

FISCAL ECONOMICS- 18MEC32C

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Public Finance – Nature and Scope of Public Finance – Musgrave’s Theory- Principles of Maximum Social Advantage- Private Goods – Public Goods – Merit Goods – Market Features – Externalities – Analysis of External Benefits and External Costs.

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UNIT- V

Fiscal Policy – Objectives – Functional Finance – Federal Finance – Principles of Federal Finance, Allocation of Resources Between Central And States – Local Finance –Evaluation of Thirteenth Finance Commission Report.

TEXT BOOKS

- 1.Musgrave and Musgrave, Theory of Public Finance, McGraw Hills, London.
- 2.B.P. Tyagi, Public Finance, Jai Prakash Nath, 2004.
- 3.H.D. Bhatia, Public Finance, Vikas Publishing House, 2006.
- 4.Department of Economic Affairs, Report on 11th Finance Commission

UNIT -I

Meaning and Definition of Public Finance:

Public finance is a study of income and expenditure or receipt and payment of government. It deals the income raised through revenue and expenditure spend on the activities of the community and the terms 'finance' is money resource i.e. coins. But public is collected name for individual within an administrative territory and finance. On the other hand, it refers to income and expenditure. Thus public finance in this manner can be said the science of the income and expenditure of the government.

Different economists have defined public finance differently. Some of the definitions are given below.

According to prof. **Dalton** "public finance is one of those subjects that lie on the border lie between economics and politics. It is concerned with income and expenditure of public authorities and with the mutual adjustment of one another. The principal of public finance are the general principles, which may be laid down with regard to these matters.

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

To sum up, public finance is the subject, which studies the income and expenditure of the government. In simpler manner, public finance embodies the study of collection of revenue and expenditure in the public interest for the welfare of the country

Nature of Public Finance

Nature of Public finance implies whether it is a science or art or both.

1. Public Finance is a Science: Science is a systematic study of any subject which studies casual relationship between facts. Public finance is a systematically study relating to revenue and expenditure of the government. It also studies the casual relationship between facts relating to revenue and expenditure of the government.

i. Public finance is not a complete knowledge about human rather it is concerned with definite and limited field of human knowledge.

ii. Public finance is a systematic study of the facts and principles relating to government revenue and expenditure.

iii. Scientific methods are used to study public finance.

iv. Principles of public finance are empirical.

Science is of two types:

a) Positive science and

b) Normative science.

In positive science one knows about factual situation or facts as they are. It describes "what is". As against it, normative science presents norms or ideals. It describes "what ought to be" or what is right or wrong i.e. value judgement. By the study of public finance one gets factual information about the problems of government's revenue and expenditure. Public finance is therefore, a positive science. Study of public finance also reveals what should be the quantum of taxes. Which taxes, direct or indirect, should be imposed. On what items more or on what items

less of public expenditure be incurred. Public finance is therefore a normative science. Thus, study of public finance offers suggestions regarding revenue and expenditure of the government as also apprises of their factual position.

2. Public Finance is an Art: In the words of J.N. Keynes, "Art is the application of knowledge for achieving definite objectives." Fiscal policy which is an important instrument of public finance makes use of the knowledge of the government's revenue and expenditure to achieve the objectives of full employment, economic equality, economic development and price stability, etc. To achieve the objective of economic equality taxes are levied at progressive rate. Since every tax is likely to be opposed, it becomes essential to plan their timing and volume. The process of levying tax is certainly an art. Budget making is an art in itself. Study of public finance is helpful in solving many practical problems. Public finance is therefore an art also. In sort, public finance is both science and art. It is a positive science as well as normative science.

Scope of Public Finance (Subject Matter of Public Finance)

The scope of public finance may be summarised as under:

1. Public Revenue
2. Public Expenditure
3. Public Debt
4. Financial Administration
5. Economic Stabilisation

1. Public Revenue: Public revenue concentrates on the methods of raising public revenue, the principles of taxation and its problems. In other words, all kinds of income from taxes and receipts from public deposit are included in public revenue. It also includes the methods of raising funds. It further studies the classification of various resources of public revenue into taxes, fees and assessment etc.

2. Public Expenditure: In this part of public finance we study the principles and problems relating to the expenditure of public funds. This part studies the fundamental principles that govern the flow of Government funds into various streams.

3. Public Debt: In this section of public finance, we study the problem of raising loans. Public authority or any Government can raise income through loans to meet the short-fall in its traditional income. The loan raised by the government in a particular year is the part of receipts of the public authority.

4. Financial Administration: Now comes the problem of organisation and administration of the financial mechanism of the Government. In other words, under financial or fiscal administration, we are concerned with the Government machinery which is responsible for performing various functions of the state.

5. Economic Stabilization: Now –a-day's economic stabilization and growth are the two aspects of the Government economic policy which got a significant place in the discussion on public

finance theory. This part describes the various economic policies and other measures of the government to bring about economic stability in the country.

From the above discussion, we can say that the subject-matter of public finance is not static, but dynamic which is continuously widening with the change in the concept of state and functions of the state. As the economic and social responsibilities of the state are increasing day by day, the methods and techniques of raising public income, public expenditure and public borrowings are also changing. In view of the changed circumstances, it has given more responsibilities in the social and economic field.

Source: <https://freebcomnotes.blogspot.com/2016/12/meaning-nature-and-scope-of-public.html>

Principle of Maximum Social Advantage (With Diagrammatic Representation)!

The fiscal or budgetary operations of the state have manifold effects on the economy. The revenue collected by the state through taxation and the dispersal of public expenditures can have significant influence on the consumption, production and distribution of the national income of the country.

The fiscal operations of the government resolve themselves into a series of transfers of purchasing power from one section of the community to another, along with the variations in the total incomes available in the community. In fact, the fiscal activities of the state affect the allocation of resources, the use of resources from one channel to another, hence, the level of income, output and employment.

Hence, it is desirable that some standard or criterion should be laid down to judge the appropriateness of a particular operation of public finance — the government's revenue and expenditures. In a modern welfare state, such a criterion can obviously be nothing else but the economic welfare of the people.

It follows, thus, that the particular financial activity of the state which leads to an increase in economic welfare is considered as desirable. It may be considered as undesirable if such an activity does not cause an increase in the welfare or even sometimes, it may be the cause of a reduction in the general economic welfare. The guiding principle of state policy has been technically desirable as the Principle of Maximum Social Advantage by Hugh Dalton.

According to Dalton, the principle of maximum social advantage is the most fundamental principle lying at the root of public finance. Hence, the best system of public finance is that which secures the maximum social advantage from its fiscal operations. Maximum social advantage is the maxim for the states. The optimum financial activities of a state should, therefore, be determined by the principle of maximum social advantage.

It is obvious that taxation by itself is a loss of utility to the people, while public expenditure by itself is a gain of utility to the community. When the state imposes taxes, some disutility or dissatisfaction is experienced in the society. This disutility is in the form of sacrifice involved in the payment of taxes — in parting with the purchasing power.

Similarly, when the state spends money, some utility is created in the society. Some satisfaction is experienced by a group of people in the society on whom, or for whom, the public expenditure is incurred by the state. This is the social benefit or welfare of the public expenditure.

As such, 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.

The principle of maximum social advantage implies that public expenditure is subject to diminishing marginal social benefits and taxes are subject to increasing marginal social costs. Thus, an equilibrium is reached when social advantage is maximised, i.e., when the size of the budget is such that marginal social benefits of public expenditures are equal to the marginal social sacrifice of taxation.

Dalton states, “Public expenditure in every direction should be carried just so far, that the advantages to the community of a further small increase in any direction is just counter-balanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other sources of public expenditure and public income.”

Thus, a rational state seeks to maximise the net social advantage of its fiscal operations. The social net advantage is maximum when the aggregate social benefits resulting from public expenditure is maximum and the aggregate social sacrifice involved in raising the public revenue is minimum. According to the principle of maximum social advantage, thus, the public expenditure should be carried on up to the marginal social sacrifice of the last unit of rupee taxed.

Diagrammatic Representation:

In technical jargon, the maximum social net advantage is achieved when the marginal social sacrifice (disutility) of taxation and the marginal social benefit (utility) of public expenditure are equated. Thus, the point of equality between the marginal social benefit and the marginal social sacrifice is referred to as the point of aggregate maximum social advantage or least aggregate social sacrifice.

The equilibrium point of maximum social advantage may as well be illustrated by means of a diagram, as in Fig. 1.

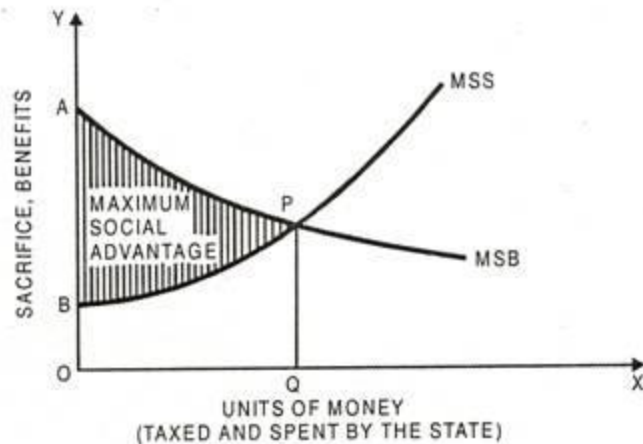


Fig. 1. The Maximum Social Advantage

In Fig. 1, MSS is the marginal social sacrifice curve. It is an upward sloping curve implying that the social sacrifice per unit of taxation goes on increasing with every additional unit of money raised. MSB is the marginal social benefit curve. It is a downward sloping curve implying that the social benefits per unit diminishes as the public expenditure increases.

The curves MSS and MSB intersect at point P. This equality (P) of MSS and MSB curves is regarded as the optimum limit of the state's financial activity. It is easy to see that so long as the MSB curve lies above the MSS curve, each additional unit of revenue raised and spent by the state leads to an increase in the net social advantage.

This beneficial process would then be continued till marginal social sacrifice (MSS) becomes just equal to the marginal social benefit (MSB). Beyond this point, a further increase in the state's financial activity means the marginal social sacrifice exceeding the marginal social benefit, hence the net social loss.

Thus, only under the condition of $MSS = MSB$, the maximum social advantage is achieved. Diagrammatically, the shaded area APB (the area between MSS and MSB curves, till both intersect each other) represents the quantum of maximum social advantage. OQ is the optimum amount of financial activities of the state.

Further, the ideal of maximum social advantage is attained by the state, if the following principles of financial operation are followed in the budget.

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 spending is done, such that benefits derived from the last unit of money spent on each item becomes equal.
3. Marginal benefits and sacrifices must be equated.

Source: <https://www.yourarticlelibrary.com/economics/principle-of-maximum-social-advantage-with-diagrammatic-representation/26377>

Free Good

A free good is a good needed by society but available with no opportunity cost. It is a good without scarcity. For example, air is a free good, because we can breathe it as much as we want. By breathing, we do not diminish the available resource for other people.

Water is usually another free good. If you live by a river, you can take water without reducing the amount available to others. Though in some areas, water can become scarce in drought conditions – then water is no longer a free good.

- Note: a good may be given away for no charge (e.g. healthcare is free at the point of use) However, it is not a free good because there is an opportunity cost – in this case, healthcare is paid for out of taxes.

Private Good

This is a good which has rivalry and excludability. E.g. If you sell a bottle of Coca-Cola to one individual – others cannot consume it.

- Also, private goods have an opportunity cost, if we use resources to produce a bottle of Coca-Cola, we cannot use that glass, sugar and water to produce other goods.
- These goods are provided in a free market when a firm can make a profit from them.

Public Good

A public good has two characteristics:

- Non-rivalry – consuming the good doesn't reduce the amount available to other people.
- Non-excludable – once provided you can't stop anyone consuming it.

Examples of public goods include street lights, law and order and national defence.

- Typically, public goods are not provided in a free market because firms cannot charge people directly and there is scope for 'free-riding on other people paying for it.
- Note: Goods provided by the public sector (government) are not necessarily public goods. e.g. government provide education, but education is a merit good, not a public good)

Source: <https://www.economicshelp.org/blog/2104/economics/private-public-and-free-goods-defined/>

External Benefit and External Cost (transcript)

The existence of external cost and external benefit leads to misallocation of resources.

Introduction

When an action generates benefit for which the benefactor has no right to collect payment and the beneficiary has no obligation to pay, an external benefit arises.

When an action generates adverse spillovers for which the impact or has no obligation to pay and from which impactee has no right to claim damages, an external cost arises.

The existence of external benefit and external cost leads to misallocation of resources.

External cost

For example, when drivers are not liable for the health damage of car exhaust, drivers will equate only marginal private cost with marginal benefit. But if drivers are forced to pay for the health damage of car exhaust, their marginal cost will go up by the amount of the external cost.

In other words, drivers are forced to equate marginal social cost with marginal benefit.

As a result, quantity demanded will go down and price of gasoline will go up if the marginal benefit stays the same.

External benefit

On the other hand, if inventions are not patentable to keep out imitators, licensees of inventions will equate only marginal private benefit with marginal cost. But if licensees are protected against imitators, their marginal benefit will go up by the amount of the external benefits.

In other words, licensees can now afford to equate marginal social benefit with marginal cost.

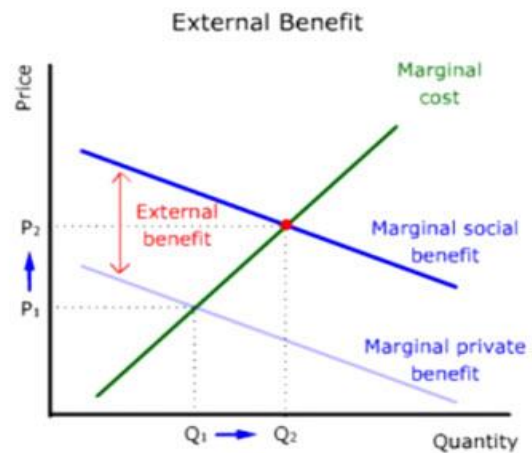
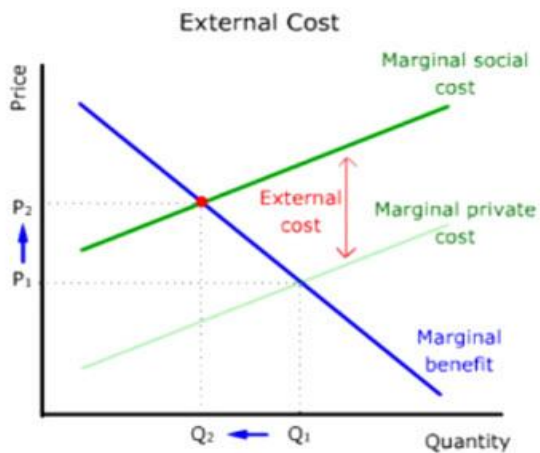
As a result, quantity supplied will go up and price for inventions will also go up if the marginal cost stays the same.

Side-by-side comparison

Here is a side-by-side comparison of the effects on price and quantity demanded when external cost and external benefit are internalized.

When external cost or external benefit is present, the market price for the activity that generates external cost or external benefit is too low to be efficient.

When these externalities are internalized, price will go up in both cases. But the quantity demanded will go down when external cost is internalized. And the quantity supplied will go up when external benefit is internalized.



Summary

- External cost and external benefit exist because some property rights have not been clearly defined.
- When external cost is present, the activity that generates external cost is priced too low and the quantity demanded is too high to be efficient.
- When external cost is internalized, price will go up and quantity demanded will go down if demand stays the same.
- When external benefit is present, the activity that generates external benefit is priced too low and the quantity demanded is too low to be efficient.
- When external benefit is internalized, price will go up and quantity supplied will go up if supply stays the same.

Source: <https://liveingeconomics.org/article.asp?docId=287>