M.A Semester III

FISCAL FUNCTIONS

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INTRODUCTION “WHAT IS PUBLIC SECTOR ALL ABOUT”

In the United States economy of today, *over 20 percent of GNP is purchased by government; total government expenditures including transfers equal 35 percent thereof and tax revenue absorbs over 30 percent of GNP.* Though sizable, this government participation falls short of that in other developed economies, especially those in Western Europe, where the governmental share of economic activity is frequently over 50 percent.

- Beyond the budgetary function, public policy influences the course of economic activity through monetary, regulatory, and other devices.
- Public enterprise also plays a major role in most European countries, though it is of limited importance in the United States.
- The modem "*capitalist" economy is thus a thoroughly mixed system in which public and private sector forces interact in an integral fashion. The economic system, in fact, is neither public nor private, but involves a mix of both sectors.*

MODES OF ANALYSIS

In an analysis of the public sector, various types of questions may be asked.

1. What criteria should be applied when one is judging the merit of various budget policies?

2. What are the responses of the private sector to various fiscal measures, such as tax and expenditure changes?

3. What are the social, political, and historical forces which have shaped the present fiscal institutions and which have determined the formulation of contemporary fiscal policy?

NEED FOR PUBLIC SECTOR

1. The claim that the market mechanism leads to efficient resource use (i.e., produces what consumers want most and does so in the cheapest way) is based on the condition of competitive factor and product markets. Thus, there must be no obstacles to free entry and consumers and producers must have full market knowledge. Government regulation or other measures may be needed to secure these conditions.

2. They may also be needed where competition is inefficient due to decreasing cost.

3. More generally, the contractual arrangements and exchanges needed for market operation cannot exist without the protection and enforcement of a governmentally provided legal structure.

4.Even if the legal structure is provided and barriers to competition are removed, the production or consumption characteristics of certain goods are such that they cannot be provided for through the market. Problems of "externalities" arise which lead to "market failure" and require correction by the public sector, either by way of budgetary provisions, subsidy, or tax penalty.

5. Social values may require adjustments in the distribution of income and wealth which results from the market system and from the transmission of property rights through inheritance.

6. The market system, especially in a *highly developed financial economy, does not necessarily bring high employment, price level stability, and the socially desired rate of economic growth.* Public policy is needed to secure these objectives. As the events of the eighties have shown, this is the case especially in an open economy subject to international repercussions.

7. Public and private points of view on the rate of discount used in the valuation of future (relative to present) consumption may differ.

MAJOR FUNCTIONS

1. The provision for social goods, or the process by which total resource use is divided between private and social goods and by which the mix of social goods is chosen. This provision may be termed the *allocation function* of budget policy. Regulatory policies, which may also be considered a part of the allocation function, are not included here because they are not primarily a problem of budget policy.

2. Adjustment of the distribution of income and wealth to ensure conformance with what society considers a "fair" or "just" state of distribution, here referred to as the *distribution function*.

3. The use of budget policy as a means of maintaining high employment, a reasonable degree of price level stability, and an appropriate rate of economic growth, with allowances for effects on trade and on the balance of payments. We refer to all these objectives as the *stabilization function*.

THE ALLOCATION FUNCTION

We begin with the allocation function and the proposition that certain goods-referred to here as social, or public, as distinct from private goods-cannot be provided for through the market system, i.e., by transactions between individual consumers and producers. In some cases the market fails entirely, while in others it can function only in an inefficient way. *Why is this the case?*

SOCIAL GOODS AND MARKET FAILURE

The basic reason for market failure in the provision of social goods is not that the need for such goods is felt collectively whereas that for private goods is felt individually. While peoples' preferences are influenced by their social environment, in the last resort wants and preferences are experienced by individuals and not by society as a whole. Moreover, both social and private goods are included in their preference maps. *Just as I can rank my preferences among housing and backyard facilities, so I may also rank my preferences among my private yard and my use of public parks. Rather, the difference arises because the benefits to which social goods give rise are not limited to one particular consumer who purchases the good, as is the case for private goods, but become available to others as well*

SOCIAL GOODS AND MARKET FAILURE

If I consume a hamburger or wear a pair of shoes, these particular products will not be available to other individuals. My and their consumption stand in a rival relationship. But now consider measures to reduce air pollution. If a given improvement in air quality is obtained, the resulting gain will be available to all who breathe. In other words, consumption of such products by various individuals is "non-rival" in the sense that one person's partaking of benefits does not reduce the benefits available to others. This has important implications for how consumers behave and how the two types of goods are to be provided.

- **The market mechanism** is well suited for the provision of private goods.
- It is based on exchange, and exchange can occur only where there is an exclusive title to the property which is to be exchanged.
- In fact, the market system may be viewed as a giant auction where consumers bid for products and producers sell to the highest bidders.
- Thus the market furnishes a signaling system whereby producers are guided by consumer demands.

For goods such as hamburgers or pairs of shoes this is an efficient mechanism. Nothing is lost and much is gained when consumers are excluded unless they pay. Application of the exclusion principle tends to be an efficient solution.

But such is not the case with respect to social goods. Here it would be inefficient to exclude any one consumer from partaking in the benefits, since such participation does not reduce consumption by anyone else. The application of exclusion would thus be undesirable even if it were readily feasible.

PUBLIC PROVISION FOR SOCIAL GOODS

The problem, then, is

“ **How the government should determine how much of such goods is to be provided**?”.

Refusal of voluntary payment by consumers is not the basic difficulty.

The problem could be solved readily if the task were merely one of sending the tax collector to consumers to whom the benefits of social goods accrue. But matters are not this simple.

PUBLIC PROVISION FOR SOCIAL GOODS

The difficulty lies in ***deciding the type and quality of a social good that should be supplied to begin with and how much a particular consumer should be asked to pay***.

It may be reasonable to rule that the individual should pay for the benefits received, as in the case of private goods, but this does not solve the problem; the difficulty lies in finding out how these benefits are valued by the recipient

NATIONAL AND LOCAL SOCIAL GOODS

Although social goods are available equally to those concerned, their benefits may be spatially limited.

This suggests that the ***nature of social goods has some interesting bearing on the issue of fiscal federalis~entralization or decentralization***.

As we will see later, a good case can be made for letting national public services be provided by national government and local public services by local government.

PUBLIC PROVISION VERSUS PUBLIC PRODUCTION

- Private goods may be produced and sold to private buyers either by private firms, as is normally done, or by public enterprises, such as public power and transportation authorities or the nationalized British coal industry.

- Social goods, such as spaceships or military hardware, similarly may be produced by private firms and sold to government; or they may be produced directly under public management, as are services rendered by civil servants or municipal enterprises.

- If we say that social goods are provided publicly, we mean that they are financed through the budget and made available free of direct charge. How they are produced does not matter.

PUBLIC PROVISION VERSUS PUBLIC PRODUCTION

1. When looking at the public sector in the national accounts, we will see that *the cost of such provision is divided about equally between compensation paid to public employees (whose output may be viewed as public production) and outputs purchased from private firms*.

2 Public production of private goods which are then sold in the market plays only a very limited role in the U.S. system.

THE DISTRIBUTION FUNCTION

The allocation function, concerned with the provision of social goods, inevitably departs from the market process but nevertheless poses the type of problem with which economic analysis has traditionally been concerned, i.e., *the efficient use of resources given a prevailing distribution of income and pattern of consumer preferences*.

The issue of distribution is more difficult to handle. Yet, distribution issues are a major point of controversy in the budget debate. In particular, **they play a key role in determining tax and transfer policies.**

HOW INCOME SHOULD BE DISTRIBUTED

Distribution should be arranged so as **to maximize total happiness or satisfaction, and that distribution should meet certain standards of equity, which, in a limiting case, may be egalitarian**.

The choice among these criteria is not simple, nor is it easy to translate any one criterion into the corresponding "correct" pattern of distribution.

We will encounter these difficulties when dealing with redistribution policy again in interpreting the widely accepted proposition that people should be taxed in line with their "*ability to pay*."

There are two major problems involved in the translation of a justice rule into an actual state of income distribution.

- It is difficult or impossible to compare the levels of utility which various individuals derive from their income.

- Difficulty arises from the fact that the size of the pie which is available for distribution is not unrelated to how it is to be distributed

FISCAL INSTRUMENTS OF DISTRIBUTION POLICY

Among various fiscal devices, Redistribution is implemented most directly by-

(1) A tax-transfer scheme, combining progressive taxation of high-income with a subsidy to low-income households.

2) Redistribution may be implemented by progressive taxes used to finance public services, especially those such as public housing, which particularly benefit low-income households.

FISCAL INSTRUMENTS OF DISTRIBUTION POLICY

Finally, Redistribution may be achieved by

(3) A combination of taxes on goods purchased largely by high-income consumers with subsidies to other goods which are used chiefly by low-income consumers.

THE STABILIZATION FUNCTION

Having dealt with the role of budget policy in matters of allocation and distribution, we must now note its bearing on the macro performance of the economy, i.e., progressive tax is defined as one in which the ratio of tax to income rises with income.

INSTRUMENTS OF STABILIZATION POLICY

Policy instruments available to deal with these problems involve both monetary and fiscal measures, and their interaction is of great importance.

MONETRY INSTRUMENTS

Monetary Instruments While the market mechanism, if it functions well, may be relied upon to determine the allocation of resources among private goods, it cannot by itself regulate the proper money supply. the money supply must be controlled by the central banking system and be adjusted to the needs of the economy in terms of both short-run stability and longer-run growth.

FISCAL INSTURMENTS

- Fiscal policy as well has a direct bearing on the level of demand. Raising public expenditures will be expansionary as demand is increased, initially in the public sector and then transmitted to the private market. Tax reduction, similarly, may be expansionary as taxpayers are left with a higher level of income and may be expected to spend more.

- Changes in the level of deficit thus play an important role. At the same time, much will depend on how the deficit is financed.

- If accompanied by an easy monetary policy, the expansionary effects of deficit finance will be greater as the deficit can be met by increased credit.

- If matched by tight money, placing the additional debt will call for an increase in the rate of interest and thus have a restrictive effect on market transactions. Moreover, effects upon international capital flows, as the American economy has seen in the 1980s, are again of major importance.

CONCLUSION

1. Modem so-called capitalist economies are in fact mixed economies, with one-third or more of economic activity occurring in the public sector.

2. The term public sector is used to refer to the parts of governmental economic policy which find their expression in budgetary (expenditure and revenue) measures.

3. Three major types of budgetary activity are distinguished: namely,

- a) the public provision of certain goods and services, referred to as "social goods";
- (b) adjustment in the state of distribution of income and wealth
- (c) measures to deal with unemployment, inflation, and inadequate economic growth.

4. In discussing the provision of social goods (the allocation function), reference is made to goods and services which must be paid for through budgetary finance. Whether the production of these goods is by a public agency or whether the goods and services are purchased from private firms is a different matter.

5. Provision for social goods poses problems which differ from those which arise in connection with private goods. Since social goods are nonrival in consumption, consumer preferences are not revealed by consumer bidding in the market. Therefore a political process and budgetary finance are required.

6. The pattern of distribution which results from the existing pattern of factor endowments and their sale in the market is not necessarily one which society considers as fair. Distributional adjustments may be called for, and tax and transfer policies offer an effective means. of implementing them, thus calling for a distribution function in budget policy.

7. Tax and expenditure policies affect aggregate demand and the level of economic activity. Their conduct has important bearing on maintaining economic stability, including high employment and control of inflation. Hence, the stabilization function enters as the third budgetary concern.

8. A major problem is how to conduct fiscal policy so that its major objects including allocation, distribution, and stabilization aspects--can be met at the same time

THANKYOU