Public Finance (सार्वजनिक वित)

Course No.	**ECONA310**
Course title:	**Public Finance**
CRDIT	4

Unit	Title	Credits L	T
I.	**Public Finance: An Introduction** Meaning and definition of public finance – Public finance and private finance – the principle of Maximum Social advantage. Market Failure; Private Goods, Public Goods and Merit Goods. Overview of Different Role of Government: Allocation, Stabilization and Distribution.	10	**4**
II.	**Taxation** Revenue-Meaning, source, tax and non-tax revenue and importance – Canons of Taxation. Types of tax: Direct and indirect taxes, Progressive, proportional and regressive taxation, single and multiple taxation. Current Issues of India's Tax System. Effects of taxation. Taxable Capacity: Determinants of taxable capacity. Shifting and incidence of taxes. Distinction between impact and incidence of taxation. Factors affecting incidence of tax. Tax evasion.	12	**4**
III.	**Public Expenditure and Public Debt** Public Expenditure: classification of public expenditure. Causes and growth of public expenditure. Effects of public expenditure on production, employment and distribution. Growth of public expenditure. Public Debt: Meaning and classification. Need for public borrowing – Effects of public debt on production, consumption and distribution. Burden of public debt. Redemption of public debt. Growth of public debt.	11	**4**
IV.	**Public Finance in India** **Indian Fiscal Policy, Budget: Concepts, instruments and objectives Types of Government Budgets: Revenue Account, Capital Account and Different Concepts of Budgetary Deficits in the Indian Context. Economic and Functional Classification of Central Govt. Budgets.** **Fiscal Federalism in India; Center State Financial Relations and Evaluation of Previous and Features of Latest Finance Commission. State and Local Finances.**	**11**	**4**

UNIT -I

Public Finance: An Introduction

Meaning and definition of public finance – Public finance and private finance – the principle of Maximum Social advantage.

Market Failure ; Private Goods, Public Goods and Merit Goods.

Overview of Different Role of Government:

Allocation , Stabilization and Distribution.

UNIT-II

Taxation

Revenue-Meaning, source, tax and non-tax revenue and importance –

Canons of Taxation.

Types of tax: Direct and indirect taxes, Progressive, proportional and regressive taxation, single and multiple taxation.

Current Issues of India’s Tax System.

Effects of taxation.

Taxable Capacity: Determinants of taxable capacity. Shifting and incidence of taxes. Distinction between impact and incidence of taxation.

Factors affecting incidence of tax. Tax evasion.

UNIT-III

Public Expenditure and Public Debt

Public Expenditure: classification of public expenditure. Causes and growth of public expenditure. Effects of public expenditure on production, employment and distribution. Growth of public expenditure.

Public Debt: Meaning and classification. Need for public borrowing – Effects of public debt on production, consumption and distribution. Burden of public debt.Redemption of public debt. Growth of public debt.

UNIT-IV

Public Finance in India

Indian Fiscal Policy

Budget: Concepts, instruments and objectives

Types of Government Budgets: Revenue Account, Capital Account and Different Concepts of Budgetary Deficits in the Indian Context. Economic and Functional Classification of Central Govt. Budgets.

Fiscal Federalism in India; Center State Financial Relations and Evaluation of Previous and Features of Latest Finance Commission. State and Local Finances.

SYLLABUS OF MA ECONOMICS

Unit – 1

Principles of public Finance:Principles of maximum Social Advantage. Role of public finance in the developing Economics. Fiscal economics : An overview. Of allocation, distribution and stabilization. Functions. Market failure. Public goods and externalities. Public goods and free-rider problem.

Unit –II

Principles of Taxation :Meaning and type of taxes; requirements of a good tax structure. Approaches to taxation : micro analysis of direct and indirect taxes; individual income tax, corporation income tax, sales tax including value-added tax and expenditure tax. Incidence of taxes; nature of tax burden and principles of tax incidence. Theories and measures of tax incidence. Effects of taxes on work efforts, savings, investment, and growth. Trade-off between equity and efficiency. Taxable capacity.

Unit – III

Economics of Pubic Debt and Public Expenditure :

Sources of public debt. Classical theory of public debt. Compensatory aspects of debt policy. Burden of public debt. Management of public debt. Growth of internal and external public debt. in India. Theories of growth of public expenditure. Pattern of public expenditure. Pure theory of public expenditure. Growth of public expenditure in India.

Unit – IV

Reforms in Budgeting System and Stabilization Polices :

Performance and programming budgeting. Classification of budgets. Fiscal policy : traditional and modern views on fiscal policy. Instruments of fiscal policy; built-in-stabilizes and compensatory fiscal policy. Fiscal policy for stability and growth. Fiscal policy and economic development.

Unit – V

Fiscal Federalism : Role of fiscal federalism. Allocation, distribution, and stabilization in a federation. Union-state-local financial relations in India. Growth and composition of statutory and non-statutory financial transfers in India. Nature and extent of deficits in central and State budgets. Policy measures to correct fiscal imbalances. Economic analysis of recent union budgets.

Public Finance (सार्वजनिक वित) **लोकवित्त**

समूह जिसका
Representative of
public Govt.(state)

Monetary Income
Finance .....funds

Public Finance also known as public economics is study of economic activities of Govt .

सार्वजनिक वित वो अर्थशास्त्र है जिसमे सरकार की आर्थिक क्रियाओं का अध्ययन किया जाता है

सार्वजनिक वित्त सरकार के आय व व्यय का विस्तृत अध्ययन है।

सरकार की आय तथा व्यय सम्बन्धी समस्याओं के अध्ययन को सार्वजनिक वित्त कहते है।

The Concept Of Public Finance(सार्वजनिक वित)

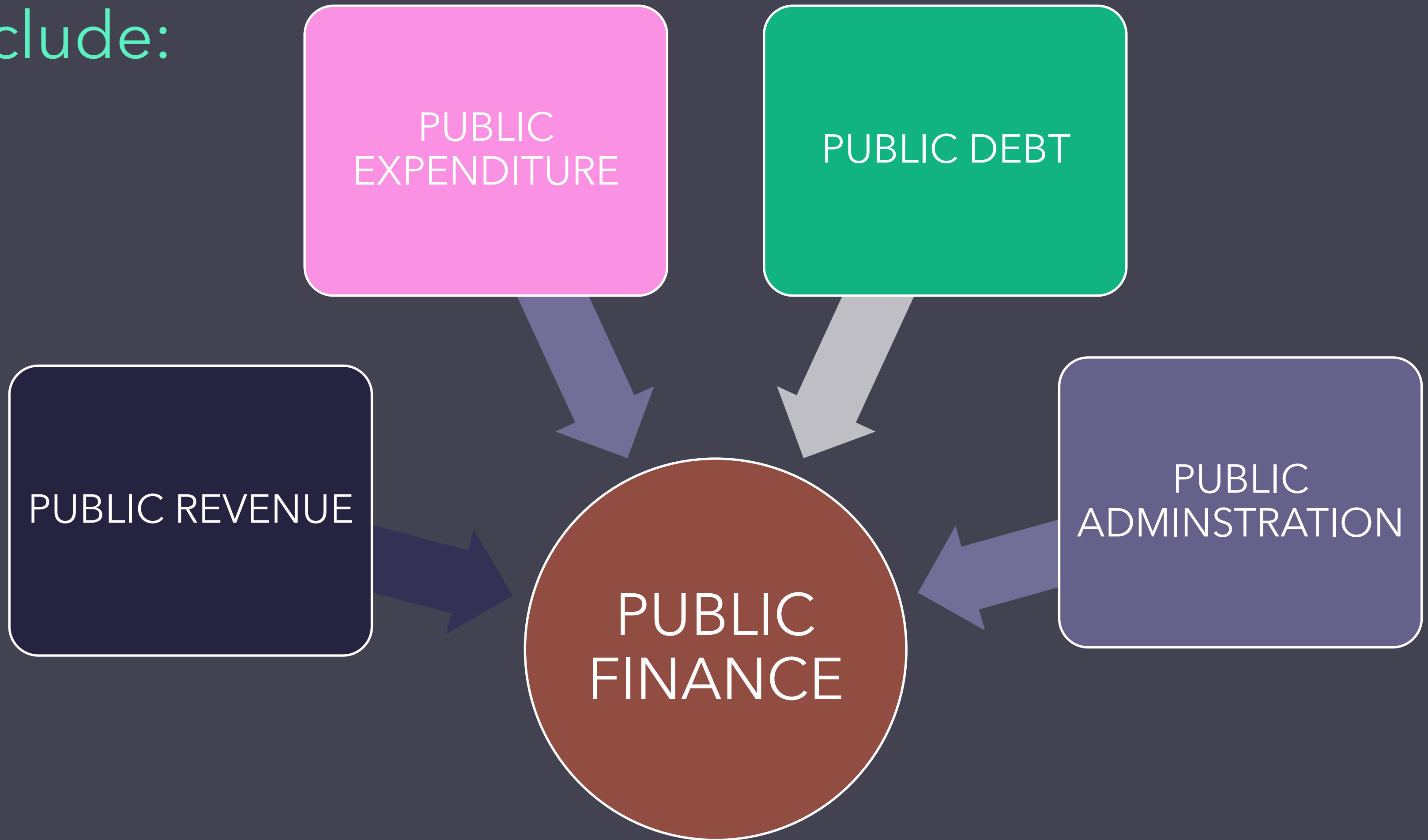
- Public finance is a study of income and expenditure of the government at the central, state, and local levels.

However in the modern day context, public finance has a wider scope – it studies the impact of government policies on the economy.

- Government has to perform certain functions in a country such as to supply certain public or collective goods.

Components of Public Finance(सार्वजनिक वित का क्षेत्र /विषय सामग्री)

The main components of public finance include activities related to collecting revenue,
making expenditures to support society,
The main components include:



THE SCOPE OF/COMPONENTS OF PUBLIC FINANCE

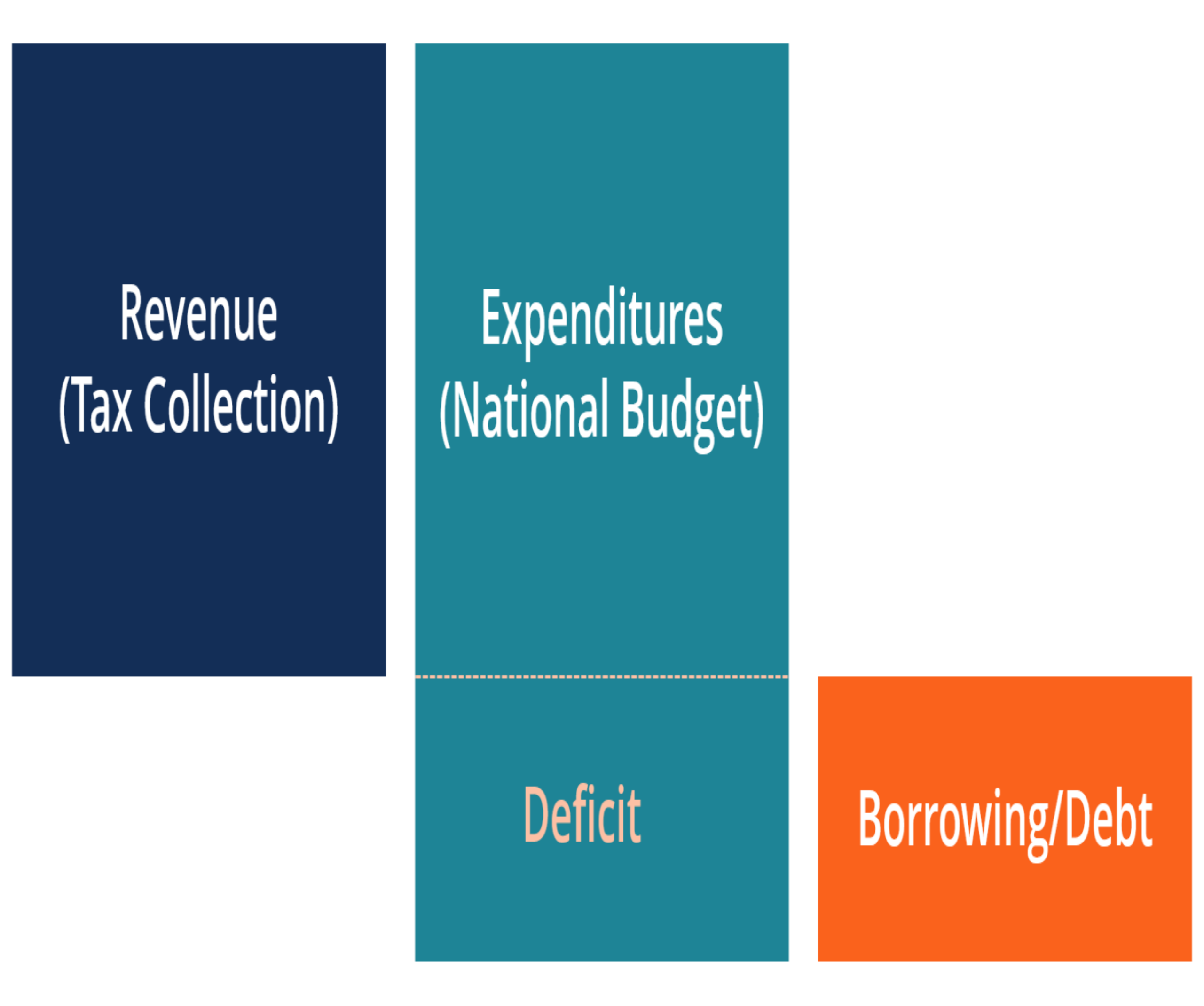
सार्वजनिक वित का क्षेत्र /विषय सामग्री)

Public Income/Revenue (सार्वजनिक राजस्व)

public income refers to the income of the government.
The government earns income in two ways – tax income and non-tax income.
This area studies methods of taxation,
Deficit financing

Public Expenditure (सार्वजनिक व्यय)

government actually spends money on infrastructure, defense, education, healthcare, etc. for the growth and welfare of the country.
Expenditure of govt. to Achieve full employment .control inflation, eco. Development ,eco welfare



PUBLIC DEBT(सार्वजनिक ऋण)

When public expenditure exceeds public income,
the gap is filled by borrowing money from the public, or from other countries or world organizations such as The World Bank.
These borrowed funds are public debt.
It also suggests methods to manage public debt.

FINANCIAL ADMINISTRATION(वितिय प्रबंध)

राजस्व की सार्वजनिक आय, व्यय एवं ऋणों की व्यवस्था के लिए एक प्रशासन

Administration of all public finance i.e. public income, public expenditure, and public debt.

Financial administration includes preparation, passing, and implementation of government budget and various government policies.

It also studies the policy impact on the social-economic environment, inter-governmental relationships, foreign relationships, etc.

5 राजकोषीय नीति/आर्थिक स्थिरता (Fiscal Policy/Economic Stability)-

राजकोषीय नीति का मुख्य कार्य अर्थव्यवस्था में सन्तुलन बनाये रखना है। इस नीति से देश के अन्दर उत्पादन से सम्बन्धित क्रियाओं का नियमन होता हैं। इस नीति का मुख्य कार्य वितरण को न्यायपूर्ण बनाना है और मूल्यों को स्थिरता प्रदान करना है। इसमें देश में आर्थिक स्थायित्व लाने हेतु राजकोषीय नीति के प्रयोगों का अध्ययन किया जाता है।

FUNCTIONS OF PUBLIC FINANCE

There are three main functions of public finance as follows -

Functions of Public finance

- Allocation Function(बंटवारा)
- Distribution Function(वितरण)
- Stabilization function(स्थिरीकरण)

THE ALLOCATION FUNCTION

There are two types of goods in an economy – private goods and public goods.

Features of Private goods निजी वस्तुएं

1. Exclusive (वर्जित होती हैं). Only those who pay for these goods can get the benefit of such goods, for example – a car.
2. They are rival in consumption (प्रतिधवंधि)..वस्तु के एक व्यक्ति के उपभोग से इस वस्तु की दूसरे के लिए कमी हो जाती है

They are produced by Pvt firms

public goods (सार्वजनिक वस्तुएं)

1. Non-exclusive. Everyone, regardless of paying or not, can benefit from public goods, for example – a road.
2. Non rival .(प्रतिस्पर्धा नहीं होती)
3. Free Riders मुफ़्त की सवारी
4. Produce and provided by govt

Allocation of resources:

The most important objective of fiscal operations is to determine how the Country’s resources will be allocated to different sectors of the economy in order to achieve predetermined goals./max. social advantage. Public finance supports the government for optimum utilization of all-natural and man-made resources

The national budget determines how funds are allocated to different heads of expenses. The policy of public expenditure is used by the government to directly undertake resource allocation for different sectors.

On the other hand, the government can use taxation and subsidies to indirectly influence resource allocation

. The government may impose lower tax rates or even provide subsidies on highly desirable goods. Whereas, on goods that are less demandable government may impose a higher tax rate.

Public finance supports the government for optimum utilization of all-natural and man-made resources Public finance supports the government for optimum utilization of all-natural and man-made resources

The allocation function deals with the allocation of such public goods.

What goods and services are to be produced

- Education
- Road
- Building
- Construction of power facilities
- Low cost housing
- Subsidies to consumers
- How much of each good or service to be provided

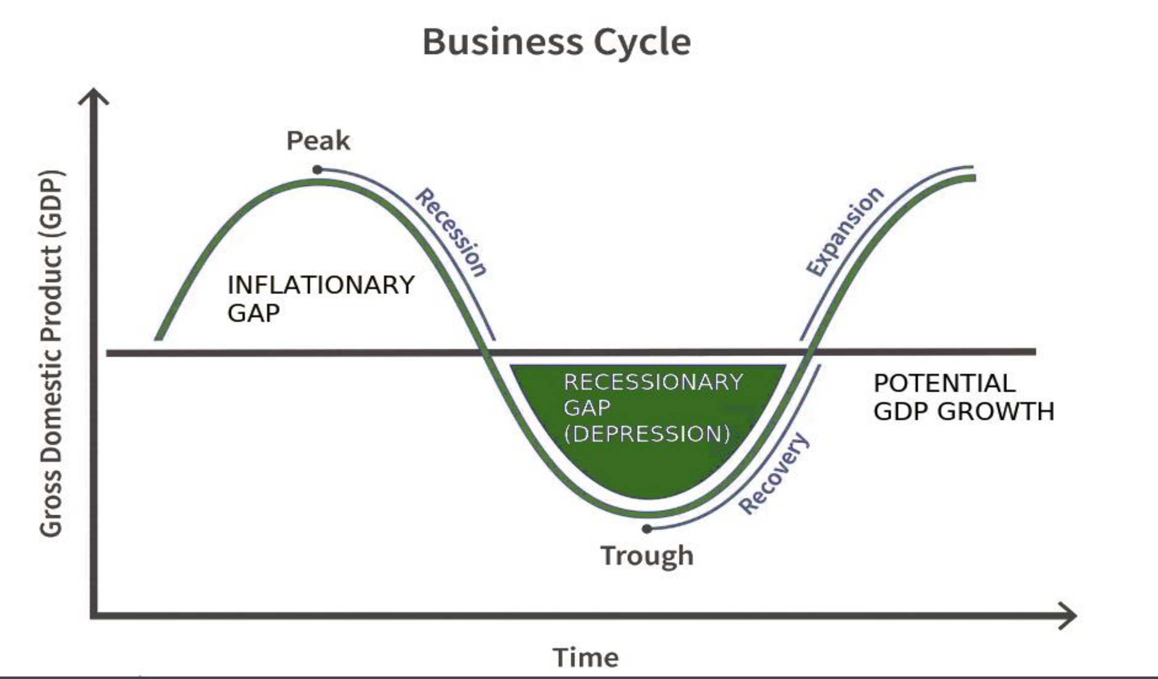
THE DISTRIBUTION FUNCTION (वितरण कार्य)

There are large disparities of income and wealth in every country in the world.. The distribution function of public finance is to lessen these inequalities as much as possible through redistribution of income and wealth.

THE STABILIZATION FUNCTION (स्थिरीकरण कार्य)

Every economy goes through periods of booms and depression. This causes instability in the market. To cope up with incapability, public finance is one of the tools.

The objective of the stabilization eliminates or at least reduce these business fluctuations and its impact on the economy. deficit budgeting during the time of depression and surplus budgeting during the time of boom helps achieve the required economic stability.



Depression AD<AS Causing unemployment

To increase AD(C+I+G)

- Govt. increase expenditure
- Decrease taxes
- Provides subsidies

The policies like deficit budgeting and surplus budgeting during the time of depression and bloom respectively help to achieve economic stability. Deficit spending is when the amount spent exceeds the revenue at a particular time. A budget surplus is when the income or the receipts are more than the expenditures or the outlays.

Similarities between Public Finance and Private Finance☹सार्वजनिक वित और निजी वित में समानता)

Private finance(निजी वित)

is the study of income and expenditure, borrowings, etc. of individuals, households and business firms.(एक व्यक्ति ,एक फर्म या एक परिवार के आय व्यय और ऋण संबंधी अध्ययन हो निजी वित कहा जाता है)

Public finance is concerned with the revenue/incomes and expenditure, borrowings, etc. of Govt. (Center state ,local govt) .

(a) Same Welfare Objective:समान उदेश्य

उद्देश्य की समानता-लोकवित्त एवं निजी वित्त दोनों का ही अन्तिम उद्देश्य "अधिकतम सन्तष्टि" है। एक व्यक्ति श्रम एवं पूँजी का प्रयोग अपनी आवश्यकताओं को सन्तुष्ट करने के लिए करता है। दोनों के पास सीमित साधन होते हैं और दोनों ही इनसे अधिकतम सन्तुष्टि प्राप्त करना चाहते हैं।

Private finance is concerned with the maximization of individual welfare while public finance is concerned with the maximization of a community's welfare from given resources.

(b) Balance between income and expenditure:

आय और व्यय में संतुलन **सन्तुलित बजट**)

-निजी तथा लोक वित्त दोनों में ही आय तथा व्यय के बीच सन्तुलन स्थापित करने का प्रयास किया जाता है जिससे ऋण लेने की आवश्यकता ना पड़े

both try to balance income and expenditure

(c) Scarcity of Resources(सीमित साधन):

Both have limited resources at their disposal. Both public and private individuals are required to match their income and expenditures in such a way that both make the optimum use of resources which are scarce.

(d) Capacity to borrow(उधार की क्षमता) ऋणों की प्राप्ति

जिस प्रकार निजी वित्त में जब व्यय आय से अधिक हो जाता है, तो उस घाटे की पूर्ति के लिए ऋण लिये जाते हैं, उसी प्रकार सरकार भी घाटे की पूर्ति के लिए आन्तरिक तथा बाह्य ऋण लेती है।.

Both private and public loans are required to be repaid.

सम–सीमान्त उपयोगिता सिद्धान्त का पालन-

दोनों वित्त ही सम सीमान्त उपयोगिता के सिद्धान्त का पालन करते हैं तथा उपलब्ध सीमित साधनों का अधिकतम प्रयोग करते हैं।

Differences between Public and Private Finance
सार्वजनिक वित और निजी वित में अंतर)

1. Adjustment of Income and Expenditure
(आय और व्यय का समायोजन)

2.Difference in nature/objective of expenditure(व्यय के उदेश्य में अंतर)

निजी वित्त में व्यक्ति का उद्देश्य अधिकतम लाभ अर्जित करना होता है, जबकि लोक वित्त में सरकार का अन्तिम उद्देश्य सामाजिक लाभ होता हैं

to increase employment ,reduce poverty ,for eco Growth, economic stability etc

व्यक्ति अपनी वर्तमान आवश्यकताओं को प्राथमिकता देता है, जबकि सरकार वर्तमान के साथ-साथ भविष्य पर इसके प्रभाव को भी देखती है।.

4..Difference in nature of Budget (बजट की प्रकृति में अंतर :

Public finance is related to the yearly budget of the government, which is fixed,

but private finance is related to daily, weekly or monthly budget of an individual or household.

व्यक्ति अपनी आय तथा व्यय के अनुसार बचत का बजट बनाता है तथा आय को अधिक तथा व्यय को कम से कम करके बचत करना चाहता है, surplus budgets is a great virtue in the private sector,

Income >expenditure

इसके विपरीत सरकार आर्थिक विकास तथा युद्ध काल में घाटे का बजट बनाना उचित समझती है।

Deficit budget income <expenditure

6. गोपनीयता का अन्तर–

निजी वित्त में गोपनीयता का विशेष ध्यान रखा जाता है, क्योंकि कोई भी व्यक्ति अपनी आय तथा व्यय को निजी समझता है तथा इसकी गोपनीयता को बनाये रखना चाहता है,

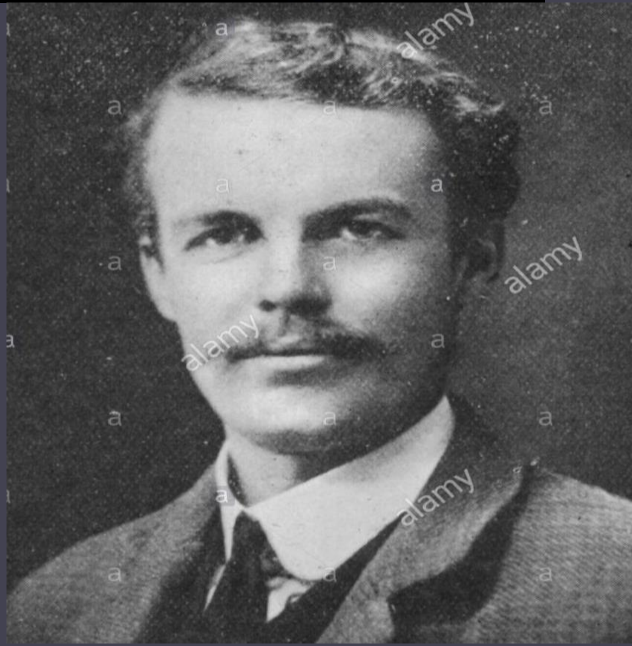
जबकि सरकार को अपनी क्रिया में पारदर्शिता लाने के लिए इसे सार्वजनिक करना आवश्यक है।

Principle Of Maximum Social Advantage
(अधिकतम सामाजिक लाभ का सिद्धान्त)

Fundamental Principle which should determine fiscal operations of the government

Dr. Dalton and Prof. Pigou. Dr. Dalton

British Economist Hugh Dalton.
calls it as the "Principle of maximum social advantage"



Prof. Pigou describe as
"Principle of Maximum Aggregate Welfare"

Principle Of Maximum Social Advantage (अधिकतम सामाजिक लाभ का सिद्धान्त)

The 'Principle of Maximum Social Advantage' was introduced by British economist Hugh Dalton. '

Principle of Public Finance

राज्य का मुख्य उद्देश्य समाज को अधिक सुख सुविधाएं पहुंचाना है

According to Dalton, the best system of

public finance is that which secures the maximum social advantage from its fiscal operations. प्रोफ़ेसर डाल्टन के अनुसार, "लोक वित्त का सर्वोत्तम व्यवस्था बजट है जिसका मुख्य उद्देश्य अधिकतम सामाजिक लाभ की प्राप्ति करना है।"

(The optimum financial activities of a state)

Assumptions of the Principle

- • All taxes result in sacrifice and all public expenditures lead to benefits.
- • Public revenue consist of only taxes and no other sources of income to the government.
- • The government has no surplus or deficit budget but only balanced budget.
- • Public expenditure is subject to diminishing marginal social benefit and
- taxes are subject to increasing marginal social sacrifice.

Dalton’s Principle of Maximum Social Advantage :

Dalton explains the principle of maximum social advantage with reference to

- ❑ Marginal Social Sacrifice(सीमांत सामाजिक त्याग) (MSS)
- ❑ Marginal Social Benefit)(सीमांत सामाजिक लाभ) (MSB

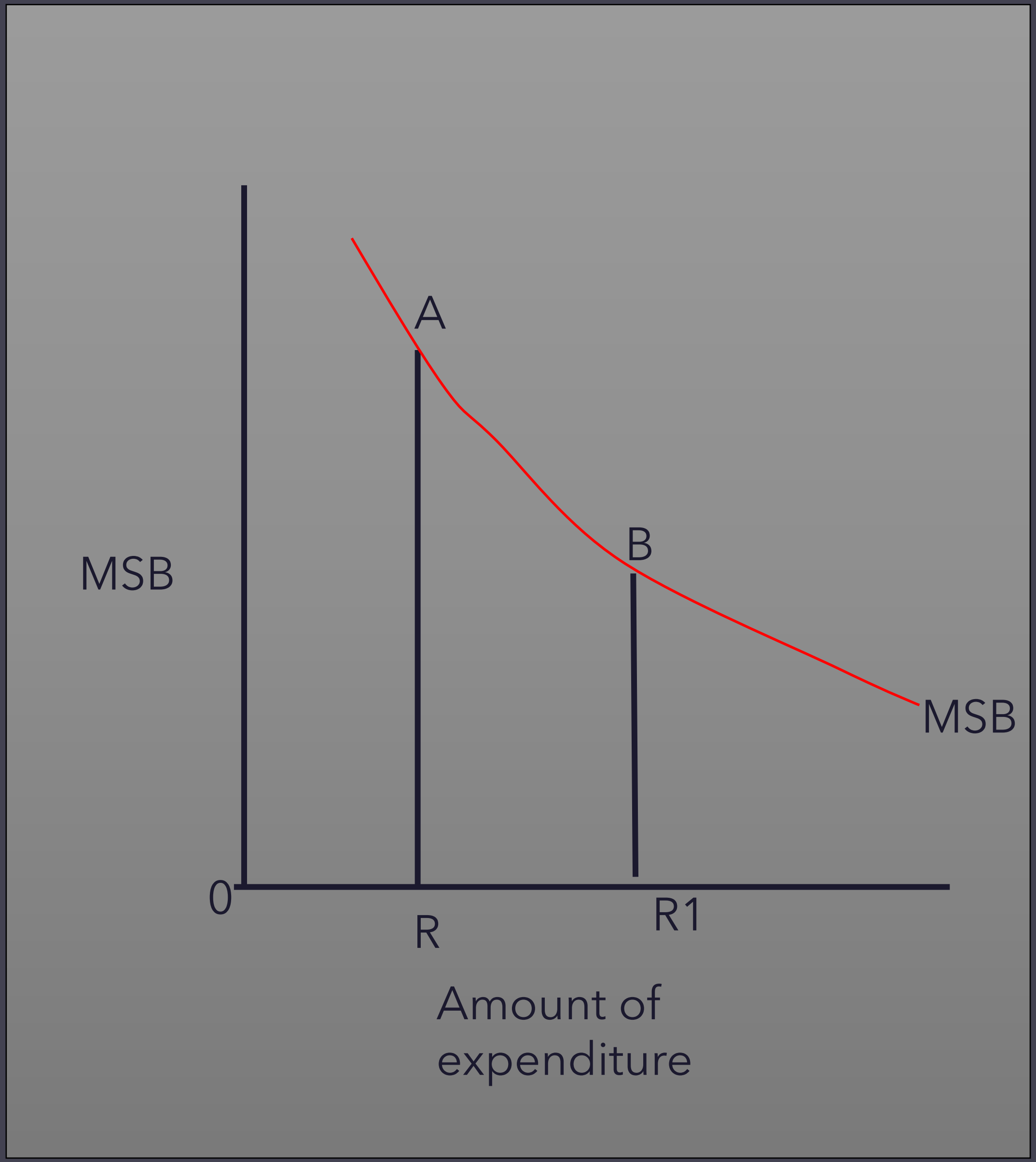
Public expenditure is spending made by the government of a country on collective needs such as education ,health , pension ,infrastructure, subsidies etc.

Public expenditure benefits People .

The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal Social Benefit (MSB).

Marginal Social Benefit
सीमांत सामाजिक लाभ)

social benefit from each additional unit of public expenditure declines as more and more units of public expenditure are spent.
In the beginning, the units of public expenditure are spent on the most essential social activities.
Subsequent doses of public expenditure are spent on less and less important social activities. As a result, the curve of marginal social benefits slopes downward from left to right



Government revenue is money received by a government.

Main source of govt revenue is taxes

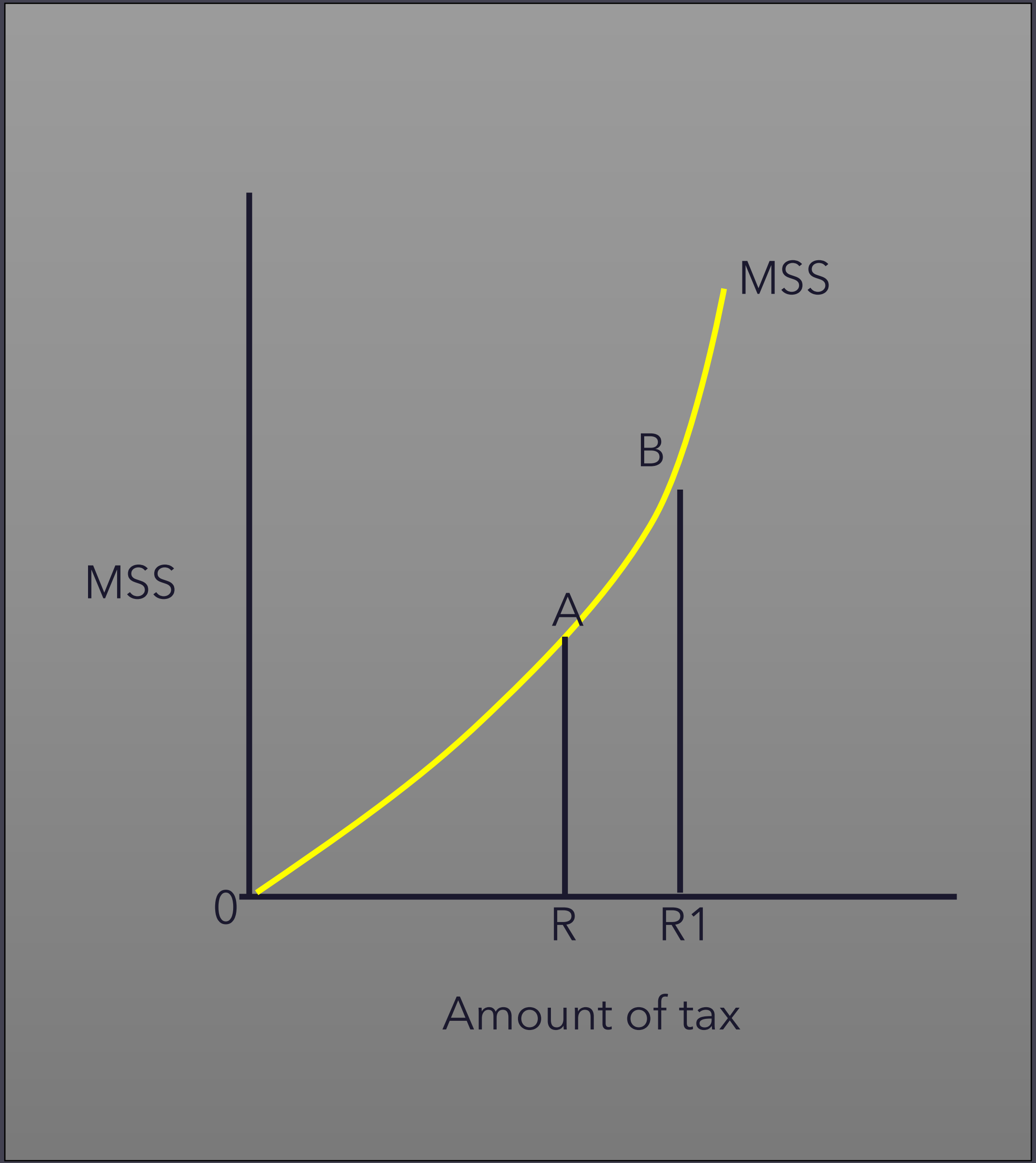
While imposition of tax puts burden on the people (sacrifice, disutility,कष्ट, त्याग)

Marginal Social Sacrifice (MSS) refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax.

Marginal Social Sacrifice सीमांत सामाजिक त्याग)

Every unit of tax imposed by the government taxes result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing

जब कर लगाया जाता है तो लोगों को कर देने के लिए मुद्रा का त्याग करना पड़ता है समाज पे बोझ पड़ता है marginal social sacrifice goes on increasing.



Principle Of Maximum Social Advantage (अधिकतम सामाजिक लाभ का सिद्धान्त

Conditions for max. social advantage

(अधिकतम सामाजिक लाभ की शर्तें)

1. सार्वजनिक व्यय पर खर्च किए रुपये से सामाजिक लाभ उस त्याग के बराबर होना चाहिए जो कर के रूप में अंतिम रुपये को त्यागने से होता है

Marginal social benefit =marginal social sacrifice

MSB=MSS

2. सार्वजनिक व्यय की प्रत्येक इकाई का सीमांत सामाजिक लाभ बराबर होनी चाहिए MSB1=MSB2=MSB3………

3. करभार का वितरण ऐसा होना चाहिए

करदाता का कर देने का सीमांत सामाजिक त्याग बराबर होना चाहिए

मुद्रा की सीमांत उपयोगिता सभी करदाताओं के लिए बराबर होना चाहिए

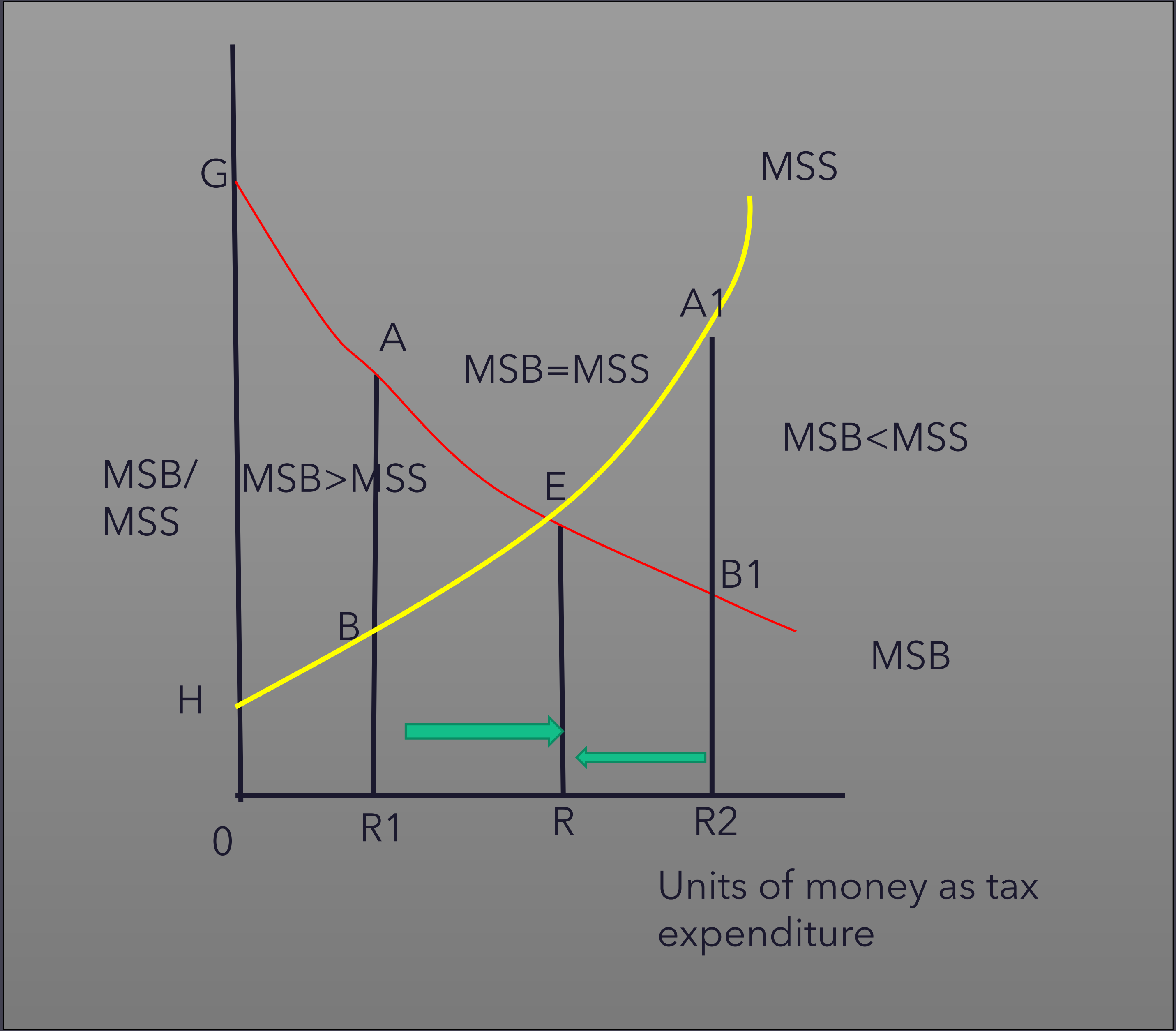
MSS1=MSS2=MSS3……

Principle Of Maximum Social Advantage
(अधिकतम सामाजिक लाभ का सिद्धान्त)

According to Dalton, लोक वित प्रत्येक दिशा में उस सीमा तक बढ़ाना चाहिए जब तक की व्यय से उत्पन्न होने वाला संतोष राज्य द्वारा लगाए गए करों से होने वाले असंतोष के बराबर ना हो (The optimum financial activities of a state is where it is carried out up to the level where social benefit (satisfaction from expenditure)=social sacrifice(satisfaction lost through taxes)

Principle of maximum social advantage is the most fundamental principle of public finance

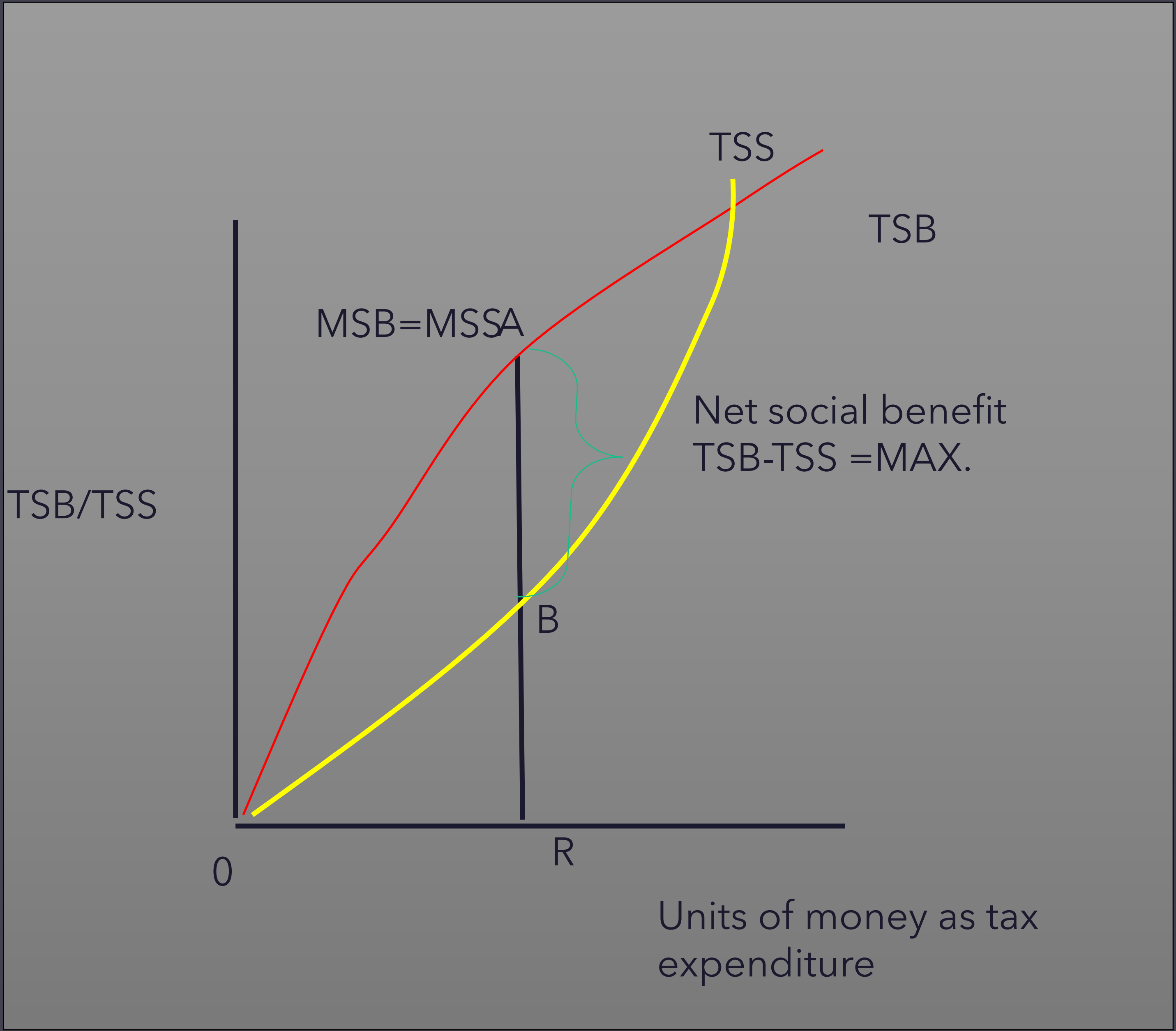
Max. Social advantage
अधिकतम सामाजिक लाभ
MSB=MSS



In terms of TSB &TSS.
Max. Social advantage
अधिकतम सामाजिक लाभ

TSB-TSS=MAX.

Slope of TSB=slope of TSS



Musgrave's version of Maximum Social Advantage.

Richard Musgrave who termed it as Maximum Welfare Principle of Budget Determination

(बजट निर्धारण का अधिकतम कल्याण का सिद्धान्त).

According to Musgrave, The optimum size of the budget is where satisfaction obtained from the last unit of money spent is equal to the sacrifice from the last unit of money taken in terms of taxes.

$$MSB=MSS$$

Marinal Net Social Benefit (शुध सामाजिक लाभ) =0

$$MNSB=MSB-MSS=0$$

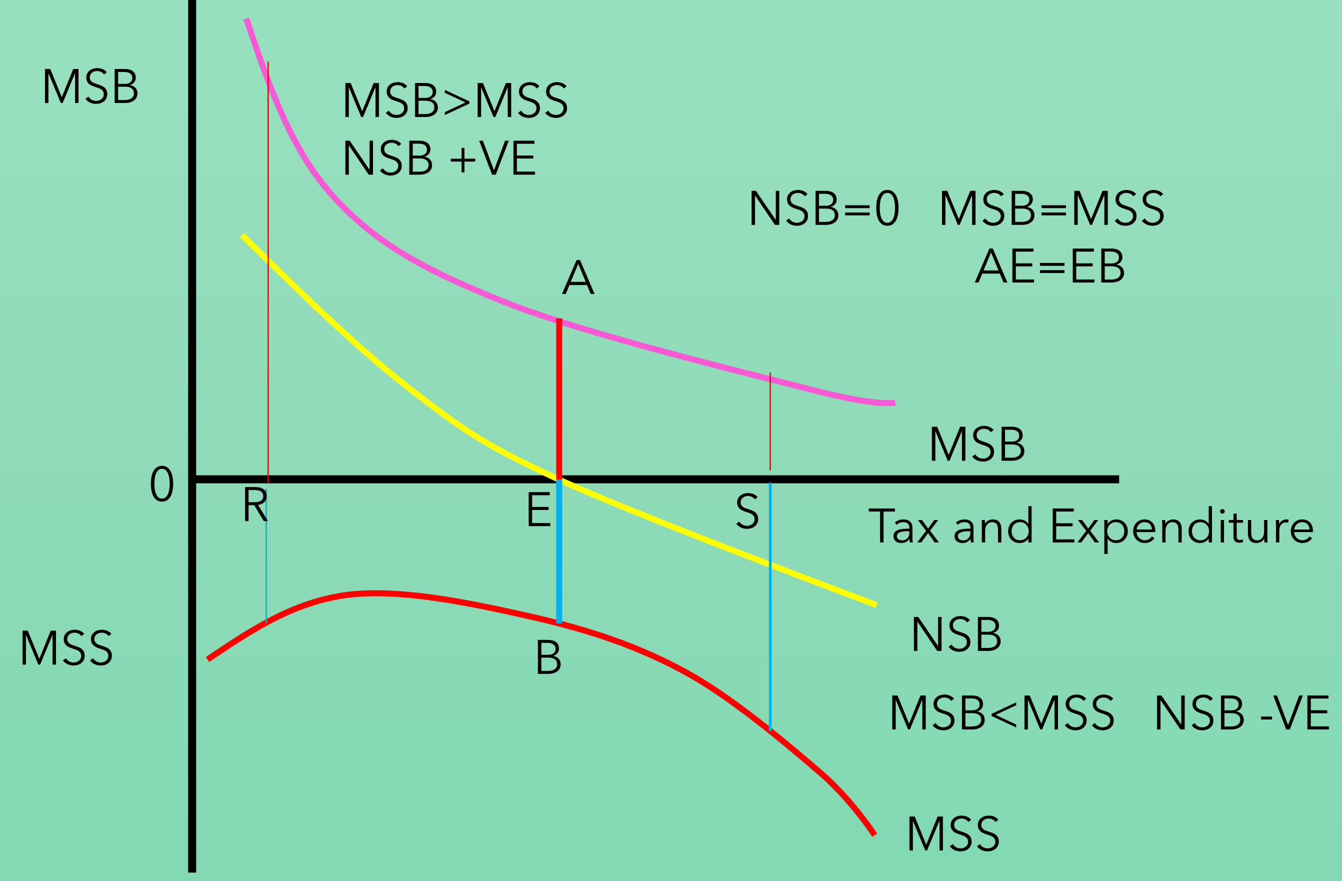
Total social Benefit =Max

On the positive part of Y-axis MSB is measured and on the negative part, MSS is measured As additional units of taxation are raised from the people, MSS increases.

Accordingly, the curve MSS slopes downwards from left to right showing rising MSS..

The optimum size of the budget is determined at OE, where NSB is zero. At this size of the budget, the marginal social benefit AE is equal the marginal social sacrifice EB (MSB = MSS)

Net Social Benefit (NSB)= MSB-MSS



Gains and losses of budget operations

Distribution of resources :

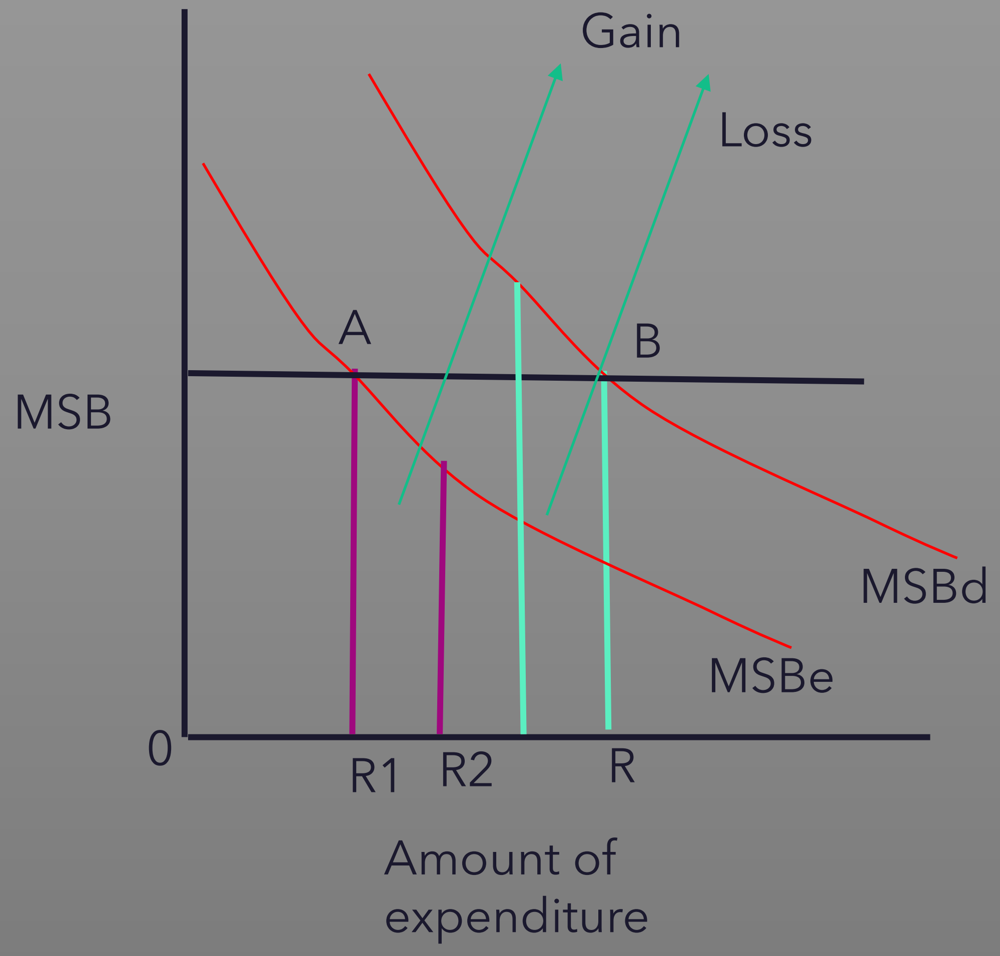
Achieving maximum social advantage govt also follows the principle of equi-marginal utility. Public expenditure has to be incurred on numerous items.

सार्वजनिक व्यय की प्रत्येक व्यय से का सीमांत सामाजिक लाभ बराबर होनी चाहिए

Suppose govt has to distribute recourses b/w education and defense

MSB education =MSB defense

Public spending is done, such that benefits derived from the last unit of money spent on each item becomes equal.



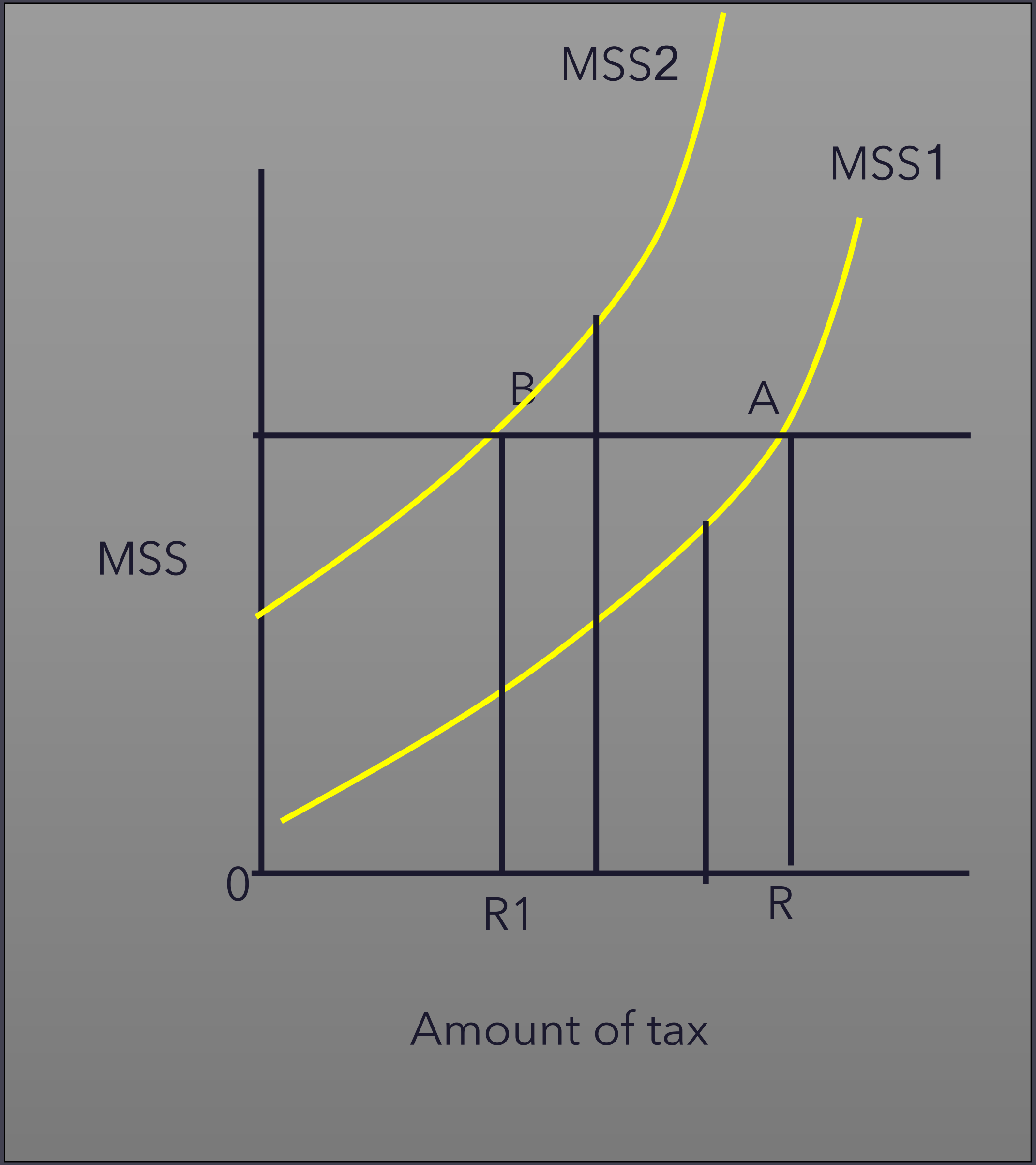
Distribution of Tax Burden:

Minimum Social Sacrifice: The tax burden should be such distributed in the community so that the sacrifice is the minimum
 (or the advantage is maximum).

करभार का वितरण ऐसा होना चाहिए प्रत्येक करदाता का सीमांत सामाजिक त्याग बराबर होना चाहिए

मुद्रा की सीमांत उपयोगिता सभी करदाताओं के लिए बराबर होना चाहिए

MSS1=MSS2=……



Market Failure /failure of market Mechanism☹बाजार की असफलता)

Market failure (बाजार असफलता):

Market failure is the economic situation defined by an inefficient distribution of goods and services in the free market:

Put another way, each individual makes the correct decision for him/herself, but those prove to be the wrong decisions for the group :

In a typical free market, the prices of goods and services are determined by the forces of supply and demand,

Market failure occurs when quantity of goods or services supplied is ≠ socially optimum out put

(efficient allocation /distribution) MSB=MSC

Market failure When Production

either more than socially optimal Actual output > socially optimal output

Or less than socially optimal Actual output <socially optimal output

Causes of market failures

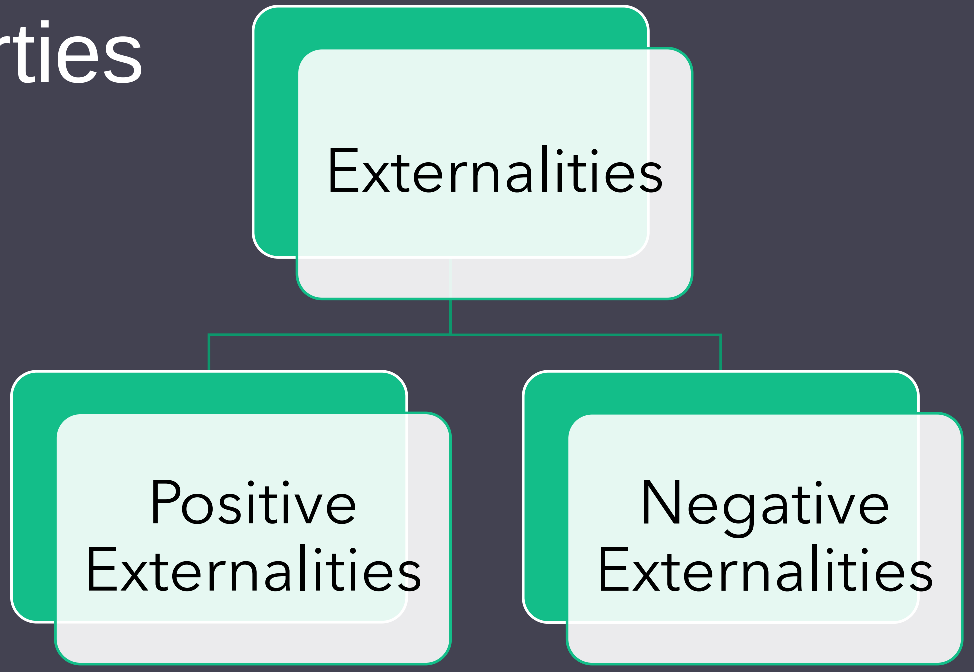
Market failure may occur in the market for several reasons, including:

1. Externality(बाहरी प्रभाव)

An externality refers to a cost or benefit resulting from a transaction that affects a third party. The benefits or negative associated with the production or consumption of goods that spillover (passed onto) to third parties

third party effect

It can be positive or negative.



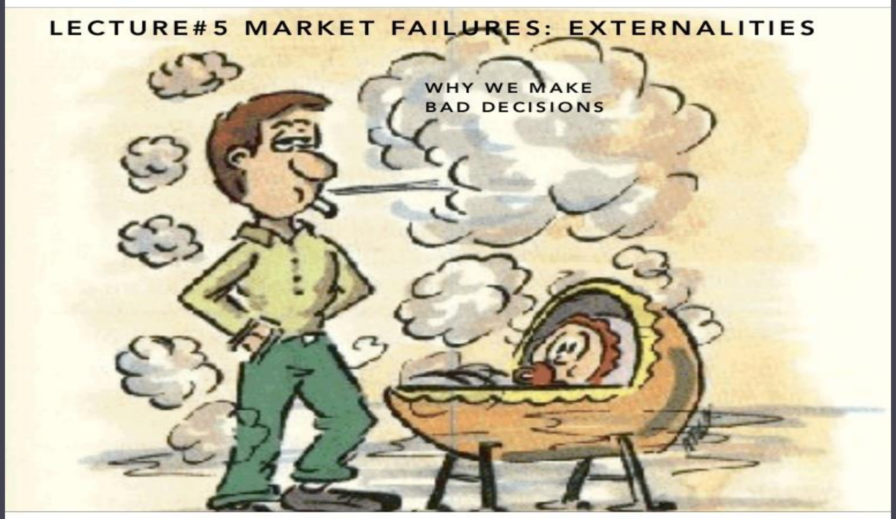
A positive externality

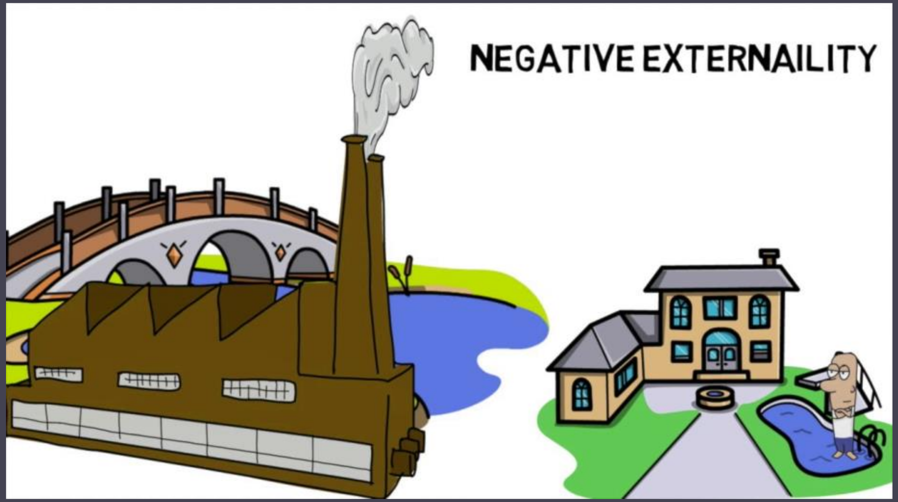
provides a positive effect on the third party.
 For example, providing good public education mainly benefits the students, but the benefits of this public good will spill over to the whole society.

Beekeeper; who through buying the bees, tending to the bees and harvesting the bees honey receives financial return but not only this.
 The beekeeper helps farmers and other flower growers(pollination)

Negative externalities

is a negative effect resulting from the consumption and production of a product, and that results in a negative impact on a third party.
For example, even though cigarette smoking is primarily harmful to a smoker, it also causes a negative health impact on people around the smoker





Public Goods have positive externalities

The characteristics of **pure public goods** are the opposite of private goods: **social good** or **collective good**

1. **Non-excludability:** The benefits derived from pure public goods cannot be confined solely to those who have paid for it. Indeed non-payers can enjoy the benefits of consumption at no financial cost – economists call this the **'free-rider'** problem. in other words the marginal cost of supplying a public good to an extra person is zero

$$MC=0$$

1. **Non-rival consumption:** Consumption by one consumer does not restrict consumption by other consumers –. If it is supplied to one person, it is available to all. means that when one person uses the public good, another can also use it.

A good is rival (in consumption) if the same unit of the good cannot be consumed by more than one person at the same tim

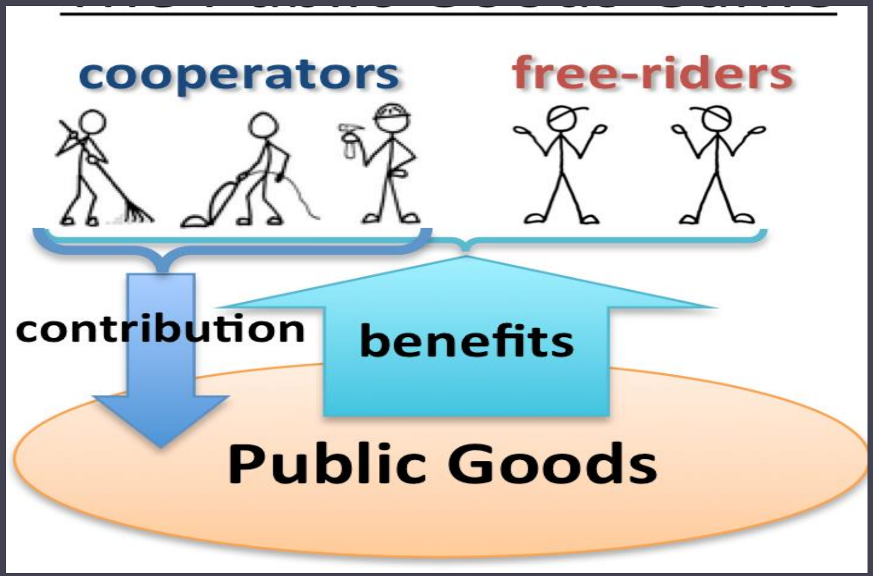
	Excludable	Non-Excludable
Rivalrous	**Private Goods** Food, clothes, cars and other consumer goods	**Common Goods** Fish, timber, coal
Non-Rivalrous	**Club Goods** Cinemas, private parks, satellite TV	**Public Goods** air, national defence

Rival and excludable goods: private consumption goods... we know that ! Rival and non-excludable goods: common resources, e.g. red tuna in the sea Non-rival and excludable goods: pay-TV, computer software, patented knowledge - ideas Non-rival and non-excludable goods: pure public goods, e.g. national defense, scientific knowledge - ideas, public TV

1.Non-rejectable: The collective supply of a public good for all means that it cannot be rejected by people, a good example is a Defense system

There are relatively few examples of ***pure*** public goods.

- Examples include **flood control systems,** some of the **broadcasting services** , **public water supplies, street lighting** for roads and motorways, **lighthouse protection** for ships and also **national defense services**.



Public goods

Public goods are goods that are consumed by a large number of the population, and their cost does not increase with the increase in the number of consumers. Public goods are both non-rivalrous as well as non-excludable. Non-rivalrous consumption means that the goods are allocated efficiently to the whole population if provided at zero cost, while non-excludable consumption means that the public goods cannot exclude non-payers from its consumption. Public goods create market failures if a section of the population that consumes the goods fails to pay but continues using the good as actual payers. For example, police service is a public good that every citizen is entitled to enjoy, regardless of whether or not they pay taxes to the government.

Merit goods :

The concept of merit goods in economics was introduced by an American economist Richard A. Musgrave.

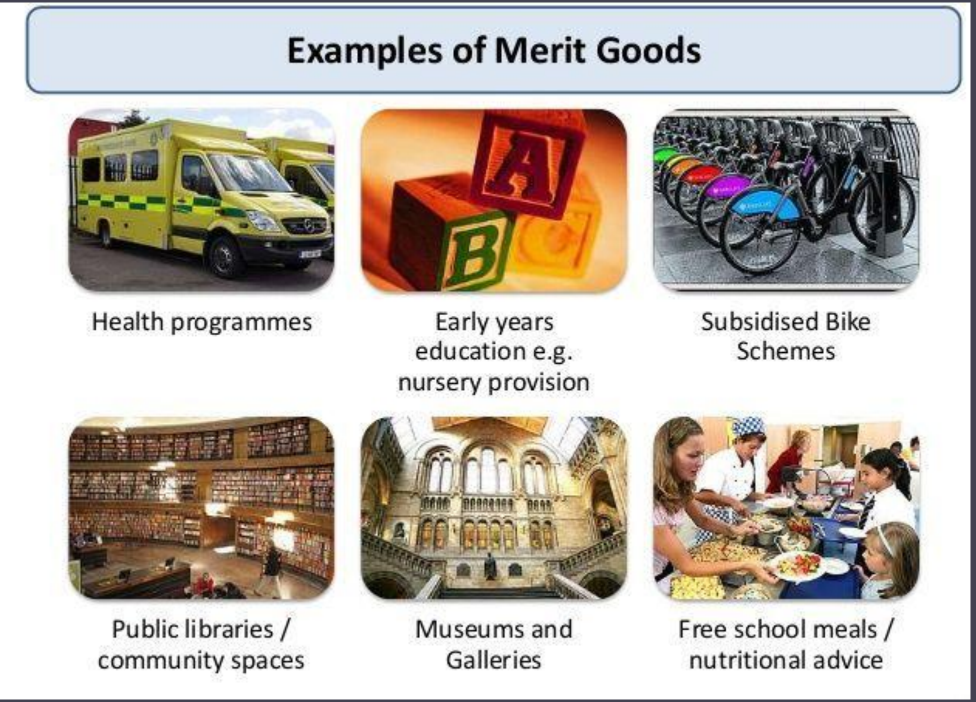
Goods which create external benefits (positive externalities), or spillover benefits, on a third party due to their production and/or consumption.

although these may not be fully recognized – hence the **good** is under-consumed.

Example: education and healthcare.

Merit goods are promoted by the government. The government wants to increase the consumption of these goods to increase the welfare of the society. Govt. gives subsidy to promote consumption or sometimes provides free of cost to the poor.

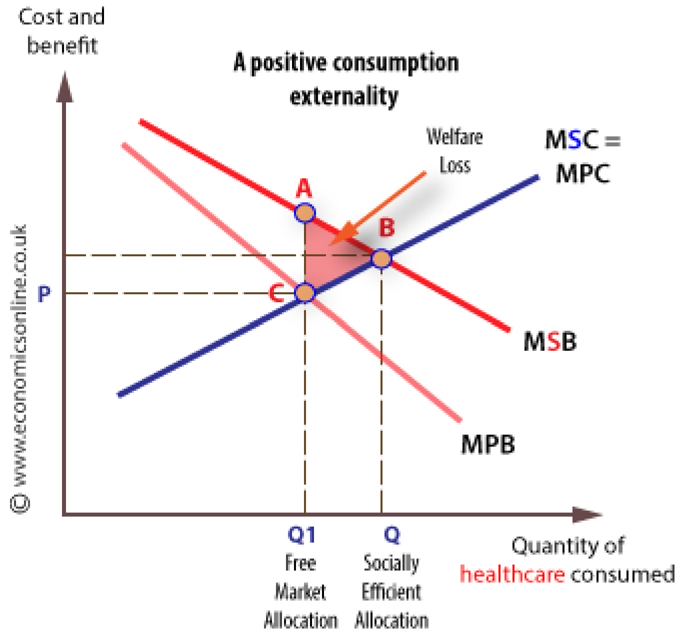
Merit goods are those goods and services that the government feels that people will **under-consume**, and which ought to be **subsidised** or provided **free at the point of use** so that consumption does not depend primarily on the ability to pay for the good or service.



Goods or services whose consumption is believed to confer benefits on society as a whole greater than those reflected in consumers' own preferences for them. A good may be classed as a merit good if it causes positive externalities. Education is typically cited as an example. In the absence of government intervention individual choice will lead to under-consumption of a good causing a positive externality.

A merit good is a good which when consumed provides external benefits, although these may not be fully recognised – hence the good is under-consumed. Examples include education and healthcare.

although they are private goods, generate strong positive externalities when they are consumed



Merit goods are goods which are **socially desirable**, and which are likely to be **under-produced and under-consumed** through the market mechanism.

Examples of merit goods include education, health care, welfare services, housing, fire protection, refuse collection and public parks.

merit goods could be, and indeed are, provided through the market, but **not necessarily in sufficient quantities to maximise social welfare.**

Why might merit goods be underprovided by the market?

Merit goods will tend to be underprovided by the market because:

- they generate positive externalities;
- there is an unequal distribution of income;
- consumers may lack perfect information;

Consumers may lack perfect information

At one level, market provision of health care and education may not provide a socially optimum outcome because consumers may not be aware of all the benefits of such goods, and may behave in a foolish manner

There is an unequal distribution of income

Perhaps a more basic reason for the market tending to under-provide merit goods is that, given the highly unequal distribution of income, and the widespread poverty such as exists in most economies today, many people would be unable to afford adequate education, health care and housing in the absence of state provision or subsidy. A market system only takes effective demand into account; that is, demand backed by the ability to pay the asking price. It does not respond to human demand as indicated by peoples' needs, so quite simply the poor may have to go without. Thus, on the grounds of **equity**, it may be decided that such merit goods as health and education should be provided free on the basis of need rather than according to ability to pay. Underpinning this approach would be the view that all have a fundamental human right to the various merit goods, which should not be determined by the market criteria of prices and profits.

if all people receive adequate levels of healthcare, the nation's workforce is likely to be fitter and healthier, less working days would be lost through sickness, and this would have beneficial effects on the level of output and economic growth; vaccinations and preventative health care which prevent the spread of contagious diseases such as small-pox and whooping cough, clearly not only benefit the individuals receiving the treatment, but also the rest of society at large.

A merit good or service is something that adds to the welfare and well-being of society when it is produced and consumed. Take a pharma company producing a vaccine to inoculate children against Hepatitis B. That will clearly mean better health for citizens and a more productive workforce.

Merit goods , are not provided to the entire society; rather they are given to **particular class of society, certain targeted people**

whereas pure public goods /social goods are arranged for all sections of the society.

The government here believe that the deserving people may *under-consume* such goods and hence provides these to them at low cost or no cost.

3. Merit Goods Directly Benefit Their Receivers And Create Social Benefits As Well.

Construction Of Schools Builds A Literate Society Which Creates A Better Country.

Public Library,. Hospitals and school

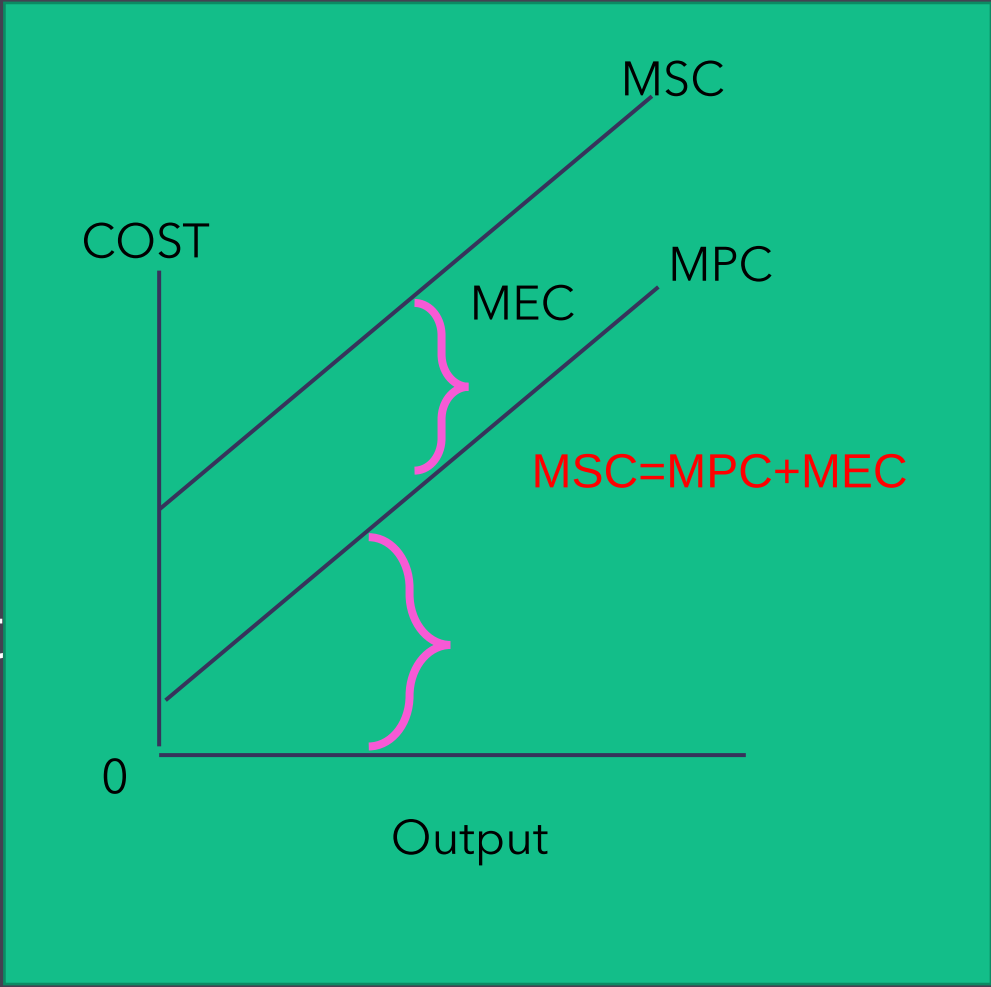
- Because public goods are non-excludable it is difficult to charge people for benefitting form a good or service once it is provided
- The free rider problem leads to under-provision of a good and thus causes market failure

Why are public goods an example of market failure?

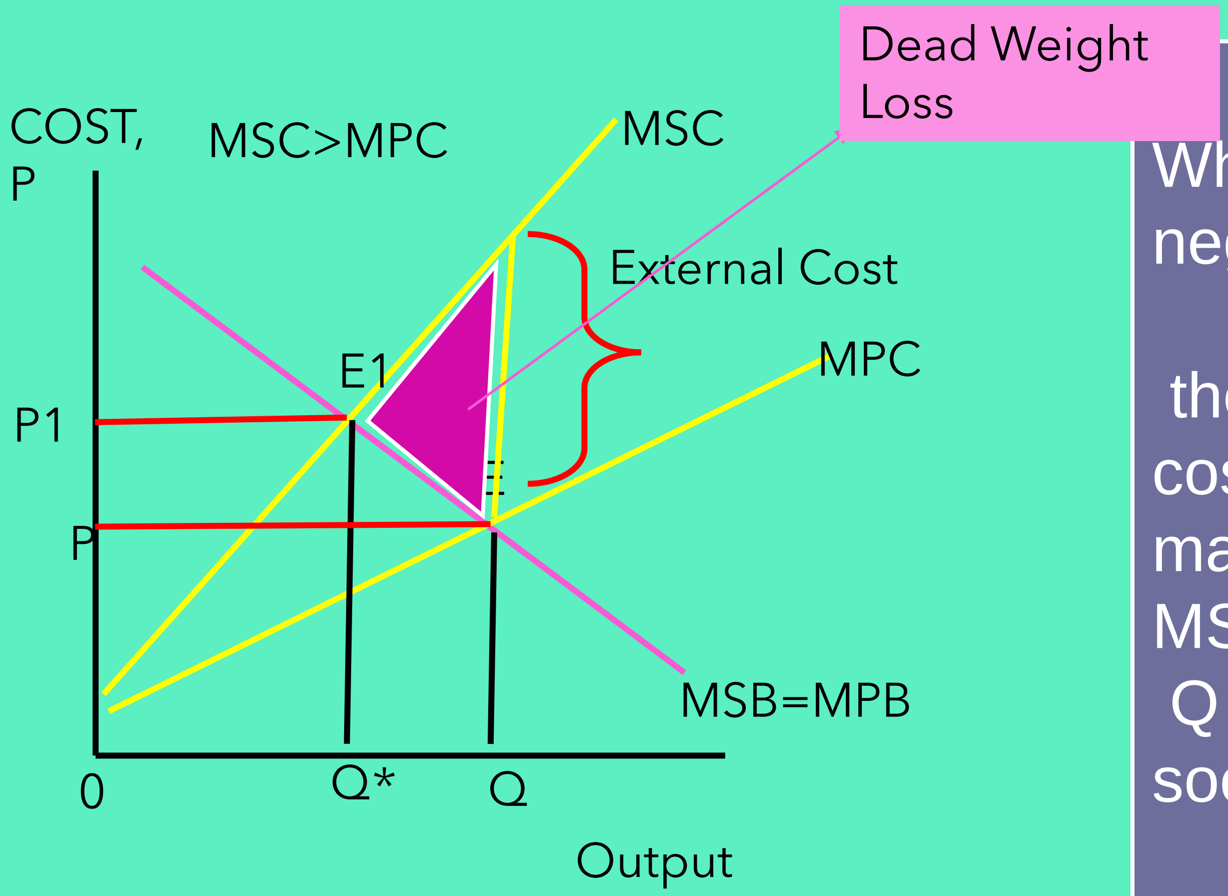
- Pure public goods are **not normally provided by the private sector** because they would be unable to supply them for a profit.
- It is up to the government to decide what output of public goods is appropriate for society.
- To do this, it must **estimate the social benefits** from making public goods available.

A Negative Externalities and market failure

When there are negative externalities,
 the marginal social cost differs from the marginal private cost
 MSC>MPC
Marginal private cost =cost of producing goods(cost of inputs)
Marginal external cost =cost (negative effect)on third party .It includes all the marginal costs that society bears
MSC=MPC+MEC
MSB=MPB+MEB
MSB=MPB+0



Negative Externalities



When there are negative externalities,

the marginal social cost differs from the marginal private cost MSC>MPC

Q is too large to max social welfare

Positive Externalities and market failure

When there are positive externalities,
the marginal social benefit differs from the marginal private benefit

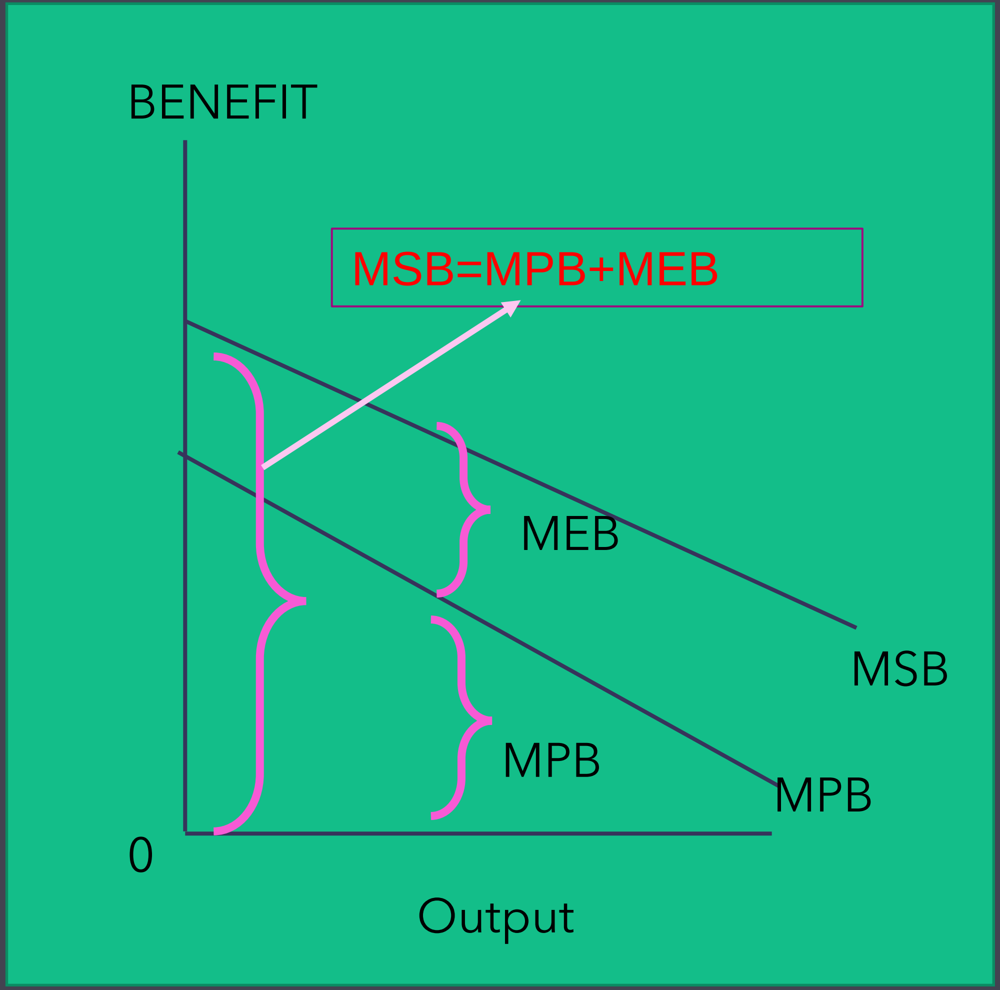
MSB>MPB

MSB=MPB+MEB

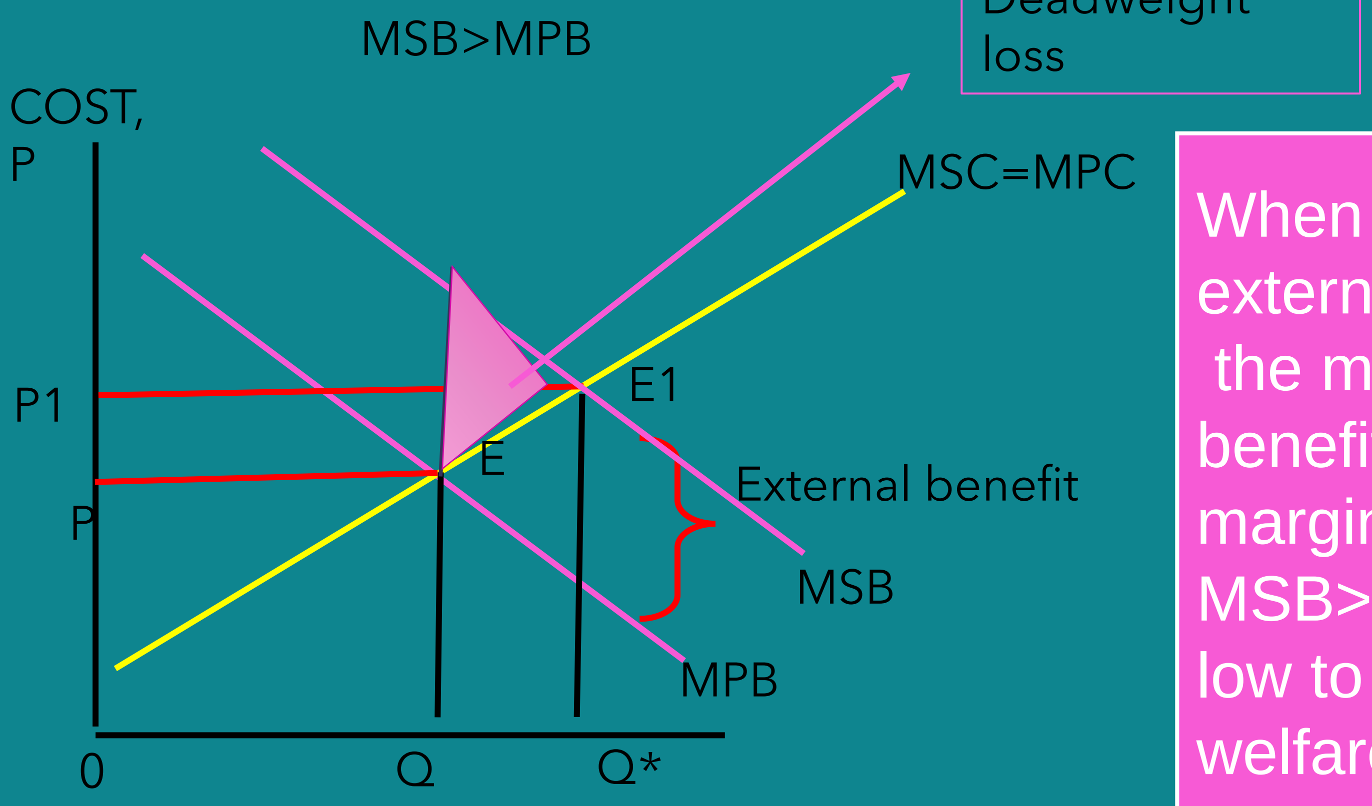
Marginal private Benefit =benefit derived from producing/consumption of goods

Marginal external benefit =benefit to third party .It includes all the marginal benefits that society receives

The marginal social benefit includes the marginal private benefit plus the benefit of positive externalities associated with that production •



Positive Externalities



When there are Positive externalities,
the marginal social benefit differs from the marginal private
MSB>MPB Q is too low to max. social welfare