UNIT I

MEANING AND SCOPE OF PUBLIC FINANCE

MEANING OF PUBLIC FINANCE

Public finance deals with the income and expenditure of public authorities. It include all sorts of governments. That is, it deals with finance of the Government- Central, state and Local. It also deals with the problems of adjustments of income and expenditure of the government.

DEFINITION OF PUBLIC FINANCE

According to Prof. Dalton, "It is concerned with the income and expenditure of public authorities and with the adjustments of one to another".

According to Adam Smith "Public finance is an investigation into the nature and principles of the state revenue and expenditure"

IMPORTANCE OF PUBLIC FINANCE

The importance of public finance can be discussed under two heads:

a. Functions of the State.
b. Effects of financial operations on economic life.

IMPORTANT SUB DIVISIONS (OR) CLASSIFICATION OF PUBLIC FINANCE

Public finance includes five major sub-divisions are:

a. Public Revenue.
b. Public Expenditure.
c. Public Debt.
d. Budget.
e. Financial control and administration.

NATURE OF PUBLIC FINANCE

Public Finance is an Art.

Public finance is defined as an art as it applies knowledge for obtaining various objectives. Its essential component that is fiscal policy uses knowledge of government income and expenses for achieving numerous goals like full employment, economic equality, and development.

Public Finance is a Science

It is referred to as a science as it systematically studies the relationship between various facts of government finance. Public finance studies the relationship between income and expenditure of the government.

SCOPE OF PUBLIC FINANCE

a. Stabilization of Prices.

Public finance avoids fluctuations and maintains stability in the prices of goods and services. The government uses this tool for monitoring inflation and deflation like situations in country. During the time of deflation, government reduces the prices of goods for increasing demand by cutting down their tax rate. Whereas during inflation, the government raises capital expenditure and tax rate.

b. Equal Distribution of Wealth.

It helps in equal distribution of income and wealth among people in an economy. Inequalities in income and wealth distribution is one the serious problem faced by underdeveloped countries. Rich persons receive more and more but poor are not even getting enough to fulfil their basic needs. Therefore for overcome this issue the government is required to spend on development activities for poor peoples.

c. Economic Stability.

Stabilization of country's economy is another important role played by public finance. The government uses taxation as a tool to control and improve the economic conditions. When an economy faces prosperity and people have more funds in their hands, it increases the tax rate. On the other hand, it reduces the tax rate to bring up the demand during the deflation period.

d. Proper Allocation of Resources.

Efficient allocation of resources is a must for the growth of every economy. Public finance supports the government for optimum utilization of all-natural and man-made resources. The government may impose lower tax rates or even provide subsidies on highly desirables goods. Whereas, on goods which are less demandable government may impose a higher tax rate.

e. Encourages Savings and Investment.

Public finance is a tool that helps the government in motivating its people for saving and investment habits. Peoples are generally not able to save their income due to large spending on consumption activities leading to low or zero investment. Government by decreasing the tax rates and giving some relief on goods prices can encourage people for saving and investment activities.

f. Promote Exports.

Export of goods and services is essential for earning sufficient foreign exchange for every country. Public finance assists the government in promoting exports and disfavouring of imports in an economy. Goods to be exported are imposed to lower tax rate or even exempted from the tax category. Whereas, imports of goods are restricted by charging higher tax rates on them.

g. Develops Infrastructure Facilities.

Infrastructural development in a country requires the huge costs to be incurred by the government. Public fiancé raises sufficient funds for the government for meeting these expenses. It enables in providing better and well maintained public amenities such as hospitals, roads, railways, educational facilities, etc.

PUBLIC FINANCE AND PRIVATE FINANCE

Public finance deals with study of income, expenditure, borrowing and financial administration of the government.

Private finance is the study of income, expenditure, borrowing and financial administration of individual or private companies.

SIMILARITIES BETWEEN PUBLIC AND PRIVATE FINANCE

a. Objectives – satisfaction of human wants.
b. Borrowings - essential.
c. Budget –balancing the revenue and expenditure.
d. Financial level- Scarce and minimum resources.

DISSIMILARITIES BETWEEN PUBLIC AND PRIVATE FINANCE

a. Revenue and Expenditure Adjustment.
b. Adjustment in Scarcity or Deficit.
c. Publicity and Audit.

d. Future Period.
e. Wealth and Welfare.
f. Motive of Expenditure.
g. Nature of Budget.
h. Authority.
i. Nature of Resources.
j. Changes.
k. Revenue Differences.

PUBLIC GOODS VS PRIVATE GOODS

Public goods, as the name suggests, are for the facility and welfare of the public in general for free of cost. But, where public goods benefit the mass population.

Private products are the ones which are sold by private companies to earn profits and fulfil the needs of the buyers. But private products are only for those who have affordability. To know these differences in detail, read below.

DIFFERENCES BETWEEN PUBLIC AND PRIVATE GOODS

BASIS	PUBLIC GOODS	PRIVATE GOODS
Meaning.	Public goods are the ones which are Provided by the nature or the gover--nment for free use by the public.	Private goods are those ones which are manufactured and sold by the private companies to satisfy the consumer needs and wants.
Provider.	Nature or Government.	Manufacturers i.e. entrepreneurs.
Consumer Equality.	Rich and Poor are treated equally.	Preference to rich consumers.
Availability.	Readily available to all.	Reduces with each consumption.
Quality.	Remains Constant.	Varies with ability to buy.
Decision.	Social Choice.	Consumer's Decision.
Objective.	Overall Growth and Development.	Profit Earning.
Trade in free Market.	No.	Yes.
Opportunity Cost.	No.	Yes.
Free riders Problem.	Yes.	No.
Rivalry.	Non-rival.	Rival.
Excludability.	Non-excludable.	Excludable.
Demand Curve.	Horizontal.	Vertical.
Examples.	Police service, National defence, Public transports, roads, dams etc.	Clothes, Cosmetics, Footwear, Cars, Electronic products and food.

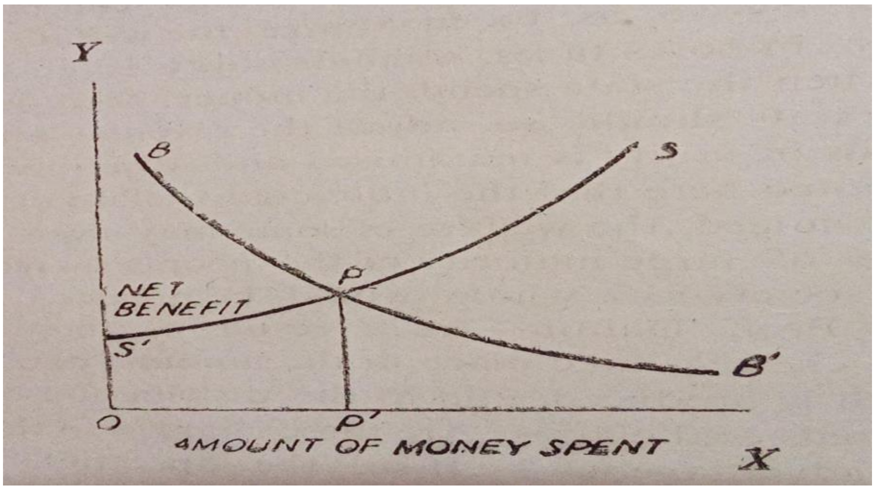
PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

The principle says that the state should collect the revenue and spend the money so as to maximise the welfare of the people. Prof. Dalton called this principle as the Principle of Maximum Social Advantage and Prof. Pigou called it as the Principle of Maximum Aggregate Welfare and also called as Net Social Advantage.

EXPLANATION:

Every additional unit of tax raised, the burden of sacrifice will go on increasing and the amount of benefit will go on decreasing. Thus, the point will be reached where the benefit derived from a unit of money spent by the state will be just equal to the sacrifice imposed in raising that unit of revenue. So, the government stop, at this point the marginal sacrifice is equal to the marginal benefit. This the optimum limit of the state's public finance activity. Thus, the public expenditure incurred the point, where MU is equal to Marginal disutility due to taxation of public income.

DIAGRAM

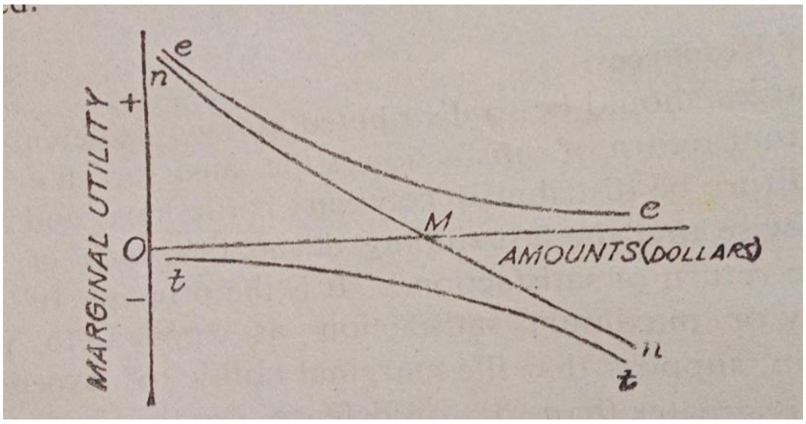


OX represents the amount of money spent and OY represents the sacrifice or benefit received by the amount spent. SS^1 represents sacrifice or disutility curve and BB^1 represents the benefit or utility curve. If public expenditure increases the marginal benefit (BB^1) decreases and tax revenue increases the marginal sacrifice SS^1 increases as shown in the diagram. At the point P where both curves shows the optimum limit of state's financial activity. It is the point where marginal sacrifice is equal to marginal benefit.

MUSGRAVE'S VIEWS ON THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

The minimum sacrifice approaches to the allocation of taxes is matched by a maximum benefit approaches to the determination of public expenditure, and the two are combined in general theory of budget planning.

DIAGRAM



In the below diagram above OX axis represents Marginal Social Benefit (MSB) and below OX axis represents Marginal Social Sacrifice (MSS). Where tt and ee curve represents MSS and MSB respectively. The line nn is obtained by deducting tt from ee and measure the net benefits derived from successive addition to the public budget. OM optimum size of budget derived from where marginal net benefits are zero.

Hence, it can be concluded that there are three fundamental principles of financial operations that can help the state for achieving the idea of maximum social advantage.

a. Benefit is equal to sacrifice.
b. Resources of the state should distributed on different heads of expenditure.
c. Paid in taxation is equal to all tax payers.

TEST OF SOCIAL ADVANTAGE

Prof. Dalton suggested certain tests of social advantage are:

a. Preservation of the community.
b. Improvement in Production.
c. Improvement in Distribution.
d. Stability and Full Employment.
e. Provision of Future.

LIMITATIONS AND DIFFICULTIES OF MAXIMUM SOCIAL ADVANTAGE

a. Comparison of benefit, sacrifice and gains.
b. Marginal Analysis.
c. Future benefit.
d. Different Effects.
e. Political and Social Objective.
f. Unavoidable Expenditures.
g. Tax and other than Revenue.