

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 FISCAL FUNCTIONS

According to Prof. Musgrave, there are three major fiscal functions of public sector.

They are (a) allocation functions, (b) distribution functions and (c) stabilization functions.

A. Allocation Functions

We begin with allocation functions and the proposition that certain goods cannot be provided for through the market system. In some cases the market fails entirely, while in others it can function only in an inefficient way. They are :

- (i) **Social Goods and Market Failure.** The basic reason for market failure is the provision of social goods in 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 A can rank my preferences among housing and backyard facilities, so A may also rank my preferences among my private yard and my use of public parks. Rather, the difference arises because the benefits which social goods give rise to 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.
- (ii) **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 so simple. 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.
- (iii) **National and Local Social Goods.** Although social goods are available equally to those concerned, their benefits may be very limited. Thus, the benefits from national defence accrue nationwide while those from street lights are of concern only to local residents.

This suggests that the nature of social goods has some interesting bearing on the issue of fiscal federalism—centralization or decentralization. Thus, a good case can be made for letting national public services be provided by national government and local public services by local government.

B. Distribution Functions

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.

(i) Determinants of Distribution. In the absence of policy adjustments, the distribution of income and wealth depends first of all on the distribution of factor endowments including personal earnings, abilities and the ownership of accumulated and inherited wealth. The distribution of income, based on this distribution of factor endowments, is then determined by the process of factor pricing, which in a competitive market sets factor returns equal to the value of the marginal product.

(ii) How Income should be Distributed. Economics helps to determine what constitutes an efficient use of resources, based on a given pattern of distribution and effective demand. But there is the further question as to what constitutes a fair or just state of distribution. Modern economic analysis has steered shy of this problem. The essence of modern welfare economics has been to define economic efficiency in terms which exclude distributional considerations. A change in economic conditions is said to be efficient (i.e., to improve welfare) if and only if the position of some person, say A, is improved without that of anyone else, including B and C, being worsened. This criterion, which may be qualified and amended in various ways, cannot be applied to a redistributive measure which by definition improves A's position at the expense of B's and C's. While the "someone gains, no one loses" rule has served well in assessing the efficiency of markets and of certain aspects of public policy, it contributes little in solving the basic social issues of fair distribution.

The answer to the question of fair distribution involves consideration of social philosophy and value judgments. The scholars have come up with a variety of answers, including the view that persons have the right to the fruits derived from their particular endowments, that 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. First, it is difficult or impossible to compare the levels of utility which various individuals derive from their income. Second, there is no simple way of adding up utilities, so that criteria based on such comparisons are not operational. This limitation has led people to think in terms of social evaluation.

C. Stabilization Functions

After analysing the budget policy in the matters of allocation and distribution, **we must now note its bearing on the macro performance of the economy.**

1. Need for Stabilization Policy. Achievement of these targets does not come about automatically but requires policy guidance. Without it, the economy tends to be subject to substantial fluctuations and may suffer from sustained periods of unemployment or inflation. To make matters worse, unemployment and inflation—as we have painfully felt in the 1970s—may exist at the same time. With growing international interdependence, forces of instability may be transmitted from one country to another, which further complicates the problems.

The overall level of employment and prices in the economy depends upon the level of aggregate demand, relative to potential or capacity output valued at prevailing prices. The level of demand is a function of the spending decisions of millions of consumers, corporate managers, financial investors, and unincorporated operators. These decisions in turn depend upon many factors, such as past and present income, wealth position, credit availability and expectations. In any one period, the level of expenditures may be insufficient to secure full employment of labour and other resources. For various reasons, including the fact that wages and prices tend to be downward rigid, there is no ready mechanism by which such employment will restore itself automatically. Expansionary measures to raise aggregate demand are then needed. At other times, expenditures may exceed the available output under conditions of high employment and thus may cause inflation. In such situations, restrictive measures are needed to reduce demand. Furthermore, just as deficient demand may generate further deficiency, so may an increase in prices generate a further price rise, leading to renewed inflation. In neither case there is an automatic adjustment process which ensures that the economy is promptly returned to high employment and stability.

2. Instruments of Stabilization Policy. There are two instruments of stabilization policy as monetary instruments and fiscal instruments. Let us explain these two aspects.

(i) 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. As Walter Bagehot pointed out a century ago, "Money does not control itself." If left to its own devices, the banking system will not generate precisely that money supply which is compatible with economic stability, but will—in response to the credit demands of the market—accentuate prevailing tendencies to fluctuation. Therefore, 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. Monetary policy—including the devices of reserve requirements, discount rates, and open market policy—is thus an indispensable component of stabilization policy. Expanding the money supply will tend to increase liquidity, reduce interest rates, and thereby increase the level of demand, with monetary restriction working in the opposite direction.

(ii) Fiscal Instruments. 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 tax-payers 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. Thus, it must have a restrictive effect on market transactions.