Role of State in Economic Activities

Dr. Sweta Sharan

Assistant Professor

Department of Economics

Magadh Mahila College, Patna University

Introduction

- The role of state in economic activities is a complex affair
- The **Anarchists** hold the view that a day will come when people will be lifted so much morally that there would be no need of government at all.
- The **Mercantilists** believe that the state should actively participate in the social and economic spheres.
- The **Physiocrats** were of the view that the state should not impose any artificial barriers on individual's economic behavior. They believed in the law of nature.

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- **Adam smith**, the father of Political Economy, believes that the state should not interfere in the internal economic life of the citizens of a country as it hampers economic progress. He advocates the doctrine of noninterference or laissez-faire. Adam Smith, however, justifies certain cases in which state interference is necessary.

- The **communists,** on the other band, hold, the opposite view. They advocate that state should own all factors of production. The decisions of what to produce, how much to produce and for whom to produce should all be carried out by the state.

- **Capitalist** government have struck a happy mean. The states intervene directly or indirectly in all those economic and social activities where the community as a whole can benefit.

Need for Public Sector

- Public sector is needed to guide, correct and supplement market mechanism in performing economic functions
- Government regulation is required for efficient resource utilization
- It may also be needed where competition is inefficient due to decreasing cost
- Contractual arrangements and exchanges needed for market mechanism cannot exist without protection from governmentally provided legal structure

Major Fiscal Functions

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

- Allocation Functions
- Distribution Functions
- Stabilization Functions

Allocation Function

This function is based on the proposition that certain goods cannot be provided through the market system. For some goods there are cases of market failure while for some other goods market function in an inefficient way. Those goods are:

- Social goods and market failure: Generally the need for social goods is collective while for that of a private good is individual.

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- Public provision for social goods: Supply of social goods by the government is yet another a difficult point to determine. In this context the benefits received by the individuals can be taken into account. However theses benefits are valued differently by every individual
- National and local social goods: Although social goods are available equally to all individuals, their benefits may be very limited. The benefits from defence accrue nation wide while that from street light is limited only to local residents. Thus the nature of social goods effects fiscal federalism

Distribution Functions

The distribution functions play a key role in determining tax and transfer policies. Following points are under consideration:

- Determinants of Distribution: The distribution of income is based on the distribution of factor endowments. This is turn is determined by the process of factor pricing where factor returns are equal to the value of marginal product

- The distribution of income and wealth is determined by market forces and laws of inheritance. This normally creates inequality of income of wealth. Tax transfer policies of government help in reducing these inequalities and thus helps in appropriate distribution of income

Stabilization Functions

- Need for stabilization policy: Achievements of the policy of allocation and distribution without proper policy guidance leads to substantial fluctuations in inflation, unemployment or other macroeconomic variables.

- Instruments of Stabilization Policy: Basically there are two instruments of stabilization policy; monetary instruments and fiscal instruments

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Monetary Instruments: The central banking authority of an economy is responsible for controlling the money supply. The instruments like reserve requirements, discount rates and open market policy are an indispensable components of stabilization policy. Expanding the money supply increases liquidity, reduces interest rates consequently increasing the level of demand and vice-versa

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Fiscal Instruments: Fiscal policy also directly affects the level of demand. Raising public expenditure just like reduction in tax rates will have an expansionary affect as demand is increased. Changes in the level of deficit and the way it is financed is also important. If the deficits are managed by easy monetary policy, the expansionary effects of deficit financing will be greater. If tight monetary policy is used then it will pose restrictive effects on market transactions

Thank you