BUSINESS ECONOMICS IV

SEMESTER IV

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MODULE I

CHAPTER I

MEANING AND SCOPE OF PUBLIC FINANCE
1. Principles underlying financial activities of state or government at national, state & local levels.

2. Income and expenditure and adjustments


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.
Keyenes 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

GREAT DEPRESSION → POLICE STATE → WELFARE STATE

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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 APPRICCIATE 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 FINANCE 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.

- SOCIALLY ADVANTAGEOUS
DALTON’S VIEWS

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

Y

S₃

S₂

S₁

O

MSS Curve

X

Units of Tax (Rupee)

 Increasing Marginal Social Sacrifice Curve
Diminishing Marginal Social Benefit Curve

Units of Public Expenditure (Rupees)

Marginal Social Benefit

B₁, B₂, B₃

O M₁ M₂ M₃
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
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. Convinient
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 eccepted
• 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