

# BUSINESS ECONOMICS IV

SEMESTER IV

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# MODULE I

## CHAPTER I

### MEANING AND SCOPE OF PUBLIC FINANCE

# Meaning Of Public Finance

1. Principles underlying financial activities of state or government at national, state & local levels.
2. Income and expenditure and adjustments
3. Economist Mrs. HICKS defines it as “ study of examination and appraisal of methods of provision of necessary funds by government bodies for collective satisfaction of wants.
4. It deals with problems of raising and allocation of funds.

# Scope of Public Finance

- Traditional explanation : Financing state activities
- Narrowly defined
- Financial operations of the public treasury.
- A study of administration of finances
- Excluded economic and social effects of these operations.
- But Keynes had a different approach.

# **Scope... contd.**

- Keynes emphasized that **financial and fiscal operations** can be used to remove **imbalances in the economy** by influencing the **level of income and employment**.
- Government mobilizes the funds for rapid economic development.
- Economic and social effects of fiscal policy is now considered as the part of public finance.

# Chapter 2

## **MAJOR FISCAL FUNCTIONS OF PUBLIC FINANCE**

# FISCAL FUNCTIONS

1. DEFENCE
2. MAINTAINING LAW AND ORDER
3. COLLECTION OF REVENUE
4. ADMINISTRATION



# FISCAL FUNCTIONS

1

• **ALLOCATION FUNCTION**

2

• **DISTRIBUTION FUNCTION**

3

• **STABILIZATION FUNCTION**

4

• **GROWTH FUNCTION**

# 1. ALLOCATION FUNCTION

- Allocation of resources between public goods and private goods
- Allocation is done through budgetary policy
- Market mechanism does not and cannot provide public goods
- So govt. Aims at optimum allocation of resources for public goods
- Private sector satisfies the individual wants
- Through market mechanism by supplying private goods.
- But it fails to satisfy social wants.
- Hence government needs to make provision of social goods to satisfy social wants

## 2. DISTRIBUTION FUNCTION

- PRIMARILY CONCERNED WITH DIVISION OF INCOME & WEALTH AMONG PEOPLE IN A SOCIETY.
- UNDERDEVELOPED COUNTRIES ARE SUFFERING FROM INCOME AND WEALTH INEQUALITIES.
- MAJORITY OF POPULATION IS BELOW POVERTY LINE
- HENCE GOVERNMENT TRIES TO HAVE FAIR EQUITABLE DISTRIBUTION OF INCOME AND WEALTH
- PROGRESSIVE TAXATION
- SUBSIDIES TO POOR SECTION
- TAX AND EXPENDITURES

# PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

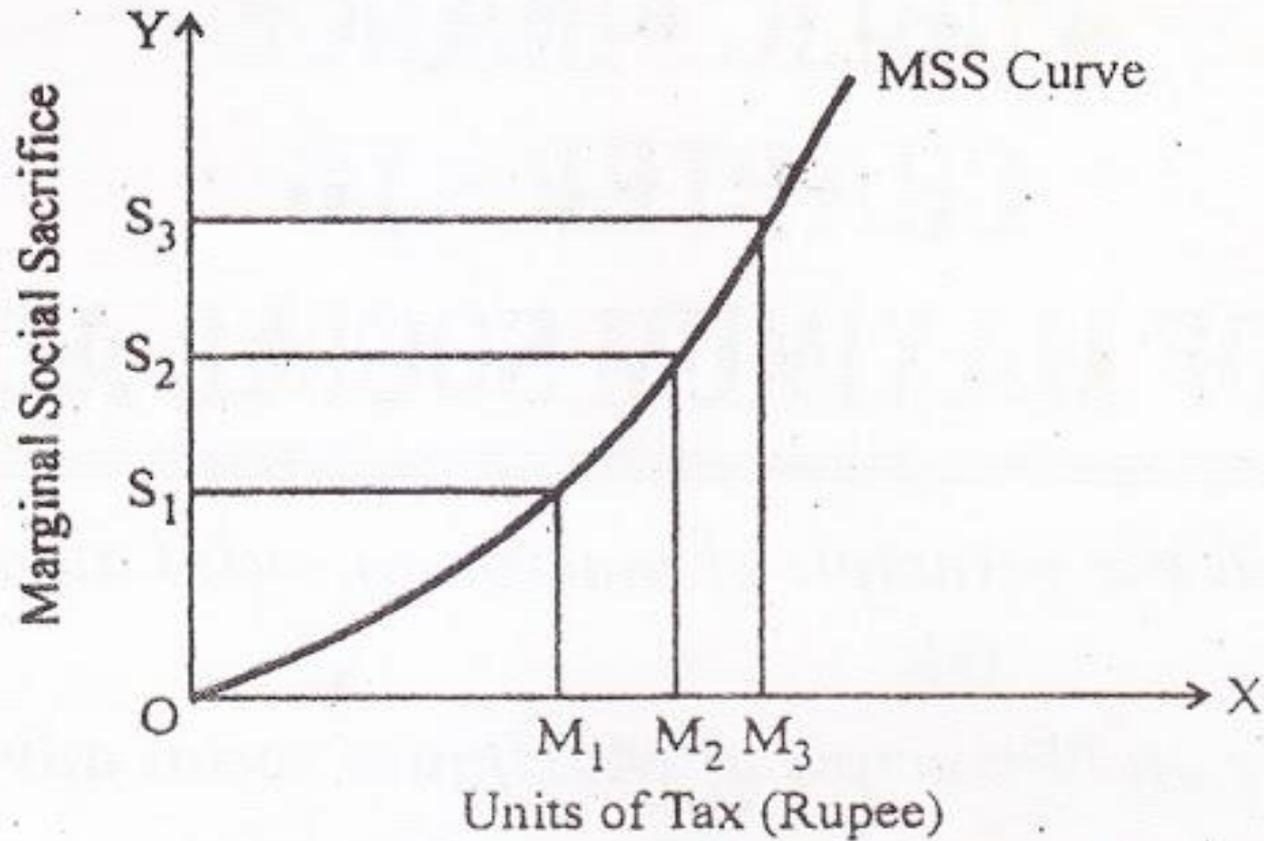
- CLASSICAL VIEW
- THEY FAILED TO APPRICIATE FULLY THE ADVANTAGES OF PUBLIC EXPENDITURE.
- THEY ADVOCATED LIMITED ACTION BY PUBLIC AUTHORITY
- MINIMUM TAXATION AS TAX IS EVIL
- GOVT SHOULD SPEND LITTLE

# DALTON'S VIEWS

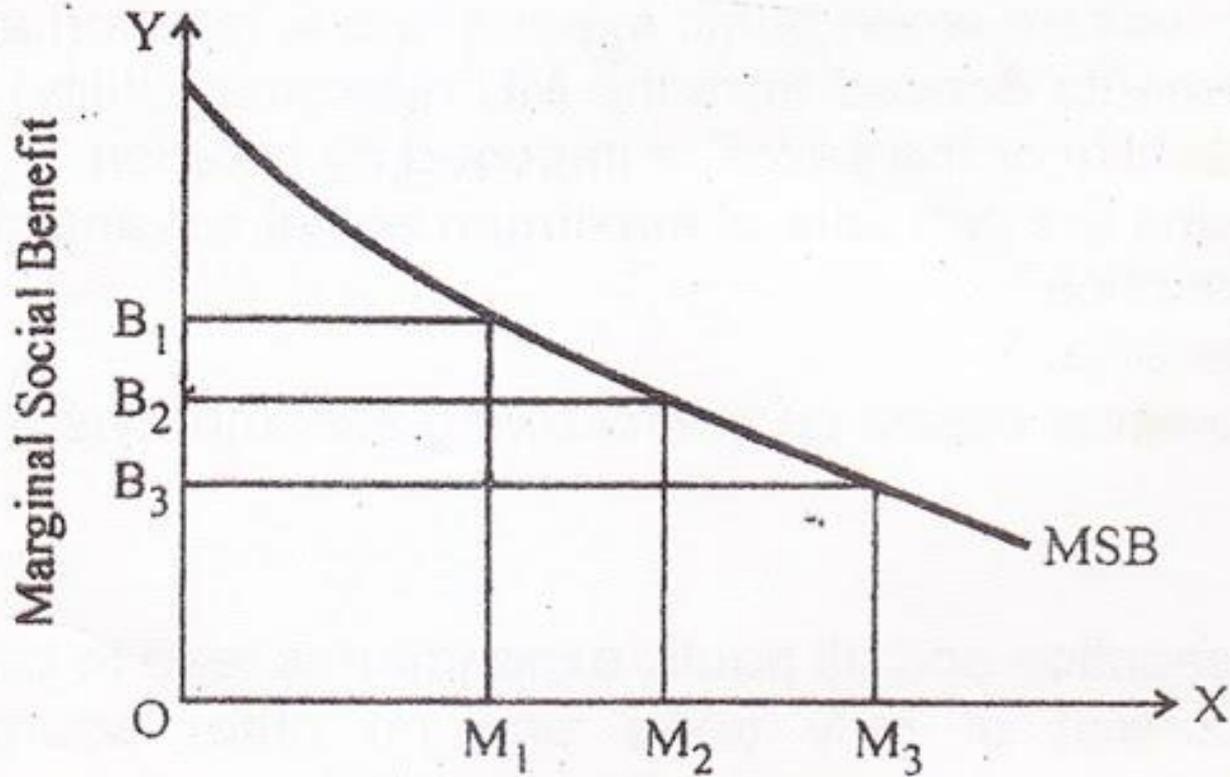
- STATEMENT: THE PRINCIPLE OF MSA STATES THAT THE PUBLIC FINNANCE LEADS TO PUBLIC WELFARE HENCE PUBLIC EXPENDITURE AND TAXATION ARE CARRIED OUT UPTO THAT POINT WHERE BENEFITS DERIVED FROM THE MU OF EXPENDITURE IS EQUAL TO THE MARGINAL DISUTILITY OR SACRIFICE IMPOSED BY TAXATION.
- CHANGES CONSUMPTION, PRODUCTION AND DISTRIBUTION PATTERNS OF INCOME AND WEALTH.
- SOCIALY ADVANTAGEOUS

# DALTON'S VIEWS

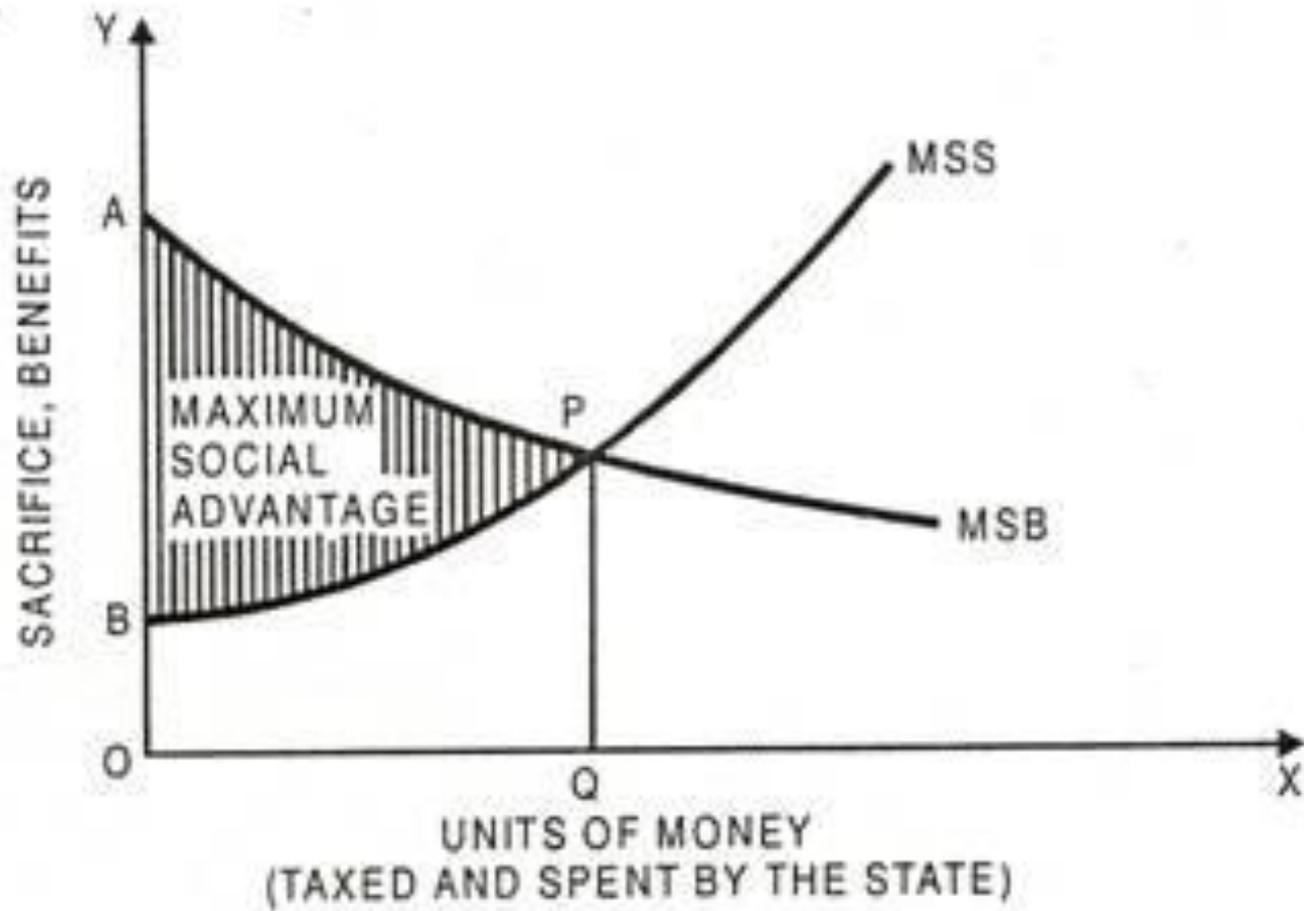
- Marginal utility from public expenditure = Marginal disutility from taxation
- Marginal social benefits = Marginal Social sacrifice



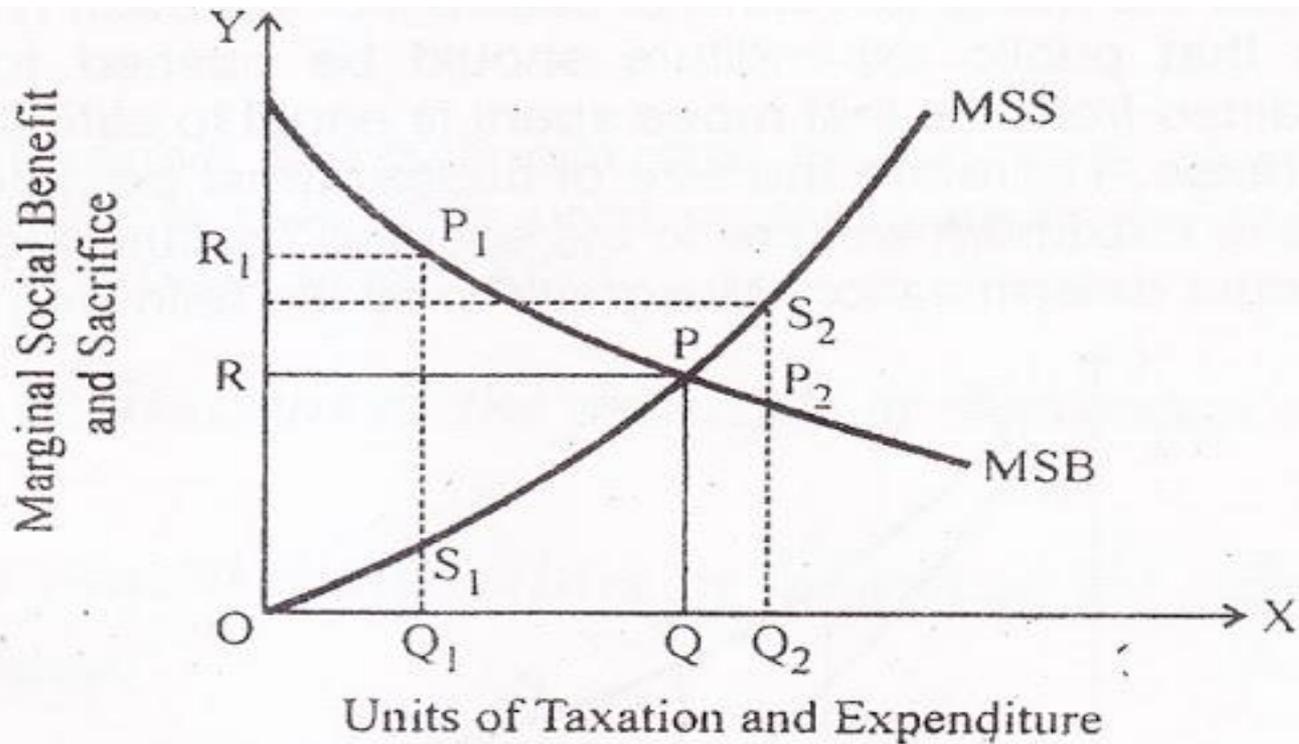
**Increasing Marginal Social Sacrifice Curve**



Units of Public Expenditure (Rupees)  
**Diminishing Marginal Social Benefit Curve**



**Fig. 1. The Maximum Social Advantage**



**Maximum Social advantage is obtained at the Point of Intersection of MSS and MSB Curves**

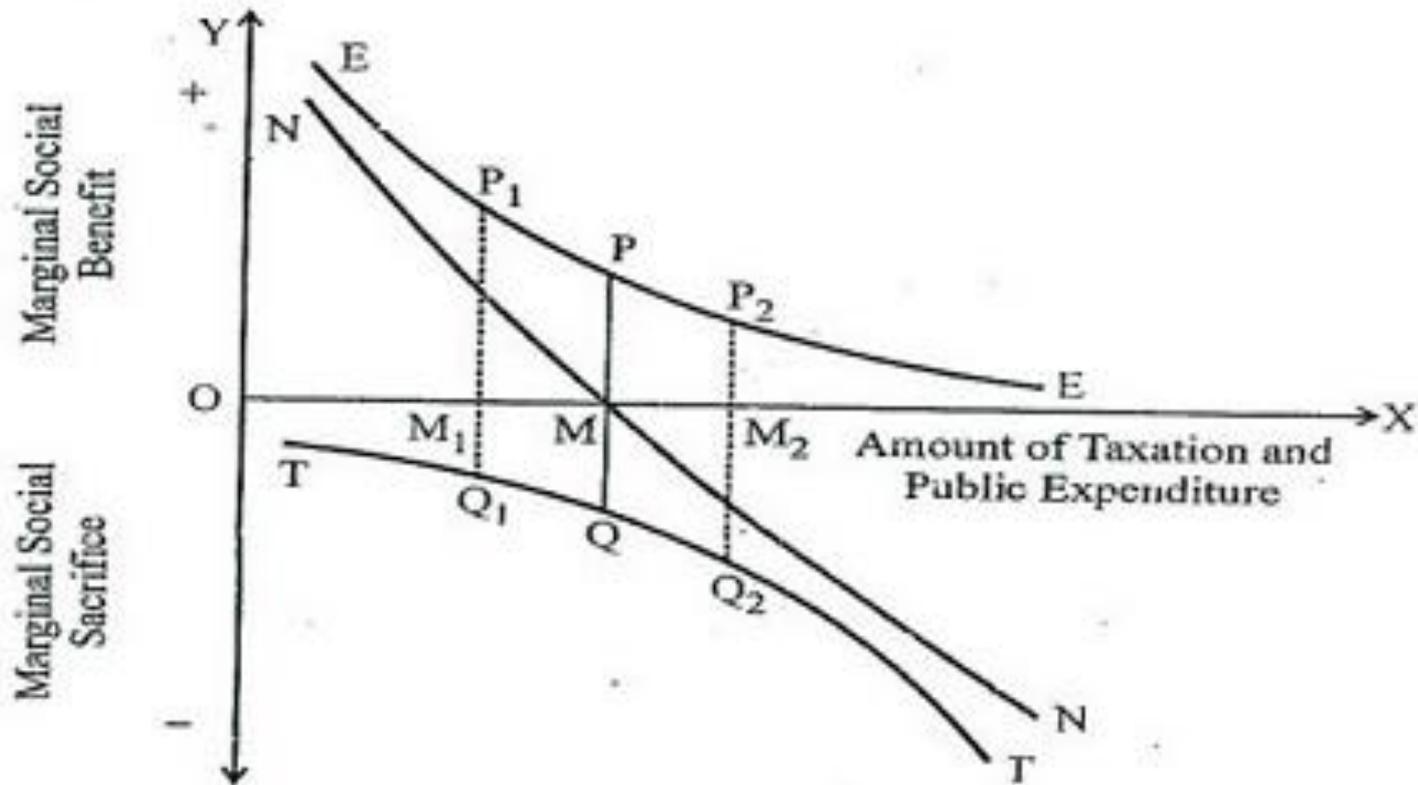
# THE LAW OF SUBSTITUTION

- THE GOVERNMENT HAS TO KEEP ON SUBSTITUTING THE DISBURSAL OF EXPENDITURE FROM ONE USE TO OTHER TO EQUATE MARGINAL SATISFACTION IN EACH TYPE OF OUTLAY.
- THE BURDEN OF TAXATION HAS TO BE SPREAD AMONG THE PEOPLE IN SUCH A WAY THAT MARGINAL SACRIFICE ON EACH INDIVIDUAL IS THE SAME.

# **THE LAW OF SUBSTITUTION**

- 1. TAXES SHOULD BE DISTRIBUTED IN SUCH A WAY THAT THE MARGINAL UTILITY OF MONEY SACRIFICED BY ALL THE TAX PAYERS IS THE SAME.**
- 2. PUBLIC EXPENDITURE IS INCURRED IN SUCH A MANNER THAT BENEFITS DERIVED FROM THE LAST UNIT OF MONEY SPENT ON EACH ITEM BECOME EQUAL**
- 3. MARGINAL BENEFITS AND SACRIFICES MUST BE EQUATED**

# MUSGRAVE'S APPROACH



**Fig.2.4 : Gains and Losses from Budget Operation**

# Musgrave's Approach

- MSA is called as '**Maximum Welfare Principle of Budget Determination**' in Musgrave's Approach.
- According to him the **optimum size of budget** is essential to decide the maximum social welfare.
- The optimum size of the budget is determined at a point when the **Marginal social benefits** of the fiscal operations accruing to the society becomes **zero**.
- In the previous diagram the point Q represents the optimum size of the budget as at this point **net social benefit is zero**.
- At this point, **Marginal Social Benefit = Marginal Social Sacrifice**.

# Principle of MSA in Practice

- Taxation:
- The focal point of MSA is the least aggregate sacrifice.
- Least aggregate sacrifice implies that the deprivation of the people by the imposition of taxes should be minimum.
- Eg: Payment of a certain tax by rich person means less sacrifice to him than payment of the same amount by the poor person.
- All modern government adopt progressive taxation to ensure and establish justice and equality of sacrifices by people.
- It is justified on the basis of the principles of ability and equity as applied.

# Principle of MSA in Practice

- Expenditure :
- Government should spend for the right cause and in the right manner.
- Must ensure that there is no wastage and malallocation of resources.
- The three objectives of public expenditure are:
  1. Defence and law and order
  2. Maximization of production to meet basic requirements
  3. Equitable distribution of income and resources.

# Dalton's Test to prove the importance of Public Expenditure

- The following objectives check whether public finance is adding to the net social advantage or no:
  1. Preserving society
  2. Economic welfare of the community
  3. An improvement in production capacity, organization of production and improvement in the composition and pattern of production.
  4. Improvement in distribution
  5. Economic sustainability
  6. Full employment and economic growth.

# Limitations of the principle of MSA

- Difficulties in measuring Social Benefit
- Unrealistic Assumptions
- Neglect Non-Tax Revenue
- Lack of divisibility
- Large Budget size
- Assumption of Static Condition
- The effect of Budgetary Policy Spill Over to the Future
- Inconsistent Methodology
- Misuse of Government funds
- Contra-cyclical measures

# Objectives of Taxation

1. Raising Revenue
2. Reducing income Inequalities
3. Reducing Regional Disparity
4. Protecting Domestic Industries
5. Regulation of Consumption/Social welfare
6. Price Stability
7. Control of Cyclical Fluctuations
8. Reducing BOP difficulties
9. Promoting Macro-Level Objectives

# Canons of Taxation

1. Canon of Equality or Equity
2. Canon of Certainty
3. Canon of Economy
4. Canon of Convenience
5. Canon of Elasticity
6. Canon of Productivity
7. Canon of Simplicity
8. Canon of Diversity
9. Canon of Co-ordination
10. Canon of Expediency

# Merits and Demerits of Direct Tax

# Merits of Direct Tax

1. Equity: Principle of ability to pay
2. Progressive
3. Elasticity : Revenue increases with increase in individual income.
4. Certainty : Exact and Precise estimation, can know in advance about the amount.
5. Economical: Administrative cost is less
6. Educative : Create a civic sense among tax payers
7. Anti-inflationary: Reduces the disposable income

# Demerits of Direct tax

1. Sacrifice : Cause resentment
2. Inconvenient : Collected in lumpsum
3. Evasion and Corruption
4. Expensive: Elaborate mechanism, huge expenses
5. Narrow-Based : Large number of masses remain untouched
6. Arbitrary: No scientific formula, not based on potential of tax payer
7. Disincentiveness : Discourage savings, negative impact on investments, productivity

# Merits and Demerits of Indirect tax

# Merits of Indirect Tax

1. Convenient
2. Less Pinching
3. Difficult to evade
4. Broad based
5. Social Value
6. Elastic
7. Complementary
8. Progressive

# Demerits of Indirect Taxes

1. Inequitability/ Regressive
2. Less Productive
3. Inflationary
4. Discourage savings
5. No educative value
6. Uncertain
7. Overburden

# Meaning of Public Expenditure

- Expenditure incurred by public authorities at different levels
- To satisfy common wants
- To create and maintain conditions conducive to economic development

# Objectives of Public Expenditure

- Administrative of Law & order and Justice
- Maintenance of police force
- Defence goods
- Diplomats
- Public Administration
- Servicing of Public debt
- Development of industries
- Development of transport and Communications
- Provisions for public health
- Creation of Social goods

# Canons of Public Expenditure

- Canon of Benefit : must bring maximum public expenditure. Pursue common interest to promote general welfare.
- Canon of Economy: Avoidance of wasteful & extravagant expenditure at all levels. Must be productive and efficient, with minimum cost.
- Canon of Sanction : Not without approval of proper authority. No misuse and proper audit
- Canon of surplus: But no longer accepted
- Canon of Elasticity: It should vary according to requirements and circumstances
- Canon of Productivity: Should encourage production, stimulate productive activity, raise employment and standard of living.
- Canon of Equitable Distribution
- Canon of Coordination
- Canon of Neutrality: No adverse effect