SES'S L.S.RAHEJA COLLEGE OF ARTS AND COMMERCE

Course: SYBCOM Business Economics IV Unit: I Prepared by: Ms. Samiksha Jadhav

1. **PUBLIC FINANCE**: The word public refers to general people and the word finance means resources. So Public Finance means resources of the masses,how they are collected and utilized.Thus, it is the branch of economics that studies the taxing and spending activities of government. It is that branch of general economics which deals with the financial activities of the state or government at national, state and local levels. The discipline of public finance describes and analyses government services,subsidies and welfare payments,and the methods by which the expenditures to these ends are covered through taxation,borrowing,foreign aid and the creation of money.

2. **SCOPE OF PUBLIC FINANCE**

   Prof.Dalton categories the scope of public finance into four areas which includes public income, public expenditure public debt and financial administration.

   (a) Public revenue: The study of various sources of government's income, the principles guiding the raising of income (e.g. canons of taxation), their relatives merits and demerits and their effects on the economy (e.g. impact and incidence of taxation).

   (b) Public expenditure: The study of the manner in which public expenditure is classified, the principles guiding public expenditure (canons of public expenditure), causes of growth and effects of public expenditure.

   (c) Public debt: The study of public debt forms a very important part of public finance in modern times as governments are increasingly resorting to debt to meet the growing needs of the people. Public finance studies the sources, burden and impact of public debt.

   (d) Financial administration: This includes the study of the preparation, passing and implementation Of the budget, budgetary policies and their socio-economic impact, inter-governmental financial relations, fiscal management and fiscal responsibility.

3. **FUNCTIONS OF PUBLIC FINANCE**.

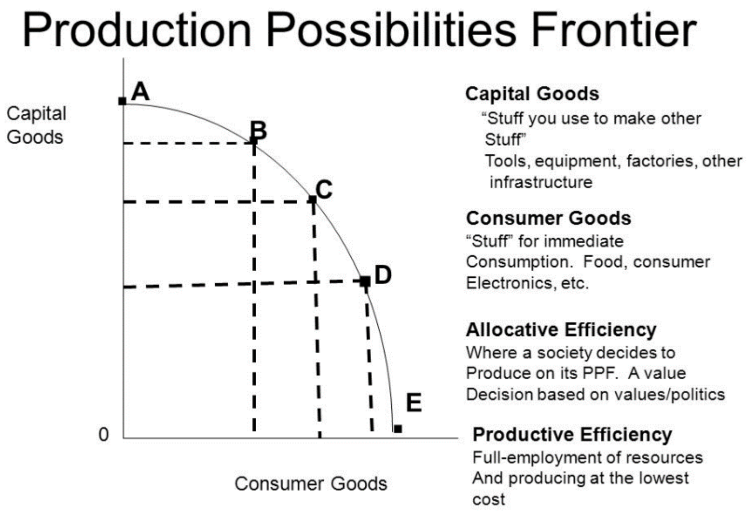
   The functions of public finance all activities with regard to collection of revenue and expenditure on various activities .Earlier theories public finance narrow definition of the functions to be carried out by public authorities. It is clear that the area of state activity has enlarged over the past two decades which increased the functions and scope of public finance.

4. **ECONOMIC ACTIVITIES OF THE STATE** The scope of public finance was confined to the traditional functions of the state, that is, provision of defense, law and order, justice and civic amenities. But with the emergence of welfare states the scope of public finance was broadened public finance now includes the use of the budget as a tool to correct distortion in the economy, to mobilise resources, to maintain price stability create employment prevent market failure, achieve growth equity and maximize social welfare.

5. **FUNCTIONAL FINANCE:** The government should maintain a reasonable level of aggregate demand at all times by using the budget. Most developed economies followed functional finance policies in order to control trade cycles. Developing countries followed such policies to promote economic growth.

6. **FISCAL OPERATIONS :**The scope of public finance includes fiscal operations and their objectives. Fiscal operations refer to raising public revenue, spending to achieve certain goals and financial administration. For such operations, the government uses fiscal tools like taxation, public expenditure and public debt.
   The following are the objectives of fiscal operations;

   (a) Allocation of resources: The most important objectives of fiscal operations is to determine how the Country's resources will be allocated to different sectors of the economy in order to achieve predetermined goals. The national budget determines how funds are allocated to different heads of expenses. The policy of public expenditure is used by the government to directly undertake resource allocation for different sectors. On the other hand, the government can use taxation and subsidies to indirectly influence resource allocation.



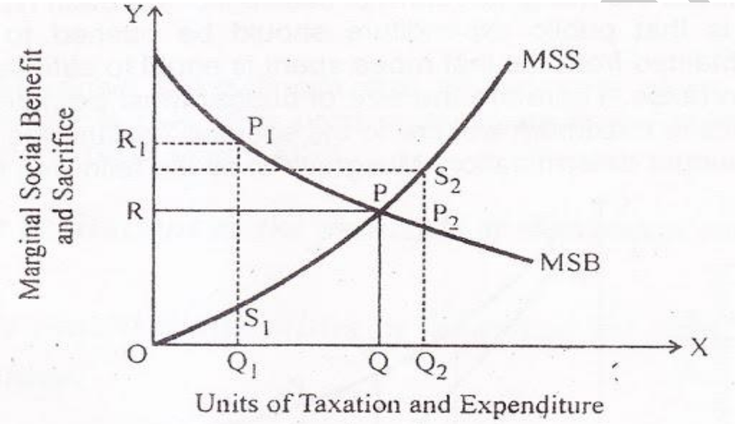
(b) Distribution: Fiscal operations can be effectively used affect the distribution of national income and resource Taxation and public expenditure policies are used by the government to reduce inequalities. Progressive direct taxation impose heavier burden on the rich than the poor. Public expenditure on social infrastructure and subsidies on food housing, health and education help reduce income inequality.

(c) Stabilisation: Developed economies experience business cycles. Economic stability implies absence of sharp cyclical movements in the form of booms and depressions. To bring about such stability, counter-cyclical fiscal operations are adopted. To counter depression and recession, government expenditure is increased to generate employment and taxes are reduced to encourage consumption and investment. During inflation, public expenditure is reduced and taxes are raised.

(d) Economic growth: In developing and underdeveloped economies, the objectives of fiscal operations are more promotional in nature. The basic focus of fiscal operations in such economies is the use of budgetary operations to achieve growth and development. This is done by encouraging capital formation and investments through public expenditure and tax incentives to private sectors.

7. **DALTON'S APPROACH TO MAXIMUM SOCIAL ADVANTAGE:**

According to Dalton the principle of maximum social advantage is the most fundamental principle lying at the root of public finance. According to the principle of maximum social advantage, the best system of public finance is that which secures the maximum social advantage from its fiscal operations. The maximum social advantage is achieved when the state in its financial activities maximise the surplus of social gain or utility (resulting from public expenditure) over the social sacrifice or disutility (involved in payment of taxes.) The principle of public finance, thus, requires the state to compare the sacrifice and benefits of the society in its fiscal operations.



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

8. **MUSGRAVE'S APPROACH TO MAXIMUM SOCIAL ADVANTAGE :** According to Richard Musgrave, the principle of maximum social advantage is called as **Maximum Welfare Principle of Budget Determination.** According to Musgrave, the principle explains that taxation and public expenditure should be carried out up to that level where satisfaction obtained from the last unit of money spent is equal to the sacrifice from the last unit of money taken in terms of taxes.

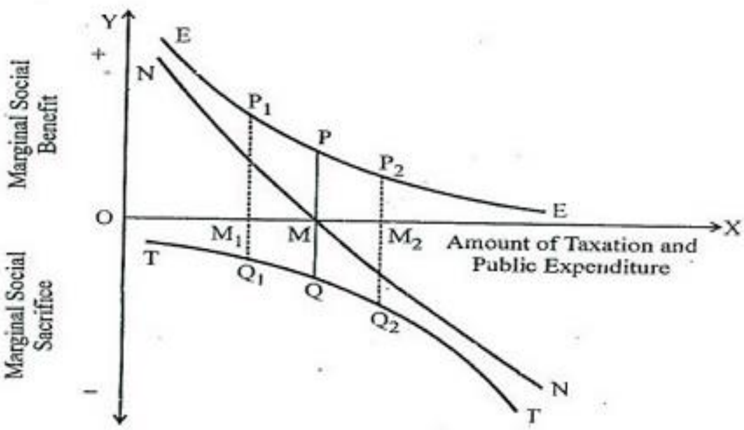


Fig.2.4 : Gains and Losses from Budget Operation

9. **PUBLIC GOODS:** A **public good** is a good that is both non-excludable and non-rivalrous in that individuals cannot be effectively excluded from use and where use by one individual does not reduce availability to others.

10. **PRIVATE GOOD**: A **private good** is defined as an item that yields positive benefits to people that is excludable, i.e. its owners can exercise private property rights, preventing those who have not paid for it from using the good or consuming its benefits; and rivalrous, i.e. consumption by one necessarily prevents that of another.

11. **MARKET FAILURE:** is the economic situation defined by an inefficient distribution of goods and services in the free market. Furthermore, the individual incentives for rational behavior do not lead to rational outcomes for the group. Put another way, each individual makes the correct decision for him/herself, but those prove to be the wrong decisions for the group. In traditional microeconomics, this is shown as a steady state disequilibrium in which the quantity supplied does not equal the quantity demanded.

Q1 Rewrite the sentence by selecting the correct option for the following: (1 mark each)

1. The _______ goods have non-rival consumption and non-excludability as its characteristics.
   i. Private goods
   ii. Public goods
   iii. Merit goods
   iv. None of the above

2. According to Musgrave, the major function of public finance is __________
   i. Allocation function
   ii. Distribution function
   iii. Stabilization function
   iv. All of the above

3. The Maximum Social Welfare Principle of Budget Determination is associated with______
   i. Hugh Dalton
   ii. Paul Samuelson
   iii. Edwin Seligman
   iv. Richard Musgrave

4. __________ is a concept in economic theory which describe the allocation of goods and services by a free market is not efficient.
   i. Market failure
   ii. PPC
   iii. Allocative efficiency
   iv. Public goods

5. Externalities are also called as________
   i. Spillover effect
   ii. Neighbourhood effect
   iii. Third party effect
   iv. All of the above

6. _________ introduced the concept of production possibility curve.
   i. Prof. Alfred Marshall
   ii. Prof. Paul Samuelson
   iii. Prof, Baumol
   iv. Prof. Peter Drucker

7. ________can be defined as the taxes where shifting of final burden of tax is not possible.
   i. Indirect taxes
   ii. Direct taxes
   iii. Lumpsum taxes
   iv. Subsidies

8. CGST, SGST and IGST are _________types of taxes.
   i. Indirect taxes
   ii. Direct taxes
   iii. Lumpsum taxes
   iv. Local

9. Burden of external debt affecting production and resources allocation is termed as______
   i. Direct money burden
   ii. Direct real burden
   iii. Indirect money and real burden
   iv. All of the above

10. Disposable income is __________
   i. Income before tax
   ii. Income before transfer payments are added
   iii. Gross income of firms
   iv. Income after deduction of direct taxes

Q2 Explain the concepts (2 marks each)

1. Public Finance
2. Public goods
3. Functional Finance
4. Private goods
5. Public Finance
6. Market failure

Q3 Answer in detail for the following (10 marks each)

1) Discuss the meaning and scope of Public Finance.
2) Discuss the major Fiscal Functions of the government.
3) Explain Dalton's approach to the Principle of Maximum Social Advantage.
4) Explain the Musgrave's Approach to the Principle of Maximum Social Advantage.
5) Discuss the causes of market failures.
6) Discuss the role of government in correcting market failures.
7) Discuss the Principle of Maximum Social Advantage.
   i) Dalton's approach
   ii) Musgrave's approach
8) Explain the allocative, productive, distributive efficiency.
9) Explain the efficiency of markets with the help of Consumer's and Producer's Surplus.

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SES'S L.S.RAHEJA COLLEGE OF ARTS AND COMMERCE

Course: SYBCOM Business Economics IV Unit: II Prepared by: Ms. Samiksha Jadhav

1. **Tax: A tax** is a compulsory contribution to state revenue without quid-pro-quo, levied by the government on workers' income and business profits, or added to the costs of some goods, services and transactions.

2. **Non-tax revenue:** is the recurring income earned by the government from sources other than taxes. The most important receipts under this head are interest receipts (received on loans given by the government to states, railways and others) and dividends and profits received from public sector companies. Various services provided by the government -- police and defence, social and community services such as medical services, and economic services such as power and railways -- also yield revenue for the government.

3. **Direct tax: A direct tax** is paid directly by an individual or organization to the imposing entity. It is the tax of which impact and incidence is on the same person/ organization and the burden of tax cannot be shifted. A taxpayer, for example, pays **direct taxes** to the government for different purposes, including real property **tax**, personal property **tax**, **income tax** or **taxes** on assets.

4. **Indirect tax: An indirect tax** is collected by one entity in the supply chain (usually a producer or retailer) and paid to the government, but it is passed on to the consumer as part of the purchase price of a good or service. The consumer is ultimately paying the **tax** by paying more for the product.

5. **Progressive tax**: A **progressive tax** is a **tax** in which the **tax** rate increases as the **taxable** amount increases. The term "**progressive**" refers to the way the **tax** rate progresses from low to high, with the result that a taxpayer's average **tax** rate is less than the person's marginal **tax** rate. A **progressive tax** is a **tax** that imposes a lower **tax** rate on low-income earners compared to those with a higher income, making it based on the taxpayer's ability to pay. That means it takes a larger percentage from high-income earners than it does from low-income individuals.

6. **Proportional tax**: A **proportional tax** is an income **tax** system where the same percentage of **tax** is levied on all taxpayers, regardless of their income. A **proportional tax** applies the same **tax** rate across low, middle, and high-income taxpayers. Proportional tax is a tax imposed so that the tax rate is fixed, with no change as the taxable base amount increases or decreases. The amount of the tax is in proportion to the amount subject to taxation.

7. **Regressive tax:** A **regressive tax** is a **tax** applied uniformly, taking a larger percentage of income from low-income earners than from high-income earners. It is in opposition to a progressive **tax**, which takes a larger percentage from high-income earners. A regressive tax is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases. "Regressive" describes a distribution effect on income or expenditure, referring to the way the rate progresses from high to low, so that the average tax rate exceeds the marginal tax rate.

8. **Impact of tax:** Impact refers to the initial burden of the tax. The impact of a tax falls upon the person from whom the tax is collected and can or cannot be shifted as per the type of tax. The impact of a tax is on the person on whom it is imposed first. The impact of a tax, as such, denotes the act of impinging.

9. **Incidence of tax:** Incidence refers to the ultimate burden of the tax. The incidence rests on the person who pays it eventually. It is the extent to which an individual or organisation suffers from the imposition of a **tax**. Dalton incidence as the direct money burden of tax on the person who ultimately pays it. Incidence, thus, rests on the person who cannot shift the money burden of the tax to any other person.

10. **Redistributive effect of taxation:** Redistribution of income and redistribution of wealth are respectively the transfer of income and of wealth (including physical property) from some individuals to others by means of a social mechanism such as taxation. It is also called as redistributive effect of taxation.

11. **Canons of taxation:** By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. In fact, canons of taxation are related to the administrative part of a tax. Adam Smith first devised the principles or canons of taxation in 1776.

12. **Canon of Equality:** Canon of equality states that the burden of taxation must be distributed equally or equitably among the taxpayers. If everyone is asked to pay taxes according to his ability, then sacrifices of all taxpayers become equal. This is the essence of canon of equality (of sacrifice).

13. **Canon of Certainty:** The tax which an individual has to pay should be certain and not arbitrary. According to A. Smith, the time of payment, the manner of payment, the quantity to be paid, i.e., tax liability, ought all to be clear and plain to the contributor and to everyone.

14. **Canon of Economy:** This canon implies that the cost of collecting a tax should be as minimum as possible. Any tax that involves high administrative cost and unusual delay in assessment and high collection of taxes should be avoided altogether.

15. **Canon of Convenience:**
    Taxes should be levied and collected in such a manner that it provides the greatest convenience not only to the taxpayer but also to the government. Thus, it should be painless and trouble-free as far as practicable.

16. **Canon of Productivity:**
    According to a well-known classical economist in the field of public finance, Charles F. Bastable, taxes must be productive or cost-effective. This implies that the revenue yield from any tax must be a sizable one. Further, this canon states that only those taxes should be imposed that do not hamper productive effort of the community. A tax is said to be a productive one only when it acts as an incentive to production.

17. **Canon of Elasticity:** This canon implies that a tax should be flexible or elastic in yield. It should be levied in such a way that the rate of taxes can be changed according to exigencies of the situation. Whenever the government needs money, it must be able to extract as much income as possible without generating any harmful consequences through raising tax rates. Income tax satisfies this canon.

18. **Canon of Simplicity:** Every tax must be simple and intelligible to the people so that the taxpayer is able to calculate it without taking the help of tax consultants. A complex as well as a complicated tax is bound to yield undesirable side-effects. It may encourage taxpayers to evade taxes if the tax system is found to be complicated.
19. **Canon of Diversity:**
    Taxation must be dynamic. This means that a country's tax structure ought to be dynamic or diverse in nature rather than having a single or two taxes. Diversification in a tax structure will demand involvement of the majority of the sectors of the population.

20. **Tax tolerance** : It is the amount of tax that a population is willing to tolerate and put up with. According to Wiseman-Peacock, people's capacity to bear tax burden with an increase in public expenditure

21. **Revenue Budget**: It comprises revenue receipts and expenditure met from these revenues. The revenue receipts include both tax revenue (like income tax, excise duty) and non-tax revenue (like interest receipts, profits).

22. **Capital Budget** consists of capital receipts (like borrowing, disinvestment) and long period capital expenditure (creation of assets, investment). Capital receipts are receipts of the government which create liabilities or reduce financial assets, e.g., market borrowing, recovery of loan, etc. Capital expenditure is the expenditure of the government which either creates assets or reduces liability. Capital budget is an account of assets and liabilities of the government which takes into consideration changes in capital.

Q1. Re write the sentences by choosing the correct option for the following:

1. Which of the following is not the characteristics of a tax?
   i. Compulsory payment
   ii. Involves sacrifice
   iii. Involves quid-pro-quo
   iv. None of the above
2. Which of the following is not a non-tax revenue?
   i. Fees
   ii. Penalties
   iii. Custom duties
   iv. Borrowings
3. A ____________tax is a tax in which the tax rate increases as the taxable amount increases.
   i. Regressive
   ii. Progressive
   iii. Proportional
   iv. Non of the above
4. A ____________ tax is an income tax system where the same percentage of tax is levied on all taxpayers, regardless of their income.
   i. Regressive
   ii. Progressive
   iii. Proportional
   iv. Non of the above

5. _____________ of a tax refers to the initial burden of the tax.
   i. Impact
   ii. Incidence
   iii. Shifting
   iv. Non of the above

6. ____________of taxation we simply mean the characteristics or qualities which a good tax system should possess.
   i. Impact
   ii. Incidence
   iii. Shifting
   iv. Canons

7. ____________is the amount of tax that a population is willing to tolerate and put up with.
    i. Canons of tax
    ii. Impact of tax
    iii. Tax tolerance
    iv. Incidence of tax

8. __________ explains the tax which an individual has to pay should be certain and not arbitrary.
    i. Canon of Certainty
    ii. Canon of Equality
    iii. Canon of Economy
    iv. Non of the above

9. ___________comprises revenue receipts and expenditure met from these revenues.
    i. Revenue Budget
    ii. Capital Budget
    iii. Annual Budget
    iv. Non of the above

10. Capital Budget consists of capital receipts like borrowing, disinvestment and long run period capital expenditure creation of assets, investment.
    i. Revenue Budget
    ii. Capital Budget
    iii. Annual Budget
    iv. Non of the above

Q2 Explain the Concepts (2 marks each)

1. Public Revenue
2. Tax
3. Direct tax
4. Progressive taxation
5. Public Revenue
6. Impact and Incidence of tax

Answer in detail for the following (10 marks each)

1) Discuss the various sources of Public revenue.
2) Discuss the canons of taxation.
3) Discuss the merits and demerits of direct taxes.
4) Discuss the merits and demerits of indirect taxes.
5) Explain the relation between incidence of tax and elasticity of demand.
6) Discuss the incidence of tax and elasticity of supply.
7) Discuss the incidence of tax under different cost structures.

8) Give an overview of economic effects of taxation on consumption, savings, investments and production,
9) Give an overview of economic effects of taxation on redistribution of income and on inflation.

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