MEC-006 /2017-18

PUBLIC ECONOMICS

Section-A

1. Critically evaluate the Kaldor-Hicks Ccriteria and their complementarity for the avoidance of Scitovsky Paradox.

Kaldor, Hicks and Scitovsky have given their tests for judging an increasing in welfare. Like Pareto, they isolate the problem of production from that of distribution. They deal with policy change with ambiguous welfare effects saying that if the people benefiting from it can gainfully compensate the losers, then the policy change is desirable otherwise not. This extension is popularly called the compensation principle.

1. It is assumed that individual tastes do not change and there are no external effects.

2. It is assumed that inter-personal comparisons of welfare are inadmissible.

3. It is assumed that individuals are the best judges of their own welfare.

4. It is implied that although social welfare depends on the level of distribution and the level of production, it is possible to study only the changes in the level of production.

The compensation principle that underlies all the welfare criteria was proposed by Kaldor. His formulation is: Let there be a policy measure which takes the society from state A to state B, then state B of the society is preferable to state A, if the gainers from the policy measures can compensate the losers and still be in a better position.

Prof. Hicks proposed a test which is the reverse of Kaldor test. He pointed out that in any policy proposal there are two parties, one gainers and the other loses. In the event of a decision of the proposal the losers may try all the means to forestall this, to keep this eventually out and this criterion Hicks proposed the reverse test: state B of society is socially preferable to A if the losers from the policy change from A to B can't profitably bribe the gainers into not making the change from A to B.

Scitovsky's Paradox:

Scitovsky has pointed out that the Kaldor – Hicks compensation test has a contradiction. He pointed out that it is possible according to Kaldor-Hicks criteria that state B is better than state A, but once the society moves to the state B, the same criteria may reveal that the return move from B to A is also desirable on welfare grounds. This contradiction has been called the 'Scitovsky Paradox'. Scitovsky pointed out that to get at the correct criterion of welfare we must remove this contradiction. He has therefore offered his own criterion called the "Scitovsky Double criterion".

Scitovsky wanted an economic change to satisfy double test-the fulfillment of Kaldor-Hicks test plus the non-fulfillment of the reversal test. This means, that a movement from state A to state B must be desirable in terms of the Kaldor-Hicks criteria but a return from B to A should not be an improvement on these criteria.

The essence of Kaldor, Hicks and Scitovsky criteria can be expressed thus: The Kaldor-Hicks criteria are met if in an economic change, "gainers can over-compensate the losers, "The reversal test is satisfied" if losers are able to bribe the gainers to stay in the old position". The Schtovsky double test is satisfied "By the fulfillment of the Kaldor-Hicks test plus the non-fulfillment of the reversal test".

2. Does privatization decentralize economic power? Discuss.

Decentralization is the process of distributing or dispersing functions, powers, people or things away from a central location or authority. While centralization, especially in the governmental sphere, is widely studied and practiced, there is no common definition or understanding of decentralization. The meaning of decentralization may vary in part because of the different ways it is applied. Concepts of decentralization have been applied to group dynamics and management science in private businesses and organizations, political science, law and public administration, economics and technology. I think privatization does decentralize economic activities forcing authorities to share power among the stakeholders. As has been the case in Nepal, say in banking or educational or healthcare sector after privatization, we see the entry of private players have made economic activities be accessible to almost every citizen or at least to the larger sector. Decentralization in its truest sense does mean the same thing, that is, to make public to be able to reach out to the mainstream business.

What privatization does is let the general public to act on their own Conscience to what they want to do with the newly found tool, with which comes the input of those voices which were never heard before and their ideas put into the business spreads the outcomes/services to larger part of the society, in contrary to which, authorities having limited resources and poor management would not be able to do. And collective Conscience is extremely powerful. World's biggest economies are based on privatization and general public have larger role to play than the government. Privatization is often described as the transfer of state assets and/or control (partial or full) to the private sector. The implication for development is derived from the belief that private ownership or control brings greater economic efficiency, more innovation, improved responsiveness to consumer demands, and wider choice for individuals (i.e. shares, goods). The argument of maximizing profits also implies increased savings and greater investment, which in their turn produce rapid growth and higher incomes, both symbols of development. This approach can be called an ‘income-centred’ approach to development.

Privatization is a fuzzy concept that evokes sharp political reactions. It covers a great range of ideas and policies, varying from the eminently reasonable to the wildly impractical. Yet however varied and at times unclear in its meaning, privatization has unambiguous political origins and objectives. It emerges from the countermovement against the growth of government in the West and represents the most serious conservative effort of our time to formulate a positive alternative. Privatization proposals do not aim merely to return services to their original location in the private sphere. Some proposals seek to create new kinds of market relations and promise results comparable or superior to conventional public programs. Hence it is a mistake to define and dismiss the movement as simply a replay of traditional opposition to state intervention and expenditure. The current wave of privatization initiatives opens a new chapter in the conflict over the public-private balance.

Section-B

3. Why is Fiscal Federalism efficient in provision of public services?

As a subfield of public economics, **fiscal federalism** is concerned with "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government" (Oates, 1999). In other words, it is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration. An important part of its subject matter is the system of transfer payments or grants by which a central government shares its revenues with lower levels of government.

Federal governments use this power to enforce national rules and standards. There are two primary types of transfers, conditional and unconditional. A conditional transfer from a federal body to a province, or other territory, involves a certain set of conditions. If the lower level of government is to receive this type of transfer, it must agree to the spending instructions of the federal government. An example of this would be the Canada Health Transfer.

An unconditional grant is usually a cash or tax point transfer, with no spending instructions. An example of this would be a federal equalization transfer.

This may be noted that the concept of fiscal federalism is relevant for all kinds of government: unitary, federal and confederal. The concept of fiscal federalism is not to be associated with fiscal decentralization in officially declared federations only; it is applicable even to non-federal states (having no formal federal constitutional arrangement) in the sense that they encompass different levels of government which have de facto decision-making authority.

This, however, does not mean that all forms of governments are 'fiscally' federal, only that 'fiscal federalism' is a set of principles that can be applied to all countries attempting 'fiscal decentralization'. In fact, fiscal federalism is a general normative framework for assignment of functions to the different levels of government and appropriate fiscal instruments for carrying out these functions

In 2017, Governor of Rivers State of Nigeria, Ezenwo Nyesom Wike said that he believes true fiscal federalism will "strengthen the economy of his country as all sections will develop based on their comparative advantages". These questions arise: (a) how are federal and non-federal countries different with respect to 'fiscal federalism' or 'fiscal decentralization', and (b) how are fiscal federalism and fiscal decentralization related (similar or different)?

Chanchal Kumar Sharma clarifies that while "fiscal federalism constitutes a set of guiding principles, a guiding concept" that helps in designing financial relations between the national and subnational levels of the government, "fiscal decentralization on the other hand is a process of applying such principles".

Federal and non-federal countries differ in the manner in which such principles are applied. Application differs because unitary and federal governments differ in their political and legislative context and thus provide different opportunities for fiscal decentralization.

4. Distinguish between External Debt and Internal Debt. What factors should a government take care of so that the economy does not fall into a debt trap.

Difference Between Internal Debt and External Debt!

The basic character of an internal debt is quite different from that of the external debt. In external debt, at the time of repayment there is a real transfer of resources.

In case of internal debt, however, since it is borrowed from individuals and institutions within the country repayment will constitute only a re-distribution of resources without causing any change in the total resources of the community.

There can, thus, be no direct money burden caused by internal debts since all payments cancel each other out in the aggregate community as a whole. Whatever is taxed from one section of the community servicing the debts is distributed among the bond-holders by way of repayment of loans and interest; and quite often, the tax-payer and the bond-holder may be the same person.

At the most, to the extent that the incomes of tax-payers (in a sense, debtors) are reduced, so will the incomes of creditors/ bond-holders increase, but the aggregate position of the community will, nevertheless, remain the same.

However, internal debt may involve a direct real burden on the community according to the nature of the series of transfer of incomes from tax payers to the public creditors. To the extent the tax-payers and the bond-holders are the same, the distribution of wealth will remain unaltered; hence there will not be any net real burden on the community.

There will, however, be a change in the distribution of income when the bond-holders and the tax-payers belong to different income-groups, so that the transfers might increase, the net real burden of the community increases. That is to say, there will be a direct real burden of internal debts, if the proportion of taxes paid by the rich is smaller than the proportion of public securities held by the rich.

This usually happens in practice. Under the existing income inequalities in the society, the bulk of government securities are held mainly by the rich and even a progressive taxation generally will be incapable of counter-balancing the incomes yielded by them from such securities. Thus, the resulting increase in inequalities imposes a net direct real burden (of an internal debt) on the community.

Moreover, the transfers of incomes involved in the service of an internal debt are, by and large, transfers from the younger to the older generations and from the active to the inactive enterprises.

The government imposes taxes on enterprises and earnings from productive efforts for the benefit of the idle, inactive, old, leisurely class of bond-holders. Hence, work and productive risk- taking efforts are penalised for the benefit of accumulated wealth, which certainly adds to the net real burden of debts.

Like external debt, internal debt also involves an additional and indirect real burden on a community, as the taxation required for the servicing of the debt tends to check production in so far as it reduces the tax-payer's ability to work and save.

Again, when heavy taxation is required to meet debt charges, the government might introduce economies in desirable social expenditure which may also adversely affect the community's power and willingness to work and save, thereby reducing the general economic welfare to an extent.

It may, however, be argued that though the taxpayer's ability to work and save will be reduced by taxation raised for servicing the debts, that of the creditors (bond-holders) will be increased through the receipt of the debt payment; hence, in balance there will not be any indirect real burden on the community. But this may not be so.

Because, where the debt involves a direct real burden, it is also probable that taxation will reduce more the personal efficiency and desire to work than the receipt of debt payments may increase the same. Thus, there will be a net loss in the ability and desire to work, while the ability to save would be least affected by the transfer of income.

Furthermore, the creditor class will not have any incentive to work hard by the prospect of receiving interest on bonds; on the contrary, it may make them more lazy and passive, reducing their desire to work further, which may, thus, cause a further loss to production and a further increase in the indirect burden of the debt.

5. Discuss how public choice is derived through different voting models.

Public choice or **public choice theory** is "the use of economic tools to deal with traditional problems of political science".Its content includes the study of political behavior. In political science, it is the subset of positive political theorythat studies self-interested agents (voters, politicians, bureaucrats) and their interactions, which can be represented in a number of ways – using (for example) standard constrained utility maximization, game theory, or decision theory. Public-choice analysis has roots in positive analysis ("what is") but is often used for normative purposes ("what ought to be") in order to identify a problem or to suggest improvements to constitutional rules (i.e., constitutional economics).

The Journal of Economic Literature's classification code regards public choice as a subarea of microeconomics, under JEL: D7: "Analysis of Collective Decision-Making" (specifically, JEL: D72: "Economic Models of Political Processes: Rent-Seeking, Elections, Legislatures, and Voting Behavior"). Public choice theory is also closely related to social-choice theory, a mathematical approach to aggregation of individual interests, welfares, or votes. Much early work had aspects of both, and both fields use the tools of economics and game theory. Since voter behavior influences the behavior of public officials, public-choice theory often uses results from social-choice theory. General treatments of public choice may also be classified under public economics.

Public choice theory is often used to explain how political decision-making results in outcomes that conflict with the preferences of the general public. For example, many advocacy group and pork barrel projects are not the desire of the overall democracy. However, it makes sense for politicians to support these projects. It may make them feel powerful and important. It can also benefit them financially by opening the door to future wealth as lobbyists. The project may be of interest to the politician's local constituency, increasing district votes or campaign contributions. The politician pays little or no cost to gain these benefits, as he is spending public money. Special-interest lobbyists are also behaving rationally. They can gain government favors worth millions or billions for relatively small investments. They face a risk of losing out to their competitors if they don't seek these favors. The taxpayer is also behaving rationally. The cost of defeating any one government give-away is very high, while the benefits to the individual taxpayer are very small. Each citizen pays only a few pennies or a few dollars for any given government favor, while the costs of ending that favor would be many times higher. Everyone involved has rational incentives to do exactly what they are doing, even though the desire of the general constituency is opposite. Costs are diffused, while benefits are concentrated. The voices of vocal minorities with much to gain are heard over those of indifferent majorities with little to individually lose. However the notion that groups with concentrated interests will dominate politics is incomplete because it is only one half of political equilibrium. Something must incite those preyed upon to resist even the best organized concentrated interests. In his article on interest groups Gary Becker identified this countervailing force as being the deadweight loss from predation. His views capped what has come to be known as the Chicago school of political economy and it has come in sharp conflict with the so-called Virginia faction of public choice due to its assertion that politics will tend towards efficiency due to nonlinear deadweight losses and due to its claim that political efficiency renders policy advice irrelevant.

While good government tends to be a pure public good for the mass of voters, there may be many advocacy groups that have strong incentives for lobbying the government to implement specific policies that would benefit them, potentially at the expense of the general public. For example, lobbying by the sugar manufacturers might result in an inefficient subsidy for the production of sugar, either direct or by protectionist measures. The costs of such inefficient policies are dispersed over all citizens, and therefore unnoticeable to each individual. On the other hand, the benefits are shared by a small special-interest group with a strong incentive to perpetuate the policy by further lobbying. Due to rational ignorance, the vast majority of voters will be unaware of the effort; in fact, although voters may be aware of special-interest lobbying efforts, this may merely select for policies which are even harder to evaluate by the general public, rather than improving their overall efficiency. Even if the public were able to evaluate policy proposals effectively, they would find it infeasible to engage in collective action in order to defend their diffuse interest. Therefore, theorists expect that numerous special interests will be able to successfully lobby for various inefficient policies. In public choice theory, such scenarios of inefficient government policies are referred to as government failure – a term akin to market failure from earlier theoretical welfare economics.

6. Explain the main reasons for the emergence of Horizontal Federal Fiscal Imbalance.

A horizontal fiscal imbalance (HFI) emerges when sub-national governments have different abilities to raise funds from their tax bases and to provide services. This creates differences in 'net fiscal benefits', which are a combination of levels of taxation and public services. It is these NFBs which are the main cause of horizontal fiscal disparities that in turn generate the need for equalization grants. Prominent among the objectives commonly attributed to intergovernmental fiscal transfers is 'equalization' of fiscal capacities or resolution of Horizontal Fiscal Imbalances.

Fiscal imbalance is a mismatch in the revenue powers and expenditure responsibilities of a government.

In the literature on fiscal federalism, two types of fiscal imbalances are measured: Vertical Fiscal Imbalance and Horizontal Fiscal Imbalance. When the fiscal imbalance is measured between the two levels of government (Center and States or Provinces) it is called Vertical Fiscal Imbalance. When the fiscal imbalance is measured between the governments at the same level it is called Horizontal Fiscal imbalance. This imbalance is also known as regional disparity.

While Horizontal Fiscal Imbalance requires equalization transfers, Vertical Fiscal Imbalance is a structural issue and thus needs to be corrected by reassignment of revenue and expenditure responsibilities between the two senior order of the governments.

Types

Chanchal Kumar Sharma (2012) steers clear of the confusion in the existing literature and redefines the concepts with great clarity. In his contribution he argues that there can be three types of VFAs:

- 1. Fiscal asymmetry with fiscal imbalance: Vertical Fiscal Imbalance (VFI). This means inappropriate allocation of revenue powers and spending responsibilities. This state can be remedied by reassignment of revenue raising powers.
- 2. Fiscal asymmetry without fiscal imbalance but with a fiscal gap: Vertical Fiscal Gap (VFG). This means a desirable revenue-expenditure asymmetry but with a fiscal gap to be closed. This state can be remedied by re-calibration of federal transfers.
- 3. Fiscal asymmetry without fiscal imbalance and without fiscal gap: Vertical Fiscal Difference (VFD). This means a desirable revenue-expenditure asymmetry without a fiscal gap (i.e. gap is closed). This is a state of fiscal asymmetry where there is "no imbalance and no gap" and thus needs no remedial measure.

Further extending the conceptual analytic framework presented by Chanchal Kumar Sharma (2012) which according to Bev Dahlby and Jonathan Rodden provides the most extensive review on the vertical fiscal gap and vertical fiscal imbalance concepts, the authors develop a "political economy model of the VFI and VFG in a federation (see Dahbly and Rodden 2013).

7. Distinguish between merit and public goods with the help of examples.

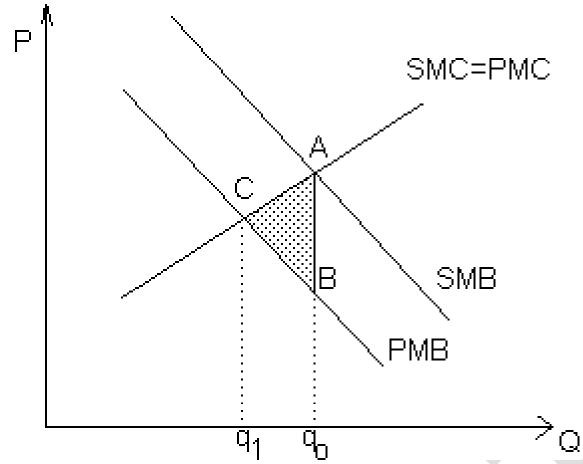
Public goods are defined as products where, for any given output, consumption by additional consumers does not reduce the quantity consumed by existing consumers. There are very few absolutely public goods, but common examples include law, parks, street-lighting, defence etc. As there is no marginal cost in producing the public goods, it is generally argued that they must be provided free of charge, because otherwise the people who benefit less than the cost of using the public good, will not use it. That will lead to a loss of welfare. Also the goods are mostly non-excludable, that means that if once provided everybody can use them, which when charged will lead to "free-riding". So these goods will not be provided by free markets as there is no way to charge for the usage, the solution is, that state must provide these goods and finance them from taxes collected from everybody.

Merit goods on the other hand are products generally not distributed by means of the price system, but based on merit or need, because people although having perfect knowledge would buy the wrong amount of them. These goods can be supplied by free market, but not on the right quantity. Merit goods are, for example, education and to some extent the health-care. They are provided by state as "good for you".

Health and education are merit goods, that can be provided by free market, but have major drawbacks when only provided privately.

Main problem is that people will not buy the sufficient amount of them even if they can afford it. People would not go into expensive insurance schemes as they think nothing will happen to them, but if something does happen, they can't afford to pay. This will lead to an uneven distribution of income as rich will be more educated and thus can potentially earn more in the future.

The merit goods when provided privately are usually affordable only to the very rich. As they carry external benefits, government thinks everybody should have them. For example if one is vaccinated it benefits the others as it decreases the risk of epidemic diseases, whereas good education (or investment to human capital) will increase the economic growth and the overall well-being(the supply-side of labour) later on. This view is best explained by social marginal benefits(SMB) and personal marginal benefits (PMB). In this case SMB are bigger than PMB, in free market loss of welfare occurs as shown in the diagram below:



Q_0= socially efficient level of usage
Q_1= free market equilibrium
ABC-loss of welfare due to underproduction

The provision of health-care (and to some extent education) is also very expensive and requires investment (fixed costs are high), so there is a big scope for economies of scale. It is argued that it is not morally permissible to let a private monopoly control such vital services, so a state provision would be the cheapest. There is also no evidence that bigger classes reduce the quality of education (but they are a lot cheaper to maintain). But there have been several hardships and inconvenience caused due to hospitals concentrating to one location, because the journey times increase. Still UK has one of the best records in efficiency measured in terms of the expenditure per person compared to other developed OECD countries. The life expectancy is the same in UK as in other OECD countries, but treatment of some diseases (e.g. breast cancer) is not improving very fast, and the life expectancy is not growing fast, too.

State can also take account of the long-term demographic trends (e.g. in education build more universities when the number of A-level candidates increases).

Uniform standards are quite important for education as it makes life easier for personnel managers to recruit people later on, as they can compare people better. State has introduced National Curriculum for that purpose.

That is why at present 10% of government expenditure goes to education and people have to pay 10% of their income to social security payments (only from their first tax band). State has set up a National Health Service to deal with health.

Still it would not be beneficial to have only state sector. State cannot provide the most up to date and very expensive service to some people, if the effects are not very big, because then everybody would have to pay for it. Same thing applies to education where the best possible service would be too expensive. That is why an independent sector of 7-8% of the total is established for people who can afford to pay.

This includes public schools and private health-insurance schemes like BUPA. They can provide best possible outcome without charging less wealthy people. Private hospitals for example can afford to have short waiting lists and can keep the patients in care for longer.

The state sector is generally less efficient than private sector as it has got no profit motives. Conservative government has solved this dilemma by introducing competition to health-care (GP can choose to which hospital they send their patients, the creation of internal markets) and to education (universities are funded based on performance, schools are encouraged to transfer from local authority control to state control or to "opt out". Then they will be funded based on the number of students, so better schools attracting more students will receive more funding). This competition is not very efficient at the moment, because the knowledge in education market is poor and the government is unlikely to allow schools to leave the market. It also carries disadvantages as GP-s refuse to accept elderly people whose treatment is more expensive than average etc.

The bureaucracy costs are generally high in state sectors. The creation of competitive internal markets involved recruitment of extra managers etc.

Education and health are very expensive, so if government needs to cut public expenditure, it is likely to affect the quality of education and health.

There are also general disadvantages for high government intervention. If the government builds schools it can crowd out the private investment in the local area etc.

The NHS started out in 1940 based on the Beveridge report as a completely free service for life, but subscription charges were soon introduced. The people might think that they were fooled. On the other hand private providers are more likely to change their policies or go to bankruptcy altogether.