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DEPT OF ECONOMICS

SYBA-STUDY MATERIAL ON PUBLIC FINANCE (ECO-IV)-SEM-III (2020-21)

Note: following are brief notes, students have to refer to references given at the end of this unit for the in-depth knowledge of the topic.

UNIT-I -INTRODUCTION

- **Meaning, Scope and functions of Public Finance.**

1. Need to study Public Finance –
   Importance of Public finance in developing countries-
   a. Helps in reducing income inequalities
   b. Helps in stabilizing the economy
   c. Helps in controlling inflation and deflation
   d. Help in the development of infrastructure facilities, like roads, railways, communication means, health and education facilities
   e. Promotion of Exports, which helps to earn foreign exchange
   f. It promotes saving and investment in the country
   g. Efficient allocation of resources. More taxes on unhealthy goods and services.
   h. It helps in balanced development. It helps in the reduction of rural-urban imbalance; as well as agriculture-industry imbalance, through its policies.
2. Meaning of Public finance: it is the study of financial activities of the government
3. **According to Dalton,** "Public Finance is concerned with income and expenditure of public authorities and with the adjustment of one to the other"
4. **Scope of Public Finance:**
   i. **Public revenue –** it is the income of the government, such as taxes and non-taxes, such as, fees, rent, fines, donations and grants etc.
   ii. **Public Expenditure –** it is the expenditure of the government, such as infrastructure, defense, health, education etc.
   iii. **Public debt** – it is the borrowing taken by the government bodies when government revenue falls short of government expenditure. It is of two types, internal debt and external debt
   iv. **Financial administration** – it is related to the administration of all public finance i.e. public revenue, public expenditure, and public debt. It includes preparation, passing, and implementation of government budget. It studies the policy impact on the social-
   economic environment, inter-governmental relationships, foreign relationships, etc.
5. **Functions of Public Finance**:

i. Allocation Function – this refers to the allocation of money on various sectors, such as education, defense, health, transport & communication, administration etc.

ii. Distribution Function – this is mainly undertaken for the reduction of income inequalities among the population. For instance, government follows Progressive taxation, wherein more taxes are imposed on the rich and giving subsidies to the poor. Higher taxes on luxury goods and subsidized education, health care and housing to the poor.

iii. Stabilization Function – each country faces prosperity and recession in its economic activities. The government of a country tries to stabilize the economy through different policies. For example, during recession, it follows deficit budgeting, whereas, during prosperity, the government may follow surplus budgeting.

- **Public Finance versus Private Finance.**

Sr no	Point	Public finance	Private finance
1	**Meaning**	Study of income and expenditure of the government	Study of income and expenditure of private individuals or companies
2	**Similarities**	• Tries to attain balance between income and expenditure • Both face the problem of gap between income and expenditure, so both need to borrow money	
3	**Objective**	Satisfaction of wants of all people in the economy	Satisfaction of personal wants
4	**Determination of expenditure**	Expenditure is determined first and accordingly tries to get revenue	Income is determined first and accordingly expenditure is undertaken
5	**Unavoidable expenditure**	The government cannot avoid expenditure on defense, subsidies etc	Individuals can avoid unnecessary expenditure
6	**Nature of Budget**	mostly deficit budget	Has to be surplus budget
7	**Nature of resources**	Unlimited resources	Limited resources
8	**Main motive**	Public welfare	Profit maximization
9	**Long-term/ short-term**	Long-term considerations due to objective of public welfare	Short-term considerations or objective of quick returns on investment
10	**Compulsive/voluntary methods**	Government follow compulsive methods, such as tax payment is compulsory	Private individuals cannot make the people buy their products or invest in their companies
11	**Transparency of budget**	Full transparency of government budget	Budget is confidential

- **Market Failure:**

A. Meaning: It refers to inefficient distribution of goods and services in a free market. price of a good is determined by its supply and demand forces. Market failure occurs due to disturbance in market forces, leading to disequilibrium. In other words, the demand for the good is not equal to its supply. The distortions in market, may be in the forms of monopoly power, price limit, minimum wage requirement or government regulations.

B. **Causes of Market Failure:**

   i. **Externality –** it is the either cost or benefit resulting from the transactions between two parties, borne by the third party who are not involved in the actual production process. Externality can be negative or positive. For example, public education mainly benefits the students, but has its spill over effects on the entire society. This is positive externality. Negative externality is the negative effects on the society, such as, all types of pollution caused by the industries, transport vehicles etc.

   ii. **Public Goods –** since public goods, such as, roads, railways are non-excludable and non-rivalrous, their misuse causes a cost to the government, creating inefficiency of the resources.

   iii. **Market Control –** monopoly power or existence of oligopoly market, control the supply and price of the product. This prevents efficient allocation of resources. Similarly, buyers control the demand for the product under the monopsony market. thus these practices of controlling the supply and demand for the product prevents the equality between the demand and supply of the product, leading to market failure.

   iv. **Imperfect information of the market to buyers and sellers –** due to lack of information about the price of the product, the buyers my pay higher price; or the seller may accept higher or lower price of the product than the actual opportunity cost of the product.

C. **Solutions for Market Failure are in the forms of price mechanism, legislations to control the use of cigarettes, liquor etc. market information can be accurately published.**

- **Difference between Public Good and Private Good:**

Sr no	Point	Public good	Private good
1	Meaning	It is consumed by all people simultaneously	It is consumed by the individuals who buy it
2	Feature	It is non excludable	It is excludable
3	Feature	No rivalry in consumption	Rivalry in consumption
4	Example	Education in municipal school	Education in private school

5	Examples	Roadways, railways, public health center, public garden defense etc	Food, clothes house, car etc.
6	Problem	Free-rider problem	No free rider problem
7	Price	Less interest to pay for the price	People who buy have to pay the price of the good

Externalities:

It is the either cost or benefit resulting from the transactions between two parties, borne by the third party who are not involved in the actual production process. Externality can be negative or positive. For example, public education mainly benefits the students, but has its spillover effects on the entire society. This is positive externality. Negative externality is the negative effects on the society, such as, all types of pollution caused by the industries, transport vehicles etc. Public goods have positive externalities, like police protection, health funding, education etc. An externality exists if some of the variables which affect one decision-maker's utility or profit are under the control of another decision-maker. In this case, the externality is detrimental, but in other cases, there may be beneficial externalities, as for example, when an apple-grower is located next to a beekeeper. The bees will cross-pollinate the apple trees, benefiting the apple- grower, and feed off the apple blossom, benefiting the beekeeper as well.

Efficiency and equity trade off:

Efficiency implies that the society is getting maximum benefits from scare resources, where,as equity means the benefits are distributed equally among the members of the society.

Efficiency is concerned with optimal production and allocation of resources, whereas, equity is related to how the resources are distributed equally among the members of the society.

Pareto efficiency is concerned with the creating of the situation where one cannot be made better off without making other worse off. For example when the resources are used to produce more of defense goods, efficiency is attained, however, it may create inequality because less resources will be available for the production of food items. So the poor will be starved.