**1. Overview of Public Finance**

"Public Finance" is the area of general economics that deals with the national, state, and local financial operations of the state or government. With the growth of the government's operation base over the past three centuries, it has taken on a lot of significance to research public finance. Economic theorists, from classical to modern times, have been influenced by their views on the role of the state in determining the nature, scope, and subject-matter of public finance.

**Definition of Public Finance**

As mentioned above, the classical economists assigned a nominal role to the government and advocated freedom of the individual. They described public finance as the subject that deal with only the revenue and expenditure of the government. Adam Smith presented greater importance to government expenditure whereas Ricardo and Mill outlined preference to government revenue. They had incorporated the study of government debt as well.

However, failed to provide a scientific, logical, and detailed definition of public finance. For the first time Bastable produced a systematic dissertation on public finance in 1892. According to him, "Public Finance deals with expenditure and income of public authorities of the State and their mutual relation as also with the financial administration and control. Consequently in the year 1922 a more reliable, authentic and scientific work, Principles of Public Finance was delivered by Dalton, who explained public finance as "concerned with income and expenditure of public authorities, and with the adjustment of one to the other".

**In the traditional sense, public finance is a study of the nature and canons of state expenditure and state revenue. In simple word, public finance is a fiscal science.**

Aforementioned to the publication of, General Theory of Keynes in 1936, almost all the economists considered public finance as an enquiry into how the governments raise their income and how do they spend it and how do they administer their finances.

J M Keynes first time underlined that the “fiscal operations of the government can be used to remove falsifications in the economy by influencing the general level of income and employment and also to mobilize resources for rapid and balanced development of the economy.

According to Adam Smith “public finance is an investigation into the nature and principles of the state revenue and expenditure.”

According to Dalton, "public finance is one of those subjects which is on the borderline between economics and politics. It is concerned with the income and expenditure of public authorities, and with the adjustment of the one with the other”.

Ursula Hicks points out that: "the main content of public finance consists then of the examination and appraisal of the methods by which government bodies provide for collective satisfaction of wants and secures necessary funds to carry out their purposes."

Modern public finance analyses the complex problems that center around the income-expenditure process of government and considers the fundamental problems of government's fiscal activity such as:

1. To what extent the state should intervene in the economic field.
2. What should be the volume of public revenue?
3. What should be the amount of public expenditure?
4. In what way should taxes be imposed?
5. What should be the features of the tax system?
6. How should the tax burden be dispersed?
7. What should be the efficient incidence of tax on production, consumption, distribution, and welfare?
8. In what ways public expenditure should be incurred?
9. How can it improve social welfare?
10. What would be the standard for a budget?
11. What should be the kind of the burden of public debt?
12. How it should be operated?

**2. Nature of Public Finance**

**2.1 Public Finance is a Science**

Science is a systematic analysis of any topic that explores the causal connection between evidence. Public finance is a comprehensive survey of government revenue and expenditure. The casual relationship between facts relating to government revenue and expenditure is also examined. Prot. Plehn has enunciated the following arguments in favor of public finance being science:

Public finance is not a full knowledge of individuals, but rather a definite and limited area of human knowledge.

A systematic analysis of the facts and concepts relating to government revenue and expenditure is public finance.

In order to research public finance, scientific methods are used.

Principles of public finance are empirical in nature.

Science is of two types:

a) Positive science and

b) Normative science.

One knows about the factual condition or the truth as they are in positive science. 'What is defined. Normative research, in comparison, presents norms or values. It determines "what ought to be" or what, i.e., value judgement, is right or wrong. Through the analysis of public finance, one gets factual details about the revenue and spending problems of the country. Hence, public finance is a constructive science.

Public finance analysis also shows what the tax rate should be. The taxes that should be levied, directly or indirectly. On which items to incur more or on which items to incur less public expenditure. Consequently, public finance is a normative science. Thus, public finance analysis provides suggestions on government revenue and spending as well as information on their factual status.

2.2 Public Finance is an Art:

In the words of J.M. "Keynes, "Art is the use of knowledge to achieve definite goals." Fiscal policy, which is an important public finance tool, uses government income and expenditure knowledge to achieve the goals of full employment, economic equality, economic growth and price stability, etc.

Taxes are imposed at progressive rates to meet the aim of economic equality. Since it is possible that any tax is opposed, planning their timing and volume becomes important. The tax collection method is definitely an art. Budget making is in itself an art. Public finance analysis is effective in addressing many practical issues. Hence, public finance is also an art.

Public finance, in essence, is both science and art. It is both a constructive science and a normative one.

**3. Scope and subject-matter of Public Finance**

Public finance is also known as public sector economics that focuses on revenue and expenditure activities of government and their influence on the allocation of proper resources and distribution of income.

Public finance spectrum can be summarised as follows:

3.1 Public Revenue

3.2 Public Expenditure

3.3 Public Debt

3.4 Financial Administration

3.5 Economic Stabilisation

3.6 Federal Finance

**3.1 Public Revenue**

Public revenue is based on the strategies used to collect public revenue, the taxation principles, and their issues. In other words, public revenue contains all types of profits from taxes and public deposit receipts. It also concerns the means of receiving funds. It further studies the classification of different public revenue instruments into taxes, fees, assessments, etc.

**3.2 Public Expenditure**

We review the values and issues related to the spending of public funds in this segment of public finance. The basic concepts regulating the distribution of government funds into different sources are studied in this section.

**3.3 Public Debt**

We research the issue of raising loans in this segment of public finance. To meet the shortfall in its conventional revenue, public authorities or any government can collect revenue through loans. The loan raised by the government in a single year forms part of the public authority's receipts.

**3.4 Financial Administration**

 Now comes the question of the organisation and administration of the government's financial mechanism. In other words, we are concerned with the government machinery that is responsible for executing various functions of the state under financial or fiscal administration.

**3.5 Economic Stabilization**

The two facets of government economic policy, now-a-day economic stabilisation and development, have an important place in the debate on the theory of public finance. This section explains the various economic policies and other government initiatives to bring about the country's economic stability.

**3.6 Federal Finance**

## The allocation of the source of revenue and expenditure in the federal system of government between the national, state, and local governments is often studied as the topic of public finance. This public finance division is generally referred to as federal finance, which defines the allocation of funds between these regulatory authorities.

## 4. Functions of Public Finance

### Chart

### 4.1 The allocation Function

### 4.2 The distribution Function

### 4.3 The stabilization Function

**5. Difference between Public Finance and Private Finance**

Public finance refers to the government's activities of raising capital and spending taxes whereas private finance refers to the phenomenon of income-expenditure of an individual or private enterprise. However, the following are major differences between the two:

|  |  |  |
| --- | --- | --- |
| Basis of Comparison | Public Finance | Private Finance |
| Scope | Public finance is confined to the public economy and future oriented | Private finance is confined to the private economy. |
| Objectives | First and foremost, objective is general welfare. | The main object is personal profit |
| Nature | Public finance is an open affair | Private finance is a secret affair. |
| Borrowing capacity | the borrowing capacity of the government is unlimited | An individual has a limit to his creditworthiness |
| Power | The government uses fiscal power to raise income through taxation. | Private individuals have no such powers. |
| Income | In public finance, expenditure determines prima facie then income. | In private finance, income determines expenditure. |
| Effect | In public finance, fiscal operation affects the entire economic system. | Private finance has least effect on the economy. |
| Budget | A deficit budget is favored for developing countries as an anti-cyclical measure. | An individual always tend to balance budget. |

**7. Principle of Maximum Social Advantage**

Government financial operations at different levels affect the distribution and transfer of capital, development, resource use, income level, performance, and employment. It is desirable to set the norm in order to assess the importance of any activity of public authorities in the field of public finance. In modern times, the idea of the welfare state has become relevant as the primary goal of all state operations. Any action which increases the economic well-being of society would be considered desirable and an effort that does not improve the economic well-being of the people would be unacceptable.

The 'Principle of Maximum Social Advantage' was introduced by British economist Hugh Dalton and it is the fundamental principle of Public Finance. He articulates the principle of maximum social advantage with reference to two heads:

* Marginal Social Sacrifice
* Marginal Social Benefits

**Assumptions**

• All taxes lead to sacrificing and all government spending leads to gains.

• Public revenue consists only of taxes and no other form of revenue for the government.

• The government has no budget surplus or deficit, but just a balanced budget.

• Public spending is subject to decreased marginal social gains and taxes are subject to increased marginal social sacrifice.

According to Dalton, the main goal of public finance is to optimize social benefits and the concept of maximum social benefits is a guiding principle in state policy.

This theory states that revenue and government expenditure should be handled in such a way that the net profit to society is greater after a comparison of the social burden of taxes and social benefits of public spending. It is clear that the state has to balance its revenue and expenditure like the individual.

Taxation results in a lack of usefulness for individuals while spending contributes to social services. If the government levies certain taxes, society has a certain disadvantage.

This drawback is demonstrated by paying taxes or by splitting the buying authority. Similarly, when the government incurred some expenditure, citizens who or for whom that expenditure was incurred would obtain gratification. As such if the surplus social profit over social sacrifices (the product of the payment of taxes) was maximized, the social benefit of all such operations would be maximum. The government must also prepare a balance sheet of the sacrifices and advantages to society through its fiscal activities.

The Theory of Maximum Social Advantage posits that public finance contributes to economic welfare when public spending & taxation are carried out up to that point where the benefits resulting from the MU (Marginal Utility) of expenditure is equal to the Marginal Disutility or the sacrifice imposed by taxation.

**7.1 Marginal Social Sacrifice (MSS)**

Marginal Social Sacrifice (MSS) refers to the amount of social sacrifice publicly levied by imposing an additional tax unit.

Any tax unit levied by public taxes leads to loss of utility. Dalton claims that the extra cost (marginal sacrifice) of additional tax units increases, i.e. the overall social sacrifice increases at a rate that increases. The explanation is that the stock of money with society reduces as taxes are levied. Due to the decrease in the stock of capital, the marginal use of money continues to increase. Ultimately, each additional tax unit generates an increased impact and sacrifice on society. Therefore, marginal social sacrifice continues to increase.

The following diagram illustrates the marginal social sacrifice:

 

The diagram above depicts a left to right curve of the marginal social sacrifice. This shows that the amount of sacrifice often increases with each additional tax unit. The marginal social sacrifice when the tax unit was OM1 was OS1 and with tax increase at OM2, marginal social sacrifice rises to OS2, in the same way it carries on OM3 to OS3 but in a non-linear way.

**7.2 Marginal Social Benefit (MSB)**

While taxation burdens people, government spending gives advantages. The benefit that an additional public spending unit brings to society is known as Marginal Social Benefit. Just as the marginal utility from a commodity to a consumer declines as more and more units of the commodity is made available to him, the social benefit from each additional unit of public expenditure declines as more and more units of public expenditure is spent. The social benefits of each additional unit of public expenses diminish as more and more units of the good are expended. Public spending units are used initially for the most important social events. Post-dose public spending is spent on less and less social programs. Therefore, as is seen in the figure below the curve of marginal social benefits is descending from left to right.

 

In the above diagram, from left to right the marginal social advantage curve descends. This shows that public expenditure's social gain is decreasing at a rate. When the public expenditure was OM1, the marginal social benefit was OB1, and when the public expenditure augments to OM2, the MSB is reduced at OB2 and so on.

**7.3 The Point of Maximum Social Advantage**

Social advantage is maximized at the point where marginal social sacrifice intersects the marginal social benefits curve. The curve MSS and MSB intersect at point P and it is effortless 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 expansion in the net social advantage. Marginal disutility or social sacrifice is equivalent to marginal utility or social gain at this point. Beyond this point, there is a greater marginal disutility, and lower marginal usefulness or social gain.

 

Now ponder point P1. The MSA at this stage is P1Q1. This is greater than the S1Q1 MSS. Since the MSS is smaller than the marginal social gain, raising the level of taxation and public spending makes more sense. This is since the net social profit is increased by an extra unit of revenue generated and invested by the government. If the levels of taxation and spending are to the left of point P, this situation of rising taxation and public expenditure persists.

The S2Q2 MSS at point P2 is larger than the P2Q2 marginal social gain. Hence, any further increase in the level of taxation and public expenditure, beyond point P, can diminish the social advantage. This is because the marginal social sacrifice will be increased with each successive unit of additional taxation, which will be greater than the marginal utility. This shows that only at point P where the marginal social gain of public spending is equal to the MSS of taxation exceeds the full social benefit. Hence, at this point, the maximum social advantage is attained.

The manner and degree to which public expenditure and revenue should be incurred and accepted have been proposed by Prof. Dalton. According to him, public spending should be carried out in all directions to the degree that the advantage to the nation of a further small increase in either direction is only counter balanced by the drawbacks of a similar small increase in taxes from any other source of public revenue. This gives both public spending and public revenue the perfect blend.

**7.4 Limitations of Maximum Social Benefit Theory**

* There is no doubt that the idea of full social value plays a key role in State fiscal activity.
* The theoretical value of optimal social gains cannot be overlooked. However, in the above theory, there are some difficulties.
* A fiscal transaction that fosters production and better distribution between themselves is not easy to reconcile. Aid might not be an investment- and production-friendly strategy for supporting social security. For instance, it cannot take a sharply progressive taxation that encourages growth, profit and risk-taking.
* The absence of progressive taxation at the same time amplifies structural inequalities and impedes the distribution of income and wealth. Likewise, a distribution-friendly approach may be hostile to production.
* Disutility occur when paying taxes, but no such disutility is involved in public borrowing. Thus, public investment funded by public advances may have no special limit. This loses its hold on the marginal principle of equality.