FISCAL FUNCTIONS

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Three Elements Efficiency, Stability And Fairness

- Efficiency - connected with microeconomics
- Stability with macroeconomics
- Fairness. – Ethics and other social sciences

State should perform its fiscal function (the public finance function)

- In those three areas in order to preferably **eliminate or at least reduce market failure.**

Market failures

- Provide the rationale for government's allocative function.

Richard Musgrave

- The three branch taxonomy of the role of government in a market economy
- Resource allocation, (efficiency),
- Income redistribution (fairness)
- Macroeconomic stabilization

In the real world

- **Resource allocation is both market determined and government determined**
- **The state is the instrument by which the needs and concerns of the citizens are fulfilled**

Why government intervention?

- Effective and optimal allocation of limited resources.
- Suitable corrective action when private markets fail to provide the right and desirable combination of goods and services

The government can provide us with goods and services that

a. **we cannot produce on our own or**

b. **buy at a price from the market**

Example

- Property rights
- Goods which involve externalities
- Merit goods
- Government acts as a complement rather than as a substitute to the market system

Expenditure and tax policies

- Who and what will be taxed
- How and on what the government revenue will be spent
- The provision of public goods
- The process by which the total resources of the economy are divided among various uses

Expenditure and tax policies-contd-

- an optimum mix of various social goods

- the reallocation of society's resources from private use to public use.

How ?

- Government may directly produce an economic good
- Government may influence private allocation through incentives and disincentives
- The structure of industry and commerce

- **governments' regulatory activities**
- **any of a mixture of intermediate techniques may be adopted by governments**

Redistribution function

- Left to the market,
- the distribution of income and wealth among individuals in the society is likely to be skewed

Government has to intervene

- To ensure a more desirable and just distribution
- Changing the pattern of distribution of income, wealth and opportunities
- To a more socially optimal and egalitarian one.

- **Distributive justice namely, equity and fairness**
- **Either through the expenditure side or through the revenue side of the budget**
- **Effective demand**

Examples of the redistribution function (or market intervention for socio-economic reasons)

- **progressive taxation of the rich is combined with provision of subsidy to the poor households**
- **proceeds from progressive taxes used for financing public services, especially those that benefit low-income households**

Redistribution function – continued

- Employment reservations
- Unemployment benefits and transfer payments
- Families below the poverty line monetary aid and aid in kind
- Special schemes for backward regions

Conflict between efficiency and equity.

- Likely to have efficiency costs or deadweight losses.
- Appropriate trade-off between
- Equity and efficiency objectives.

Stabilization function arises from

- Keynesian proposition that a market economy does not automatically generate full employment and price stability

- **The governments should pursue deliberate stabilization policies**
- **The market system has inherent tendencies to create business cycles.**
- **Possible that a situation of stagflation**

‘Contagion effect’ increases complexity

- **Aims at eliminating macroeconomic fluctuations arising from suboptimal allocation**

The stabilization function is concerned with :

- Labour employment and capital utilization,
- Overall output and income,
- General price levels,
- Balance of international payments, and
- The rate of economic growth.

Monetary policy
Fiscal policy for stabilization

- Expenditure and taxation decisions.
- During recession
- Government increases its expenditure or cuts down taxes or adopts a combination of both

To control high inflation

- The government cuts down its expenditure or raises taxes.
- The nature of the budget
- Deficit budgets are expected to stimulate economic activity,
- Surplus budgets are thought to slow down economic activity.

Often

- There is conflict between the different goals and functions of budgetary policy
- The Government should strike a balance

Government failures

- Inadequate information,
- Conflicting objectives
- High administrative costs involved in government intervention
- could be greater than the cost of the market failure itself.

- Individuals may use government as a mechanism for maximizing their self-interest.
- Governments may not always be unbiased and benevolent.
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