Unit I

Meaning nature & Scope of Public finance

Public finance deals with the income & expenditure of public authority. Public authorities include all ~~short~~ sorts of govt. hence, it can be said that it deals with the finance of the govt - central, state & local that are ~~st~~ 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 inturn effect the life of the nation. Therefore every indivi-

-dual 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 be~~ each tries to ~~blo~~ 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 where as the proceeds of public finance are used for the benefit of the community as as a whole.

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2) In case off ~~public~~ private finance a individual adjust income to expenditure on other hand, in case of public finance a public autho-rity adjust expenditure to income.

3) An individual generally belives in surplus budget & deficit budget is considered undesirable on other hand a public authority find it usefull to have deficit budget for several years.

4) Private individuals are motivated by profit where 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.

1) 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 in 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 ~~objet~~ 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 with the changes in the concept of the state, fn of state & the changing problems of economics. All this are the factors responsible for the scope & imp of public finance.

Role of Public finance on developing economic

Public finance can accelerate the economic development in many ways such as increasing the rate of saving & 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 private consumption & thereby promote saving & investment. By raising resources through public borrowing it transfer resources to the govt for economic development. More over, fiscal ~~contesst~~ concession in the form of depreciation allowances, provision of finance, foreign exchange, tax-holiday, liberal grants, rebates & subsidies etc can push the growth of investment specialy 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 extend progressive taxation in direct taxes & heavy taxation on luxury goods can ~~have~~ help to bring equal distribution of income & wealth. Simultaniously redistributive role of fiscal majors, 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 inflatio~~ The imbalance betw demand & supply of ~~real~~ real resources may lead to inflation to U.D.Cs. In order to check inflation, surplus budgetary policy can be used by the govt. Progressive taxation → direct taxes & commodity taxes should be emphased. Similarly ~~only~~ in antiinflationary method can be taken to meet the challenge.

4) Full employment & ~~in~~ economic growth —

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

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5) R. Thus public finance has assumed a great importance & is increasing day by day as the State has started performing manyfold fn.

Q) Define Public goods & Private goods:
→ A pure public good is defined as a good as one persons consumption of a good doesnt reduced the amount available to others. i.e The consumption of a public good is non rival in character. For eg- national defence, 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~~ persons doesnt reduce the amount ~~that~~ available to others.
3) Inapplicability of exclusion principle (non excludibility) often gives rise to free rider problem
4) Absence of revealed preference (less than the optimal amount of these goods will be ~~pro~~ provided without the govt raising money to pay for them through general taxation)

5) Public goods cannot easly 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 closed to zero.

8) Budgetary provisions are made to supply public goods

Private Good-

Private goods have been define as
"Private goods yield utility (satis-faction) 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 ~~al~~ ~~availa~~ availity to price a good, divesibility 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 where as private goods are supplied by the private sector

2) Public goods are supplied through the budget where as private goods a 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 consumptn 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 neautral & non rival in consumption where as private goods are competative & rival in consumption

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

Social goods - Social ~~good~~ 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 ~~note~~ noted here that social goods are subject to consumer sovereignty, i.e they are produce 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 f buyers pay.

Merit Goods - Merit goods too are public goods but their provision can't be explained on the same ~~ter~~ lines 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 ~~goo~~ choice arises since this goods are consumed in free market because of ignorance

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

Public Good — {Cause of Market failure}

a) A pure public good is a good having the property of non rivalry & non excludability. Non excludability means it is technically impossible or extremly 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 doesn't do well at providing public goods. If no one can be excluded from 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 ~~get~~ be a free rider and doesnt ~~a~~ want to pay for the provision of the good because it is possible to get it free once ~~t~~ someone else pays for its provision*.

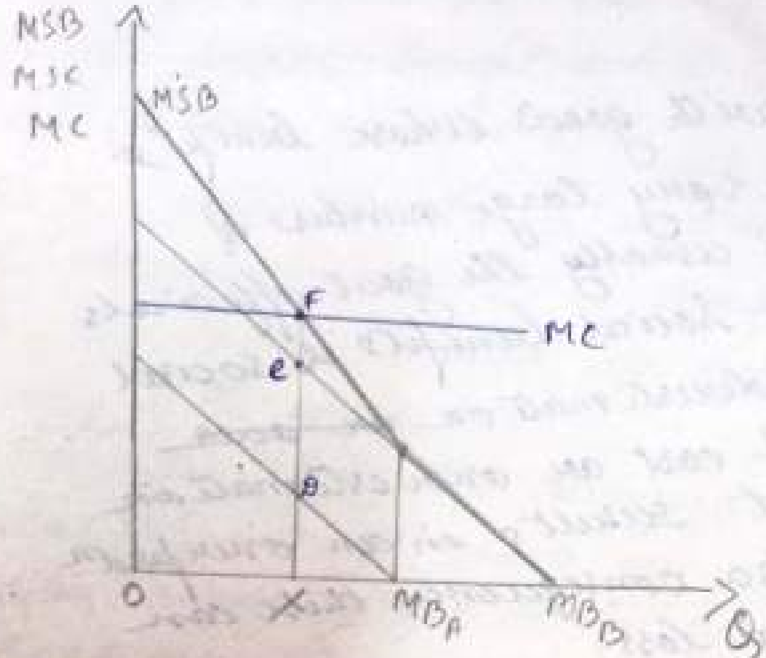
Para 2 Thus as the market fails to ~~provide~~ make efficient provision for the public goods, many economist suggest the policy of govt intervention to deal with such situation. (Example of public good - light house, national defence, flood control project etc.)

Para 1 * as ~~a~~ everyone ~~wants~~ intends to become a free rider, ~~the of~~ it is impossible to find out the demand curve for the public good. Thus this leads to indeterminency of the ~~eqn~~ eqution D & S price for public goods which are necessary for making efficient ~~provision~~ for such goods

Optimum Condition for the provision of the public goods / 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 refects 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 ~~do~~ of individual demand curve cant be used to derive the market demand curve as all individuals simultaneously benefit from each unit of the

Public good.



$P_X X_S + \left(\frac{7}{3}\right) P_X X_S = 10$

$P_X X_S \left(1 + \frac{7}{3}\right) = 10$

$P_X X_S \frac{10}{3} = 10$

$P_X X_S \frac{1}{3} = 3$

The above fig shows the derivation of the MSB curve. ~~which~~ MB_A & MB_B are the marginal benefit curve of 2 individual A & B. Vertical summation of the 2 of individual demand curve gives us the market demand curve i.e MSB curve. ~~such that~~ on the fig 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 consumptn with the public goods, the MSB curve is derived by verticle summatn. The optimal output is now given by the intersection of the MSB curve with the marginal cost curve. The optimal output is thus OX units of public good. Both the curve intersect at point F & thus 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 OX amount of ~~comm~~ the public good, if each individual pays a price equal to ~~to~~ the marginal benefit. Only then the private firms will be able to cover their cost of production ~~to~~

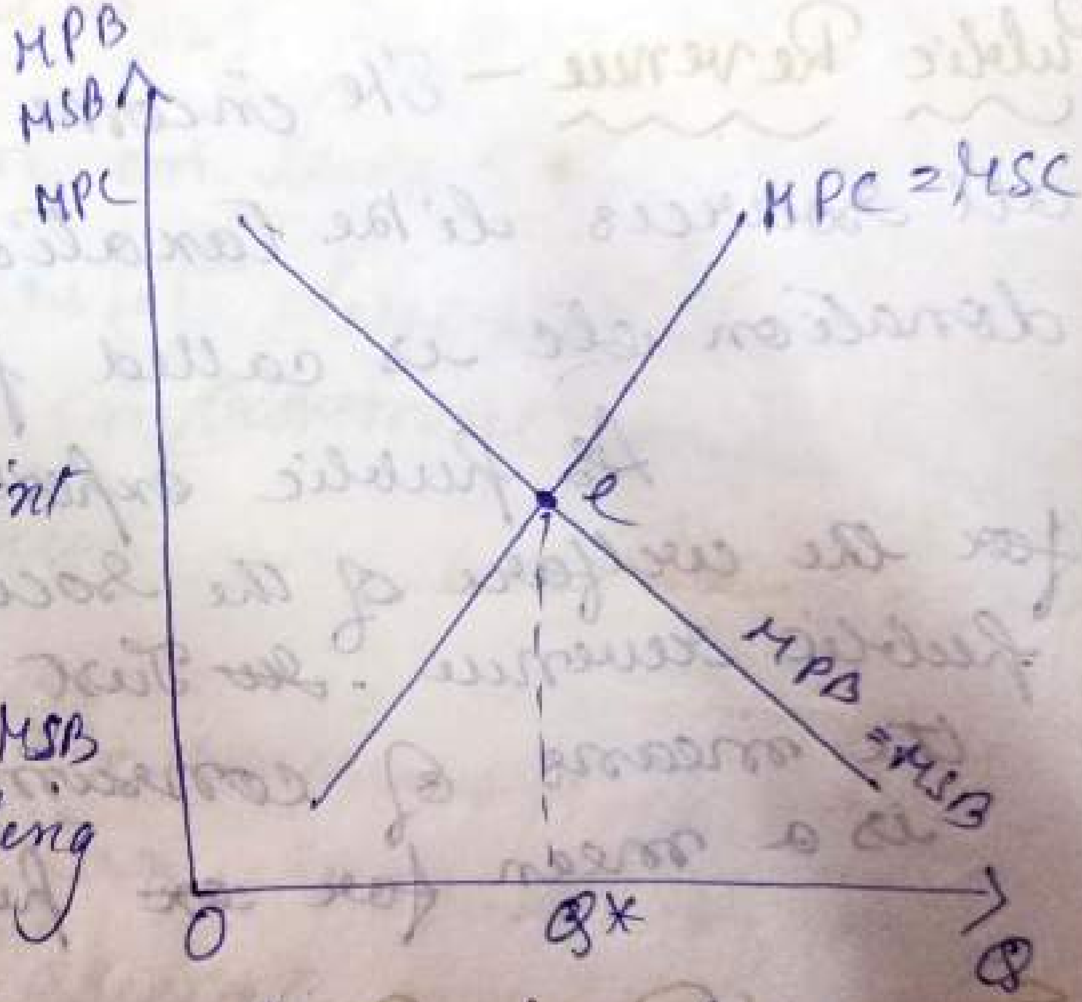
But ~~in~~ in case of a public Good, due to inability of the producer of a public good to exclude those who donot pay & want to be a freerider, the optimal production cost cannot be covered by a privite producer. Therefore, in this situation too little or even none of the public good will be produced. ~~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 takken 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 the~~ only by the person who is paying for it. Thus contrary to the public good, in case of private good ~~has the~~ ~~the~~ exclusion principal, ~~diversity~~ diversibility & the ability to price a good all go together.

The optimum allocation of private good is determined at the point where the Marginal ~~private~~ cost & the marginal ~~social~~ benefit curves intersect. ~~However~~ The existance 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 ~~or~~/under prodn or over/under consumptn. However such abnormalities can be fixed by using the ~~Po~~ Pigovian Solution or Coase theorem & so on. This can be shown as follows



In the diagram, point e the social as well as the private eq^{lm} point where the MPC curve has intersected MPB = MSB curve. The corresponding eq^{lm} level of private good is OQ*. Here the market is free from the existance of externalities and thus there is no case of over/under prod^{n} or over/under consump^{n}