

CHAPTER ONE

Basics OF PUBLIC FINANCE

Learning Objectives

After thoroughly reading this unit, you should be able to:

- Analyze the subject matter of public finance
- Appreciate the similarities and difference between public finance and private finance
- Develop acquaintance with the nature of the economic activities of the state
- Discover why public finance is needed
- Comprehend about the concept of private and public goods
- Understand the concept of fiscal policy

1.1 definition of public finance

Public finance deals with how governments raise money, how that money is spent, and the effects of these activities on the economy and on society. Public finance studies how governments at all levels – national, state and local – provide the public with desired services and how they secure the financial resources to pay for these services. Musgrave and Musgrave (1989) consider that public finance is the complex of problems that center on the revenue – expenditure process of the government. Thus, it concerned with, though not solely, the financial aspects of the business of government. It deals not only the way in which the public treasury operates, it also deals with the repercussions of the different policies with the treasury might adopt and accordingly deals with question of choice of these policies and operations. Due to such nature of the study, Dalton specifies that public finance is one of those subjects, which lie on the borderline between *Economics and Politics*.

Public finance is the study of income and the expenditure of the government. Hence, it can be defined as the science that deals with the nature and principles of the income and expenditure of the government. The term ‘*public*’ means the government that is central, state and local authorities. Rising of necessary funds for incurring expenditure constitutes the subject matter of public finance. It also deals with the problems of adjustments of income and expenditure of the government. It is also known

as fiscal operations of the treasury. Thus, fiscal operations and fiscal policies are integral parts of public finance.

The need to study public finance arises as governments provide public goods including government financed items and services such as roads, military forces, lighthouses, and streetlights. Private citizens would not voluntarily pay for these services, and therefore businesses have no incentive to produce them. It also enables governments to correct or offset undesirable side effects of a market economy. These side effects are called spillovers or externalities. For example, households and industries may generate pollution and release it into the environment without considering the adverse effect pollution has on others. If it costs less to pollute than not to, people and businesses have a financial incentive to continue polluting. Pollution is a spillover because it affects people who are not responsible for it. To correct a spillover, governments can encourage or restrict certain activities. For example, governments can sponsor recycling programs to encourage less pollution, pass laws that restrict pollution, or impose charges or taxes on activities that cause pollution.

Public finance provides government programs that moderate the incomes of the wealthy and the poor. These programs include social security, welfare, and other social programs. For example, some elderly people or people with disabilities require financial assistance because they cannot work. Governments redistribute income by collecting taxes from their wealthier citizens to provide resources for their needy ones. The taxes fund programs that help support people with low incomes.

Ethiopia has also adopted the policy of welfare state for bringing about social and economic justice. Public finance policy of the country is drawn up in tune with the constitutional commitment of welfare state. Under the welfare state, government performs important functions and takes up certain public or collective welfare measures which private sector cannot provide.

1.2. The Scope of Public Finance

Public finance deals with the income and expenditure pattern of the government. Hence, the substances concerned with these activities become its subject matter. The subject matter of the public finance is classified under five broad categories: *public revenue, public expenditure, public debt, financial administration/economic stabilization and Fiscal federalism*. We shall now explain them briefly.]

A. Public Revenue

Governments undertake various activities and they must have funds, or revenue, to pay for these activities. Public revenue is, therefore, represents the means for public expenditure. Accordingly, most governments generate

revenue from taxes, such as income taxes, capital taxes, and sales and excise taxes. This category involves sources of the public revenue, principles of taxation, effects of taxes on the economy, methods of raising revenue and the like are dealt with. Various sources of public revenue are categorized in to *tax revenue* and *non-tax revenue*.

£ Tax Revenue

Taxes are compulsory payments to government without expectation of direct return or benefit to tax payers. It imposes a personal obligation on the taxpayer. Taxes received from the taxpayers, may not be incurred for their benefit alone. Tax revenue is one of the most important sources of revenue. Taxation is the powerful instrument in the hands of the government for transferring purchasing power from individuals to government. The objectives of taxation are to reduce inequalities of income and wealth; to provide incentives for capital formation in the private sector, and to restrain consumption to keep in check domestic inflationary pressures etc.

The various types of taxes can be grouped under three heads. First type can be titled taxes on income and expenditure which include income tax, corporate tax etc. The second is taxes on property and capital transactions and includes estate duty, tax on wealth, gift tax etc. The third head, called taxes on commodities and services, covers excise duties, customs duties, sales tax, service tax etc. These three types can be reclassified into direct and indirect taxes. The first two types belong to the category of direct taxes and the third type comes under indirect taxes.

£ Non-Tax Revenue

This includes the revenue from government or public undertakings, revenue from social services like education and hospitals, and revenue from loans or debt service. To sum up, non-tax revenue consists of interest receipts, dividends and profits, and fiscal services and others.

B. Public Spending/expenditure

This category deals with the principles of public expenditure and its effect on the economy. The term '*public expenditure*' is used to designate the expenditure of government bodies. It differs from private expenditure in that governments need not pay for themselves or yield a pecuniary profit. You can observe that each year national, state and local governments create a budget to determine how much money they will spend during the upcoming year. The budget determines which public goods to produce, which spillovers to correct and how much assistance to provide to financially disadvantaged people. The chief administrators of the government propose the budget and the legislature finally pass the budget. Government of a country uses its expenditure and revenue programs to produce desirable effects on national income, production, and employment.

As Keynes emphasized, public expenditure plays an essential role in the determination and distribution of national income. In so, public expenditure plays the dual role of administration and economic achievement of a nation. Wise spending is essential for stability of government and proper earnings are a prerequisite for wise spending. Hence, planned expenditure and accurate foresight of earnings are the important aspects of sound government finance.

Government spending may take two forms: *exhaustive spending* and *transfer spending*. Exhaustive spending refers to purchases made by a government for the production of public goods. For example, to construct a new harbor the government buys and uses resources from the economy, such as labor and raw materials. In transfer spending the government transfers income to people to help them support themselves.

Transfers can be one of two kinds: cash or in-kind. Cash transfers are cash payments, such as social security checks and welfare payments. In-kind transfers involve no cash payments but instead transfer goods or services to recipients. Examples of in-kind transfers include food stamp coupons and Medicare. Recipients of food stamp coupons exchange the coupons for groceries.

Public expenditure can also be done under two broad heads of *developmental expenditure* and *non-developmental expenditure*. The former includes social and community services, economic services, and grants-in-aid. The latter mainly consists of interest payments, administrative services and defense expenses. Expenditure can also be classified into revenue and capital expenditure.

C. Public Debt

This category deals with the causes, methods and problems of public borrowings and its management. This includes both internal debt and external debt.

£ Internal Debt

Increasing need of government for funds cannot be fully met by taxation alone in under developed and developing countries due to limited scope of taxation. Government therefore has to resort to alternate sources. Rising of debt is one such source. Debt, though involves withdrawal of resources by curtailing private consumption, has certain advantages. Transfer of funds from public to government is voluntary. Loans do not reduce the wealth of the lenders. Debt raised for productive purpose will not be a burden on the economy.

There are many objectives of creation of public debt. Debt may be raised to meet the normal current expenditure, exigencies like war, finance productive government enterprise, finance public social welfare and economic development. Capital receipts mainly consist of market

borrowings, small savings and external loans, disinvestments of public sector undertakings and recoveries of loans.

£ External Debt

In under developed and developing countries, internal sources are limited. Under developed and developing countries, therefore go for external debt. The transfer of capital at international level may take the form of financial aid through grants and loans, commodity aid and technical assistance. External debt is an immediate source of funds for development. However, such debt has drawbacks including political subordination and other obligation and excess supply of goods and services in debtor country. However, such external inflows help to achieve faster growth.

D. Financial Administration

This category includes the preparation of financial budget, the control and administrations of the budget and relevant problems including auditing, administration of financial distributions and accounting and reporting of governments expenditures and fund flows. In other words, all public financial management activities involve issues of financial including public budget, its passing, implementation, auditing and other similar matters.

E. Fiscal federalism and Economic Stabilization

This category of public finance studies about the intergovernmental fiscal relations, sharing of expenditures responsibilities among different levels and constituents of the government, the sharing of revenue raising power and subsidies or grants among different levels of federal governments. Moreover it studies the use of financial policies of the government from the viewpoint of economic development. Accordingly, it analyses the use of public finance to bring the economic stability, growth and distributive justice in the country. These aspects of the economic policy of the government have assumed such a great significance that they are often given a separate treatment in the discussion of public finance theories.

1.2.3 Features of Public and Private Finances

There are both similarities and differences between public finance and private finance. Let us discuss the similarities first.

A. Similarities between Public Finance and Private Finance

Among the diverse set of commonalities observed of public and private finances, one aspect is both private and public finances aim at obtaining maximum satisfaction. As such, individuals are concerned with the personal wants, while the government is concerned with the social wants. Thus, both the private and public finance have the same objective, vis-à-vis satisfaction of human wants. On the other hand, both individuals and governments face the problem of economic choice. That is their sources of revenue are limited, comparing with their expenditure. Hence, they have to satisfy the unlimited ends with limited means.

Closely related to this aspect, borrowing is a common feature of both private and public finances. When the current income becomes insufficient to meet the current expenditure, the individuals and governments rely upon borrowings and accordingly they have loan repayment plans. Individuals and governments also have incomes and expenditures, which they must try to balance each other.

B. Dissimilarities between Public Finance and Private Finance

Even though the private and public finances look alike, there are certain fundamental differences between them.

Adjustment of income and expenditure: In private finance, the individual first considers his income and then decides about his expenditure. Nevertheless, the case of public finance, the government first estimates the volume of expenditure and then tries to find out the methods of raising the necessary income. That is the private finance tries to adjust its income to expenditure, whereas the public finance tries to meet the expenditure by raising income.

Nature of benefit: The private finance aims at individual benefit that is the benefit of individual household. However, the public finance aims at collective benefit, i.e. the benefit of the nation as a whole.

Postponement of expenditure: In private finance, the individual can postpone or even avoid certain expenditure, as s/he likes. However, in the case of public finance, the Government cannot avoid certain commitments like social welfare measures and thus cannot postpone certain expenses like relief measures, defense, etc.

Allocation of resources: In private finance, the individual can allocate or distribute his income in various ways to obtain maximum satisfaction. Nevertheless, it is not possible in the case of public finance; government cannot aim at maximum satisfaction on the expenditures made.

Motive of expenditure: In the case of private finance, the individual expects return in benefit from the expenditure made. However, the government cannot expect return in benefit from various expenditures made. That is profit or benefit is the motive of private finance whereas the social welfare and economic development is the motive of public finance.

Influence on expenditure: The expenditure pattern of private finance is influenced by various factors such as customs, habits culture religion, business conditions etc. Nevertheless, the pattern of expenditure of public finance is influenced and controlled by the economic policy of the government.

Nature of perspective: In private finance, the individual strives for immediate and quick return. Since his life span is definite and limited, he gives importance to the present or current needs and allots only a little portion of income for the future. However, the government is a permanent organization and is the caretaker of the present and the future as well.

Thus, the government allots a considerable amount of its income for the promotion of future interests. That is private finance has a short-term perspective whereas the public finance has a long term perspective.

Nature of budget: In private finance, individuals prefer surplus budget as virtue and a deficit budget is undesirable to them. However, the government does not prefer a surplus budget. If the government brings surplus budget, it will create negative opinion on the government. This is because surplus budget is the result of high level of taxation or low level of public expenditure both of which may affect the government adversely.

Nature of resources: In private finance, the individuals have limited resources. They cannot raise the income, as they like. They do not have the power to issue paper currencies while in the case of public finance the government has enormous kinds of resources. Besides the administrative and commercial revenues, the government can get grants-in-aid and borrow from other countries. The government can print currency notes to increase its revenue.

Coercion: Under private finance, the individuals and business units cannot use force to get their income. Nevertheless, in public finance the governments can use force in the form of imposing taxes to get income i.e. taxes are compulsory in nature. It is an obligation on the part of the taxpayer. No one can refuse to pay taxes if he is liable to pay them. Besides the above, the government can undertake any of the existing private business by way of nationalization, which is not possible in the hands of individuals.

Publicity: Individuals do not like to disclose their financial transactions to others. They want to keep them secret. Nevertheless, the government gives the greatest publicity to its budget proposals and the allocation of resources to different heads. It is widely discussed. Publicity strengthens the confidence of the people in the government.

Audit: In the case of private finance, auditing of the financial transactions of the individuals is not always necessary. On the other hand, the accounts of the public authorities are subject to audit and inspection.

Government is a political organization comprising the individuals and institutions authorized to formulate public policies and conduct affairs of state. Governments are empowered to establish and regulate the interrelationships of the people within their territorial confines, the relations of the people with the community as a whole, and the dealings of the community with other political entities. The emergence of governments is attributed to two principal causes. One comprises a number of underlying economic causes, including a great expansion in trade and the development of manufacturing. These conditions began to undermine the system that was based on isolated and self-sufficient economic units, and to make necessary

the creation of large political units. The other cause was the political reformation. The modern nation-state became a definite form of government in the 16th century. The history of government in the 19th century and in part of the 20th is notable for the broadening of the political base of government through extension of suffrage and other reforms.

A tendency that became especially marked in the 20th century was the development and implementation of the concept that government, in addition to maintaining order and administering justice, must be an instrument for administering public and social services including, among many others, conservation of natural resources, scientific research, education and social security. As it is quite clear, meeting these and other responsibilities and obligations of the state requires availability of important resources at the disposal of the government of which financial resource is the determinant one. Therefore, this concern caused the emergence of the study of public finance. Public finance mainly deals with how governments raise money, how that money is spent and the effects of these activities on the economy and on society. Public finance studies how governments at all levels – national, state and local – provide the public with desired services and how they secure the financial resources to pay for these services.

In connection with the above issues, in this unit you will discuss about the nature and scope of public finance. Emphasis is given for discussion of main economic roles of the state and the need for public finance.

1.3. Economic Activities and the State: The Role of Governments

Classification of goods as private goods and public goods:

justification for the role of government and private sector in the economy

The subject about the role of a government is the area of debate among the scholars. The role that a government play in the economy depends , among many things, on the underlying country circumstances, the political spheres, the government's philosophy with regard to its own size, the level of development and the nature of goods and services that may be demanded by the society, etc...

Why government? What role a government can play?, etc.... To understand the government role, it is worth noting to briefly discuss about the nature and classifications of goods and services produced in an economy, we should consider two basic criteria of categorizations.

Criterion I: The Nature of Consumption

This criterion attempts to categorize goods based on whether there is rivalry in consumption of a particular good. Accordingly, some goods and services are individually consumable. In such instances, consumption is said to be rival because there is competition between those who are willing and able to consume the same type of good or service. In other words, there is rivalry between consumers themselves.

In contrast, many goods cannot be consumed alone. There are also many goods and services, though, that may be consumed individually, whose utility increases when they are consumed jointly. For instance, you cannot consume telephone service alone. Neither will you enjoy peace delivered to you alone and denied to the rest; nor would you like to live in a city where you are the only healthy person. In such cases, consumption is said to be non-rival. In these and other similar cases, the nature of consumption tends to be non-rival.

Criterion II: The Feasibility of Product Divisibility or Exclusion criteria

There are certain goods the availability of which to users is decided in a discriminatory manner where only those who pay the stipulated market price of good may be allowed the use of it. That is such a good may be priced and the principle of exclusion can be applied to its users. Exclusion, in essence, refers to the ability of the suppliers to exclude those who want to consume a commodity or service but do not want and/or are not able to pay the market price. For some commodities and services, exclusion is quite easy while for some types of goods or services it is quite difficult. Even there are cases where exclusion is very impossible. Peace is very expensive but once produced everybody is free to consume and enjoy it. It is impossible to prevent one from consuming peace because s/he is not willing or able to pay the price.

Likewise, radio transmission, for example, is an expensive business, but once produced and it is in the air customers cannot be effectively charged for consuming the transmission. In some cases, exclusion could be possible, yet the very high cost of exclusion may justify its free supply. A typical example of this is road. There can be private roads doing business by charging the users, at least in principle. However, the high cost may justify 'free riding' whereby drivers attempt to avoid the charge to the service. Subsequently, such occurrences may make voluntary (i.e. non-coercive, automatic) transaction impracticable that in turn results in undersupply of such products in a free competitive market economy.

Considering the above criteria now we continue with identification of the types of goods and services. Hence, the consumption of a particular good could be rival or non-rival and product divisibility could be easily enforced

for one product and could be difficult for other. In such a manner, there are four types of goods as indicated in Table 1.1 below.

Table 1.1 Types of Goods and Services

	Criteria	Exclusion	
		<i>Easy to Feasible</i>	<i>Difficult to Impossible</i>
Consumption	• <i>Individual (Rival)</i>	• Private Goods	• Common – Pool Goods
	• <i>Joint (Non-Rival)</i>	• Collective (Club) Goods	• Public Goods

A. Private Goods

As you can observe from Table 1.1 above, private goods are goods that can be consumed individually and for whom exclusion is easy. Due to this, there is competition (rivalry) among buyers in consumption of such goods. The same holds true among the sellers since each seller can effectively exclude free riders – those who want to consume the product but need to avoid the respective pay. The impersonal competitive market is believed to be both effective and efficient in production and distribution of such goods and services. Grocery commodities, bazaar items like clothes, shoes, pencils, etc. are examples of private goods.

Further, marginal analysis works very well here. Putting it differently, the total production cost of a given private good will increase as one more unit is produced and consumed. Therefore, the marginal cost of producing and consuming one extra unit is commonly greater than zero.

B. Common Pool Goods

Common pool goods are goods and services that can be consumed individually but excluding those who are not willing and/or able to pay is difficult. In such cases, there is rivalry (competition) between consumers. However, it is difficult (or even it may be impossible) to exclude those who are not willing and/or able to pay the necessary price. An example of this type may be fishing in an open sea. You can individually consume the fishes you caught. The more the other fishers fish the less successful you will be.

Thus, there is rivalry between you and the other fishers and between the other fisher themselves. However, there is no *market* mechanism that will prohibit you or the other fisher from fishing. Thus, you will over fish and they will over fish and eventually all of you will be worse off. A common pasture (grazing land) is another example. This phenomenon is sometimes known as the *tragedy of commons*. The tragedy arises from *collective ownership of resources and/or ill-defined ownership*.

C. Collective Goods

These are goods and services that can be consumed jointly only but exclusion is easy. Because of the joint nature of consumption, there is no rivalry between consumers (although there might be weak temporary competition on queue). A good example is telephone service. You cannot consume telephone service alone. It is in your interest if other people have telephone. Furthermore, it should be in your interest that other people have telephones no matter whether you have one or not since you can reach the other person using somebody else's (or public) telephone. If fact, there might be a kind of competition between consumers on queue – this is a temporary competition on the *waiting line*. The nature of this “competition” is totally different from the type we get in private goods. On the other hand excluding those who are not willing and/or able to pay is quite easy for collective goods. If you do not pay, telecom can easily cut you off. Watching a game in stadium is also a collective good. The other name for collective goods is club goods because they require *subscription*. If there is any competition between consumers, it is in order of subscription *not* in consumption.

D. Public Goods

These are goods and services that can be consumed jointly only and also excluding those who are not willing and/or able to pay is either very difficult or very impossible. Thus once a public good is produced, everybody is free to consume it. There is no market mechanism that will force people pay for their consumption of public goods. A good example is radio program – once produced it is in the air. Anyone with a radio receiver can ‘*trap*’ the program without any payment for the producer. Peace, public health, justice, defense are some of the other examples. Most public goods are not divisible and therefore we do not know how much of the total public good produced is consumed by a single person. It is unlikely that you can calculate the percentage of the total peace produced by the nation consumed by you alone.

Figure 1.1 Goods and Services Produced in an Economy

		Exclusion	
		Easy to feasible	Difficult to Impossible
Consumption	Individual (Rival)		
	Joint (Non-rival)		

Seriously speaking, there is no clear-cut distinction between the private, common-pool, collective and public goods. Many of the goods and services produced in economy might possess all of the characteristics we discussed above. All goods and services produced in an economy are scattered about a matrix like in the figure depicted above. Thus, it is hard to conceive a market that can properly function without intervention.

Externalities in Consumption of Goods

Production and/or consumption and/or transaction of some goods and services may affect the well-being of those who have not involved (also known as third party) in the production and/or consumption and/or transaction. Such effects are known as *externalities* which are also known as *neighborhood effects* or *spillover effects*. The production/consumption of some goods may have a favorable effect on third party. Conversely, the production/consumption of some goods may result in unfavorable effects to those who are not involved in it. Accordingly, one shall discriminate between two types of externalities: positive and negative externalities.

£ Positive Externality

To conceptualize positive externality, let us assume that you have a garden in which you grow vegetables and flowers. You are toiling on your garden for your purpose but your neighbors are enjoying your garden even one of them has started an apiculture (beekeeping) business. Her bees are feeding on the nectars of your flowers and she is even selling honey and wax. Quite obviously, your neighbor is obtaining some advantages from the activity you are engaged in. Do you think that you have any right to claim payment for your nectars? What if she refuses to pay? Can you prevent the bees from flying into your garden and collect the nectars?

Your neighbors might be *morally* obliged to compensate part of your costs in your garden or they should help you. However, without coercive measure market alone cannot force them to do so. In economic terms, your garden has produced a positive externality to your neighbors. They get the pleasure without paying the price for the utility they consume.

£ Negative Externality

Unlike the positive externality, negative externality is associated with negatively affecting the welfare of the third party. Assume that you have industrialist neighbor who manufactures furniture and other metal works. Because of the high demand for the products, commonly she has arranged a night shift working until the midnight. You have no problem with both the person and the business except that the extreme noise nuisance created by the machines all day long and even in the night that makes you restless. Can you demand compensation? What if he asks compensation from you to move his factory away from your home? There is no easy solution! In this example, the factory produces negative externality to its neighbors. Undoubtedly, such externality will cause an economic loss to other economic units.

THE ROLE OF GOVERNMENT

Important questions relating to the role of government may include; should the government provide a police force? Parks? Highways? Dams? If so, how much of a police force? How many roads? How many dams? What the government does do and what the government should do? It is just as clear that the two are not necessarily the same.

The voluntary exchanges that occur in the market economy comprise the private sector of the economy. The public sector of the economy consists of government activity and has a different economic character. Typically, government activity is financed by mandatory taxes. After citizens pay their taxes, they can choose to consume some public sector output, such as highways and parks, often without additional charges. Citizens receive some output, such as national defense, whether they like it or not. Furthermore, they are obligated to live under the government's rules or face the penalties imposed by the police and court systems.

The principle underlying the private sector of the economy is voluntary exchange. People engage in market transactions because they want to, and the basis of all transactions is voluntary agreement between buyer and seller. In the public sector of the economy, the government forces people to obey its rules and pay for its output. People may be supportive of their government and agree with what the government is doing, but no matter how much they agree, ultimately the government forces those who are not in agreement. Coercion and force underlie government activity, whereas voluntary agreement underlies market activity. If the market economy works so well, as the previous section has argued, why is any government necessary?

Although some people would argue that we would be better off with no government at all, most people think that there is a role for government and that many government activities make them and their fellow citizens better off. This provides a good starting place for analysis because people want the

government to undertake activities that are in the public interest. Because presumably we all benefit from public parks, police protection, and national defense, we all share in paying for these services through our tax dollars. But this raises a whole new set of questions. How do we know that we all benefit from the government's programs? Should someone who never uses a park be forced to pay for it? If these things really benefit us, why do we have to be forced to pay for them? These questions will be addressed throughout this material as we analyze the activities of government within the context of the economic system within which the government exists.

A few paragraphs earlier, the activities of government were justified by saying that the government can act in the public interest. Considering the efficiency of a market economy, one still might wonder why a government must act in the public interest when the invisible hand of the market guides us so well. There are three possible reasons. First, the market system might not function at all without certain government activities to protect the rights of those engaged in production and exchange. Second, the government might be able to undertake some economic activities better than the market and, for efficiency reasons, should be used in those cases. Third, market allocation might treat some individuals in a manner generally viewed as inequitable, so programs to benefit the least fortunate members of the society might be desired on equity grounds. In summary the role of the government can be summarized as follows:

i) *To provide pure public goods which the market cannot*

Such as defense and security services, court systems, maintaining rules and orders, political administrations, creating enabling condition for the market to operate efficiently.

ii) *To correct/subsidize the effect of externalities created by market operations*

Such as compensation for damage created by pollution/air purification, developing/financing city drainage system, provide waste management system, etc...

iii) *To provide collective goods which have natural monopoly where the general public would be better off if provided by single supplies due to economy of scale*

Such as production of goods/services whose utility can be enjoyed with no additional cost or with least cost or no incremental cost once produced. For example, pure water production and distribution, power production and distribution, telecommunications services, etc....

iv) *To fill the gap that may be created by the market due to insufficient demand*

Such as public education, public health services , public transportation services, etc....

v) *To provide infrastructures and participate in development activities where the market cannot do so because of non-marketability of*

positive externalities created by such goods or due to lack of sufficient capital.

1.1.5 framework OF Musgrave'S three functionS of the State

In an attempt to justify the need for government in general and its economic role in particular, Richard Musgrave (1959) has developed a three-function framework. Musgrave suggests that, for conceptual purposes, the functions of government should be separated into three functions or branches, *macroeconomic stabilization*, *income redistribution*, and *resource allocation*.

A. Macroeconomic Stabilization

The stabilization function – the maintenance of high employment and price stability – is ordinarily assigned to the central government. This is true for several reasons. First, sub-national governments commonly cannot much affect macroeconomic conditions within their boundaries, and thus have little reason to try, because most of the effects of macroeconomic policy attempted by sub-national government will "leak" out of the area. The second problem with sub-national macroeconomic policy is the limited power to borrow and the lack of the power to print money. Even if sub-national governments had the ability and incentive to attempt stabilization, they would have difficulty in engaging in the deficit financing that is often required to implement expansionary policy, unless their borrowing is supported by the central government. Where central governments do support sub-national borrowing, the result is commonly irresponsible behavior that threatens the macroeconomic stability of the nation.

B. Redistribution of Income

The distribution function is also commonly assigned primarily to the central level of government. Again, this is true for several reasons. First, sub-national attempts at redistribution may not be successful, and they are likely to distort the geographic allocation of economic resources. Progressive taxation intended to "soak the rich" may drive out capital and high-income individuals. If this occurs, taxation that appears progressive may actually be regressive. For example, the long-run incidence of property taxes levied on mobile capital by one sub-national jurisdiction may be on immobile factors, land and labor, rather than on the owners of property.

C. Resource Allocation

The third function of governments is efficient allocation of resources. With respect to resource allocation function, Musgrave argues that policies of sub-national branches of governments should be permitted to differ in order to reflect the preferences of their residents. Decentralization of taxing and spending power allows sub-national governments to tailor schemes that match the demand of their constituency that will increase efficiency ultimately because local governments have better information about their residents' needs than the central government.

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