role of state in a modern economy.
2. Write in detail, the changing perspectives about the role of government in a free enterprise economy.
3. Discuss the importance of government in a free enterprise economy.
4. How the decay of laissez-faire policy led to the growth of public finance and public economics ?
5. Describe the role of government in a mixed economy.
6. Discuss the various forms of extending government activities in a mixed economy.
7. Discuss the relationship between economic development and the concept of mixed economy.

8. Why is the concept of mixed economy more relevant for promoting the economic development of less developed countries ?

LESSON NO. : 1.3 **Author : Prof. Janak Raj Gupta**

Government as an Agent For Economic Planning and Development

1.3.1 Introduction
1.3.2 Objectives
1.3.3 Government as an agent for economic planning
1.3.4 Government as an agent for promoting economic development
1.3.5 Summary
1.3.6 References
1.3.7 Short Cencepts
1.3.8 Questions for your Practice

1.3.1. Introduction

In this lesson you will understand the importance of the role of the government to expedite the process of economic development in under developed countries. Then for promoting economic development why planning is necessary. What characteristics of the under developed countries do not allow the private sector to play its role? Planning mechanism is essential for the optimum allocation of public goods as market mechanism does for private goods. Therefore, operationalization of planning is the pre-requisite for allocation and financing of public goods i.e., for raising public revenue and incurring public expenditure, though the importance of planning is far greater for the latter activities (allocation of public expenditure).

The lesson is divided into two parts: (a) Government as an agent for economic planning and (b) Role of the government in economic development.

1.3.2. Objectives

The main objective of the lesson is to acquaint you about the role of the government in promoting economic development of under developed countries. And why planning is necessary to move towards the desired direction of economic development. Price mechanism alone cannot promote socially optimum pattern of production. In the absence of planning the resources may be invested in real estate and jewellery where returns are assured, thereby adversely affecting the process of economic development.

1.3.3. Government as an Agent for Economic Planning

Distinction between Planned and Unplanned Economy

The unplanned economy relies on market forces for the utilisation of the community's resources. The market mechanism interprets consumer's preferences to the producer through the medium of level of prices and promise of higher profits.

Hence the producer acts according to market forces. A planned economy, on the other hand, represents a much more determinate organisation of resources and specifying goals to be achieved and the commodities to be produced. The state is vested with the necessary powers to pursue these goals and exploit the resources along the pre-determined channels in conformity with the goals already fixed.

Thus, the main objectives of planning are:

(a) Formulation of objectives or goals to be achieved;

(b) Fixing targets to be achieved and priorities of production for each sector of the economy;

(c) Mobilisation of the financial and other resources required for the execution of the plan and achieving planned target;

(d) Creation of the necessary organisation or agency for the execution of the plan e.g. Planning Commission in India ; and

(e) Creating assessment machinery for the periodic evaluation of the progress made.

It is immaterial whether there is public ownership and/ or control of resources or not, although public ownership and control would be more conducive to effective planning. State initiative and state regulations and control are, however, essential for successful execution of a plan. Robbin says, "Planning in the modern jargon involves government control of production in some form or the other." A central economic authority regulates output, prices, etc.

In the words of Mrs. Barbara Wootton, Planning may be defined as the conscious and deliberate choice of economic priorities by some public authority. But the public authority must also carry out these priorities through some government agency.

Thus, planning in short, may be defined as conceiving, initiating, regulating and controlling economic activity by the government according to set priorities with a view to achieving well-defined objectives within a given time.

In under developed countries government resorts to planning both by direction and by inducement.

Planning by Inducement:

In this type of planning, the planners either subsidise production or control prices, if it is intended to increase the consumption of a commodity. The first acts on the supply side and the latter on the demand side. Lower price is an inducement for the consumer while subsidy is an inducement for the producer. This is planning through the market mechanism. The citizens want freedom of choice in consumption. This freedom exerts pressure for free adjustment of production to consumption. Similarly, the worker demands freedom to choose his own job. This means that besides consumer market there must also be a labour market. This leaves a narrow sphere for state control.

The basic idea is that the market controls the entrepreneur and state can control the entrepreneur by controlling the market . The state tries to manipulate the market by means of incentives and inducements through price fixation, taxation, subsidies, etc. The government seeks to influence economic and investment decisions by offering incentives or disincentives and does not control or regulate the functioning of the economy directly. Planning by inducements avoids swollen bureaucracy. Thus, it is planning by persuasion rather than compulsion. There is freedom of enterprise, freedom of production and consumption, subject to some regulation or control by the state.

However, immobility of resources imposes serious limitations on planning by inducement. This immobility creates shortages which cannot be eliminated merely by price control and rationing. Measures have to be taken not only to distribute supplies equitably but also to augment supplies. There are economists who are not prepared to consider inducement planning as planning in the real sense of the word. According to them, there can be no planning without direct controls or directions so as to compel economic activities to conform to the plan programmes and objectives.

The merits of inducement planning are: (a) consumer's sovereignty remains intact; (b) freedom of enterprise; (c) flexible; and (d) it is democratic.

As against these merits, there are some demerits too: (a) it may fail to achieve the objectives of planning or targets of production; (b) the private entrepreneurs care more for profit than for the growth of the economy; (c) the fiscal and monetary policies of the government are not so successful in the under-developed countries; (d) The producers may not find the incentives offered by the state attractive enough to follow the state guide lines. The disincentives for the consumers may not be deterrent enough to curb wasteful consumption; (e) the working of the market forces fail to bring about proper adjustment between demand and supply and thus create imbalances in the economy, and (f) it may lead to controls and black markets. Planning by inducement is said to be like a situation where you can take the horse to water but cannot make it to drink.

As Prof. Dobb rightly observes: "Without large public sector and large government investment the plan targets may remain pious hopes that are unrealised in practice."

Planning by Direction:

Planning by direction implies that detailed instructions are given both to producers and consumers and other economic agents regarding the targets to be achieved. A list of all commodities to be produced with the quantity of each has to be prepared as well as a separate list for each of the complements and substitutes. Planning by direction is very comprehensive. It covers the entire economy. There is complete concentration of economic authority in the hands of the government. There is one authority which is sole incharge of planning, directing and execution of the plan in accordance with pre-determined targets and priorities. Only planning by direction can guarantee the success of the plan, otherwise the targets would turn out to be mere pious wishes. This means that the economic planning should have at its back the full authority of the state. As Dr. Oskar Lange observes, "With regard to the socialist sector the national plan represents a binding directive. The targets of the national plan and its financial provisions represent orders to be carried out by the various ministries and the enterprises. They are duty bound to carry out the directives of the plan."

Planning by direction suffers from certain demerits or shortcomings: (i) It is undemocratic since the people in this system are ignored all along. It is bureaucratic and totalitarian and, as such, involves the treatment of human beings as mere pigs in a big bureaucratic mechanism. There is no economic freedom. Rationing and control result in black marketing and corruption; (ii) Owing to the complexity and many-sidedness of modern economic system, planning by direction does not yield satisfactory results. It is too formidable a task. No person or body of persons can perform this task satisfactorily. (iii) There is bound to be shortage of some and surplus of other commodities. (iv) Besides, this sort of planning is bound to be inflexible. The plan once prepared must be adhered to, no part of the plan can be altered affecting the whole plan. (v) The fulfillment of the plan cannot be anticipated, because conditions keep changing. Black markets emerge to overcome the imperfections of the plan. (vi) Planning by direction also leads to excessive standardisation which impinges on consumer's sovereignty. (vii) It also involves huge administrative costs, elaborate censuses, numerous forms and army of clerks.

As Lewis remarks, "When government is doing only a few things we can an eye on it, but when it is doing everything it cannot even keep an eye on itself." There are a few difficulties or shortcomings of planning by direction. But the choice between these two types of planning is determined by the system of government prevailing in the country. A democratic government adopts planning by inducement whereas a socialist state will adopt planning by direction.

Self-Check Exercise-I

1 Distinguish between Planning by Direction and Planning by Inducement.

Ans. ....
....
....

Types of Government Participation

In underdeveloped countries government resorts to mixture of the two i.e., it can either directly participate or resort to regulatory measures.

Government in a mixed economy can directly participate in performing certain economic and social activities. Sometimes, both the public and the private sectors operate simultaneously to supplement their efforts. And sometimes their objectives may be different. For example, in India there has been an ever increasing extension in the government activities. The proportion of total public expenditure (both of the Union and the State Governments) to national income has increased to as much as 40 per cent from a meager figure of about 20 per cent when we embarked on the path of planned economic development. As already discussed, Mr. Wagner, a German thinker, projected as early as in mid-19h century that there were secular tendencies of increasing state intervention. Today, there may be no country in the world which could be characterized as a free enterprise economy following purely laissez-faire policy. Take the case of India, Industrial Policies of 1948 and 1956 recognize that both the private and the public sector have key roles to play for the economic development of the country. Through the Industrial Policy of 1956, the commanding heights of the economy were entrusted to the public sector which had the minutest planning. Even in the recent past when the government announced the introduction of New Economic Policy in 1991 and embarked upon the drives of privatization, liberalization and globalization, the role of planning has not got diluted. The government continues to have a monopoly of the social sector like education, social security and medical and public health. Even certain economic activities, particularly those directed towards poverty alleviation programmes, remained the sole privilege of the government sector.

Many a times the direct participation by the government necessitates the operation of planning by inducement through indirect regulatory measures such as taxes and duties, tariffs, subsidies (public expenditure), availability of bank credit, etc. Take the example of deficit financing. Although deficit financing gives a virtual confiscatory power to the government to purchase whatever it likes without resorting to mobilization of resources through taxes and non-tax measures, yet it disturbs the equilibrium in the monetary market, which necessitates the application of regulatory measures like credit regulation. Thus the application of planning by inducement is another manifestation of government intervention in a mixed economy.

Sometimes government can also use indirect measures to achieve the planned targets in a mixed economy. Suppose the government wants to discourage imports and encourage exports. Then the government can resort to increasing import duties and giving export subsidies. Similarly, for affecting the desired changes in production pattern tools of taxes and public expenditure can be employed. Availability and restriction of bank credit is another form of planning by inducement to control the private sector in a mixed economy. Likewise regulatory pricing mechanism is also another indirect form for containing the private sector in mixed economy. Thus, the activities of the government do not stop at having only planning by direction. In a mixed economy, the government also tries to regulate the working of the private sector through various inducement measures so as to achieve the set social objectives and planned targets. Sometimes, these regulatory measures may take the shapes of direct physical controls like licensing, quotas, etc. with which we are quite familiar.

As already stated whether these measures succeed or not it depends upon a number of other factors, yet the fact remains that the government in a mixed economy tries to influence economic activities through these measures.

For the economic fields, where the government itself does not want to enter or where even regulatory devices fail, the government may resort to even more direct physical controls. The government may not issue license for economic activities which it does not want to promote. Quota and rationing systems are other such manifestations through which the government tries to allocate the scarce resources and achieve the planned targets. Import and export restrictions also fall in this category. It is another thing that such physical controls often promote economic inefficiencies and breed corruption. That is the main reason that India is now bidding farewell to these direct physical measures.

Self-Check Exercise-2

2 Explain the different forms in which government can intervene in a mixed economy like India.

Ans. ....

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1.3.4 Government as an Agent for Promoting Economic Development:

In a view of the peculiar circumstances in which politically, socially and economically the underdeveloped countries are placed, there is not only a great urgency about economic development but also an infinitely much greater effort is required to generate the forces of economic growth. This effort is obviously beyond private enterprise in such countries who lack resources. Owing to adverse political, economic and social factors, these countries have been for long in a state of economic stagnation. They are now becoming painfully aware of the widening disparity between their economic conditions and that of the advanced countries, which are getting richer every day whereas they are caught up in the vicious circle of poverty. This necessitates a comprehensive set of measures to be adopted by the government not only to rouse them up from the state of economic slumber but to see them march quickly on the road to development. Thus the role of the government is far greater in underdeveloped countries.

The following are the principal measures, which are necessary for the government of an underdeveloped country to take in order to accelerate the process of economic growth.

(i) Mobilization of Resources

The most important task before the under developed countries is not only the lack of resources but also their mobilization for building capital assets. The main problem before the government is to find the economic surpluses and then mobilize these surpluses for economic development. Raja J. Chelliah in this regard distinguishes between three forms of economic surplus:

(a) Existing Economic Surplus,

(b) Potential Economic Surplus,

(c) Additional Economic Surplus.

These concepts are discussed in detail in lesson no.2.

(ii) Reduction of Inequalities

Another important function of mobilizing additional economic surplus is to reduce economic inequalities. As the process of economic development starts in mixed economies there are in-built tendencies of increasing income inequalities. Since income and wealth inequalities are socially intolerable beyond a particular limit, it becomes the duty of the government to initiate some progressive tax and expenditure policies so as to contain them. It must be noted that since taxes adversely affect ability to work, save and invest and willingness to work, save and invest, therefore, progressivity in their case should not be very steep. The Indian example bears testimony to this fact that over successive years we have reduced progressivity in our tax system without any adverse effect on the tax-yield. Rather public expenditure should be made more progressive so as to promote ability and incentives for increasing production.

(iii) Provision of Economic and Social Overheads

If economic growth is to be accelerated, it is necessary for the government to provide economic and social overhead facilities also called the overhead capital and services or infrastructure. Economic infrastructure includes transport facilities, e.g. railways, roads, harbors, air fields, etc., means of communications, e.g. postal, telegraph and telephone facilities, electric and even atomic energy, irrigation facilities, etc. The social overheads of infrastructure consist of educational institutions (schools, colleges and universities) both for general education and technical training, public health facilities and other welfare schemes. As Dr. D. Bright Singh puts it "The availability of adequate overhead facilities brings about external economies to other industries, lowers their capital coefficient and by thus improving the efficiency of general investment, makes possible a more rapid rate of economic growth."[1]

The under-developed countries are woefully suffering from the lack of such facilities on account of which their rate of growth has been slow and tardy. Only the government can have the ability and willingness to make investments in these directions, where the private investor cannot hope to get any tangible return and remove a big hurdle in the way of economic growth. Actually, the governments in underdeveloped countries are making large investments in the provision of overhead facilities. Of total public investment, they have ranged from 54 per cent in Sri Lanka, 56 per cent in India, 66 per cent in Burma and 72 per cent in Thailand.

(iv) Provision of Financial Facilities

Finance is the crux of the problem of development. We know that the under-developed countries suffer from scarcity of capital which is the greatest handicap in their economic growth. No doubt that their savings are meager but even the meager savings are not available for economic development. To mobilize these savings, a sound banking system is essential and other financial institutions are required to canalize these savings into investments and supply the credit needs of trade and industry. The government should see that appropriate financial institutions are set up to meet the requirements of the entrepreneurs.

In India, for instance, the government took steps to reform the banking system and put it on a sound footing. Fourteen major commercial banks were nationalized in 1969. In the agricultural sector to meet the short-term credit needs of the farmers, co-operative societies were set up and, for long-term credit land mortgage banks or land development banks have been organized. Two funds were set up: National Agricultural Credit Operations Fund and National Agricultural Credit (Stabilization) Fund .The former is meant to give long-term loans to State Governments to enable them to buy shares of co-operatives and to grant medium-term loans to co-operatives and long-term loans to land development banks and to enable them to convert short- term loans into medium-term loans. Agricultural Refinance

Corporation was set up to serve as a refinancing agency for agricultural credit and to give assistance for reclamation of land, development of special crops, mechanical farming, poultry, etc. Small Farmers' Development Agencies (S.F.D.A.'s) were established and Marginal Farmers and Agricultural Labour (M.F.A.L) schemes were taken up. Micro Finance is made available to Self Help Groups (SHGs) to bring the poor out of poverty trap. Agro-industries corporations have also been set up to give loans for the purchase of tractors and agricultural machinery.

In the industrial sector too, financial and other institutions were established to promote industrial development. To assist the small scale and cottage industries several boards were set up such as the Cottage Industries Board, All India Handicrafts Board, Central Marketing Organization, Inventions Promotion Board, State Financial Corporations, National Small Industries Corporation, etc. For the large-scale industries, the Industrial Finance Corporation of India and the Industrial Development Bank of India were set up. Unit Trust of India was created to promote investment. National Industrial Development Corporation was established to grant special loans for the rehabilitation and modernization of cotton textile mills and jute mills. Industrial Credit and Investment Corporation was set up to assist the creation, expansion and modernisation of industrial enterprises in the private sector. For re-lending facilities Refinance Corporation for Industry was set up. Export Credit and Guarantee Corporation was created to ensure against export risks, and to furnish guarantees to banks to assist exporters to secure liberal credit facilities. This gives some idea as to what a government in an under-developed country can do in the matter of provision of financial facilities.

(v) Institutional Changes

Out-moded institutions and legal and social structure too stand in the way of economic development of the under developing countries. Lot of reforms and reorganizations are essential to initiate and accelerate the process of growth. These institutional changes include land reforms like the abolition of the feudal system, abolition of absentee land lordism, tenancy reforms to give security to the tenants and fix fair rent payable by them, ceilings on land holdings, community development projects in the rural areas to promote self-reliance and local leadership, etc. In the sphere of trade and industry, government encourages small industries and prevent the creation of monopolies. To improve labour efficiency, technical institutes are set up, social security schemes are introduced and housing schemes and welfare activities are undertaken. Producers' co-operatives are also encouraged.

The government also regulates relations between labour and capital to maintain industrial peace by means of labour legislation to increase output and minimize losses. The government also promotes marketing to enable the producers to get a fair price for their products. Institutions like protection of property rights, effects law enforcement are also important to economic development.

These measures accelerate economic growth by improving the organization of production and building up non- material or intangible capital which assist productive effort as much as material capital.

Self-Check Exercise-3

3 How resources can be mobilized and utilized for promoting economic development?

Ans. ....

....

....

1.3.5 Summary

It may be summarized that without the active participation of the government no underdeveloped country can usher in a new era of economic development. Private sector alone can not ensure a high rate of economic growth because initially due to the lack of basic economic and social infrastructure it would not come forward for making investment. Building infrastructure requires huge investment with no guarantee of immediate direct economic return, therefore, government alone can perform this task. Further, to carry the production and consumption pattern in the desired direction, planning becomes the pre-requisite. In the mixed economies government adopts both planning by direction and planning by inducements.

1.3.6 Glossary

Immobility of resources	:	Resources are sticky and can not freely change hands.
Economic Surplus	:	Excess of income over consumption.
External Economies	:	Benefits of economic activities (Mobilising this surplus for productive purposes to other parties).
Mixed Economy	:	Where both private and public sectors operate.

1.3.7 References:

1. Singh, D Bright, *Economic Development,* Asia Publishing House, 1966.
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6. Lewis, W.A., *Development Planning,* George Allen and Unwin, London 1996.
7. Chelliah, Raja J., *Fiscal Policy in Underdeveloped Countries,* George Allen and Unwin, London, 1971.

1.3.8 Questions for your Practice

Long Questions :

1. Explain the role of government for promoting economic development of underdeveloped countries.
2. Why for the government in underdeveloped countries, planning for development is necessary for accelerating the rate of economic growth.
3. Discuss the role of government as an agent for economic planning and developement.

Short Questions :

1. Explain the following concepts:
    1. Potential economic surplus.
    2. Planning by direction.
    3. Planning by inducement.
    4. Social infrastructure.
    5. Economic infrastructure.

Lesson No. 1.4 **Author: Dr. Harvinder Kaur**

Private Goods, Public Goods and Merit Goods

1.4.1 Introduction
1.4.2 Objectives
1.4.3 Type of Goods
1.4.4 Private Goods and Public Goods: Meaning
1.4.4.1 Private Goods
1.4.4.2 Public Goods
1.4.4.3 Merit Goods
1.4.4.4 Difference between Private Goods and Public Goods.
1.4.5 Provision of Public Goods
1.4.6 Summary
1.4.7 Technical Words
1.4.8 Questions for your practice
1.4.9 Suggested Readings.

1.4.1 INTRODUCTION:

Human wants can be classified into private wants and public wants. Private wants are satisfied by individuals according to their personal incomes/purchasing power. These are satisfied to different degree as they are able to purchase private goods accoding to the level of their incomes. Private goods are financed and supplied by the market on price payments. On the other hand, Public wants/ Social wants/Collective wants are required to be satisfied by all in equal amounts whether the people have capacity to pay or not for the satisfaction of these wants and goods/services. No direct demand schedule exists for a public good. Hence, there may be no market for a public good. Although it is often the case that Government is involved in production of public goods, but this is not necessarily the condition. Public goods may be naturally available,they may be produced by private individuals and firms, by non-state collective action or they may not be produced at all. Some economists argue that specific features like non-rivalness and non-excludability may cause problems for the production of such goods. These issues are known as public goods problems.More technically, public goods problems are related to the broader issue of externalities and free riders problem. How social wants can be more efficiently satisfied has been discussed in detail in this lesson.

1.4.2 Objectives: After having gone through this lesson, you should be able to:

- understand the meaning of private goods, public goods and merit goods.
- differentiate between public goods and merit goods.
- explain the elements of externalities in public goods.
- discuss the free riders problem.

1.4.3 Type of goods:

Table 1

(I)	Private Good- collective good (social good)- common good- common pool resources-
(II)	club good- public good.rivalrous good and non excludable good complementary good vs. substitute good
(III)	free good vs. scarce good, durable good- non durable good- intermediate good- final good. consumer good- capital good
(IV)	inferior good- normal good- ordinary good- Giffen good- luxury good - superior good.
(V)	merit good - demerit good.

1.4.4 Private Goods and Public Goods: Meaning

1.4.4.1 Private Goods: In the words of T.F Pongue and I.C Sgontz, Private goods have been defined as "Private goods yield utility only to the person consuming the goods, these are denied to others". The availability of such goods to users can be decided in a discriminatory manner. Such a good may be subjected to principle of exclusion by making it a priced product. According to exclusion principle those who do not pay the market price for such goods are excluded from their consumption. Thus person 'A' consumes a private good because he pays the price for it and person 'B' is excluded from its consumption since he does not pay the price. We can also say that those who can not pay its market price are debarred from its use. In this sense it becomes divisible so far as its use is concerned. Private good yields utility to that person only who consumes the good so private goods are rival in consumption. Thus, the ability to pay the price, its divisibility, rivalness and the excludability are the characteristics which one can find in private goods.

Under the existence of exclusion principle, the market functions as an auction system. Consumers demand for the product and in the process they reveal their preference. Producers take the signal thus given and produce those goods which consumers want. Mobile phone, goggles, wrist watch, necklace, a purse are some examples of the private goods. The owner of these goods can exclude others from using these goods.

The market provides most of the private goods efficiently because only those consumers who pay for them the benefits accrue to them.

Self Check Exercise

Q. 1 Define Private Goods. Give examples.

Ans ....

....

....

1.4.4.2 Public Goods and Services

Paul A Samuelson is the first economist to develop the theory of public goods. In his classic paper (1954) ' The Pure Theory of Public Expenditure' he defined a public good, or as he called it in the paper a " collective consumption good" as follows: " Goods which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good."

Examples of Public goods/Public Services:

Public goods/services is a term usually used to mean goods/services provided by the government to its citizens, either directly (through the public sector) or by financing private provision of goods/services.

Public goods/Services may include

- Defence and law enforcement
- Education
- Public transportation
- Broadcasting and Communications
- Fire service
- Health care/vaccination programmes
- Water services
- Police service
- Waste management.
- Dams
- Clean air and other environmental goods.
- Public art.
- Information goods such as software development, authorship and invention.

A public good's status may change overtime. Technological progress can significantly impact excludability of traditional public goods: encryption allows broadcasters to sell individual access to their programming. On the other hand, technological progress can also create new public goods.

Characterstics of Public Goods

I. Non-rival and Non- excludable

In economics, a public good/service is a good/service that is non-rival as well as non excludable. This means consumption of the good/service by one individual does not reduce the amount of the good/service available for consumption by others and we can say another person cannot be prevented from consuming it. Thus, if one individual eats a cake, there is no cake left for anyone else; but breathing air in a park or drinking water from a stream or benefit from defence services does not significantly reduce the amount of fresh air or water available to others or defence services to others. The same benefits are available to all and without mutual interference. So, the total supply available to the community can be made available to each person in community. Non-excludability means an individual can not be prevented from consuming the good whether or not individual pays for it. This means it is not possible to exclude individuals from the public good's consumption.

A good which is rival but non-excludable is sometimes called a common pool resource. The concepts of non-excludability and non-rivalness are highly theoretical. For example, the definition of non-excludability states that it is impossible to exclude individuals from consumption. In realty, perhaps any good can become excludable. For example, radio or television broadcasts have in the past been used as a classic example of non-excludable goods but as technology has developed it is now possible to encrypt these signals without a special decoder from the broadcast.

Table - 2

Excludability

	Goods	Yes	No
Rivalness	Yes	Private goods: eg. food, clothing, toys, furniture, in automobiles	Congestible public goods like Road, Common pool resources e.g. the fish the sea.
	No	Club goods: e.g. bridges, cable television.	Public goods: e.g. national defence, Fresh air on account of Public parks.

You can see in the table 2 that public goods/social goods/social services, like defence against foreign aggression or the use of fresh air on acount of public parks etc. are not subject to the principle of exclusion and principle of rivalness. Which means that within certain limitations, every member of the society is equally entitled to the use of a public good (service) irrespective of his contribution to its cost of production. There are certain public goods for which there is rivalry but no excludablity. In the case of congestible public goods, after a point the enjoyment received by the consumer is diminished by crowding or congestion like on roads and parks.

II) Indivisibility and Impossibility of rejection

Some of the public services are indivisible. These cannot be priced in the market in order to deprive some members of the society from their benefits. Similarly, in some cases a consumer can not surrender the use of a service even if he wants to do so. A typical example is that of defence service. For example a mlitary that defends one citizen from invasion does so for the entire public. Once the country is protected against foreign aggression, no section of the society can be excluded from enjoying its benefits. On the other hand, an individual also can not ask to be left undefined by the defence arrangements of the state, or refuse the benefit of a reduction in air pollution or that of street lighting etc.[1] It must be noted that the indivisibility of a good does not necessarly imply that every citizen of the society has actually an equal share in its benefits.[2] In case of a war, protection against enemy attack may to some extent, depend upon one's places of residence and work. People living near public parks may derive more benefits from them even when all members of society are equally entitled to their use.

III) Zero marginal cost and Decreasing average cost:

Since the cost of extending the Public good, services or providing the good to an additinal person is close to zero, thus the good is accessible to growing numbers of people without any additional marginal cost. Also public goods are usually subject to the law of decreasing average cost. On account of these two characteristics, the cost of production of public goods would fall if they are produced on the large scale. This wide dispersion of benefit renders them unsuitable for private entrepreneurship. It is impossible to recapture the full returns they engender. For these reasons, the provision of these goods should be in the hands of the public authorities.

IV) Existence of Externalities:

Public goods are also characterised by the existence of externalities or spill-over effects. These externalities are the incidental benefits or losses to the members of the society on account of production and use of public good. An externality exists if a benefit is not included in the demand price or a cost is not included in the supply price. Sometimes, their effects are only partially reflected in prices and the market transaction. Sometimes, laissez faire economists such as F. Hayek and M. Friedman refer to externalities as "neighbourhood effects" or "spill-overs". But it should not be thought that all externalities are small, spilling over only in the "neighbourhood". For example, the burning of fossil fuels influences the Earth's entire population, and causes global warming which could have disasterous effects for the planet as a whole. Musgrave (1969) pointed out, externalities are the other face of non rivalry.[3] An example is a sense of security on account of an efficient law and order enforcing machinery which, in turn, encourages savings, production and investment incentives. In the case of these externalities we can not identify the persons who are actually benefiting (or losing) on account of these public goods and the extent of these benefits (or losses). Accordingly, we can not charge from the beneficiaries for their gain nor can we compensate the losers. Since, such externalities are not marketable this demand that the public goods should be in the hands of State.

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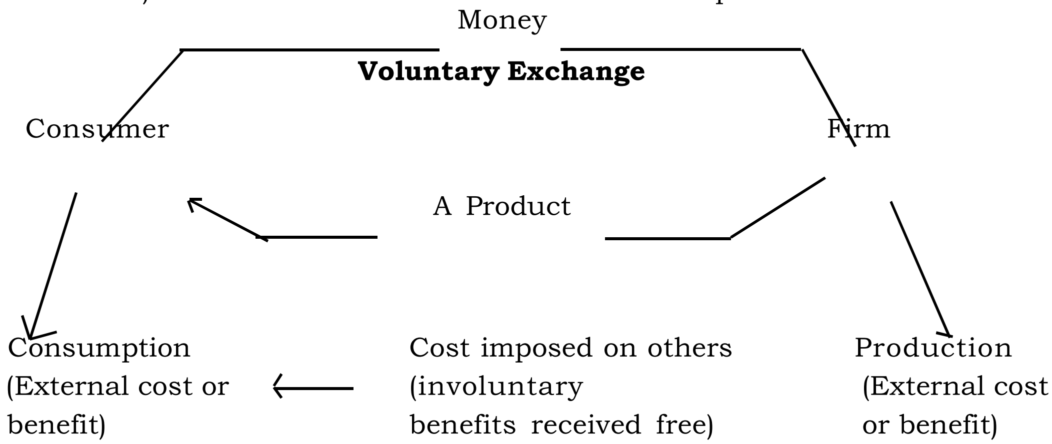

Externalities can be of two type:

(i) Positive externalities

(ii) Negative externalities

i) Positive externalities: When the action of one party benefits another party. For example : Education leads to a more civicly minded public; children gain from having educated parents; society benefits in so far as education reduces crime. Similarly, if one person is vaccinated it benefits the others as it decreases the risk of epidemic diseases. Promoting positive externalities is an important function of governments. Town planning, guidelines for house sites, street lighting, parks, good sanitation, greening of towns etc. generate positive externalities.

(ii) Negative externalities: When the action of one party disturbs in any way the other party. Most of the important negative externalities are concerned with pollution, and political corruption. So, we can say along with public goods, there can be public bads that have negative externality effects instead of positive ones.

An externality affects the prices in the economy, which in turn transmits their effects to production and consumption decision of other economic units. This causes a divergence between the private and social marginal costs or benefits of the good/ service in question. For example, pollution caused by factories, power houses, railways etc. is a cost to the society but not to the individual undertakings. Similarly, beneficial externalities of social overheads like roads etc. cause a divergence between private and social marginal benefits. These externalities are of two types:

(i) Market external effects- the losers/beneficiaries can be identified and compensated/charged for the same. So such goods may be left in the hands of the private sector.

(ii) Non market external effects- individual economic units can not be identified and compensated/ charged for the loss/ gain. So, provision of such goods should preferably be in the hands of the public authorities since they can do so irrespective of their commercial profitability.

Self Check Exercise - 2

1. **Differentiate between positive externalities and negative externalities.**

Ans ....
....
....

V) The Free Rider Problem: The production of public goods results in positive externalities which are not remunerated because no private organisation can reap all the benefits of a public good which they have produced, so there will be insufficient incentive to produce it voluntarily. In the words of A.R. Prest and N.A. Barr, "If a public good is supplied at all it is available to everyone irrespective of whether any particular individual has expressed any interest in having it or any willingness to pay for it. So, an individual will think that by keeping quiet about his needs and preferences he can enjoy the fruits of such output without paying a penny for it, this is the famous 'free riders' problem." Consumers can take advantage of public goods without contributing sufficiently to their production because a public good is indivisible and principle of exclusion does not apply. This is called the "free rider problem", or occasionally, the "easy rider problem", because consumer's contributions will be small but non-zero. Look the case of national defence, a standard example of a pure public good, a free rider knows that he or she can not be excluded from the benefits of national defence regardless of whether he or she contributes to it. Indivisibility and non exclusion make the pricing of jointly consumed goods difficult or impossible. Moreover, exclusion tends to become more difficult as the size of the consuming group becomes larger. Every individual may argue that the supply would not be affected by his/her not paying for it.

Some of the possible solutions to free rider problem

(i) Assurance contracts in which participants make a binding pledge to contribute to a contract for building a public good, contingent on a quorum of a pre-determined size being reached.

(ii) Majority rule voting : It is determined through preference for spending on a public good/ service.

(iii) The Coasian solution named for the economist Ronald Coase proposes a mechanism by which potential beneficiaries of a public good band together and pool their resources based on their willingness to pay to create the public good.

(iv) Compulsory contribution : If voluntary contribution of public goods will not work, then the obvious solution is making their contribution compulsory. Government or states impose taxation to fund the production of public goods. The difficulty is to determine how much funding should be allocated to different public goods, and how the costs should be split.

(v) The Government may subsidise production of a public good in the private sector. For instance, the state may subsidise devices to reduce air pollution and appeal to citizens to cover the remaining cost and similarly, the state may give subsidy to private producer of specific medicine.

Self check exercise - 3

Q3. Define public goods .

Ans ....
....
....

Q4. Write three characterstics of public goods.

Ans ....
....
....

Q5. What is free riders problem?

Ans ....
....
....

1.4.4.3 Merit Goods: Certain private wants which are essential for each and every citizen of the nation but which can not be satisfied by poor people due to their low level of income, are required to be satisfied by the Government. Musgrave calls them merit wants. The merit goods when provided privately are usually affordable only to the very rich. As these goods carry external benefits, government thinks every body should have them. Merit wants are thus the private wants which are satisfied by the government for benefit of the poor otherwise it will create problems in the society. A.R. Prest and N.A. Barr opine that the state should always be prepared to help those who are incapable of economic reasoning or of having any perception of what is an advantageous and what is a disadvantageous course of action economically.It is called principle of merit wants or demerit wants. This principle justifies laws preventing employment of young children/child labour (demerit wants) or legislation giving state support for the mentally handicapped (merit wants). To increase efficiency the state may choose to encourage greater production or consumption of a merit good through regulation of subsidies or to produce the good itself. Goods typically considered to be merit goods include basic education and preventive health care.

The use of such goods by some members of the society bring an indirect benefit to others also. Goods where competition is to be encouraged should be called merit goods and goods whose consumption is to be discouraged are called demerit goods.

1.4.4.4 Difference between Private Goods and Public Goods

Private goods and Public Goods are differentiated on the basis of basic characterstics in the following chart:

Private Goods	Public Goods
1. Private costs and benefits	1. Externalities
2. Excludable	2. Non-excludability
3. Rivalrous	3. Non-rivalary
4. Element of independence	4. Element of jointness
5. Exclusively made for profit	5. Aim is social welfare
6. Possibility of rejection	6. Impossibility of rejection
7. Payment and benefit simultaneous.	7. Payment and benefits not simultaneous.
8. Benefits obvious	8. Benefits obscure
9. Payee and beneficiary identical	9. Payee and beneficiary can be different.
10. Production/Supply/financing left to market mechanism.	10. Regulated by public institutions.
11. $MRS^{A}_{xY} = MRS^{B}_{xY} = MT_{xY}$	11. $MRS^{A}_{xY} + MRS^{B}_{xY} = MT_{xY}$

Last characterstic can be explained in the following manner.

If two consumers A and B allocate their budgets between two private goods X and Y, the standard equilbrium condition is that marginal rate of substitution in consumption should be equal to the marginal rate of transformation between the two commodities i.e. $MRS^{A}_{xY} = MRS^{B}_{xY} = MT_{xY}$. If, alternatively, A and B have to choose between one private good(Y) and one public good(X) the equilibrium condition then becomes $MRS^{A}_{xY} + MRS^{B}_{xY} = MT_{xY}$. In other words, we have now a condition of additivity rather than equality between marginal rate of substitution in consumption.

1.4.4.5 Provision of Public Goods: It is evident that public goods are not necessarily produced/provided or financed by public institutions. But, Governments frequently intervene to reverse market failures or to reduce transaction costs so as to enhance consumption or supply and thus positive externalities. Government for instance provide preventive care - non profitable health care niche and - subsidise education because they have an overall positive social effect. This we can see from the following chart:

Production	Supply: Public	Supply: Private
Public	Defence Services	Public utility operation e.g. electricity
Private	Drugs made available without charge to the elderly, aids patients, laprosy patients etc.	Refrigerator, Toothpaste, Watch overcoat, Necklace

It shows that the public sector deals with the delivery of goods and services by and for the government whether national, regional or local.

Moreover, pure public goods do not exist, with the possible exception of national defence. Most goods possess elements of both publicness and privateness. The difference between goods is mostly of degree and not of kind. Such goods which are neither pure public goods nor pure private goods are called mixed goods. Musgrave discussed a number of mixed cases, such as (i) public goods with limited externalities, (2) non - substitute externalities and (3) mixed benefit goods.

Let us illustrate the issue with the help of examples:

(i) Take the example of cholera inoculation as such a measure protects the person so inoculated from cholera. It is a case of personal benefit but we know that such inoculation confers external benefits since the danger of infection is reduced. The existence of external benefits points toward budgetary process. But in this case the budgetary intervention does not involve full budgetary provision. It takes the form of subsidy to private purchases.

(ii) Take the case of education. One person derives benefits from his own education in the form of higher income But when all members of society are educated, cultural enviornment of the society improves. So, subsidy should be given to educate all. So, education is being transformed into a non pure public good.

(iii) Consider highways- the most important public good. The introduction of advanced "on the fly" identification and billing system (toll tax) reduced transaction costs so dramatically that privately owned and oprated highways are now common in many countries. This is an example of a public good gradually going private.

Self Check Exercise - 4

6. Differentiate public goods and private goods on the basis of four characteristics.

Ans ....
....
....

1.4.6 Summary:

In this lesson, you have read that private goods and public goods are differentiated on the basis of different characteristics like purchasing power of an individual or ability to pay the price of a good, the divisibility of a good, operation of exclusion principle, financing pattern of supply of goods etc. The availability of private goods to users can be decided in a discriminatory manner. Those who do not pay the market price for those goods are excluded from their consumption. Public goods are non - rival, non - excludable and indivisible. The indivisible goods, whose benefits can not be priced and therefore to which the principle of exclusion does not apply are called pure public goods. All members of a society are equally entitled to their use. Besides, certain essential private wants satisfied by the government at low prices are called merit wants. In the case of private goods, benefits are wholly internal (rival); while in the case of public goods, benefits are whole external (non-rival). But sometimes, mixed situation of many kinds arise, private consumption generate external benefit, when private goods are subsidised or public goods/services are transformed into non-pure public goods.

1.4.7 Technical Words

Congestion charges: Fees charged during periods of peak usage of certain facilites such as roads and parks to reduce congestion. It is a by-product of Club theoirm.

Externality: A cost or benefit falling on a third party who is not direcly involved in a transaction as buyer or seller.

Free rider: A person who takes advantage of non-excludablity by consuming a public good without contributing to the cost of its production

1.4.8 Questions for Practice

1. Distinguish the basic characterstics of private goods from those of the public goods.
2. Explain the basic characterstics of a pure public good. What are mixed goods?
3. Write short notes on the following:
   (i) Public Goods
   (ii) Private Goods
   (iii) Merit Goods
   (iv) Free Riders Problem
   (v) Mixed Goods
   (vi) Externalities
   (vii) Differentiate positive externalitives and negative externalities.
   (viii) Public goods and zero marginal cost.
   (ix) What is BOT principle.
   (x) Differentate private wants and social wants.

1.4.9 Suggested Readings

1. Musgrave, R.A. - ***"Provision for Social Goods"*** in J. Magolis and H.Guitton (Ed), Public Economics, Macmillan, 1969.
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3. Bhatia H.L. - ***Public Finance.***
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Lesson No.1.5 **Author : Prof. Janak Raj Gupta**

Market Failures and Imperfections

1.5.1 Introduction
1.5.2 Objectives
1.5.3 Market failures and imperfection
1.5.4 Merit Goods
1.5.5 Summary
1.5.6 Technical words
1.5.7 References
1.5.8 Questions for your Practice

1.5.1 Introduction

In this lesson, you would know that under what circumstances role of the government becomes imperative. What type of goods and services should be provided by the government and which should be left in the hands of the private sector, i.e., where market forces of demand and supply can not determine the consumer's choices.

This lesson contains the various characteristics of public goods, viz. product indivisibility, externalities, cost behavior, and non-profit considerations. In the lesson, characteristics of merit goods have also been explained.

1.5.2 Objectives

After having gone through this lesson, you would be able

- to examine the failures of the market system ;
- to examine the various characteristics of public goods, i.e., which goods should be provided by the government ;
- to understand the meaning of merit goods (because although these are available in the market, but why should government provide them to vulnerable sections of the society).

1.5.3 Market failures and Imperfections

The theory of exchange predicts that the forces of demand and supply will operate to allocate resources efficiently. Efficiency here means that it is impossible to alter the allocation of resources to make some one better of without making someone else worse off (Pareto Optimality). There are many economists who consider this result desirable. As a consequence much effort has been devoted to formulating the marginal conditions necessary to assure the desired outcome. This outcome will be produced by market forces if private property rights are well defined, there are not public goods, transaction costs are zero, and no individuals possess monopoly power. In this environment economic theory predicts that the interaction of consumers and producers in the market will result in an efficient allocation of resources.

However, the real world is not quite as perfect as the theories constructed to explain it. Public goods are present in the economy. The market process may not result in establishing the marginal conditionalities predicted by the theory of demand and supply. As a result some observers claim that market forces fail. The market did not produce the predicted (desired) results. Some critics point out that this is not a market failure but a failure of the theory of demand and supply. Theories are generally very poor standards by which to judge the real world results.

As compared to private goods for which market exists and which is unrestrictedly bought and sold, a public good is one that is non-rival in consumption. The public goods have the characteristics that consumption of the good by one individual does not reduce the amount available to others., Once a pure public good is produced, it can be consumed by many individuals. For example, the national defence of a country that is non-rival in consumption, all residents of any country consume the total output of the public good and they have free claim on it. Further, more additional individuals can avail of defence services without reducing the defence services available to others.

In case of pure public goods, market forces fail altogether to reveal preferences, while it can reveal to some extent in case of other social goods and merit goods. However, market mechanism is completely imperfect to maximize individuals welfare insofar as all public goods are concerned.

In the absence of information regarding individual preferences the tax or "prices" charged from individuals will differ. If the individuals are charged a price too high they will want to reduce the output of the public goods, while individuals who are charged a price which is too low will want to expand the output.

Although many attempts have been made to apply the market principle to the provision of public goods, yet no attempt has been successful. One such approach is the benefit approach. It is pointed out that just as private spending optimally meets the subjective wants of individual consumers, the same principle should be applied to the wants satisfied by the government. But the proponents of this school immediately recognized that market rule is not applicable to public goods as these are indivisible and are consumed in equal amounts by all. The existence of externalities – positive and negative, also exposes the failure of the market mechanism to determine accurately the optimum public expenditure. The way-out suggested was that the consumer's equilibrium condition in case of public goods may be fulfilled by the consumption of equal quantities of the commodity at different prices such that there is equi-proportionality between the utility to every individual and the price paid by him. No doubt, in this way, the optimum distribution of the consumer expenditure between public and private goods can be distributed but it fails to provide answer to the question as to how much resources should be allocated by the government for the provision of public goods. Lindahl attempted to determine simultaneously the optimum amount of public spending and the optimum distribution of tax burden in the case of benefit principle. The Lindahl model, however, encounters the same difficulties. Firstly, the individuals will not readily reveal their true preferences for public goods. Secondly, even when they reveal their true preferences, the optimum quantity of public goods to be provided cannot be determined without first determining the optimum distribution of income.

Self-Check Exercise-I

Q.1. Why do market forces fail to exhibit consumers' true preferences for public goods?

Ans. ....

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In short, in the following situations market forces fail and become inefficient to reveal true individuals preferences. Therefore, the government must intervene and provide such goods in order to maximize social welfare.

(a) Product Divisibility
(b) Externalities
(c) Zero Marginal Cost
(d) Decreasing Average Cost
(e) Non-profit considerations

(a) Product Divisibility

There are goods which are priced in the market and their use is exclusively restricted for those who are willing to pay the stipulated price. The use of such commodities is governed by the principle of exclusion. All those who are not inclined to pay its market price or those who cannot afford to pay that price are excluded from its consumption. Thus, the commodity becomes divisible insofar as its use is concerned. Such goods are termed as pure private goods. On the opposite side, there are certain other goods called as pure public goods for the use of which no discrimination is made amongst the users. All the members of the society, whether they are capable of paying for them or not, indiscriminately make use of them. For instance, the defence services are equally utilized by all the inhabitants of a country. No section of the society can be excluded from their use. It means the defence services are indivisible. These cannot be priced in the market and their use is not governed by the principle of exclusion. In such cases market forces totally fail to determine the demand and supply and hence optimum level of output.

In case of divisible products, since the supply can be made available only to those who can pay for them, the consumers of such goods voluntarily pay for maintaining a requisite level of their supply. In case of these goods, the demand preferences and the price which the consumers are willing to pay provide good indication of the type of commodity which should be produced. Thus all decisions about the divisible goods, such as the type of commodity and its quantity to be produced are dictated by the market forces. But in case of the indivisible goods, the market mechanism fails to help in making such vital decisions and all these decisions are made by the government. As mentioned above, the prices of divisible goods are paid by the individuals who use them. But the indivisible goods, like defence services, pose the problem of financing them. In case of these services, everyone knows that even if he/she does not pay for these services, these will still be available to them. This creates a tendency to avoid payment towards them. As a result most of the people will not pay voluntarily on the assumption that the supply of these services will continue owing to the payments made by others. Buchanan has referred to this as the *problem of free riders*.. It means that everybody is inclined to enjoy the benefit of such public services without having to contribute voluntarily towards the cost of supplying these services as he does in case of private goods. In such a situation, their financing becomes a problem. To overcome this difficulty, a provision for compulsory contribution by the members of the society through taxation is made. Thus it is clear that in case of indivisible goods or services not only the decisions concerning their production are left to the government or to its agencies but the financing of their production is also carried through taxation.

Such goods which are indivisible and the benefits of which are not governed by the principle of exclusion are called as the pure public goods. On the opposite, the pure private goods are those which are completely divisible and in case of which the principle of exclusion applies in full measure.

The mere fact that a good is indivisible does not necessarily mean that the benefit of it is shared by all the members of the society in an equal measure. For instance, the people in the border areas may be relatively less protected than others and hence receive more benefits from expenditure on defence. Similarly in a metropolitan city, the people having their houses near public parks are better served by them than those who live at relatively farther away places. The important thing in this connection is not whether all the individuals have the equal opportunities to use them or not but that their production is financed through taxation and access to such goods is free.

(b) Externalities

A pure public good can be distinguished from a pure private good on the basis of the existence or non-existence of externalities. The term externalities refers to the economic effects that arise due to the production or use of the good to other parties or economic units. These are in the form of an economic gain or an economic loss and are responsible for creating a divergence between their private and social marginal costs and benefits. The process of production may create certain bad effects on the society, although this may be completely disregarded by the individual producing units. For instance, a manufacturing plant may emit smoke or smells which are a disutility to the workers and the people living in the close proximity of the plant. Similarly, an oil refinery may pose health hazard for the people living nearby and damage the buildings through its effluents. The noise created by automobiles, railway trains and jet planes, may cause disturbance and loss to the efficiency of the people who are continuously exposed to it. The consumption of petrol also involves similar bad effects. A free orchestra in the common park is enjoyable to those who come to hear it but may be a source of much annoyance for the captive audience or nearby residents who would like to sleep.

When there are such bad or negative externalities, the society has to bear some social costs that may be somewhat reduced by the government through taxation.

Just as there are bad social effects of certain goods and services, similarly, there are externalities in the form of economic gains or benefits to the society. The construction of a railway line or road linking a steel plant benefits not only the steel plant but also the people of the entire area through which that line passes. Bernard P. Herber has put such externalities into two categories – market and non-market external effects.

(i) Marketable External Effects:

When the external effects – both social costs and social benefits, can be priced in the market with reference to the supply and demand behaviour, these are known as the market external effects. For instance, suppose an irrigation project is started in an area. Then the net increase in the production of agricultural crops and the area rendered unavailable for cultivation due to the construction of dam or erosion of land by the canal tributaries and a consequent fall in production can be determined. These are called the market external effects of the project.

(ii) Non-marketable External Effects:

When the external effects of goods and services produced cannot be priced with reference to the demand and supply behaviour, these are termed as the non-market external effects. For instance a new road is constructed but it is difficult to determine the extent to which different economic entities concerned derive benefit from it. Certain categories of beneficiaries can, of course, be identified. But if the benefits of such categories of road users, called primary beneficiaries, alone are taken into account that will exclude other secondary and tertiary beneficiaries. Thus the pricing principle cannot strictly be applied in case of such projects or goods and services.

Such goods and services as have non-market external effects or where market forces are inefficient and totally fail, should be preferably produced and distributed through public authorities because they can take economic decisions irrespective of profit considerations. Thus we arrive at the conclusion that such pure public goods as have non-market external effects or where market forces fail should be included in the public sector, and those having market external effects or where market forces are efficient may be left to the private sector. This rule, of course, cannot be applied rigidly. Even such goods and services that are left to the private sector may in certain cases be reallocated to the public sector provided the society or government is convinced that such course of action is likely to promote social welfare. Alternatively, the government may subsidise their production in the private sector if their consumption is necessary for health and efficiency and will thus promote social welfare.

(c) Zero Marginal Cost

In case of a private good, the consumer has to pay something to be entitled to its use, i.e., marginal cost of the commodity or service to its user is always positive. On the contrary, in the case of pure public good, the marginal cost is either zero or close to zero. It means that an additional member of the community can derive the benefit of its use without causing any increase in its total cost to the society. When broadcasting services are provided, an increase in the number of radio and TV owners does not bring about any increase in the total cost. Similarly, if a road or a bridge has been constructed, an additional auto-vehicle may pass over it without causing any addition to the total cost to society. Since such goods and services (as transport system and broadcasting) are indivisible, these should be included in the public sector. However, the principle of zero marginal cost can be applied only to a limited extent. If one more vehicle passes over a road or a bridge or one more individual tunes to his radio, the marginal cost to the society may be zero. But it should be remembered that the principle of zero marginal cost is limited to a certain extent. If the number of road users or the users of broadcasting services increases very high the total cost to society is bound to go up and additional bridge or broadcasting tower may have to be constructed. Similarly the defense budget has to be expanded with the growth of population in a country.

(d) Decreasing Average Cost

Average cost is decreasing in case of pure public goods due to economics of scale. The pure private goods may be made available by the manufacturers under different cost conditions. In certain industries, while the production is governed by the law of increasing costs, in others the law of decreasing cost may be applicable.

On the contrary, the pure public good is one which is invariably subject to the law of decreasing average cost, because marginal cost of pure public goods is zero. Since public good is indivisible or lumpy, it is subject to the economies of scale. If left in the hands of the private sector they will exploit the common man by restricting the output. To reap the full benefits for the society either such goods should be produced by the public sector or private sector may be given subsidy so that output is expanded. The supply of telegraphic facilities over a very small area must be at a tremendously high average cost. Similarly the average cost of operating a sewerage in the whole city is certainly lower than when it serves only a specific locality or small part of the city.

(e) Non-profit considerations

In case of public goods, unlike private goods the output decisions are not guided by the considerations of maximizing profits-the main driving force of the market economy. But the optimum solution is arrived at by off-setting losses if any, through government subsidies. Therefore, pure public goods can be defined as those, which are lumpy and indivisible. These have non-marketable externalities and generally in their case MC is zero and AC is declining. Unlike private goods, whose production is guided by the market forces and the principle of profit maximization, pure public goods are produced not to earn profits but to maximize social welfare. Public goods cannot be priced in the market as they have unrevealed demand schedule and hence to finance their production taxation or some other levies have to be collected.

Self-Check Exercise-II

Q.2. Examine the characteristics of public goods.

Ans. ....

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1.5.4 Merit Goods

There are certain goods which, on the basis of the above mentioned criteria, may be regarded as private goods. The state may, however, in the larger interest of society include them in the public sector. Such goods are termed as the merit goods by Professor Musgrave as their use is considered desirable for all the members of the society. But some sections, because of their poor resources, may not be able to afford them. Normally in case of private goods, all the basic economic decisions concerning their production and distribution are guided by individual preferences. But the meritorious characteristics of the merit goods make it obligatory for the public authorities to deliberately interfere in individual choices and modify the choice pattern of society. For instance, the government may subsidise low cost housing, provide free education to the people or provide mid-day meals to the poor students (to encourage the poor to send their children to schools). Undoubtedly, the state interference in supplying these goods and services will be viewed as an encroachment upon the freedom of choice. But the broader objectives of public policy will justify such a course of action on the part of the state. If education is left to the private sector, many brilliant children belonging to the poor families will be forced to seek work rather than schooling for want of funds. Education, therefore, is the merit good. The want for education is the merit want which almost every member of the society must be able to satisfy. Similarly, if health services in a country are left to private agencies, only those members of the society can avail of them who are better off while the poor may have to go without them. The public authority in case of this merit good also will have either to take upon itself the responsibility of its supply or it should supplement its availability in cooperation with the private agencies. In all such cases of merit goods, the considerations of maximum social benefit override ideological or any other consideration against state interference in economic choices. In fact, this interference is most desirable for it attempts to correct distortions or imperfections in the market and in the exercise of consumer choices. Market forces are not the true indicators to determine the society's preference for these goods. Thus merit goods are those goods which are provided publicly like social goods but whereas the latter are meant for all sections of the community, the former are considered desirable for certain sections of the society. Further, for merit goods public sector play a compensatory or substitutive role for the private sector because the latter is guided by sole consideration of profit maximization.

Self-Check Exercise-III

3. What are Merit goods and why should government provide them.

Ans. ....

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1.5.5 Summary

Thus it may be summarized that market forces are not always perfect guide to reveal the true preferences of people. In case of private goods price mechanism, i.e., forces of demand and supply, is a perfect guide to determine the optimum allocation of resources. But because public goods are lumpy, non-excludable and have many externalities, therefore, the decision regarding the output has to be taken by the government, which may or may not be according to consumers' preferences.

1.5.6 Technical Terms

Benefit principle: The principle that taxes should be levied in proportion to the benefits received from the government expenditure.

Externality: A cost or benefit falling on a third party who is not directly involved in a transaction as buyer or seller.

Free rider: A person who takes advantage of non-excludability and non-rivalry by consuming a public good without contributing to the cost of its production

Market failure: An outcome of the market process that does not satisfy the criterion of Pareto optimality.

Non-rivalry: It is an essential characteristic of pure public goods, consumption by one person does not diminish the amount available to another.

Pareto Optimality: A situation in which no change can be made that makes some people better off without making at least one person worse off.

1.5.7 References:

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1.5.8 Questions for your Practice

Long Questions :

1. Explain under what circumstances market forces fail to achieve the optimum allocation of resources.
2. Comment on the statement that "Market forces are not always the best indicators to maximize consumer's satisfaction".

Short Questions :

1. Explain externalities of public expenditure.
2. What is a free rider problem?
3. Define pure public goods.
4. Define merit goods.

Lesson No. : 1.7 Author : Prof. J.R. Gupta

Rationale of Public Policy

Structure of the Lesson

1.7.1 Introduction
1.7.2 Objectives
1.7.3 Public Policy
- A. Concept of Public Policy
- B. Rationale of Public Policy
- C. Objectives of Public Policy

1.7.4 Summary
1.7.5 Technical Terms
1.7.6 References
1.7.7 Questions for your Practice

1.7.1 Introduction

In this lesson, you would first know about the meaning of public policy and understand how with a proper public policy framework achieving planned targets become easy.

The lesson is divided in three sections. In section A, the concept of public policy is explained, while section B contains rationale of public policy. Relationship between policy framework and planning has also been explained. In section C, the role of public policies to achieve the various economic objectives has been explained.

1.7.2 Objectives

The main objective of this lesson is to acquaint students about the use of various public policies for achieving the various economic objectives in developed and developing countries. It has also been explained that without framing proper policies, planning for economic development would be directionless.

1.7.3 Public Policy

Public policy is an important mechanism for moving a social system from the past to the future. It helps us to cope with the future. The rise in expectation of the people has compelled them to adopt policies for alleviating poverty and improving the quality of life of all sections of a society. Important ingredients of public policy are policy making, implementation and evaluation.

'Public Policy' is a concept now much in vogue. It is a frequently used term in our daily life and in our academic literature, where we often make references to the national health policy, the education policy, wage policy, agricultural policy, fiscal policy, monetary policy and so on. The concept of public policy presupposes that there is a domain of life which is not private or purely individual, but held in common and mostly governed by the state. Public problems can originate in endless words and require different policy response (such as regulations, subsidies, quotas and laws) on the local, on the state or on the national level.

Section A

Concept of Public Policy

Public policy is a compound word, composed of two words, i.e, 'public' and 'policy'. The word 'public' is the antonym of 'private', that is, its meaning is directly opposite to that of the word 'private'. 'Private' usually concerns an individual and is often used in a singular sense. Its plural version is 'public', which signifies an association or group of two or more than two individuals. In its widest sense it means all the members of a community which is represented by the word 'public'. In public policy, however, the word 'public' is neither used in its widest sense nor in its narrowest sense of just two or a few individuals. It is really used in a specific sense—— in the sense of government. Though temples, schools, hospitals and universities are public institutions, yet we do not study the policies relating to their working in public policies. It is only the policies of the Government – Central, State and Local – that are studied in the public policy. Thus the word public is used to signify government or state.

The Concept of Policy

The concept of 'policy' usually denotes, among other elements, guidance for action. It may take the following forms:

1. A declaration of goals;
2. A declaration of course of action;
3. An authoritative decision; and
4. An evaluation of outcome

Taken as a whole, policy may be defined as a purposive course of action taken or adopted by those in power in pursuit of certain goals or objectives. It should be added here that public policies are the policies adopted and implemented by government bodies and officials.

A public policy may cover a major portion of its activities which are consistent with the development policy. Socio-economic development, equality in the distribution of income or self-reliance or similar broad principles of guidance for action may be adopted as a developmental policy or national goal. Scope of public policy may be narrow covering a specific activity, such as family planning or wider such as removing unemployment and pushing up the rate of economic growth. A public policy may also be applied to all people in a country or it may be limited to a section of its people. Besides, each level of government (central, state and local) may have its specific or general policies.

Section B

Rationale of Public Policies

Public policies in modern socio-political system are generally purposive or goal oriented statements. Again, a public policy may be either positive or negative in form. In its positive form, it may involve some form of overt government action to deal with a particular problem. On the other hand in its negative form, it involves a decision by public servants not to take action on some matter on which a governmental order is sought. Public policy may have a legally coercive quality that citizens accept as legitimate, e.g., taxes must be paid unless one wants to run the risk of being fined or jailed. This legally coercive quality of public policies makes public organization distinct from the private organizations. It may also be stated that public policies and planning are inter-woven, though sometimes a distinction is made between the two. Broadly speaking a plan is a sum-total of programmes for action for attaining definite goals or objectives. In this sense, a plan is a policy statement and planning implies policy-making. But most often policies of a plan may not be stipulated specifically in plan documents.

Allocation of resources and targets to be achieved for the different sectors of the economy are at the core of every planning. But what policies should be adopted to achieve the set targets should also constitute the necessary framework of a plan. Targets cannot be achieved simply because the resources have been allocated. This is particularly true for infrastructure development. Rather targets have to be drawn within the given framework of policies, e.g., if the policy is to achieve food security, then resources should be so allocated in the plan, that are addressed to achieve the given target. Successful policies make for successful plans.

Self-Check Exercise-I

1. Define public policy and its role.

Ans. ....

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Section C

Objectives of Public Policy

Further the nature of public policy as a purposive course of action can be better understood if it is examined in the context of following objectives which public policy tend to achieve in the domain of Public Economics:

1. The allocation of resources as between different lines of production in such a way that the economic welfare of the community is maxi-

mized.

2. To distribute national income in such a way that it leads to a maximization of the total satisfaction of the community.
3. To maintain the total volume of effective demand and thus national income at such a level that there is full employment without either inflationary or deflationary tendency i.e., stabilization of the economy.

1 Public Policy for Allocation of Resources

The fundamental problem in the public policy is to determine optimally how much resources should be allocated by the government for the provision of social goods i.e., goods of which there are no markets, e.g., defence, flood control projects, highways, police, etc., and further what should be the principle of taxation which would distribute the cost of provision of the goods amongst the individuals in an optimum manner. In democratic countries where the principle of consumer sovereignty is accepted, for the optimum resource allocation for social goods and distribution of the tax shares amongst individuals it is indispensable that the government should somehow or other know what are the true preferences of the individuals for such goods. But, as a matter of fact, there is no simple, fool-proof method by which individuals' true preferences for social goods might be determined. For, social goods are such that, unlike in the case of private goods sold through the market, their services may be enjoyed by individuals without paying anything. Since social goods are lumpy those who do not reveal their preferences for the goods by bidding for them cannot be excluded from the enjoyment of the services derived from these goods. And once the preference pattern for social goods remains indeterminate, the principle of taxation for raising the required resources also remains indeterminate.

In order to overcome this indeterminacy attempts have been made from time to time to find out as to how individuals' preference pattern for social goods may be determined and how from individual preferences the total social preference pattern is determined. However, these attempts have been rewarded with a limited success. One such unsuccessful attempt is the application of the benefit principle to the government expenditure and taxation. Another is the application of the ability principle or its variant, equal sacrifice principle, of taxation. A third is the comparatively recent Pigou-Dalton approach of equalizing marginal social cost of taxation and marginal social benefit of government expenditure. But all these principles are based on such unrealistic assumptions that the individuals reveal their true preferences for social goods and cardinal measurability or inter-personal comparison of utility is possible.

Once, however, the true preferences of the individuals for social goods are known, then the determination of optimum allocation of resources is nothing basically different from the determination of an optimum amount of production by a private producer under conditions of perfect competition. The government should provide social goods up to that quantity where the individuals' aggregate demand for social goods is equal to the supply of such goods. The tax liability of individuals would also be simultaneously determined, the greater the preferences of an individual for social goods the greater being his tax liability. The fulfillment of these requirements, presupposes that the consumers' true preferences for social goods is known somehow or the other. Thus it is a Herculean task for the public policy to ensure an optimum allocation of resources.

2. Public Policy for Distribution of National Income

Another main function of the public policy is to use the government revenue expenditure programme to bring about the ideal distribution of economic welfare. But the concept of ideal distribution of welfare is mind-boggling one since the very notion "ideal" requires a clear cut definition and here the individual value judgments must have their say. Nevertheless we can say that in a democratic set-up, an ideal distribution would generally imply equality between man and man. But again this concept of equality is equally slippery. In fact, equality may be interpreted in a number of senses, viz., equality of income, equality of welfare, equality of opportunity, etc. All these different interpretations of equality may not lead to the same policy implications. For example, equality of income and equality of welfare would imply the same budget policy when all the people have the same capacity to derive welfare from a given amount of income. But more often than not the capacities of individuals to enjoy from a given amount of income are dissimilar, in which case a policy of bringing about equality of welfare by the budget policy would actually imply that the revenue-expenditure process would have to be so conducted as to create an inequality of income. Finally the same may have to be further modified if our goal is equality of opportunity.

Since, however, there is no way of making a scientific inter-personal comparison of utilities it will be futile to attempt to have either equality of welfare or equality of opportunity. But budget policy generally aims at equality of income though, even within this restricted sphere there would remain a vast scope of difference of opinion since the very concept of income is subject to widely different interpretations, i.e., money income or real income, earned income or unearned income, etc.

Public policy has also a great role to play for reducing inter-regional and intra-regional inequalities. In a large country like India with divergent distribution of resources, inter-regional or inter-state inequalities are bound to occur. Therefore, it becomes imperative for the government to devise a national policy to contain these differences as much as possible. Tax policy for underdeveloped states may be so devised that industries in such regions get maximum tax incentives. Similarly, public expenditure on economic and social infrastructure in these neglected regions must receive a top priority of the public policy. Even within a state, different regions may be endowed with different resources, leading to intra-state disparities. Therefore, public policies, particularly budgetary policies of the states must be so addressed that such disparities are also reduced to minimum.

3. Public Policy for Economic Stabilization

Public policy relating to fiscal matters, for economic stabilization seeks to maintain full employment without inflationary or deflationary tendency. Thus when private investment, consumption and foreign balance are inadequate to maintain full employment, the state should increase its own expenditure and /or induce the private units to increase their expenditure by tax reductions or more transfer payments. Exactly opposite policy should be pursued in case of private demand increase and the consequent inflationary gap.

It may be noted that although tax policy and expenditure policy are both used to maintain economic stability yet in one situation, i.e., depression then increasing public expenditure may be more effective than reducing tax burden. This is because while increase in public expenditure will have a multiplier effect on increasing the total effective demand, the reduction in tax rates may not be as much expansionary because MPC (marginal propensity to consume) being less than one, the entire amount of tax reduction may not be spent. On the other hand during inflation we should rely more on tax increase than expenditure decrease, because any decrease in public expenditure may have a long term adverse effect on the economy, besides giving wrong signals for the private demand.

It should however be borne in mind that the problem of maintaining full employment over a period of time is radically different from that at a point of time. Over a period of time, side by side with the policy of making more public and/or private investment for attaining full employment there is likely to be an increase in the productive capacity of the economy which would require to be effectively utilized during the subsequent periods. Thus over a period of time public-private investment should not only increase but increase at a sufficient rate to absorb the increased productive capacity inherited from the previous period.

Self Check Exercise - 2

1. **What is the role of public policy to achieve the goals of optimum allocation of resources, distribution of income and economic stabilization?**

Ans. ....

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Public Policy in Underdeveloped Countries

Most of the governments in underdeveloped countries are trying to develop their economy to sustain improvements in the social system and to increase the capacity of their economic system with a view to achieve the major objective of economic development. They seek to improve the relevant policies so as to usher the era of rapid economic development. It is, therefore taken for granted that government's approaches and strategies which will contribute towards this end are essential. The study of public policy presents a powerful approach for this purpose. Public policy is also an important mechanism for moving a social system from the past to the future for the overall benefit of the society.

Public Policy for Poverty Alleviation

Public policies are always made in the backdrop of national and international economic environments. For example in the post 1991 reform period, public policy in India moved towards adopting globalization, liberalization and privatization, commonly known as New Economic Policy. But then with the passage of time, though it jacked up the economic growth, yet it also led to increasing unemployment and inequalities in the distribution of income. Therefore, new policies relating to generating employment opportunities had to be adopted. Take for example the adoption of NREGS (National Rural Employment Guarantee Scheme) in 2006. Similarly, earlier also the adoption of many schemes such as SFDA(Small Farmers Development Agency), MFALA (Marginal Farmers and Agricultural Labour Agency), DPAP (Drought Prone Areas Programme), CSRE (Crash Scheme for Rural Employment), FWP (Food for Work Programme), etc., were geared towards containing poverty of the rural poor. Since socio-economic and political environments do not remain static, public policies have to be dynamic and pragmatic.

Public Policy for building Economic and Social Infrastructure

If economic growth is to be accelerated, it is necessary for the government to provide economic and social overhead facilities also called the overhead capital and services or infrastructure, for which the government will have to devise long term policies/stratgeties. Economic infrastructure includes transport facilities, e.g. railways, roads, harbors, air fields, etc., means of communications, e.g. postal, telegraph and telephone facilities, electric and even atomic energy, irrigation facilities, etc. The social overhead or infrastructure consists of educational institutions (schools, colleges and universities) both for general education and technical training, public health facilites and other welfare schemes. As D. Bright Singh puts it, "The availability of adequate overhead facilities brings about external economies to other industries, lowers their capital coefficient and by thus improving the efficiency of general investment, makes possible a more rapid rate of economic growth." The under-developed countries are woefully suffering from the lack of such facilities on account of which their rate of growth has been slow and tardy. Only the government can have the ability and willingness to make investments in these directions, where the private investor cannot hope to get any tangible return and remove a big hurdle in the way of economic growth. And for achieving all these objectives a properly designed policy framework is the pre-requisite.

However, apart from direct participation by the government, public policies can be geared to encourage participation of the private sector. Sometimes policies are formulated for the combined participation of the public and private sectors in certain areas. For example, in the present scenario an increasing emphasis is put on privatization. Even such vital sectors like power, transport and communication, education and health are being operated by the private sector because of the policies shifts. Even in key areas of infrastructure the private sector has been allowed to participate on BOT (build, operate and transfer) principle. Under this policy private sector is allowed to build and operate for a specific period, a particular infrastructure, i.e., incur the cost and retain the earnings. But after the expiry of the agreed period, the infrastructure so built is transferred back to the public authority.

Self-Check Exercise - 3

1. **Explain the type of public policy which should be used to promote economic development of underdeveloped countries.**

Ans. ....
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1.7.4 Summary

It may be summarized that public policy has a multi-disciplinary perspective encompassing economic, political science, public administration, sociology, etc., though to many "roots of the public policy lay in economic policy". It may also be mentioned that public policy for various sectors and sub-sectors should work in tandem. These should not work at cross purposes. If tax policies are designed to contain inflation then, expenditure policy should also supplement these efforts. Other policies like investment policy, price policy, labour and employment policy, wage policy, monetary policy, etc., should be geared to achieve the same objective i.e., they should not work at cross purposes. Since public policies grow out of the given economic, social and political environments these are bound to be different for developed and underdeveloped countries. Further, without pre-setting of goals which public policies intend to achieve, we cannot carry the country in the desired direction.

1.7.5 Technical Terms

BOT Principle: Under this policy private sector is allowed to build and operate for a specific period, a particular infrastructure, i.e., incur the cost and retain the earnings. But after the expiry of the agreed period, the infrastructure so built is transferred back to the public authority.

Food Security: To ensure food, both in quantitative and qualitative terms, for the growing population.

Inter-state disparities: Disparities between or amongst the states.

Intra-Regional Disparities: Disparities within different regions or districts in the same state.

Social Goods: Goods and services provided by the government.

1.7.6 References

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1.7.7 Long Questions

1. "Policy framework is essential to achieve the set goals." Discuss?
2. What is the role of public policy to have a planned economic development.
3. Discuss various sources of public revenue.

Short Questions

1. Explain the meaning of public policy.
2. What is the relationship between planning and public policy.
3. What type of public polices should be used to achieve equality in the distribution of income?
4. Discuss two objectives of public policy.

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SOURCES OF PUBLIC REVENUE

1.8.1 Introduction
1.8.2 Objectives
1.8.3 Meaning of Public Revenue
1.8.4 Classification of Public Revenue
1.8.5 Various Sources of Public Revenue and their relative importance
1.8.6 Sources of Revenue for the Centre and States in India
1.8.7 Summary
1.8.8 Glossary

1.8.1 Introduction :

You have studied in the previous chapters that how the role of state has changed from merely a 'Police State' to the extent of 'Welfare State'. The government of a country is thus expected to perform a number of functions which require huge funds. Such funds are raised from various sources. The task of collecting monetary resources and amount thus generated/collected may be termed government revenue or public revenue. The important sources of public revenue include taxes, administrative revenue, market borrowings, income from public sector undertakings, sale of public sector assets etc.

1.8.2 Objectives :

After having gone through this lesson, you would be able to

- define the concept of public revenue.
- know various sources of public revenue.
- distinguish tax revenue from non-tax revenue.
- explain principles of taxation.
- understand the concepts of buoyancy and elasticity of a tax.

1.8.3 Meaning of Public Revenue

A government needs huge funds to perform a variety of functions. The income that government collects and generates through all sources like taxes, fees, donations, public sector undertakings, sale of public assets, deficit financing etc. is called public revenue or public income.

However, the term public revenue is defined in different way by various pubic finance experts. Professor Dalton distinguishes between public receipts and public revenue. Against public reveue, the term public receipts has a wider coverage than public revenue. It includes all types of funds received by the government including those which do not belong to it. Income from public property, receipts on account of sale of or hiring out of public assets, income from public undertakings and donations etc. would form a part of the public receipts. Similarly, a government usually collects various funds which do not belong to it, such as deposits of earnest money, deposits of provident funds and so on. It also undertakes borrowings in various forms. It also creates additional currency and thereby adds to its spending power. On the other hand, public revenue covers direct and derivative revenue of the government. It covers taxes and revenue from prices.

1.8.4 Classification of Public Revenue

The public revenue has been classified on the basis of different characteristics of various sources of public revenue by public finance experts.

(1) Adam Smith classified public revenue into two categories : (a) revenue from the people and (b) revenue from the State property.

(2) Bastable categorised public revenue into (a) income which the State receives from its various functions and (b) the income which the State collects in its own capacity as 'State'.

(3) Prof. Adams classified public revenue into :
   (i) direct revenue which includes income which the state derives from public land, public enterprises, gratuities etc.;
   (ii) derivative revenue which includes taxes, fees, fines etc.; and
   (iii) anticipatory revenue derived from the public credit.

(4) Seligman classified public revenue into :
   (i) gratuitous revenue—obtained by the State without incurring any cost.
   (ii) contractual revenue— received from sale and purchase of commodities by the government to the people.
   (iii) compulsory revenue— taxes, fees and fines are the main sources of revenue under this head.

(5) Dalton divided public revenue into taxes and prices.

(6) Taylor classified public revenue into :
   (a) grants and gifts (b) administrative revenue, (c) commercial revenue, and (d) taxes.

(7) J.K. Mehta grouped the revenue of the State into : (i) tax, (ii) fee,

and (iii) duty.

(8) John F. Due categorises major potential sources of public revenue into (i) charges which cover all or part of the costs of providing certain types of goods or services to the users; (ii) taxes; (iii) borrowing; and (iv) money creation.

(9) Prof. Shirras classifies public revenue into two categories : (i) tax revenue, and (ii) non-tax revenue. This classification is called ideal classification.

   (i) *Tax revenue covers* receipts from various types of taxation.

   (ii) *Non-tax revenue* includes revenue generated through prices paid for goods and services sold by the government, the revenue from social services, the revenue from loans or debt services, deficit spending etc./receipts on revenue account.

(10) Economic classification of public revenue is the most suitable and it categorises budget into two parts: Revenue receipts/ receipts on revenue account and Capital receipts/ receipts on capital account. The government functions are divided types, the routine ones and non-routine one. It is then maintained that routine type of activities should be financed by routine type receipts like taxes and non-taxes revenue and the same should be termed receipts on revenue account. On the other hand, receipts (like market borrowings, external assistance, recoveries of loans, small savings, provident funds, special deposits, RBI securities etc.) required to finance the acquisition and disposal of assets or liabilities should be termed as receipts on capital account.

In India, Article 112 of Constitution makes it obligatory for the government to divide the budget into revenue and capital portion on the above mentioned criteria. It is for this reason that while borrowings and repayments of earlier loans would be in the capital account. The income from public undertakings and the transaction on account of interests would be in revenue account. In the same manner, investments and disinvestments, sales and purchase of assets get included in capital account. Grants get a multifold treatment. If they have been received for financing current expenditure, they are included in revenue account and if they have been received for financing capital portion of certain projects, they are not so included. This classification, however, does not suffer from the defect of overlapping and is considered to be suitable for making economic interpretations and ensures the economic as well as social accountability. But the lack of co-ordination between budget heads and the development heads is the main drawback of this classification.

1.8.5 Various Sources of Public Revenue and their relative importance

As already discussed, due to various reasons, the duties of modern government are expanding in coverage day-by-day. They are turning more intensive and qualitatively better and therefore more expensive. Due to the growing complexity the state is trying to discover new sources and forms of public revenue. An appropriate and healthy growth of financial institutions necessitates that the authorities choose their alternative sources of revenue very judiciously. The effects of a particular source on the economy, the share of the said revenue source in relation to total revenue—determine the importance of individual source of revenue.

The various forms of sources of public revenue and their relevant importance and other aspects are discussed now.

8.5.1. Taxation

A tax is a compulsory contribution and this contribution is for common benefit and there is no relationship of benefits as between the services rendered by the government and the payment of a tax.

A tax has been defined by Professor Seligman as, "a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."[1] Professor Taussing is of the opinion that the essence of tax, as distinguished from other charges by government, is the absence of a direct quid (pro) quo between the tax payer and public authority.[2] The Indian Taxation Enquiry Committee (1924-25) adopted the following definition as a working basis. "Taxes are compulsory contribution made by the members of a definite community to the governing body of the same towards the common expenditure without any guarantee of a definite service in return."[3]

A tax may be imposed on any base like: income, property, capital or commodities on different rates but they are actually paid by individuals from their income. Every tax is made up of two elements : a base, i.e. the object to be taxed and a rate structure, indicating how the base is to be taxed. Amount of money collected from a tax is called tax yield. Tax yield is determined by (a) coverage of the tax, (b) exemptions/concessions, (c) rate structure, (d) tax compliance, (e) penal provisions, and (f) administrative efficiency.

The concepts of tax buoyancy and tax elasticits are used to measure the

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1. E.R.A Seligman : Essays in Taxation, 1921, p. 432
2. F.W. Taussing : Principles of Economics, Vol. II, 4th ed., P. 535
3. Report, Para II.

responsiveness of tax revence to economic growth. Tax revenue may change through automatic response of the tax yield to changes in national income or through the imposition of new taxes, revision of the rates and/or the bases of the existing taxes, tax amnesties, stricter tax compliance and other administrative measures backed by legal action. Changes in the tax yield resulting from modifying such tax parameters (i.e. rate, base etc.) are called discretionary changes which are the result of legislative action.

Automatic changes in the tax yield resulting from variations in the national income (with tax parameters held constant) measure the elasticity of a tax. Changes in the tax yield flowing from the combined effect of automatic response and discretionary changes measure the buoyancy of a tax. It is computed by dividing the percentage change in tax yield by the percentage change in the national income. Tax buoancy thus is a crude measure which does not distinguish between discretionary and automatic growth of revenue.

Self Check Exercise-I

Q. 1 What are the various forms of sources of public revenue?

Ans ....

....

Q.2 What do you mean by elasticity of tax?

Ans ....

....

You know that a tax is a state levy and is to be paid by the tax payer and it has no direct quid-pro-quo relationship. A tax payer is not entitled to any benefit on account of the paid tax to the state. On the other hand, fee or rate, fine, special assessment or price charged by government are generally considered as tax, tax element may be present in some of these so called tax like non-tax sources of revenue. but a pure tax is not the same thing as a fee or rate. It is different in nature.

(i) Fee : A fee or a rate (such as water rate) is related to the use of a given service though the payment may have no relation to or cover some part of the value or cost or benefit of the said service. In other words, the said payment is likely to have an element of price in it and also an element of tax. Besides it, the authorities charge fee for registration of legal documents, marriages, births and deaths. Sometimes, it is difficult to distinguish between a fee and a tax. For example, vehicle licence fee is generally regarded as a tax. The Organisation for Economic Co-operation and Development considers the following fees and charges as non-tax revenues; court fees, driving licence fees, harbour fees, passport fees, radio and television licence fees where public authorities provide the service.

(ii) Fine : It is imposed to curb certain offences. Fine is imposed on persons who violate the law. A fine is also a compulsory payment; but it is not a general levy like a tax. Fines and penalities are the payments made for the contravention of law.

(iii) Special assessment or Betterment levy : In the words of Seligman, "A compulsory contribution is levied in proportion to the special benefit derived to defray the cost of a specific improvement to property undertaken in the public interest."

Thus, special assessment is compulsory payment like a tax. But it differs from tax, as it involves the quid-pro-quo criterion in the imposition. For example, certain activities of the government like construction of roads, street lighting, provision of drainage etc. confer common benefit to community as a whole, but special benefits to those whose properties are at nearby places. This results in the rise of value of the properly due to these facilities provided by the state. In order to recover a part of the expenses incurred, the government may charge special assessment from the house owners of the locality in the proportion of the increase in the value of the houses.

(iv) Escheats : The government may take possession of the property of person who had died without any heir or making a will. However, this is not an important source of revenue.

Contribution of Taxation to Public Revenue

The contribution of taxation to public revenue is immense. As it has become possible to do so through a steady extension of coverage and upward revision of rates. At the same time, economic growth itself has contributed to this trend. Quite a few taxes are closely related to the level of economic activities. Thus, as economy grows the revenue generated from direct and indirect taxes also grows. However, revenue from income tax goes up more than proportionately because income tax is normally progressive in rates and people keep on moving into higher income slabs as economy expands. This trend is further strengthened if (and this is generally so) there is an inflationary pressure on prices. In India, we have witnessed this phenomenon over the last three decades. Almost every year, the budgeted estimates of revenue from income tax have been expected by actual realization. This tendency is strong in the case of indirect taxation two. We notice that the revenue from excise duties had always remained the highest but now the CGST has taken the lead. States in India generate their own revenue through sales tax, state excise duty, SGST, land revenue, stamps and registration etc. Similarly the states have been experiencing a rapid increase in sales tax collections and excise duty revenue.

1.8.5.2. Borrowings

When revenue from taxation is not sufficient to meet the required expenditure, the authorities supplement their resources by other means; and borrowing in the market is one such source. It should be recalled that earlier economic thinking did not favour the practice of government borrowing. They favoured borrowing mainly for financing wars or sef liquiditing projects and the repayment of public loans involved additional taxation. Ricardo had also termed public debt a terrible scrouge. However, it is now recognized that public debt is not the same thing as wasteful public expenditure. The role of public debt as a useful tool in the hands of the authorities is admitted. It is realized that a growing public debt, under certain conditions, can be a help to the economy.

Keynesian analysis highlighted the possibility of chronic deficiency of effective demand in a developed capitalist economy. The remedy suggested by him was a repeated injection of public and private expenditure. If the public budget held to be a deficit one for this purpose, he was for it. Lerner modified Keynesian theory by adding that the questions of having a surplus or a deficit budget should be decided depending upon the need to expand the economy or contract it. But currently, public borrowings are considered an important means of inducing savings in the country in order to step up investment and capital formation through government spending.

The enormity and variety of public debt instruments make public debt a major economic tool in the hands of the authorities. Public debt becomes an important factor determining interest rate structure in the market. Through an appropriate policy in this regard, the government can affect the market interest rates and hence the investment pattern. Moreover, public debt itself is a major component of overall liquidity supply in the economy. A variation in its total and also in its composition would affect the demand pattern. Such a possible variation also enables central bank of the country to use it as an effective tool of monetary policy. Again, public debt provides a dependable base for the financial structure of the economy under consideration. Also the authorities can use public debt to finance their investment projects. This technique is used effectively in the under-developed countries, where public debt becomes a direct means of diverting the productive resources from existing to new uses.

But the use of public debt has its own limitations. Firstly, the law of the country may prevent the government to borrow beyond certain limit, or on market terms. For example, in India, there is no such limitation on the Central Government.

The States, however, can resort to additional borrowings only with the permission of the Centre if any previous loans of their, which had been obtained from the Centre or which has been guaranteed by it, has not been paid fully. It is to be noted that our Constitution had allocated financial powers and duties to Centre and the States in such manner that each State necessarily becomes indebted to the Centre and accordingly the above mentioned restriction has become a permanent feature of our financial set up. Secondly, Government can borrow only if it is ready to pay the rate of interest prevailing in the market. Generally, on account of better credit worthiness of the state government, it can borrow at somewhat lower rates. In India, the Central Government has a 'captive market' in which the commercial banks, LIC and others are compelled to hold, as part of their assets, the Government of India securities. Similarly, the States also use various means to sell their securities to the public. The 'coupon' rate on government loans in India, therefore, is generally lower than the prevailing rate in the market. Thirdly, a government, even if it has the authority to borrow unlimited amount, is not expected to borrow unless it really needs the funds or unless such a step is needed.

The idea of interest obligation has been considered by some economists to maintain that public loans become a burden on the economy, in the sense that the government would have to levy taxes to pay the said interest. While some are not so despondent. Of course, committed interest payment reduced the manoeuverability of the budget. But, as interest payment is made within the country, it is not burdensome in itself. Its 'burden' may arise only through its redistribution effect. However, if it causes a distortion in the investment pattern in the economy, or if it brings about a reduction in the pace of capital formation, then, of course, it is burdensome. As far as external loans are concerned, it may be guaranteed that they are burdensome in the sense that interest payment cause drain of resources from the country. But even these loans may not be burdensome in the net; they may enable the country to add to its productive capacity out of which interest is paid.

1.8.5.3. Deficit Financing

Deficit financing is related to public borrowings but it is not the same. In western countries, it is defined as loan financing of all excess governmental outlay over revenue receipts. In India, the term 'deficit' in relation to the budget is used to describe the position in the different accounts of the budget.

(i) Deficit on Revenue Account
(ii) Deficit on Capital Account
(iii) Budgetary Deficit (the combined position)
(iv) Fiscal Deficit

(i) Deficit on Revenue Account (RD) : The excess of expenditure on revenue

4. J. R. Gupta, Fiscal Deficit of States in India, (Ed.), Atlantic Publishers and Distributers, New Delhi, 2001.

account over receipts on revenue account measures revenue deficit. The revenue receipts include tax revenues (such as receipts from income tax, excise duties, corporation tax etc.) and non-tax revenue (such as receipts from departmental undertakings, fee, interest receipts, dividends and profits etc.) and also grants. Expenditure on revenue account includes both plan (Central Plan and Central Assistance for State and UT Plans) and non-plan expenditure (interest payments, defence expenditure, subsidies, debt relief to farmers, postal deficit, police, pensions, other general services, social services, economic services) non-plan revenue grants to States and UT's, and grants to foreign governments.

(ii) Deficit on Capital Account (CD) : The excess of capital disbursements over capital receipts measures the CD. The receipts on capital account such as public borrowings, external loans, small savings, provident funds, repayments of loans by third parties, etc. are taken as income of the government. Receipts on account of sale of 91 days ad hoc treasury bills and drawing down of cash balances do not form a part of capital receipts. Whereas, net receipts on account of sale of remaining varieties of treasury bills and sales proceeds of government assets are included in Capital receipts. The Capital disbursements include plan Capital disbursements and non-plan Capital disbursements.

(iii) Budgetary Deficit (BD) : It is the sum total of RD and CD. The method of financing budget deficits is known as deficit financing. It is that part of government expenditure which is financed through the sale of 91 days ad hoc treasury bills and drawing down of cash balances.[4] The government may issue new currency.

But now a more wider concept Fiscal Deficit is used to show the picture clearly.

(iv) Fiscal Deficit (FD) : Fiscal Deficit is the difference between total receipts (excluding net borrowings) and total expenditure.[5] It measures that portion of government expenditure which is financed by borrowings (that is, all borrowings including those through 91-day ad hoc treasury bills) and drawing down of cash balances.

This results in to increase in supply of money. The government should be careful that deficit financing is kept within limits; otherwise it is bound to lead to undue inflation with all the consequent effects.

Self Check Exercise-I

Q. 1 Define Fiscal Deficit

Ans ....
....
....

1.8.5.4. Income from Public Undertakings

Public undertakings are not only an important means of state intervention in economic activities, but also a possible source of public revenue. A government undertaking is one in which the government owns all or a majority of shares. However, from the point of view of income to the treasury, even a majority ownership can be important. At this stage we need not go into these details. For our purpose, it is enough to know that government investment in various undertakings can bring income to it. Such undertakings may be industrial, trading, financial, agricultural or of some other type. Government undertakings are an ideal source of revenue which can be expected to increase with the passage of time. The government does not have to resort to tax collection for financing its activities. Instead, it comes to own a part of economic activities of the country and thereby derives income. As the economy expands, the state can also derive a greater benefit out of it by expanding its investments. And these investments may be financed out of previous incomes. Further, government undertakings are employment oriented in the sense that alongwith increasing revenue, government is able to contribute to the employment creation in the country a task which every modern government would like to pursue. Also unlike private concerns, the government undertakings need not insist on large scale profiteering. It may also be noted that public undertakings can provide government with important means of helping the economy to grow. Public undertakings can be chosen to fill in the supply gaps, to enable the government to control the commanding heights of the economy and to help the government in regulating the economy in various ways through appropriate pricing policy etc.

In practice, however the government of a country may not be able to make a full use of this potential. The philosophy-which did not permit it to own commercial concerns; its ownership may be limited to public utilities which should run on no profit no loss basis or with a programme of subsidized price-has been changing. Public undertakings are known to operate inefficiently on account of lack of incentives. Moreover quite often public undertakings do not have clear cut objectives, or they may have number of objectives mixed up together. The result is that in this chaos, they fail to provide an adequate source of public revenue. In India, for example, public undertakings have not been able to provide enough of income to the government. The public enterprises of the State have shown a much poorer performance in this respect. In a number of cases, of irrigation schemes, electricity boards and transport undertakings even their running expenses have not been covered. In the case of the Central Government undertakings, mainly the Reserve Bank of India and railways have provided a growing profit income; while posts and telegraphs etc. have mostly been incurring losses. Some other Government concerns have gone in public sector undertakings, and where there was a great expectation regarding their contribution to the public revenue, the performance has been totally against the expectation. Now, the income generated from disinvestment of loss making public sector undertakings has also been becoming the source of public revenue.

1.8.5.5. Interest Receipts

Interest receipts are included in the revenue portion of the budget because they represent income (positive or negative) from loans, while loans themselves are recorded in the capital account. But as we have seen, in the present context such a classification is irrelevant. What is important is that interest receipts (as also interest payments) are becoming an important part of the budgetary receipts of a modern government. The government would like to help the economy in diverse ways and in this direction it usually advances loans to various institutions (including financial institutions), industries, co-operatives, and individuals. These loans and advances may be for various purposes which are considered useful for the economy. Over time, these loans accumulate and the interest income becomes a significant portion of its budgetary receipts. In India, the Centre has been giving loans to the State Governments (among others). But now they have become so large, that the States have often to borrow from the Centre to meet the interest and repayment obligations. The States in turn have been giving loans to local bodies, electricity boards etc. and deriving interest income from them. Our interest income from abroad is not much because the Central Government has advanced only limited amounts of loans to foreign governments.

1.8.5.6. Donation and Grants

Normally these do not form a substantial portion of government revenue. In India, however, the picture is somewhat different. Donations refer to the contributions by public to the government treasury. Some donations may be in the form of money, or gold or something else. Donations are not a common feature. They come into prominence only occasionally such as during a war. Grants are transfers made in cash, goods or services without any obligation to repay. Grants have 100% concessionality. Grants usually, refer to non-returnable payments and receipts. Now a days they have become a common feature of inter-government transactions. The Government of India has been helped by foreign countries by way of loans and grants. They have often been a sizeable portion of total foreign aid. Within our country, grants can be given by one government to the other for any public purpose (even when such a purpose is not a function of the government) thus a State Government may give a grant to the Centre for meeting defence requirement even though defence is a Central Subject. In practice, grants have been given by the Centre to States and by the States to local bodies. We have seen earlier that our constitution provides for a financially strong Centre while the States are having inherently shortage of funds. The Constitution also provides for three forms of transfer of funds from the Centre to the States to meet this financial imbalance, namely, loans, grants and sharing of taxes. There are many kinds of grants which the States may receive. Some grants are statutory, that is, they are provided under the recommendations of the Finance Commission. The Finance Commission recommends these grants on the assessment of the projected receipts and expenditure of the States. They also include grants in lieu of tax on rail passenger fares. Certain other grants are discretionary. It is for the Centre to expand them or withhold them.

Self Check Exercise-3

Q. 1 Is Income from public undertakings an important source of public revenue in India? Give reasons in support of your answer.

Ans ....
....
....

1.8.6. Sources of Revenue for the Centre and States in India :

The Government of a country may exist at different levels. In India, for example, we have the Central Government, the State Governments, and the local Governments. The Seventh Schedule of the Constitution of India lays down the functions and financial powers of the Centre and the States. This Schedule contains three lists : one for the Union, second for the States, while the third one covers Concurrent subjects. However, there is no concurrency in the financial powers.

Let us elaborate it with help of certain powers of taxation. In the case of taxes on income and expenditure-while the Centre can tax non-agricultural income covering personal income tax and corporate tax, and all kinds of expenditure thus States can tax agricultural income. In the field of property and capital transactions, the Centre can levy estate duty, wealth tax, gift tax, a tax on land and building etc. While states in pose land revenue, stamps and registration fee and urban immovable property tax. As regards taxes on commodities and services all indirect taxes are decided by GST council, the Centre can impose custom duties which is still in the control of centre government. The States, on the other hand, may impose duties or excise on alcoholic liquor for human consumption, opium, Indian hemp, and other narcotic drugs but not when they are used in medical and toilet preparation. Another important source of States revenue is the sales tax/value added tax and state excise. Fees taken in the courts go to the States, while taken in the Supreme court go to the Centre.

The non-tax revenue of the Centre government includes currency, coinage and mint. Interest receipts, dividends, and income from public sector undertakings and property are enjoyed by both layers of government. Similarly, there are receipts from various government functions, administrative and others.

As regards borrowings, the Centre can borrow from within and outside the country under Article 292 on the security of the Consolidated Fund of India. The States, however, can only borrow from within the country including the Centre. The borrowings of the states comprise the market loans, deposits of provident funds etc. The debt of the Central Government consists of more numerous items. As noted above, it borrows from abroad (and a part of such loans is passed on to the States); and it also borrows in the form of deposits of provident funds and small savings etc. Again, the Central Government borrows from the market in the form of dated or long-term loans. These loans have a maturity of twelve months or longer at the time of issue. Part of these loans is picked up by the Reserve Bank of India, the balance is normally subscribed by the LIC; commercial banks and other institutions. The Centre can borrow through the sale of treasury bills which have a maturity of thirteen weeks (91 days), 182 days, and 364 days, at the time of issue and are sold at discount to be redeemed at par. Treasury bills have mostly been sold to the Reserve Bank. Whenever a batch of earlier treasury bills matures, it is replaced by a fresh one. The outstanding amount of treasury bills has been increasing in spite of the fact that, every year, the Centre has been 'funding' (that is converting into long-dated loans) a portion of them. Our Constitution allows that one government may give a grant to another for any purpose, in practice such grants are given only by the Centre to the States.

1.8.7. Summary

1. The importance of public revenue is increasing in modern economies, the financial flows generated by the budgetary operations are assuming an ever increasing proportion to the total flows and they are exercising greater and greater influence on economic activities. The major sources of public revenue are : taxation, public borrowing, deficit financing, income from public undertakings. The importance of any source of revenue is to be judged by (i) its effects on the economy (ii) its relative position in the budgetary receipts and (iii) the needs of the authorities.
2. Taxation is the most important source of public revenue. Taxes can be distinguished from other non-tax sources on the basis of the element of compulsion, the absence of quid pro quo and their generality. The ideas regarding an ideal tax system have been undergoing a change and now they are considered a useful tool in the hands of the authorities. Over-time, the taxation side of the government budgets has expanded in its coverage; tax revenue has

also been increasing; and their rates and modes of levying have become complex in turn with growing economic complexities. In India, indirect taxes dominated the scene for long. But, now Indirect taxes are considered more burdensome than the direct ones.

3. Public borrowing is another source of public revenue. Older economic thinking looked at public borrowings with disfavour. But now they are considered important policy tools and helpful in increasing the pace of capital formation. The use of public loans for public purposes can be through their effect on interest rate structure and on supply of liquidity in the market.

   There are many misconceptions regarding the burden of public debt. Public debt may be burdensome in the sense of reducing the budgetary performance and in the sense of causing a reduction in the pace of capital formation. Foreign loans can be burdensome if their use does not add to the productive capacity of the debtor country.

4. The concept of deficit financing is related to public borrowings but is not equivalent to them. In western countries, deficit financing means any excess of expenditure over revenue. In India, Deficit financing is defined to include short term loans and therefore the deficit or excess spending only amounts to (i) cash withdrawals and, (ii) borrowing through the sale of treasury bills in India. There are inherent limitations beyond which no government would like to resort to deficit spending. Deficit spending is a sort of is hidden tax pre-inflationary. It disrupts economy in its process of monetization.

5. Public undertakings can become a very important source of public revenue. But it may not be always possible to achieve the objectives of revenue. These projects may not be directed towards making a profit. In India, public undertakings have failed to be an adequate and dependable source of public revenue. Now the process of disinvestment of sick public sector undertakings has started.

6. The actual sources of revenue available to a government would depend on its legal framework. In India, financial powers of the Centre and the States have been demarcated by the Constitution. The financial powers of the local bodies are derived from those of the States; the financial powers of Union Territories are exercised by the Centre.

1.8.8. Technical Terms

Disinvestment/Divestment— Selling of Government equity shares to private sector companies. The rationale behind disinvestment is to free huge financial resources, blocked in several non-strategic sectors, such as— hotels, trading companies, consultancy companies, consumer goods companies etc. In addition, several public sector enterprises are in deep financial crisis with high levels of accumulated debt and require urgent restructuring.

Tax amnesty - is an opportunity offered by a government to declare people their past concealment of income, wealth etc. without fear of being prosecuted.

Revenue deficit - Excess of revenue account expenditure over revenue account receipts.

Tax compliance - Cost of collection of taxes.

Revenue Deficit (RD)-denotes the difference between revenue receipts and revenue expenditure.

Capital Deficit- denotes the difference between capital receipts and capital disbursements.

QUESTIONS

1. Borrowing as a source of public revenue has gained much importance in modern times. Why ? Discuss the role of borrowing as a source of public finance.
2. How do you think deficit financing can achieve stabilisation? Discuss.

SHORT-QUESTIONS

1. Distinguish tax and non-tax sources of public revenue.
2. What is buoyancy and elasticity of a tax?
3. What is fiscal deficit?
4. Explain the process of disinvestment.
5. Deficit financing as a source of public revenue.
6. Canons of taxation.
7. Define the concept of deficit on revenue account.
8. Economic classification of public revenue.

SUGGESTED READINGS

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7. R.N. Bhargave : The Theory and Working of Union Finance in India, 1975
8. Raja J. Chelliah : Fiscal Policy of Under developed Countries
9. John F., Due & Arun F. Fried Lander: Government Finance : Economics of the Public Sector
10. G.K. Shaw : Fiscal Policy, Macmillan Studies in Economics, 1972
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13. Gareth D. Myles : Public Economics