

Paper 3.1: Public Economics

Module 1: Introduction

- Public Economics-Nature, Scope, Meaning and Evolution;

- Government-Powers, Fiscal Functions- Allocation, Distribution and Stabilisation and

- Role of Government in a Mixed Economy;

- Theory of Public Goods- Private Goods, Public Goods, Club Goods, Commons, Merit Goods and Demerit Goods;

- Public Goods and Market Failure; Public Goods as a Special case of Externalities and Market Failure;

- Principle of Maximum Social Advantage.



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Module 2: Public Choice and Policy

- Voting and Public Choice- Majority Voting rule,
- Problems in Allocating Resources and Aggregation of Preference Revelation;
- Alternative to Majority Voting Systems;
- Arrow's Impossibility Theorem;
- Sen's Theory of Social Choice; Economic Theory of democracy; Rent Seeking and Directly Unproductive Activities;
- Public Policy for Allocation of Resource-; Voluntary Exchange Model; Samuelson and Musgrave; Johansen Model; Clarke, Grooves and Ledyard Model; Tiebout Model- Theory of Club Goods.

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Module 3: Theories of Public Expenditure

- General Theories of Public Expenditure:
 - Wagner's Hypothesis;
 - Peacock- Wiseman Hypothesis;
 - Colin Clark Hypothesis;
 - Expenditure Evaluation- Criteria for Public Investment- Social cost- Benefit Analysis;
 - Reforms in Expenditure Budgeting System-
Zero Based Budgeting.



Module 4: Public Revenue and Taxation

- Public Revenue: Sources and Classification, Taxation, Tax Elasticity and Buoyancy, Taxable Capacity and Tax Effort,
- Theory of Incidence; Different Concepts of Incidence,
- Benefits and Ability to Pay Approaches, Taxation and Dead Weight Loss,
- Theory of Optimal Taxation, Equity in Taxation,
- Direct and Indirect Taxes, Effect of Taxation on Production and Distribution.



Module 5: Public Debt and Its Management

- Public Debt-Concept, Sources of Public Debt - Internal and External, Objectives,
- Reasons for Growing Public Debt;
- Classical and Modern Views on Public Debt,
- Burden of Public Debt; Public Borrowings and Price Level-Crowding out of Private Investment and Activity;
- Principles of Debt Management and Repayment.



Reading Materials

- Anderson John E: *Public Finance: Principles and Policy*, Houghton Mifflin Company, Boston.
- Bagchi A : *Readings in Public Finance*, Cambridge University Press, New Delhi
- Cullis John and Phillip Jones: *Public Finance and Public Choice: Analytical Perspective*, Oxford University Press, New York
- Hyman David N: *Public Finance- A Contemporary Application of Theory to Policy*, Thomson South – Western Ohio, USA.
- Hugh Dalton: *Principles of Public Finance*, Allied Publishers Pvt. Ltd.
- Lekhi R.K: *Public Finance*, Kalyani Publishers, New Delhi.
- Hinderick, John and Myles Gareth: *Intermediate Public Economics*,
- Musgrave R.A and Musgrave P.A: *Public Finance in Theory and Practice*, Mcgraw-Hill Kogakusha, Tokyo.
- Om Prakash: *Public Economics: Theory a practice*, Vishal Publishing Co. Ludhiana.
- Rao, Govind: *Public Finance: Theory and Practice Essay in Honour of A.Bagchi*, Sage Publications, New Delhi
- S.K.Singh: *Public Economics: Theory and Practice* S. Chand and Co., New Delhi.
- Tyagi B.P: *Public Finance*, Jayaprakashnath and Company, Meerut, India.

Chapter 1: Introduction

- Introduction
- Type of Economic Systems
- Three Sector Model and Mixed Economy
- Origin of Public Economics
- Nature, Scope and Meaning of Public Economics
- What is Government?
- Functions of Government
- Role of Government in the Mixed Economy
- Concluding Remarks

Introduction

- Basic Economic problems
 - Limited Resources
 - Unlimited human wants
- Problem of allocation of resources
 - What to produce
 - How to Produce
 - For whom to produce



Types of Natural Resources



Sun



Forest



Rock



Minerals



Animals



Air



Oil



Water



Soil

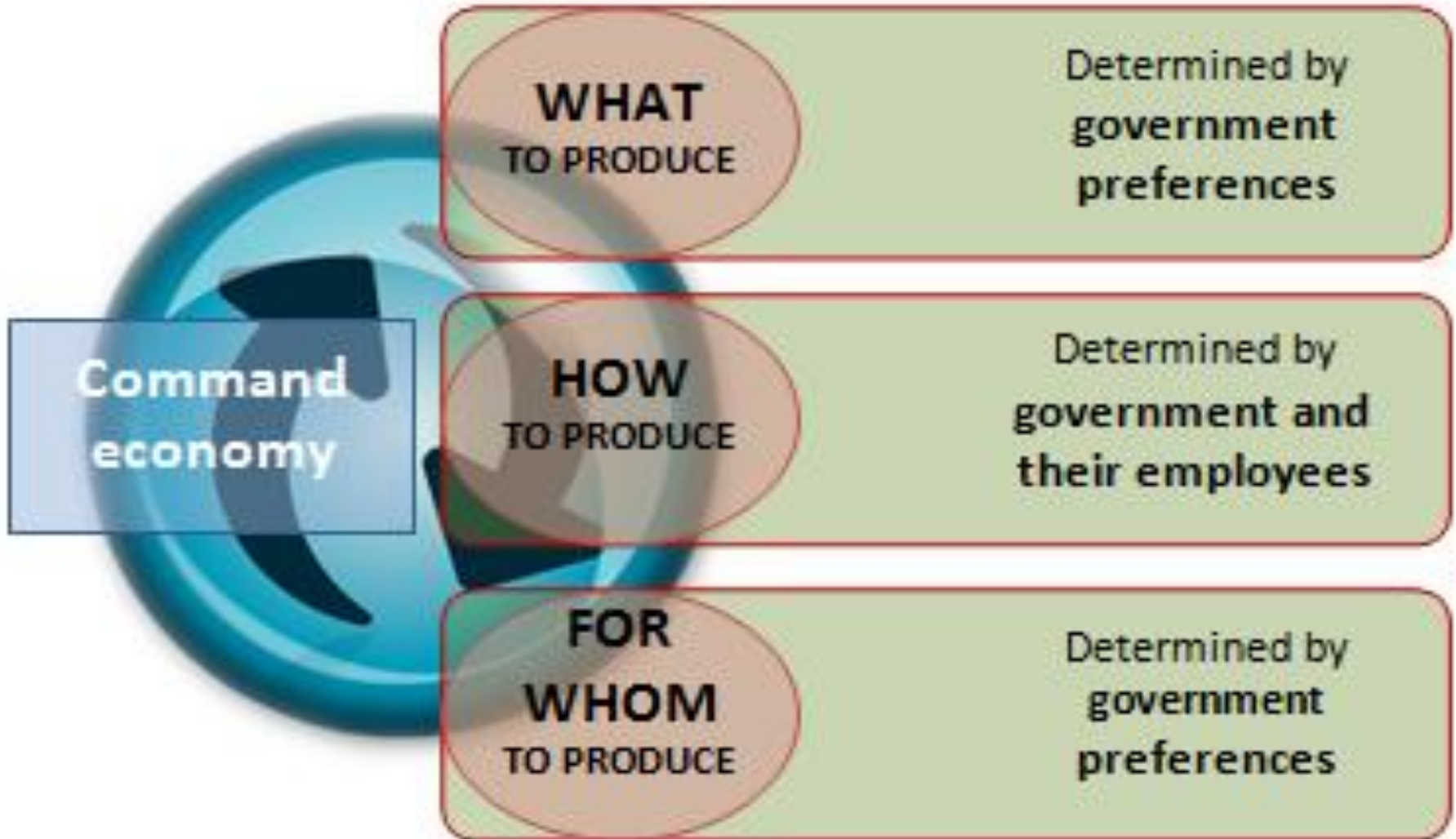
TYPES OF ECONOMY

- Commend Economy
- Market Economy
- Mixed Economy

Command Economy: Centralized Planning

- The first solution to the economic problems is the allocation of scarce resources by the government, or an agency appointed by the government.
- This method is referred to as **central planning**, and economies that exclusively use central planning are called **command economies**.
- In other words, the governments direct or command resources to be used in particular ways:
 - The government makes all the decisions.
 - It is usually led by a dictator and/or are totalitarian governments.
 - the government owns the major industries.
 - the government controls the quantity (amount) of goods produced and their prices.
 - The government also controls the wages of the workforce producing the goods.

Command Economy: Three forces



Example of command economy

- Examples of command economies in history:
 - The Soviet Union under Joseph Stalin.
 - China under Mao Zedong
 - Cuba under Fidel Castro



Commmand Economies



Karl Marx



Karl Marx Communist Manifesto,
V.I. Lenin Leader of Soviet Union,
Mao Zedong Leader of China,
Fidel Castro Leader of Cuba,
Kim Jong Il Leader of North Korea

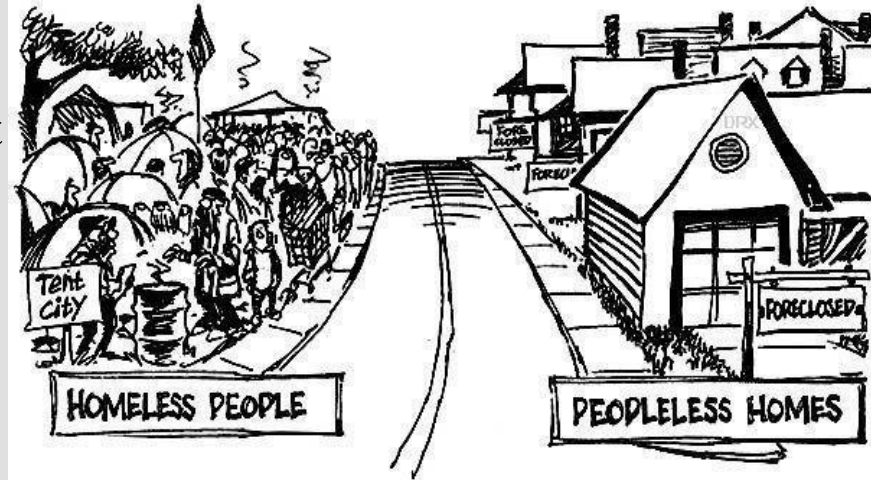
Market Economy

- Systems that rely on markets to solve the economic problem are called **market economies**.
- Businessmen make the decisions based on consumer demands.
- **Supply and demand decide** what should be produced
- In a free market economy, resources are allocated through the interaction of free and self-directed market forces.
- This means that **what to produce** is determined by consumers, **how to produce** is determined by producers, and who **gets the products** depends upon the purchasing power of

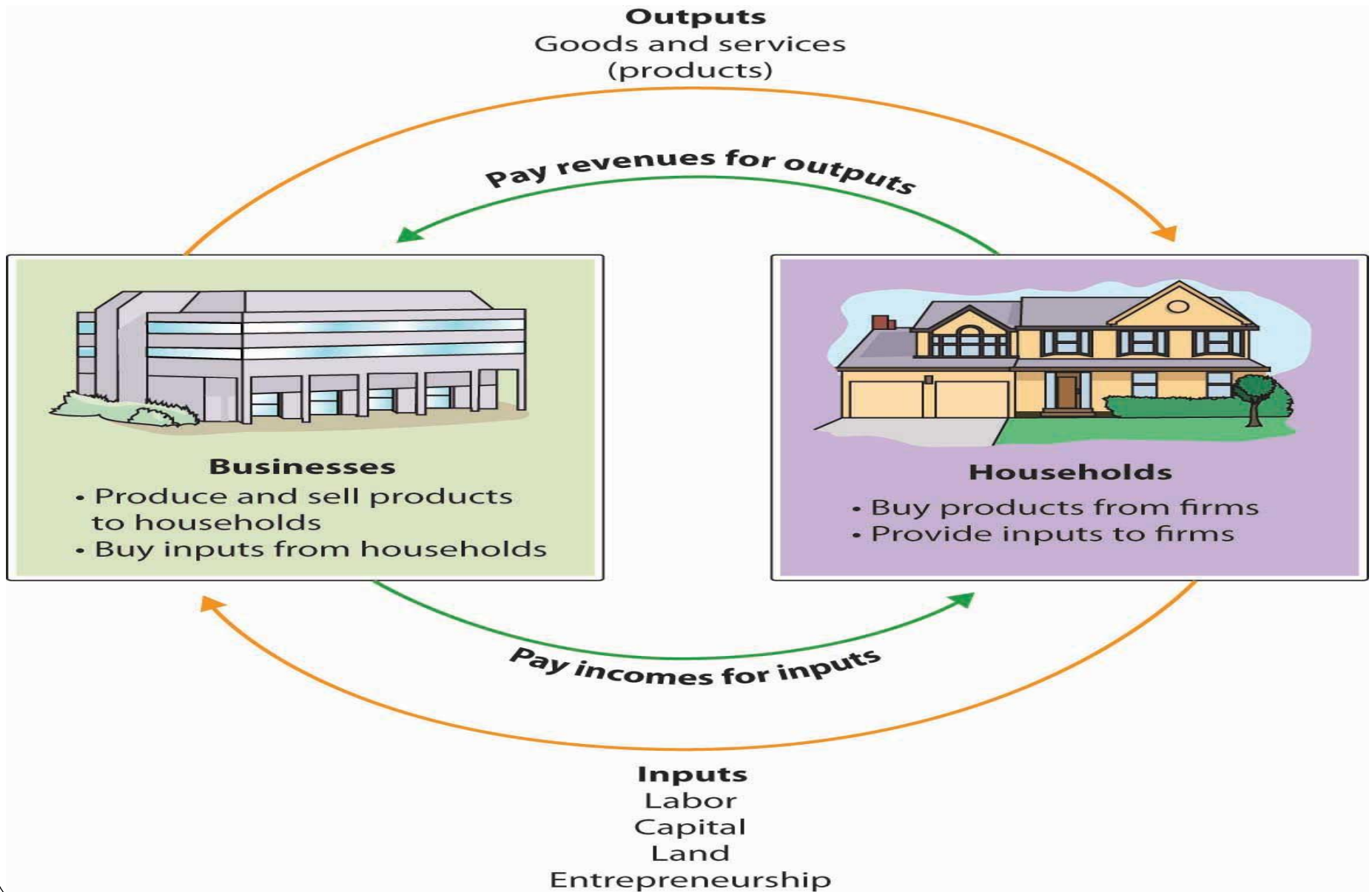


- Market economies work by allowing the direct interaction of consumers and producers who are pursuing their own self-interest. The pursuit of self-interest is at the “heart” of free market economics.
- There is No government involvement and regulation
- Laissez-faire: government is “hands off”
- Supply and demand determines the price of goods. Invisible hands brings equilibrium:
- Examples of market economies in history:
 - England/Great Britain during the Industrial Revolution.
 - The U.S. during the Industrial Revolution.

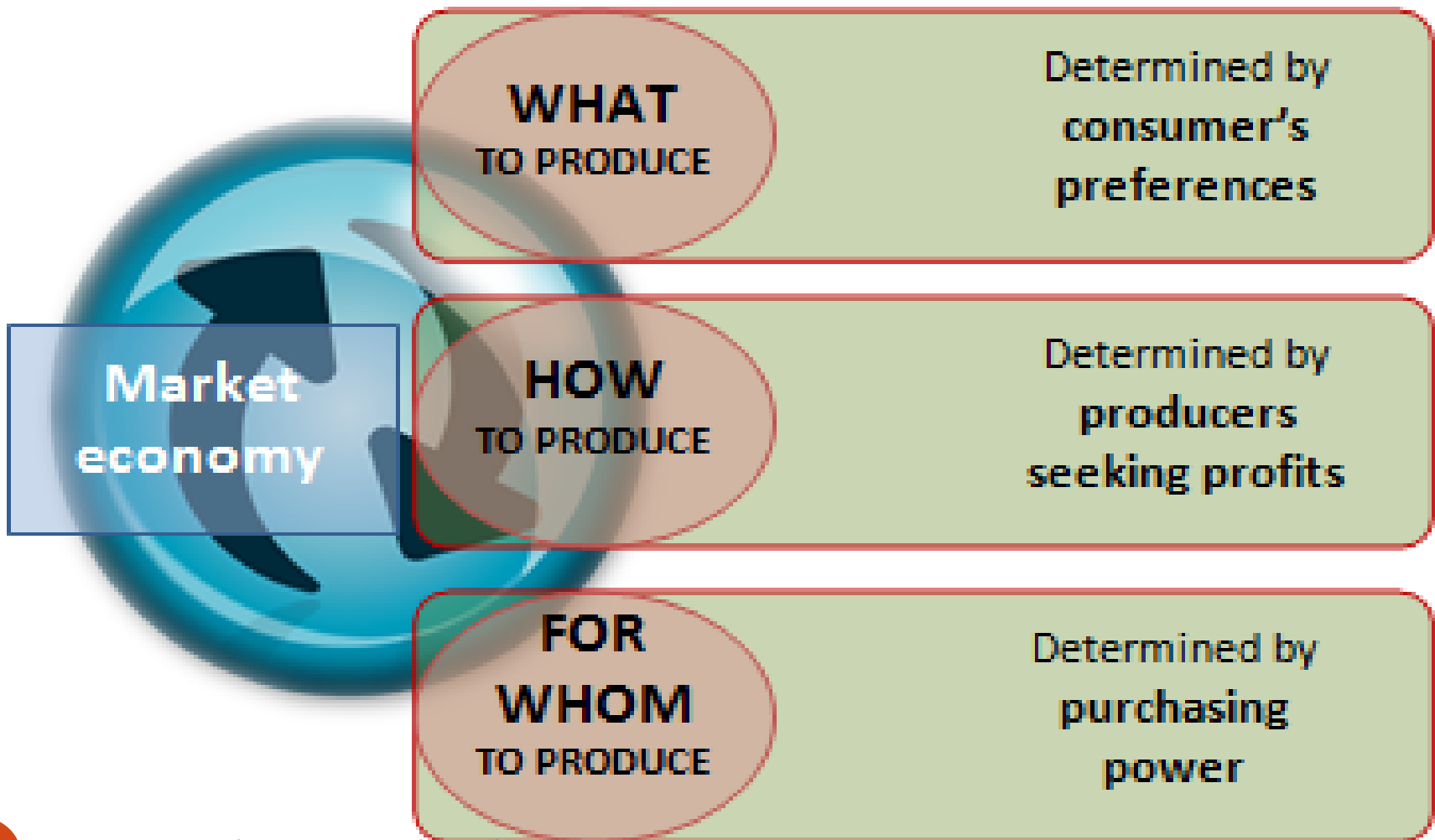
FREE MARKET CAPITALISM



Tow: Sector Economy



Market Economy: Three forces



Characteristics of Free Market

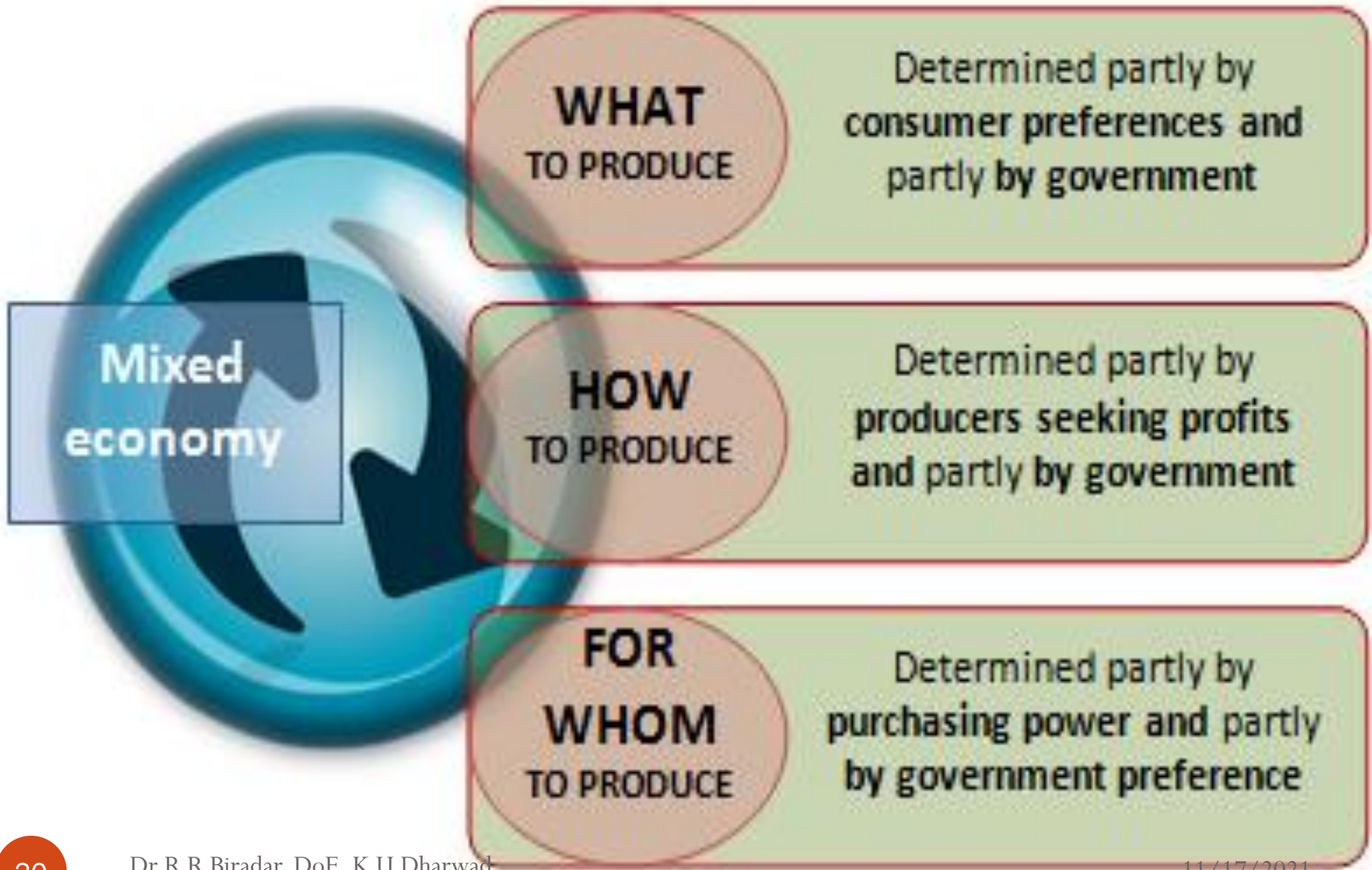
The Characteristics of a Free Market



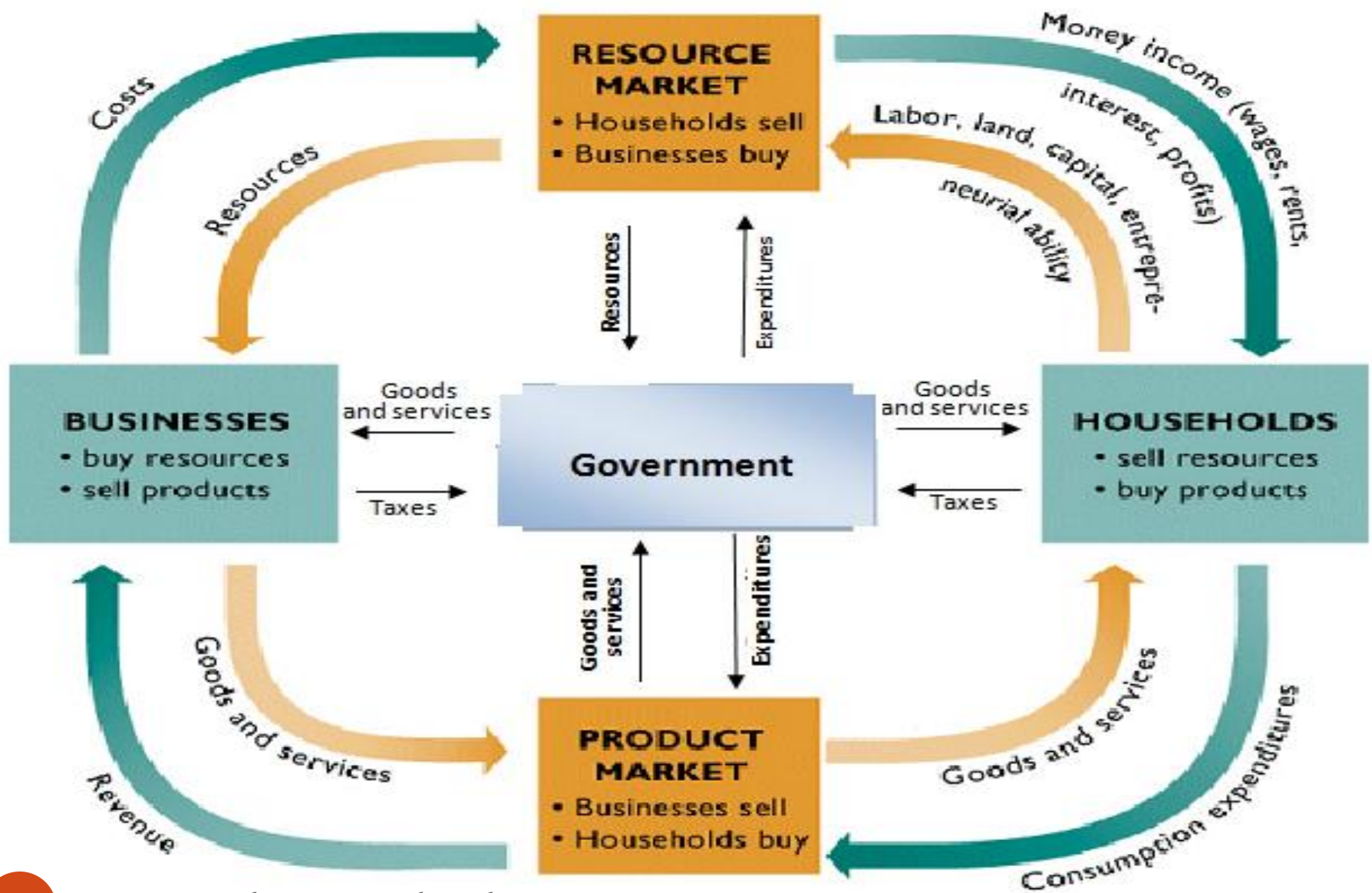
Mixed Economy

- There is a third type of economic system involving a combination of market forces and central planning, known as “**mixed economies**”.
- Mixed economies may have a “**distinct private sector**”, where resources are allocated primarily by market forces.
- Mixed economies may also have a “**distinct Public sector,**” where resources are allocated mainly by government (defence, police and fire services).
- In many sectors, resources are allocated by a combination of markets and planning (healthcare and education) which have **both public and private** provision).
 - Decisions are made by business based on consumer demands.
 - However, the government also makes some decisions:
 - **Regulates trade, Ensures safety of consumers**
 - **Protects the environment.**
 - **Introduce several welfare promoting programmes**

Mixed Economy: Three forces



Government in Mixed Economy: Three sector

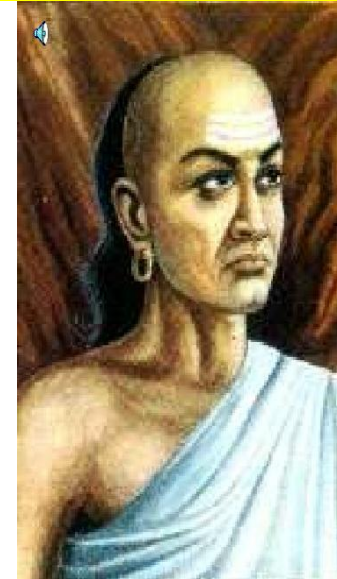


Feature of Market, Command & Mixed Economy

FEATURES	MARKET ECONOMY	COMMAND ECONOMY	MIXED ECONOMY
Ownership of property:	Private ownership	Government ownership	Private + Public (govt.) ownership
Motive or objective:	Profit maximization	Collective welfare social	<u>Private Sector</u> Profit maximisation <u>Public Sector</u> Collective Welfare
<u>Allocative mechanism:</u>	Price mechanism (demand and supply)	Rationing mechanism (central planning & quota's)	<u>Private Sector</u> Price mechanism <u>Public sector</u> Rationing mechanism
Freedom of choice: (In Production & Consumption)	Freedom of choice	No freedom of choice	<u>Private Sector</u> yes <u>Public sector</u> no
Competition:	Yes	No	<u>Private Sector</u> yes <u>Public sector</u> no
Role of government: (In allocation of resources i.e.)	Minimum role of govt. in economic affairs. Only limited to maintain law & order in the country.	All economic & non-economic affairs are in the hands of govt.	Govt. <u>limit</u> its role to the provision of necessary goods & services & regulate private sector for social welfare...
Variety of goods & services:	Yes	No	<u>Private Sector</u> yes <u>Public sector</u> no
Quality of goods & services:	High quality	Poor quality usually	<u>Private sector</u> High quality <u>Public sector</u> Poor quality usually
Response to changes in demand: Consumer sovereignty	Quick response to changes in <u>consumers</u> preferences.	Slow or no response	<u>Private Sector</u> Quick response <u>Public sector</u> Slow response
Efficiency: Producing most desirables goods (<u>allocative</u> efficiency) with least cost methods (productive efficiency)	* <u>efficient</u> allocation of resources usually because of existence of profit motive *Sometime inefficient. e.g. private Monopolies.	Inefficient allocation of resources because of absence of profit motive.	Inefficiency of private sector is minimized by govt. policies.
Shortages & surpluses: (Shortage = Demand > Supply) (Surplus = > Supply > Demand)	Price mechanism clears markets and there are no shortages & surpluses.	Central planning is unable to guess exact quantities demanded. Shortages & surpluses are present.	<u>Private sector</u> No shortages & surpluses <u>Public sector</u> Shortages & surpluses are present.
goods Healthcare, education etc.	Underproduction & under consumption.	Socially optimum	*Private sector <u>underprovision</u> *Missing markets of merit goods will be supplied by govt. provision.

Origin of Public Economics

- *Kautilya* (c. 350–283 BC) *Arthashastra*
- It argues how to manage an efficient and solid economy . It discusses the ethics of economics and the duties and obligations of a king (Chandagupta Maurya- Takshashila)
- It deals with mineralogy, mining and metals, agriculture, animal husbandry, medicine and the use of wildlife. It also focuses on issues of Welfare (redistribution of wealth during a famine)
- **Kalidasa** (4th Century AD) remarked once, “It is only for the good of the people that the king collects taxes from them just as the sun draws moisture from the Earth only to give it back a thousand fold” (Vikramaditya of Ujjain or Chandra Gupta II).



KAUTILYA'S
VIEWS ON
DEFENCE
AND STATECRAFT

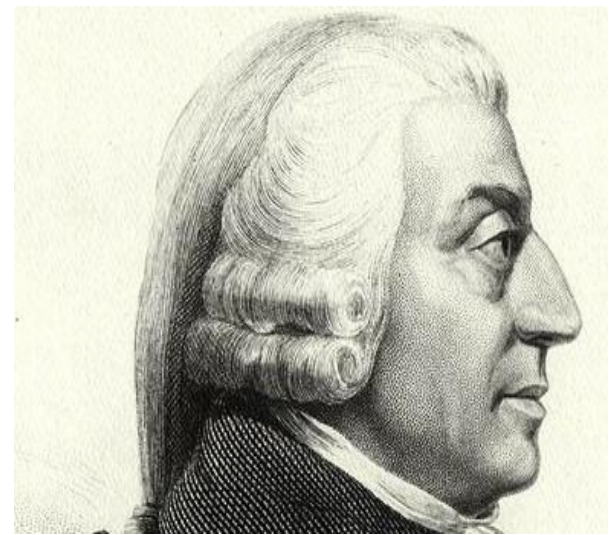


Great Poet
in Sanskrit

**Mahakavi
Kalidas**

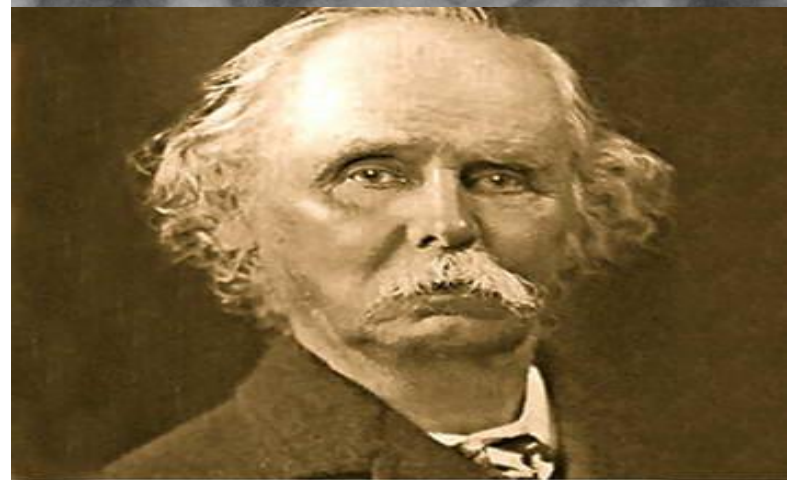
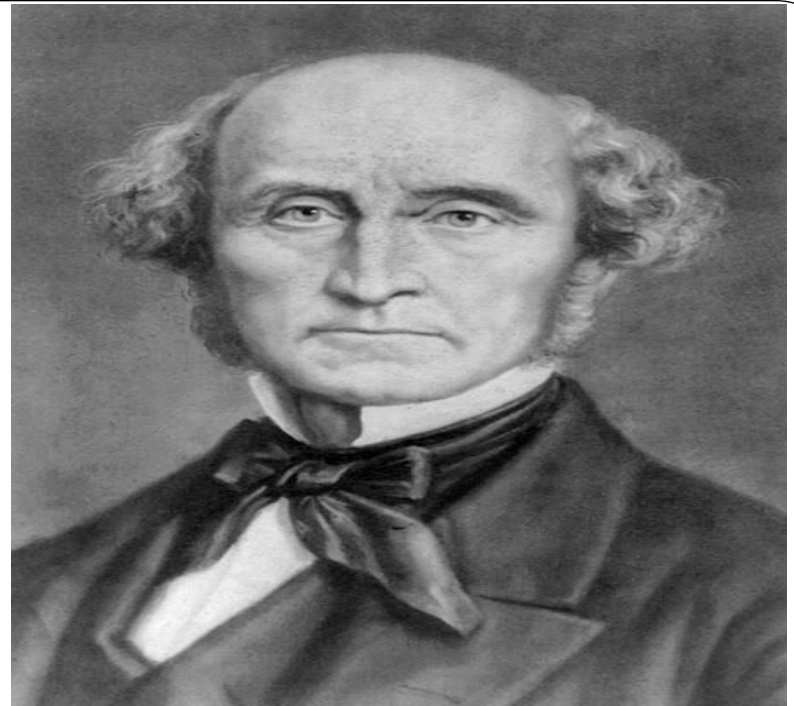
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- **Adam Smith**(1723-1790) Scotland : An Enquiry into the Nature and Causes of the Wealth (1776) . It focused on the **Revenues** of the Sovereign or Commonwealth’, the sources of the general or public revenue of the society’, and ‘**public debts**’.
- **David Ricardo** (1772-1823): The Principles of Political Economy and Taxation published (1817), devoted ten chapters to the discuss the **problems of taxation**. Chapter VIII ‘**On Taxes**’ discusses the general effects of taxes, while the remaining chapters deal with the effects of particular taxes such as on rent, houses, profits, wages etc. Ricardo discussed the problem of **public debt** in his Essay on the Funding System.



- **J.S. Mill (1806 -1873)** London: Principles of Political Economy in 1848. Seven chapters of book devoted to discuss the general principles of taxation, classification of taxes into direct and indirect taxes, effects of various taxes and the various problems of national debt.

- **Alfred Marshall (1842 -1924):** Principles of Economics (1890) does not have any connected discussion of the problems of taxation.



PRINCIPLES OF
ECONOMICS

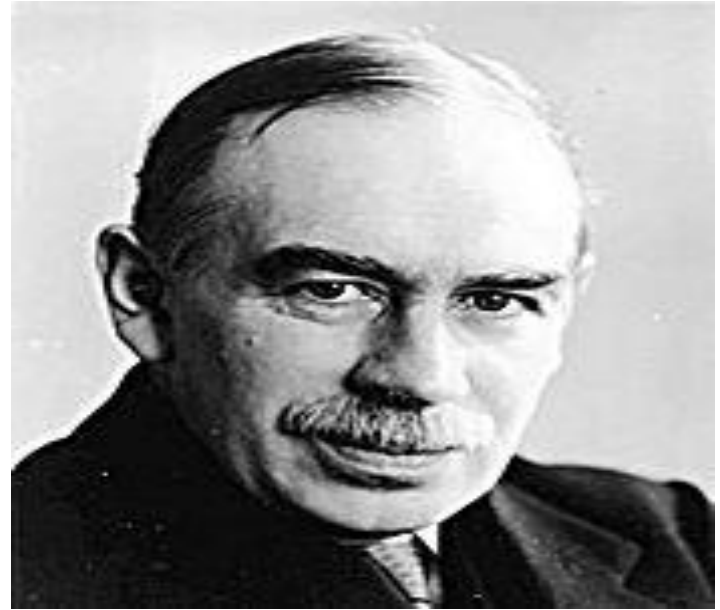
- **Charles F. Bastable (1855-1945)**
Public Finance was published in 1892
- **Hugh Dalton (1887-1962):**
Principles of Public Finance, first appeared in 1922.
- **A. C. Pigou (1877-1959)** Britain-Cambridge University. Public Finance in 1928. Since then, several significant studies have been made on the subject of public finance.



CHARLES FRANCIS BASTABLE
Hon. Secretary, 1886-1892.



- **John Maynard Keynes** (1883-1946) Cambridge-'The General Theory of Employment, Interest and Money', was published in 1936, and became a benchmark for future economic development with protection by the state: Fiscal policies
- **Richard Abel Musgrave** (1910-2007): American economist of German heritage.
- Theory of Public Finance in 1959



Nature and Scope of Public Economics

- Public economics is also known as Fiscal Economics or Public sector economics
- It deals with the finances of the government, how much of a country's resources the Government should acquire for its own use and how much and what makes them to spend the resources efficiently....
- It is concerned with the public income and expenditure of the public authorities and with the adjustment of the one to other.
- **Public economics** is the study of government policy through the lens of economic efficiency and equality
- Public economics builds on the theory of welfare economics and is ultimately used as a tool to improve social welfare.
- Public economics provides a framework for thinking about whether or not the government should participate in economic markets and to what extent it should do so.

Meaning of Public Finance

Dalton: “Subject which is concerned with the **income** and **expenditure** of public authorities and with the adjustment of the one to the other.”

- **Phillip E. Taylor:** “Public Finance deals with the finance of the public as an organised group under the institution of the government. It, therefore, deals only with the finance of the government’.
- **Finaly Shirras:** “Public Finance is the study of the principles underlying the spending and raising of funds by public authorities.
- **J.K. Mehta:** “Public Finance constitutes a study of the monetary and credit resources of the state.

- **Richard A. Musgrave**“: The complex problems that centre around the revenue- expenditure process of government is referred to traditionally as public finance....”The subject-matter of public finance is logically, though not solely concerned with the financial aspects of the business of government.
- **H.L. Lutz**: “Public finance deals with the provisions, custody and disbursement of the resources needed for the conduct of public or government functions”.
- **Prof. B.P. Herber** : “The government means of allocation are accomplished through the budgetary practices of taxing and spending...”

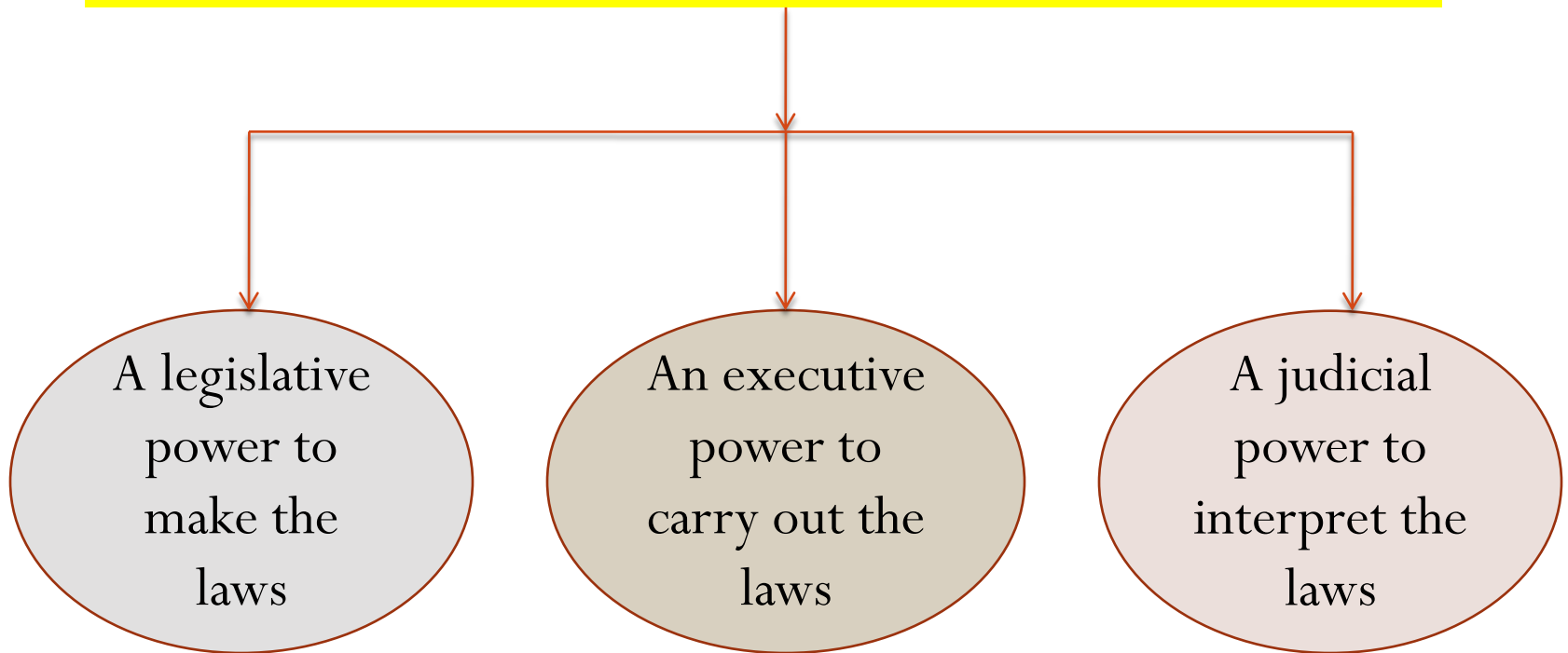
WHAT IS GOVERNMENT?

- A **government** is the system by which a state or community is controlled.
- In the Common Wealth of Nations, the word *government* is also used more narrowly to refer to **“the collective group of people that exercises executive authority in a state: (LEJ)**
- In the case of its broad associative definition, government normally consists of **legislators, administrators, and arbitrators (judicial system).**
- Government is the means by which state policy is enforced, as well as the mechanism for determining the policy of the state.
- A form of government, or form of state governance, refers to the set of political systems and institutions that make up the organisation of a specific government.

POWERS OF GOVERNMENT

- All governments are given powers to carry out their authority over the members of society.

POWERS OF GOVERNMENT



Changing Perspective-Role of Govt. Role

- Classical Economist: Adam Smith, Recordo , etc., “the best government was the one which does the least”
- Protecting the society from the violence and invasion, law and order and public works
 - Laissez-fair,
 - Invisible hand
 - Self-interest
 - $Y=C+S$, $S=I$
- Gradual Change: 1930’s Depression
- **J. M. Keynes (1936 : General Theory of employment , Interest and money) : Death-knell of Laissez-fair**
- Fiscal activities of the state to increase employment and income



Classical
Economists

Minimum role of
Government

Functions of Government

There are 3 levels of government:

- a. Federal (National)
 - b. State (Individual States)
 - c. Local (thousands and thousands of cities/counties)
- A: Allocation Function
 - B. Distribution Function
 - C. Stabilization function



FISCAL FUNCTION OF THE GOVERNMENT

A. Allocation Function

- The market fails in the following areas
 - 1) Social Good and Market failure (public good)
 - 2) Public provision of social goods
 - How much and what type of social goods
 - 3) National and local social goods (Defense and street light)

B. Distribution Functions (tax and transfer payment)

- 1) Determinant of Distribution
- 2) How income should be distributed (Pareto optimality)
 - Fiscal instruments: 1) A tax-transfer (subsidies) scheme 2)

• C. Stabilization Function

- 1) Need for stabilization
- 2) Instruments of stabilization policy:

Monetary instruments and Fiscal instruments

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Role of Govt. in Mixed Economy

- Promoting Education and health
- Promoting technology
- Supporting the financial sector-banking
- Investment in infrastructure
- Preventing environmental degradation
- Creating and maintaining social safety net



Reading materials

- Hyman David N: *Public Finance- A Contemporary Application of Theory to Policy*, Thomson South – Western Ohio, USA.
- Lekhi R.K: *Public Finance*, Kalyani Publishers, NewDelhi.
- Musgrave R.A and Musgrave P.A: *Public Finance in Theory and Practice*, Mcgraw- Hill Kogakusha, Tokyo.
- Om Prakash: *Public Economics: Theory a practice*, Vishal Publishing Co. Ludhiana.
- S.K.Singh: *Public Economics: Theory and Practice* S. Chand and Co., New Delhi.
- Ambar Ghosh and C. Ghosh: *Public Finance*, PHI Learning Publication, New Delhi