Public Finance

The Principle of Maximum Social Advantage:
According to Dalton, the best system of public finance is that which secures the maximum social advantage from the operations which it conducts.

Attainment of maximum social advantage requires that:

(a) Both public expenditure and taxation should be carried out upto certain limits and no more,

(b) Public expenditure should be utilised among the various uses in an optimal manner

(c) The different sources of taxation should be so tapped that the aggregate sacrifice entailed is the minimum

(a) Limits of Public Expenditure and Taxation: Pigou has stated that expenditure should be pushed in all directions up to the point at which satisfaction obtained from the last shilling expended is equal to the satisfaction lost in respect of the shilling called up on government service. In Pigou's statement there is a balancing of utility of expenditure with the disutility of a tax. This is the same principle by acting on which a consumer maximises his satisfaction and a producer maximises his profit. A consumer's satisfaction is maximised when the marginal utility of the last unit of a commodity purchased is equal to its price. In the same manner, a producer maximises his profit when he has equalised the output of the marginal unit of a factor of production with the payment he has made for it, i.e., when marginal productivity is equal to price.

In case of public finance, the government should try to maximise the benefit to the community as a whole from its public finance. The community's welfare is maximised when marginal social utility of an item of expenditure has been equated to the marginal social disutility of the tax imposed for the purpose. Obviously, expenditure confers a benefit and the tax entails a sacrifice and the two must be balanced against one another.

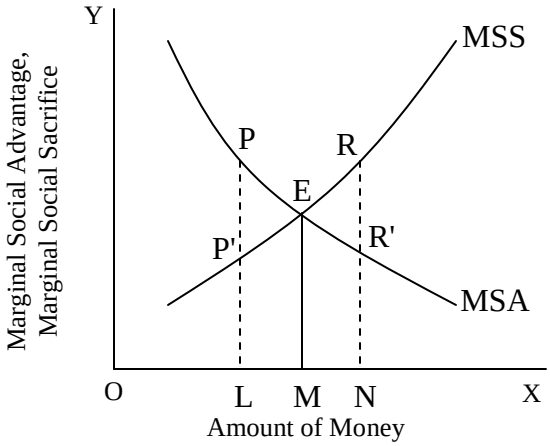
(b) Public Expenditure: Maximum Social Welfare: Achieving maximum social advantage also involves the use of the principle of equi-marginal utility. The government should act on the principle of equi-marginal utility in order to maximise social advantage from the alternative modes of expenditure.

Public expenditure has to be incurred on numerous items. No government can just heedlessly go on spending its revenues. It knows of the various demands on public revenue. A wise government should exercise all possible discrimination between the various uses in which public revenue can be put. It should arrange a list of priorities, just as a prudent consumer does.

(c) Distribution of Tax Burden: Minimum Social Sacrifice: The tax burden should be such distributed in the community so that the sacrifice entailed is the minimum (or the

advantage is maximum). A wise government should see that this suffering or sacrifice is not unnecessarily increased. The sacrifice entailed by the various taxes should be compared and optimum combination of taxes should be found out.

For instance, it is felt that raising of the income tax and corporation taxes further will result either in increasing the sacrifice entailed or in the discouragement of productive enterprise, it will be better not to put extra burden on the income tax payers.



In the above diagram MSS represents marginal social sacrifice, and MSA represents marginal social advantage. As more and more funds are collected from the people by way of taxation, MSS increases. The MSS curve rises upwards from left to right, and MSA slopes downward from left to right. The net social welfare will be maximum where the MSS from taxation is equal to MSA from public expenditure.

Role of Public Finance in a Developing Economy:

In a developing economy, the State must play a very active role in promoting economic development and public finance is the instrument that the State uses in this regard. This instrument has to be used to break the vicious circle of poverty and to accelerate economic growth. Hence, there is a great importance of public finance in under-developed countries desirous of rapid economic development.

There are various reasons why the State must play an important role in a developing economy:

(a) As an instrument of Capital Formation: Capital formation is of strategic importance in the matter of rapid economic development and the under-developed economies suffer from capital deficiency. People in less developed countries are extremely poor and they can hardly make two ends meet, not to speak of making saving and investment. It is, therefore, necessary to achieve a higher ratio of savings to national income, which is the government's responsibility to see how savings can be generated and capital formation promoted. This can be best done through fiscal measures. There is another problem that in under-developed nations the increased incomes arising from

whatever little economic development is made are spent under the demonstration effect in imitating the higher standards prevailing in the developed nations.

(b) As an instrument for Regulating Consumption and Production: There are other methods also, besides public finance or fiscal policy, by which capital formation can be promoted, e.g., taking the various means of production under government control. This system had been adopted by many nations like Russia (Former USSR), China, Czech Republic (former Czechoslovakia), Yugoslavia, Mongolia, Cuba and North Korea. But the system proved to be a failure when addressing public needs. By the end of 1980s, the socialist countries of Eastern Europe including Russia were ruins, with long lines for bread and other necessities in the stores, low and declining living standards, outdated technologies, and deteriorating environmental conditions.

(c) Matching Physical Development: In any plan of economic development, a physical plan must be matched by a financial plan. The balance has to be achieved both in real terms and in financial terms. Money incomes are generated in the process of production and supplies are utilised in response to money demands. It is important, therefore, to operate upon and modify money income flows so as to maintain a balance between the supply of consumer goods and the purchasing power available for being spent on them, between savings and investment and between receipts and payments abroad.

(d) Influencing Rates of Saving and Investment: Public Finance can exercise an important influence in increasing the rate of saving and investment. For example, the tax system can be so devised as to discourage the consumption of less essential goods and thereby release resources for being employed in more productive channels. Further, the tax system can be used to increase public saving which in turn can be used to finance an increase in public investment.

Divisions of Public Finance:
Public Finance can be studied under the following divisions:

(a) Public Expenditure,
(b) Public Revenue,
(c) Public Debt, and
(d) Budgeting.