

Unit I

Meaning Nature & Scope of Public Finance

Public finance deals with the income & expenditure of public authority. Public authorities include all sorts of govt. hence, it can be said that it deals with the finance of the govt - central, state & local that are studied in the sci of public finance. According to Dalton, "Public finance is concerned with the income & expenditure of public authorities with the adjustment of one to another."

The methods of expenditure of public bodies & the income of public bodies as well as borrowing by public bodies are known as operation of public finance. They are also known as fiscal operation as they relate to the operations of the fiscal & public result. Hence fiscal operations & fiscal policies are integral part of public finance. Fiscal operation & fiscal policies has effect upon the national production & income, national standard of living, distribution of wealth & income, money markets etc, which in turn effect the life of the nation. Therefore every individ-

Chief of the country is concerned with the methods of public finance.

Public finance VS Private finance

Similarities

1) Same objectives - Both finances broadly have the same objectives i.e. satisfaction of human wants. Private finance is concerned with personal wants while public finance is concerned with social & collective wants.

2) Both the individual & state have ^{receipt} ~~received~~ an expenditure & ~~it is~~ each tries to ~~the~~ balance each other & do their best to get maximum satisfaction.

3) Both in Public & private finance borrowing become essential when current income fall short to meet current expenditure.

Dissimilarities

1) The proceeds of ^{Private} ~~public~~ finance are used for the benefits of ^{Private} ~~individual~~ only whereas the proceeds of public finance are used for the benefit of the community as a whole.

- 2) In case of ~~public~~ ^{private} finance a individual adjust income to expenditure on other hand, in case of public finance a public authority adjust expenditure to income.
- 3) An individual generally believes in surplus budget & deficit budget is considered undesirable. on other hand a public authority find it useful to have deficit budget for several years.
- 4) Private individuals are motivated by profit whereas as public bodies are motivated not by profit but by public well fare.
- 5) The resources of an individual are more or less limited while that of public authority are enormous.

The importance of Public finance

The importance & scope of public finance can be discussed under the following heads -

- 1) The fn of the state
- 2) The effects of fiscal operations on economic life
- 3) The subject matter of public finance.

I) The fn of the State

The rise of modern state has been accompanied by an increase in the no. of state fn. To discharge their fn, the state has to increase its expenditure & to meet the expenditure it has to mobilized & exploit funds with the help of several method laid down in the economics of public finance. Hence scope & importance of the study of public finance has considerably increased in modern times with the expansion of fn & responsibilities of the state.

II) The effect of fiscal operation in economic life -

The various fiscal operation, such as public expenditure, public debt, taxation, etc significantly effect the economy. Fiscal operations are undertaken in order to achieve the object objectives like -

- 1) To secure adjustment in the allocation of resources
- 2) To secure adjustment in the distribution of income & wealth.
- 3) To secure economic stabilization.
- 4) To accelerate economic development.

All these increases the importance as well as the scope of public finance.

III) Sub matter of Public finance

Public finance is not static but dynamic in the sense that it is continuously widening in with the changes in the concept of the state, form of state & the changing problems of economics. All this are the factors responsible for the scope & comp of public finance.

Role of Public finance in developing economic

Public finance can accelerate the economic development in many ways such as increasing the rate of savings & investment, promoting stability, securing equal distribution of income & wealth etc. The role of public finance in developing economics can be explained under the following heads -

1) To increase the rate of saving & investment

→ Public finance plays a vital role to increase saving & investment in a developing economy in several ways - For example by raising the tax rate the govt checks excessive consumption & thereby promote saving & investment. By raising resources through public borrowing it transfers resources to the govt for economic

development. Moreover, fiscal concessions in the form of depreciation allowances, provision of finance, foreign exchange, tax-holiday, liberal grants, rebates & subsidies etc can push the growth of investment specially in developing economies.

2) To secure equal distribution of wealth & income →

unequal distribution of income and wealth hinders the economic development of the under-

developed & developing nation. To some extent progressive taxation in direct

taxes & heavy taxation on luxury goods can have help to bring equal

distribution of income & wealth. Simultaneously redistributive role of fiscal

measures, equal opportunities & balanced regional development programme

contributes to raise the level of national income. Moreover income elastic tax

system can play a major role in equal distribution of wealth

for which the tax structure should be flexible

3) Counteract Inflation - Inflation is a

situation of rise in prices. In order to check inflation the imbalance bet^w demand & supply of real resources may lead to inflation to U.C.s. In order to check inflation, surplus budgetary policy can be used by the govt. Progressive taxation $\rightarrow$ Direct taxes & commodity taxes should be imposed. Similarly in antiinflationary method can be taken to meet the challenge.

4) Full employment & economic growth -

To achieve full employment & economic growth the economic policies of the developing countries should follow counter cyclical fiscal policies. Public finance plays a very crucial & imperative role in the economic development of the U.C.s. It also helps to secure economic stability in the country by stabilizing the social order, by diminishing ditches of inequality. It promotes full employment without fear of inflation with the policy of managed budget. The financial policies are adopted in such a way that inflation & deflation both remain under control.

Q) P. Thus public finance has assumed a great importance & is increasing day by day as the State has started performing manifold fn.

Q) Define Public goods & Private Goods?

→ A pure public good is defined as a good as one person's consumption of a good doesn't reduce the amount available to others. i.e. The consumption of a public good is non-rival in character. For eg. national defense, law & order etc.

Characteristics of Public goods-

1) Equal consumption by all.
2) Non-rival in consumption i.e. consumption of the good by one ^{person} doesn't reduce the amount ~~avail~~ available to others.

3) Inapplicability of exclusion principle (non-excludability) often gives rise to free rider problem.

4) Absence of revealed preference (less than the optimal amount of these goods will be free provided without

* the govt raising money to pay
* for them through general taxation)

- 5) Public goods cannot easily be brought by once income (non affordable on own income).
- 6) Demand schedule of public good ~~are~~ is obtain by the vertical summation of the demand curve for all those who consume the public good.
- 7) The Marginal cost of supply of public good is close to zero.
- 8) Budgetary provisions are made to supply public goods.

Private Good-

Private goods have been define as "Private goods yield utility (satisfaction) only to the person & consuming the good, it is denied to others. Only a person who drinks a cup of coffee for eg, example, benefit from the consumption of that cup of coffee & the coffee consumed by one person can't be consume by anyone else."

The ~~at~~ availability to receive a good, divisibility of a good & of the exclusion principle all go together in case of private good.

Public goods VS Private Goods-

Distinction betⁿ public & Private goods-

- 1) Public goods are supplied by the public sector whereas private goods are supplied by the private sector.
- 2) Public goods are supplied through the budget whereas private goods are supplied through the market system or price mechanism.
- 3) Public goods are indivisible in nature & are therefore consumed in bulk on the other hand private goods are divisible & can be consumed by fraction.
- 4) Public goods are non-exclusive but in case of private good people who are not willing to pay the price charged for the consumption of good can be excluded. Thus liberal principle is applied in case of public goods while exclusion principle is applied in case of private good.
- 5) Public goods are neutral & non rival in consumption whereas private goods are competitive & rival in consumption.

- 6) For the consumption of private goods, the user has to be paid, while the consumption of public good is free of direct charges.

Social goods - Social goods are the goods which are provided by the state because their consumption are non rival & exclusion principle is inapplicable. For example, defense, law & order, urban park. It is to be noted here that social goods are subject to consumer sovereignty, i.e. they are produced on the basis of individual preferences. In this respect social goods are similar to private goods. Since the satisfaction derived from social goods by an individual consumer is independent of his own contribution, their cost are met by the public budget & through the market where private buyers pay.

Merit Goods - Merit goods too are public goods but their provision can't be explained in the same way as the provision of social goods. The provision of merit goods involves interference with consumer choice which is substituted by imposed choice. The necessity of imposed choice arises since these goods are consumed in free market because of ignorance.

2 externality. Education & health service are good example of merit good. It is left to the free market choice. These goods will not be produced in adequate quantity because benefit from them can't be taken into account in a market economy.

Public Good — {cause of Market failure}

1/ A pure public good is a good having the property of non rivalry & non excludability. Non excludability means it is technically impossible or ^{it is} extremely costly to exclude any individual from the benefit of a good. Nonrivalry means there is no rivalry among the consumers because the consumption of the good by 1 doesn't reduce the availability of the good for the others.

Para 2 The private market economy does not do well at providing public goods. If no one can be excluded from ^{its} consumption, there is no way to charge a price for the good & therefore no incentive for private entrepreneurs to produce and sell it. Even if people could be selectively excluded from consuming it, the nonrivalry in consumption means it that

it is inefficient to exclude anyone. Every individual wants to ^{be} get a free ride and doesn't want to pay for the provision of the good because it is possible to get it free once someone else pays for its provision.

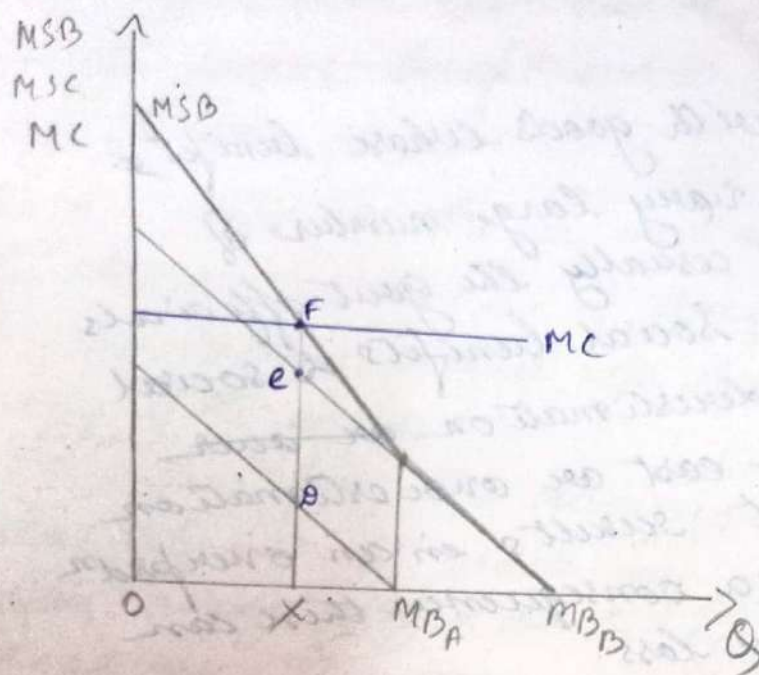
Para 3 Thus as the market fails to provide make efficient provision for the public goods, many economists suggest the policy of govt intervention to deal with such situation. (Example of Public good - light house, national defence, flood control project etc)

Para 4 * as everyone ^{intends} wants to become a free rider, ~~the~~ it is impossible to find out the demand curve for the public good. Thus this leads to indeterminacy of the ~~eqn~~ & 2 price ^{outcomes} for public goods which are necessary for ^{making} efficient provision for such goods.

Optimum Condition for the provision of the public good : / Pareto optimal level of Public good production -

In case of public good, output should be produced to the point where $MSB = MSC$. The MSB curve which reflects the demand of the society for a public good is derived by vertical summation of individual demand curve. In case of public good, horizontal Σ of individual demand curve can't be used to derive the market demand curve as all individuals simultaneously benefit from each unit of the

public good.



$$P_A X_A + \left(\frac{2}{3}\right) P_A X_B = 10$$

$$P_A X_B \left(1 + \frac{2}{3}\right) = 10$$

$$P_A X_B = \frac{10}{\frac{5}{3}} = 6$$

$$P_A X_B = \frac{1}{3} = 3$$

The above fig shows the derivation of the MSB curve. ~~which~~ MBA & MBB are the marginal benefit curve of 2 individual A & B. Vertical summation of the 2 individual demand curve gives us the market demand curve i.e. MSB curve. ~~which~~ ^{on the fig} that the X^{th} unit of good provides XD benefit to A & Xe benefit to B & the MSB is thus equivalent to $XD + Xe$ which is equal to XF . ~~Thus the MSB~~ For the non-rivalry in consumption with the public goods, the MSB curve is derived by vertical summation. The optimal output is now given by the intersection of the MSB curve with the marginal cost curve. The optimal output is thus OX unit of public good. Both the curve intersect at point F & this point F is the equilibrium point for the given public good. The corresponding level of eqm output is X which lead to maximize social welfare. Thus OX is the Pareto-efficient level of output of the Public good.



However, ~~the~~ a private firm will produce this or amount of common the public good, if each individual pays a price equal to ~~its~~ the marginal benefit. Only then the private firms will be able to cover their cost of production.

But ~~in~~ in case of a public good, due to inability of the producer of a public good to exclude those who don't pay & want to be a free rider, the optimal production cost cannot be covered by a private producer. Therefore, in this situation too little or even none of the public good will be produced. ~~through~~ Thus in case of Public good private firm fails to achieve the Pareto Pareto optimal efficiency in production. This is a glaring example of the market failure. Since private firms are not interested in the prodⁿ & supply of public goods, their prodⁿ is undertaken by government.

them can't be taken into account in a market-economy

8/ Determination of the optimum level of Private good.

Private good is a good which yield utility only to the person who is consuming it & ~~the~~ others are denied ~~the~~ of the utility of the good. Thus the utility of the private good can be enjoyed ~~by~~ only by the person who is paying for it. Thus contrary to the public good, ^{in case of} private good has ~~the~~ exclusion principle, ~~diversity~~ ~~diversibility~~ & the ability to provide a good all go together.

The optimum allocation of private good is determined at the point where the Marginal ~~private~~ cost & the marginal ~~social~~ ^{curves} benefit intersect. ~~However~~ The existence of monopoly power, externalities etc may create a situation of ~~in~~ the market failure for private good. In such circumstances the market may witness over ~~and~~ under production. ^{are over and under consumption} However such abnormalities can be fixed by using the ~~So~~ Pigouvian solution are Coase theorem & so on. This can be shown

as follows

In the diagram, point e is the social as well as the private eq^l^m point where the MPC curve has intersected MPB = MSB curve. The corresponding eq^l^m level of private good is OQ^* . Here the market is free from the existence of externalities and thus there is no case of over/under prodⁿ or over/under consumpⁿ.

