

Public Goods

- Public goods are commodities or services that benefit all members of society, and which are often provided for free through public taxation.
- Public goods are the opposite of private goods, which are inherently scarce and are paid for separately by individuals.
- Societies will disagree about which goods should be considered public goods; these differences are often reflected in nations' government spending priorities.

- The two main criteria that distinguish a public good are that it must be non-rivalrous and non-excludable.
- Non-rivalrous means that the goods do not dwindle in supply as more people consume them.
- Non-excludability means that the good is available to all citizens.

- An important issue that is related to public goods is referred to as the free-rider problem. Since public goods are made available to all people—regardless of whether each person individually pays for them—it is possible for some members of society to use the good despite refusing to pay for it. People who do not pay taxes, for example, are essentially taking a "free ride" on revenues provided by those who do pay them.

- Individual countries will reach different decisions as to which goods and services should be considered public goods, and this is often reflected in their national budgets. For example, many argue that national defense is an important public good because the security of the nation benefits all its citizens.
- Some countries also treat social services—such as healthcare and public education—as a type of public good.

The Concept of Sound Finance or Balanced Budget Approach

- According to the classical economists, fiscal policy should have the minimum range of operations and the budget should be balanced annually. They firmly stuck to the doctrine of laissez faire and Say's law of markets. As such, they believed that when supply creates its own demand, general overproduction or involuntary unemployment is impossible.
- According to Adam Smith, economic equilibrium and progress are attained through inherent and self-oriented endogenous forces of the economic system. In classical opinion, thus, when full employment is supposed to reach automatically, productivity of government services in the economic field is nil.

- And, since government services are rendered at the cost of the national product (because any government spending causes transfer of resources from the private sector to the government thereby causing reduction in the output of private enterprises), it amounts to a cut in the aggregate national product.
- Thus, when government's productivity is zero in a free enterprise economy, it is desirable that government confines itself only to its primary functions of protection and security of life and property and does not interfere with the free working of the economic system.
- As such, the smallest budget was considered to be the best in the classical era. Further, the classicists condemned all budget deficits which necessitated borrowing by the government, for they led to inflation and even if they did not, they caused reduction in the accumulation of private capital, because the resources in private hands were depleted due to government borrowings, thus, inhibiting the rate of progress.

• **Under the theory of sound finance, classicists favoured a balanced budget criterion for the following reasons:**

- (i) If the budget is unbalanced, the government has to borrow. The government's market borrowings cause reduction in loanable funds available to private productive employment and investment activities.
- (ii) Unbalanced budgets imply a wide extension of state functions beyond the capacity of the government, which may invite irresponsible governmental action.
- (iii) Unbalanced budgets may generate inflation on account of large and unproductive public expenditure.
- (iv) A balanced budget, on the other hand, is a limited budget designed in a rational way.
- (v) Economic stability is secured by the adoption of a balanced budget policy. Unbalanced budgets, on the other hand, cause economic uncertainty and promote instability.

The Concept of Functional Finance : laid down by Prof. A.P. Lerner

- Keynesian revolution in economic thinking reconstituted the whole basis of public finance and affirmed functional finance as a fiscal norm in modern times.
- Though the lead in the development of “functional finance” concept was taken by Keynes, credit goes to Prof. A.P. Lerner for coining this concept. Lerner puts that: The principle of judging fiscal measures by the way they work or function in the economy, we may call functional finance.
- He contends that the fiscal operation of the government — taxing, borrowing; public spending, management of public debt, etc., deficit financing, etc. — should be designed with the objective of fulfilling certain functions which have an immediate bearing and far-reaching effects on the economic system as a whole.

(i) the fiscal operations of the government should be conducted on a functional basis and public finance should not be considered as being induced solely by the need for securing social goods meant for collective consumption

(ii) the budget need not always be balanced. As a matter of fact, the fiscal norm of functional finance is the complete antithesis of the orthodox rule of balanced budget. The functional finance norm suggests the formation of large budgets with a wider functional coverage of government spending to promote basic economic goals, e.g., (a) to obtain optimal allocation and efficient use of scarce resources at full-employment level, (b) to achieve economic stability and bring about an equitable distribution of income and wealth in the best possible manner.

- **Lerner suggests the following rules for government's responsibility and activity under functional finance:**
- (i) The government budget should be directed towards the achievement of full employment and price stability. For this purpose, the government budget need not necessarily be balanced.
- (ii) The government should incur public debt by borrowing money from the private sector only during inflation when it is, absolutely essential to mop up the excessive purchasing power from the public, thereby reducing the pressure of excess monetary demand.
- (iii) During depression only, public expenditure in excess of current public revenue may be met by deficit financing, i.e., printing additional currency notes.

Fiscal Policy

- Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including aggregate demand for goods and services, employment, inflation, and economic growth.
- Fiscal policy is largely based on ideas from John Maynard Keynes, who argued governments could stabilize the business cycle and regulate economic output.
- During a recession, the government may employ expansionary fiscal policy by lowering tax rates to increase aggregate demand and fuel economic growth.
- In the face of mounting inflation and other expansionary symptoms, a government may pursue contractionary fiscal policy.

- **The fiscal policy is designed to achieve certain objectives as follows:-**
- **1. Development by effective Mobilisation of Resources:** The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources. The central and state governments in India have used fiscal policy to mobilise resources.
- **The financial resources can be mobilised by:-**
- **a. Taxation:** Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation in India is taxation.
- **b. Public Savings:** The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.
- **c. Private Savings:** Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issuance of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

- **2. Reduction in inequalities of Income and Wealth:** Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.
- **3. Price Stability and Control of Inflation:** One of the main objectives of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, productive use of financial resources, etc.

- **4. Employment Generation:** The government is making every possible effort to increase employment in the country through effective fiscal measures. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial units encourage more investment and consequently generate more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.
- **5. Balanced Regional Development:** there are various projects like building up dams on rivers, electricity, schools, roads, industrial projects etc. run by the government to mitigate the regional imbalances in the country. This is done with the help of public expenditure.
- **6. Reducing the Deficit in the Balance of Payment:** some time government gives export incentives to the exporters to boost up the export from the country. In the same way import curbing measures are also adopted to check import. Hence the combine impact of these measures is improvement in the balance of payment of the country.

- **7. Increases National Income:** it's the strength of the fiscal policy that is brings out the desired results in the economy. When the government want to increase the income of the country then it increases the direct and indirect taxes rates in the country. There are some other measures like: reduction in tax rate so that more peoples get motivated to deposit actual tax.
- 8. Development of Infrastructure:** when the government of the concerned country spends money on the projects like railways, schools, dams, electricity, roads etc to increase the welfare of the citizens, it improves the infrastructure of the country. A improved infrastructure is the key to further speed up the economic growth of the country.
- 9. Foreign Exchange Earnings:** when the central government of the country gives incentives like, exemption in custom duty, concession in excise duty while producing things in the domestic markets, it motivates the foreign investors to increase the investment in the domestic country.

Contra-cyclical Fiscal Policy

- **The counter cyclical budgeting rest upon two fundamental policy prescriptions. They are:**
- (a) Maximisation of expenditure and minimisation of taxation during depression, and
- (b) Maximization of taxation and minimization of expenditure during boom. In essence it means adopting a deficit budget during depression and a surplus budget during boom.

- **A contra cyclical budget should possess two components:**
- (a) Revenue budget (normal budget), and
- (b) Capital budget (counter cyclical budget).

The normal budget deals with the ordinary source of revenue like taxes, fees etc. and with the normal items of expenditure administrative, law and order expenses etc. Under this principle this part of the budget is supposed to be balanced.

- The component capital budget deals with unusual items of revenue like borrowing and extraordinary items of expenditure like government development expenditures and public works programmes. This part of the budget should be made a surplus during boom and deficit during depression.
- The advocates of counter cyclical budgetary procedure suggested the framing of a permanent council consisting of economists, businessmen, engineers to advise the government in its anti-depression expenditure policies.

- **Countercyclical fiscal policy during recession**

Here, the Government's responsibility is to generate demand by fine-tuning taxation and expenditure policies. Reducing taxes and increasing expenditure will help to create demand and producing upswing in the economy.

- **Countercyclical fiscal policy during boom**

In the case of boom, economic activities will be on upswing. Amplifying the boom is disastrous as it may create inflation and debt crisis and the government's responsibility here is to bring down the pace of economic activities. Increasing taxes and reducing public expenditure will make boom mild. Thus, slowing down demand should be the nature of countercyclical fiscal policy during boom.

Discretionary Fiscal Policy

- Discretionary fiscal policy refers to government policy that alters government spending or taxes. Its purpose is to expand or shrink the economy as needed.
- The output is determined by the level of aggregate demand (AD), so a discretionary fiscal policy can be used to increase aggregate demand and thus also increase the output. This measure would help to close the deflationary gap.
- Discretionary fiscal policy is a demand-side policy that uses government spending and taxation policy to influence aggregate demand.

- Discretionary fiscal policy differs from automatic fiscal stabilizers. These automatic stabilizers take place when, during a recession, a government automatically spends more because the economy forces more people to claim unemployment benefits. However, the government may find these automatic stabilizers to be inadequate to deal with major issues, imbalances, and instabilities in the economy. This will lead them to intentionally increase public works spending schemes as well.

Contractionary Discretionary Fiscal Policy

- When an economy is in a state in which growth is getting out of control and therefore causing inflation and asset price bubbles, a contractionary fiscal policy can be used to rein in this inflation—to bring it to a more sustainable level.
- A contractionary discretionary policy will lower government spending and/or increase taxation. This policy will shift aggregate demand to the left (this denotes a decrease).
- A fiscal policy is said to be tight or contractionary when revenue is higher than spending (i.e. the government budget is in surplus) and loose or expansionary when spending is higher than revenue (i.e. the budget is in deficit).
- Contractionary fiscal policy slows growth, which includes job growth. With fewer jobs, and higher taxes, both families and businesses are left with less income available for spending. With this decreased demand, then, the economy's growth is slowed.

Expansionary Discretionary Fiscal Policy

- Since, $\text{Aggregate Demand} = \text{Consumption} + \text{Investment} + \text{Government Spending} + \text{Net Exports}$, an expansionary policy will shift aggregate demand to the right. This kind of policy involves decreasing taxes and/or increasing government spending.
- An expansionary discretionary fiscal policy is typically used during a recession. A decrease in taxation will lead to people having more money and consuming more. This should also create an increase in aggregate demand and could lead to higher economic growth. However, it can also lead to inflation because of the higher demand within the economy.

- Expansionary fiscal policy creates jobs. With more jobs, the overall populace has more funds to spend, leading to higher levels of demand. This creates growth in the economy. Along with tax cuts, growth is especially accelerated. Among the best stimuli for the economy are unemployment benefits, proven empirically via economic studies. Tax cuts are less effective in creating jobs, as the tax rate must already be high for lowering taxes to do so.
- The drawback of expansionary fiscal policy is that it can lead to budget deficits. This is because the government is effectively spending more than it ends up receiving in taxes.

Criticisms of Discretionary Fiscal Policy

- **1. Time Lag**

Fiscal policy is characterized by a time lag, which is the time between the implementation of policy and the actual effects of that policy being felt in the economy.

- **2. Expansionary Bias**

It has an expansionary bias. No government or politician would implement a contractionary policy, so this means that expenditure will keep rising and taxes would probably not rise too.

- **3. Execution**

Contractionary policy is difficult to implement because no one wants cuts in spending. Education, defense, and health are priorities and most people want to ensure that they are adequately funded. It also cannot be maintained indefinitely. It is considered to be a short-term tool, not a long-term solution.

- 4. Trade Deficit

Expansionary fiscal policy can lead to a higher trade deficit, as higher income leads to more expenditure on imports and a higher negative trade balance.

- 5. Crowding Out

An expansionary policy may lead to crowding out. Crowding out occurs when a big government borrows money. This leads to higher interest rates for the private sector, which ultimately leads to less private investment.