Public Finance in India

Public Finance in India:

Theory and Practice

By

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To the policymakers, scholars, and students of public finance in India, May this work contribute, in some measure, to the continuing study and improvement of our nation's fiscal future.

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PREFACE

Public finance is at the heart of how societies mobilise and allocate resources to pursue collective goals. In India, where economic growth, social equity, and fiscal discipline must coexist, understanding the theory and practice of public finance is both an intellectual and practical necessity. This book, *Public Finance in India: Theory and Practice*, aims to bridge foundational concepts with the country's evolving fiscal experience, providing readers with a comprehensive understanding of how public revenues, expenditures, debt, and intergovernmental relations influence economic governance.

The volume begins with a clarification of the first principles, explaining the meaning, scope, and significance of public finance, and proceeds to analyze public goods, expenditure policies, revenue instruments, and public debt. Subsequent chapters focus on fiscal federalism, policy implications for India, and an assessment of the nation's fiscal performance. Together, they offer an integrated framework that connects analytical tools with India's policy debates and empirical realities.

Two features set this work apart. First, it combines classical theories of taxation, expenditure, and budgeting with contemporary issues such as fiscal consolidation, subsidies, and the implications of cooperative federalism. Second, it pays sustained attention to the Indian context, tracing the evolution of fiscal policy from the early post-Independence period to recent reforms in taxation, debt management, and the goods and services tax (GST). The discussion is supported by data, institutional analysis, and references to official reports, allowing readers to appreciate both continuity and change in India's fiscal architecture.

This book is intended for students, researchers, and practitioners of economics, public policy, and finance. It will also be of value to civil servants, legislators, and professionals engaged in budgeting, taxation, or development planning. By combining conceptual clarity with empirical detail, it aims to strengthen informed dialogue on how fiscal choices can support inclusive and sustainable growth.

I hope that this text not only serves as a guide to the subject but also inspires further inquiry into the challenges and opportunities of public finance in India.

I am deeply grateful to my teachers, colleagues, and well-wishers whose guidance and encouragement have been invaluable in the preparation of *Public Finance in India: Theory and Practice*. I also extend my heartfelt thanks to my family for their constant support and inspiration throughout this journey.

Dr. Surajit Ghosal
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CHAPTER 1

CONCEPT OF PUBLIC FINANCE

Public Finance: Meaning and Scope

Meaning of Public Finance

The word public refers to general people and the word finance means resources. So public finance means resources of the masses, and how they are collected and utilized. Thus, Public Finance is the branch of economics that studies the taxing and spending activities of government. 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 money creation.

Definition

According to Findlay Shirras

> "Public finance is the study of principles underlying the spendingand raising of funds by public authorities".

According to *H.L Lutz*

> "Public finance deals with the provision, custody, and disbursement of resources needed for the conduct of public or government function."

According to *Hugh Dalton*

> "Public finance is concerned with the income and expenditure of public authorities, and with the adjustment of the one to the other."

Nature of Public Finance

The nature of public finance implies whether it is a science or art or both.

Public Finance as Science

Science is the systematic study of any subject which studies the relationship between facts. Public finance has been held as a science thatdeals with the income and expenditure of the government's finances. It studies the relationship between facts relating to revenue and expenditure of the government.

Arguments in support of Public Finance as Science:

- Public finance is the systematic study of the facts and principles relating to government expenditure and revenue.
- Principles of Public finance are empirical.
- Public finance is studied using scientific methods.
- Public finance is concerned with a definite and limited field of human knowledge.

Public Finance as Art

Art is the application of knowledge to achieve definite objectives. Fiscal Policy, an important instrument of public finance, uses knowledge of the government's revenue and expenditure to achieve the objectives of full employment, economic development, and equality. Price stability etc. To achieve the goal of economic equality taxes are levied which are likely to be opposed. Therefore it is important to plan their timing and volume. The process of levying tax is therefore an art. The study of Public finance helps solve many practical problems. Public finance is therefore an art also.

From the above discussion, it can be concluded that public finance is both science and art. It is positive science as well as normative science.

It is a **positive science** as by the study of public finance factual information about the problems of government's revenue and expenditure can be known. It also offers suggestions in this respect.

It is also **normative science** as the study of public finance presents norms or standards of the government's financial operations. It reveals what should be the quantum of taxes, the kind of taxes, and on what items less of public expenditure can be incurred.

Scope of Public Finance

Public finance not only includes the income and expenditure of the government but also the sources of income and the way of expenditure ofvarious government corporations, public companies, and quasi-government ventures. Thus the scope of public finance extends to the study of inde-

pendent bodies acting under the government's direct and indirect control. The Scope of public finance includes:

1. ***Public Revenue:*** Public finance deals with all those sources or methods through which a government earns revenue. It studies the principles of taxation, methods of raising revenue, classification of revenue, deficit financing, etc.
2. ***Public Expenditure:*** Public expenditure studies how the government distributes the resources for the fulfillment of various expenses. It also studies principles that the government should keep in view while allocating resources to various sectors and the effects of such expenditure.
3. ***Public debt:*** It deals with borrowing by the government from internal and external sources. AT any time government may exceed its revenue. To meet the deficit, the government raises loans. The study of public fiancé focuses on the problems of raising loans and the methods of repayment of loans.
4. ***Fiscal administration:*** The scope of financial administration is wider. It covers all the financial functions of the government. It includes drafting and sanctioning of the budget, auditing of the budget, etc. Financial administration is concerned with the organization and functioning of the government machinery responsible for performing the various financial functions of the state. The budget is the master financial plan of the government.
5. ***Economic Stabilization and Growth:*** In the present times, public finance is mainly concerned with the economic stability and other related problems of a country. For the attainment of these objectives, the government formulates its fiscal policy comprising of various fiscal instruments directed towards the economic stability of the nation.
6. ***Federal Finance:*** Distribution of the sources of income and expenditure between the central and the state governments in the federal system of government is also studied as the subject matter of public finance. This branch of public finance is popularly known as Federal Finance.

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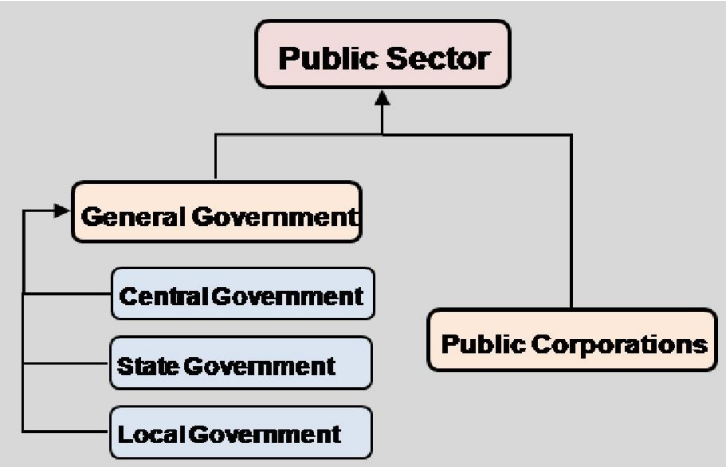
what should be the quantum of taxes, the kind of taxes, and on what items less of public expenditure can be incurred.

Differences Between Public and Private Finance

News analysts often discuss the private and public finance sectors. Despite most individuals having a general idea of what the two terms mean, a much deeper understanding of what they entail and their differences is important.

The public sector comprises all the government-owned organizations, all agencies, and state offices. The private sector on the other hand refers to all the privately owned businesses, companies, partnerships, and profit and non-profit corporations. This article will discuss in depth the meaning and differences of both private and public finance.



Public finance is the finance sector that deals with the allocation of resources to meet the set budgets for government entities.

This branch of economics is responsible for the scrutiny of the meaning and effects of financial policies implemented by the government. This sector examines the effects and results of the application of taxation and the expendituresof all economic agents and the overall economy.

Richard Musgrave, a renowned Economics professor, terms Public Finance as a complex of problems that are centered around the income and expenditure processes of the government. Public finance has several

branches; public revenue, public expenditure, public debt, budget policy, and fiscal policy.

Private Finance can be classified into two categories personal finance and business finance. Personal finance deals with the process of optimizing finances by individuals such as people, families, and single consumers. A great example is an individual financing his/her car by mortgage. Personal finance involves financial planning at the lowest individual level. It includes savings accounts, insurance policies, consumerloans, stock market investments, retirement plans, and credit cards.

Business Finance involves the process of optimizing finances by business organizations. It involves asset acquisition and proper allocation of funds in a way that maximizes the achievement of set goals. Businesses can require finances on either of the three levels; short, medium, or long-term.

1. Income and Expenditure Adjustment in Public and PrivateFinance:

   The government adjusts the income according to the expenditure budget. The private sector including individuals and private businesses adjust their expenditure according to the incomeor future estimates. The government first creates an outline for the expenditure then devises means of acquiring the monetary budget needed. Private finance involves cutting your coataccording to your clothes.

2. Borrowing in Public vs. Private Finance:

   The government can borrow from itself, it can simply go back to the people to ask for loans in whichever financial asset, e.g. bonds, when shortages arise. However, an individual can't borrow from itself.

3. Currency ownership in Public vs. Private Finance:

   The governmentis in charge of all aspects related to currency. This involves the creation, distribution, and monitoring. No one in the private sector is allowed to create currency, this is illegal and most countries classify it as a capital offense.

4. Present vs. future Income:

   The public sector is more involved with future planning and making long-term decisions. The government makes decisions that will bear fruits in the long-term, even up to ten years. These investments

could include the building of schools, hospitals, and infrastructure. The private industry makes financial decisions on projects with a shorter return waiting time.

5. Objective Difference in Public and Private Finance:

   The public sector's main objective is to create social benefit in the economy. The private industry seeks to maximize personal or profit benefits.

6. Coercion to Get Revenue:

   The government can use force to get revenue from individuals. This could involve the use of force to get taxes. The private sector, however, doesn't have this authority.

7. Ability to Make Huge and Deliberate Changes:

   The public finance sector can make huge decisions on income amount without much consequences. For example, it can effectively and deliberately increase or decrease the income amount instantly. Businesses and individuals can't make these decisions and implement them immediately.

8. Surplus Budget Concept:

   Excess income or surplus budgets is a great virtue in the private sector, this is however not the case in public finance. The government is expected to only raise what is needed for a fiscal year. Of what use would it be to have surplus budgets? It would be much easier to offer tax reliefs to the tax- payers to off-set the surplus.

Summary of Public versus Private Finance

- The public sector comprises all the government-owned agencies, companies, and state offices. The private sector comprises businesses, companies, and individuals.
- The public sector's main objective is to create social benefits while the private is to make profits.
- The overall benefits acquired from the public sector's strategies are the citizens themselves, however, the beneficiaries of the pri-

vate finance strategies are the owners, shareholders, or the individuals themselves.

- Despite having all these differences both the public and private finance sectors have some similarities. Both face the issue of scarcity, the need for borrowing, and the importance of precedence of income.
- Both the public and private finance contribute towards a country's economy and are co-dependant neither can exist without the other.

Public Good versus Private Good

The upcoming discussion will update you about the difference between public good and private good.

A pure public good is a good or service that can be consumed simultaneously by everyone and from which no one can be excluded. A pure public good is one for which consumption is non-revival and from which it is impossible to exclude a consumer. Pure public goods pose a free-rider problem. A pure private good is one for which consumption is rival and from which consumers can be excluded.

Some goods are non-excludable but are rival and some goods are non-rival but are excludable.

The first feature of a public good is called non-rivalry. A Good is a non-rival if the consumption of one unit by one person does not decrease available units for consumption by another person. An example of non-rival consumption is watching a television show.

A private good, by contrast, is a rival. A good is rival if the consumption of one unit by one person decreases available units for consumption by another person. An example of rival consumption is eating a burger.

The second feature of a public good is that it is non-excludable. A good is non-excludable if it is impossible, or extremely costly, to prevent someone from benefitting from a good who has not paid for it. An example of a non-excludable good is national defence. It would be difficult to exclude a foreign visitor from being defended.

A private good, by contrast, is also excludable. A good is excludable if it is possible to prevent a person from enjoying the benefits of a good if they have not paid. An example of an excludable good is cable television. Cable companies can ensure that only those people who have paid the fee receive programs.

Further it classifies goods by these two criteria and gives some examples of goods in each category. Goods like Lighthouse and National Defence are known as pure public goods. One person's consumption of the security provided by our national defence system does not decrease the amount available for someone else — defence is non-rival. The army cannot select those whom it will protect and those whom it will leave exposed to threats — defence is non-excludable.

Many goods have a public element but are not pure public goods. An example is a motorway. A motorway is non-rival until it becomes con-gested. One more car on the Delhi Ring Road with plenty of space does not reduce the consumption of road services for anyone else.

But once the motorway becomes congested, one extra vehicle lowersthe quality of the service available for everyone else — it becomes rival like a private good. Also, users can be excluded from a motorway by toll gates. Another example is fish in the ocean.

Ocean fish are rivals because a fish taken by one person is not available foranyone else. But ocean fish are non-excludable because it is difficult to stop other countries from taking them if they are outside a country's territoriallimits.

Public goods create a free-rider problem. A free rider is a person who consumes a good without paying for it. Public goods create a free rider problem because the quantity of the good that they person can consume is not influenced by the amount the person pays for the good. Markets fail to supply a public good because no one has an incentive to pay for it.

1. Public and Private Goods - The Tragedy of the Commons

   For this discussion, we need to establish some definitions associatedwith goods and services.

- ***Rivalrous*** - the consumption/use of the good or service by one person reduces the availability of the good or service to another person

  Example: *There are a dozen donuts in the kitchen at work. I eat one (well, more likely, I eat two) - and therefore there are fewer donuts formy colleagues to enjoy.*

- ***Non-rivalrous*** - the consumption/use of the good or service by one person does not reduce the availability or utility of the good or service to another person (these goods are often, but not limited to, intangibles)

Example: *Kauai is quite possibly my favorite place on earth. And I enjoy the beautiful scenery there. Enjoying this view doesn't prevent others on the island from enjoying it too.*

- ***Excludable*** - any excludable good or service is one that someone can be prevented from accessing if they do not pay for it

  Example: *You need a ticket to ride the train; without paying for the ticket, you do not get to use the good/service of riding the train (unlessyou break the law, of course).*

- ***Non-excludable*** - any good or service that someone cannot be prevented from accessing because of non-payment (or it is extremely expensive to exclude)

  Example: *While our taxes go to fund the military, we do not (and cannot) deny national defense services to those people in our society who have not paid taxes.*

So, when we make different combinations of rivalrous/non-rivalrous and excludable/non-excludable goods, we get what are called public and private goods. Take a look at the matrix below to see examples of different types of goods and think about how different topics related to energy and our environment fit into these categories.

Goods and Services Matrix

	excludable	**non-excludable**
rivalrous	Private Goods A private good is both rivalrous and excludable; I own and drive my sports car. I paid for it, and I drive it. While I'm driving it, no one else can. And I don't let people who didn't pay for my car drive it anyway.	Common Goods A common good is rivalrous but non-excludable; in other words the supply can be depleted, but people are not restricted in their use of the good. Natural resources can be thought of as common goods - their supplies are not infinite, but their utilization benefits all. Common goods, because they are limited but largely available to all, are susceptible to the Tragedy of the Commons.

non-rivalrous	Club or Toll Goods A club or toll good is excludable, but non-rivalrous (at least to a point); this would involve things like subscriptions to cable TV, access to private parks, or even membership in the European Union.	Public Goods A public good is both non-rivalrous and non-excludable; you and I can enjoy this good at the same time without diminishing its utility, and we didn't have to pay for it to enjoy it. Public goods are things like breathing air or enjoying a robust national defense system.

The Tragedy of the Commons

In 1968, Garrett Hardin wrote about the potential for common goodsto be exploited and depleted, specifically in the context of fears of overpopulation. While this article is now more than 40 years old, the concept persists and is certainly a challenge with the energy and sustainability issues we face today. I used to require The Tragedy of the Commons for this lesson, but most students had already encountered it in multiple courses before this one. If you've not read it, I encourage you to do so asyour time permits.

Some points to consider in thinking about the Tragedy of the Commons:

- Like the herdsmen seeking to maximize their gain, we all dothings that don't seem that bad in the bigger energy picture. It doesn't matter if I leave my TV on all the time, it's just one TV. So what if I drive a big SUV I don't need; my commute is short. How much water does it waste if I leave the sink on while I brush my teeth? While some of these goods aren't necessarily common goods, our environment is, and it's difficult sometimes to see what our impact is.
- Common goods utilized for private benefit will always be vulnerableto exploitation. We tend to fend for ourselves, not considering howour actions affect others or the future of others.
- Hardin was concerned with how a rapidly increasing population would affect the commons of the environment. As we examine the problem of the commons from an energy policy perspective, we can see that it is (at least in part) a function of our growing

population - and not just a growing population - but a growing affluent population. As more and more people aspire to enjoy the creature comforts of modern Western life, this puts pressure on our energy systems and resources and necessitates consideration in our policies governing those systems and resources.

Cases of Public Versus Private Goods

One of the most powerful ideas that legal theory borrows from economics is the idea of a "public good." Sooner or later law students learn that within the framework of contemporary neoclassical economics,the standard line is that public goods (e.g. national security) should be provided by the government whereas private goods (e.g., automobiles) oughtto be provided by markets. For legal theorists, the line between public and private goods track one of the important fault lines in the law—betweenthe private law fields of property, contract, tort, and so forth *and* public law fields such as environmental law, administrative law, and constitutional law. This post provides a basic introduction to the economic distinction between public and private goods for law students (especially first-year law students) with an interest in legal theory.

It may be helpful to quickly preview the basic idea. So here goes:

Public goods have two characteristics—non-rivalrousness and nonexcludability. For example, consumption of national defense is nonrivalrous (my being protected by the U.S. armed forces doesn't diminish your protection). National defense is a non-excludable good: the Army cannot say to Mexico, "Solum hasn't paid his national defense bill, "Go ahead and attack him."

Private goods are rivalrous and excludable. If I own a laptop computer, my use of it diminishes my ability to use it; therefore,my consumption of the laptop rivals yours. Moreover, I can exclude you from the use of my laptop (by locking it up when I am not using it).

We use markets to provide goods like laptops (that are excludable and rivalrous), but the government provides goods like national defense (that arenonexcludable and nonrivalrous).

A Note on Terminology: "Public Goods" versus "Public Interest" versus "Public Resources."

Before we go any further, let's make sure we agree about how we areusing the phrase "public good." This is important because the same phrase is used for different purposes in different contexts. So let's stipulate to the following:

The phrase "public good" or "public goods" shall be used to refer to the economists' idea of goods (in the broad sense that includes both "goods" and "services") that meet the criteria of nonrivalrousness and nonexcludability.

The phrases "public interest" or "common good" shall be used to refer to the idea of goods that benefit the public at large as distinguished from goods or interests that benefit a faction (or "special interest group").

The phrase "public resource" shall be used to refer to private goods that are owned by the government or held in trust for the public. National parks are indisputably public resources, but it may not be the case that they are public goods in the economic sense.

We could use the phrase "public good" to refer to the public interest or to public resources, but for this post, let's stipulate that "public good" shall be reserved for the economic sense of the phrase.

Markets and Government

The conventional view is that markets should provide private goods and the government should provide public goods. The case for market provision of private goods relies on the idea of *Pareto efficiency*. The *weak Pareto Principle* is the simple idea that if some action would make at least one person better off and no one worse off, then that action is good. If we have a private good, e.g. a widget, and a willing buyer and seller, then allowing the sale is Pareto efficient: the buyer prefers the widget to the money and the seller prefers the money to the widget. If we assume that the transaction has no external costs (harms to third parties), then allowing the transaction makes the buyer and seller better off and hence is required by the weak Pareto principle.

But when we come to public goods, markets simply don't work. *Why not?* Most simply, because if a good is nonexcludable, then no one will pay for it. Suppose someone goes into the business of cleaning the air witha pollution removal machine. I won't voluntarily pay for this service, because I will be able to breathe the air even if I don't pay. If a private firm offered to defend me against foreign invaders, I wouldn't voluntarily sign

on. My payment would have a negligible effect on the size of the armed forces. If others pay, I don't need to. If others don't pay, then my payment won't do any good. Of course, you will recognize that I am describing the *free rider problem*, a form of the Prisoner's Dilemma. Because markets cannot provide public goods, governments should.

As you might expect, the argument for government provision of public goods and market provision of private goods is controversial. Socialists argue that governments may do a better job of providing private goods because government planning can create welfare benefits that cannot be realized by markets. Libertarian legal theorists argue that markets can provide most if not all private goods for various reasons, including arguments that nonexcludability can often be overcome by ingenious market solutions. I won't get into either the socialist or the libertarian critique of the argument for market provision of private goods and government provision of public goods, but you should know that these criticisms have been extensively developed.

The Expanded Typology: Public, Private, Toll, and Common Pool Goods

So far, we have been assuming that excludability and rivalrousness go together and hence that there are only two categories, public goods and private goods. It is possible to have a good that is rivalrous but nonexcludable or one that is nonrivalrous but excludable. So there are four categories, not two:

1. Public goods are nonrivalrous and nonexcludable.
2. Private goods are rivalrous and excludable.
3. Toll goods are nonrivalrous and excludable.
4. Common pool goods are rivalrous and non-excludable.

We've covered the first two categories, but we need to consider categories three and four. So let's do that now.

Toll Goods and Intellectual Property

A toll good is characterized by nonrivalrous consumption but excludability. Suppose we have a highway in a rural area, where the capacity of the highway would never be approached even if access were free. Nonetheless, the use of the highway can be limited by the installation of toll booths. This

means that we can charge for access to the highway. Economists call goods that are nonrivalrous but excludable "toll goods."

One of the most important applications of the concept of a toll good in legal theory arises in the context of intellectual property. A simplified version of the conventional story goes something like this. Without intellectual property rights created by law, the *information* (e.g. the invention or composition) would be a pure public good. In a world without intellectual property, for example, the first copy of a new book could be copied by the first purchasers. This copy could then be copied by others. Eventually, the "free" copies would dominate the market. And this would destroy the incentives of authors to write! (More on the question of whether this is right towards the end of this post.)

Intellectual property law comes to the rescue. By enforcing patents and copyrights through legal sanctions, intellectual property law transforms information from a public good to a toll good. Intellectual property law creates excludability, but not rivalrousness. For more on this, see Water Wells and MP3 Files: The Economics of Intellectual Property.

Common Pool Goods and the "Tragedy of the Commons"

Common pool goods are rivalrous but non-excludable. An example might be the fish resources in those portions of the ocean that are outside national waters (the high seas). This resource is rivalrous because overfishing can result in a reduction of the stock of fish. However, excludability is difficult to establish. Self-help would work for a localized fishing area where the fish population does not range over a large area; in theory, a patrol boat could establish a virtual fence. But this solution won't work if the fish population ranges over a wide area of the high seas. Unless some international treaty regime can establish enforceable quotas, the result may be a "tragedy of the commons." Each fisher has an incentive to take the most she can, but the result of all fishers doing this is a depletion in the stock of fish that harms everyone.

Club Goods

We are almost done, but we have one or two more ideas to pick up. One is the idea of a "club good." A club good is a good where the utility of each individual's consumption of the good is a function of the number of others who consume the good. Take a golf course. If too many people try to use the course simultaneously, then the utility that each derives from the experience goes down. Golfers have to wait for tee times, the course is crowded,

and so forth. In other words, there are "crowding" problems. One solution to such problems is to form a "club," which limits the number of persons with the right to use the golf course.

Private Goods and the "Tragedy of the Anticommons"

Finally, we should note the flip side of the tragedy of the commons, dubbed by Frank Michelman, "the tragedy of the anticommons."This refers to the phenomenon where ownership in a resource has been divided among so many owners that transaction costs and holdout problems prevent Pareto efficient transactions from occurring. For example, when property was "privatized" in the former Soviet Union, a single apartment building might end up with many, many fractional owners, including ownership interests by various government entities and the residents of the building. In theory, every owner must agree before a transaction involving the building could take place. Given the large numberof owners, the costs of completing the transaction and paying off the holdouts (those who withhold consent to increase their share of the profits) can make the transaction economically unattractive. This is a case where the market is incapable of efficiently allocating a pureprivate good.

Principles of Maximum Social Advantage

The fiscal or budgetary operations of the state have manifold effectson the economy. The revenue collected by the state through taxation and the dispersal of public expenditures can have a 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. The fiscal activities of the state affect the allocation of resources, and the use of resources from one channel to another, hence, the level of income, output, and employment.

Hence, 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 modernwelfare state, such a criterion can be nothing else but theeconomic 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 increasein

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.

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 society. This disutility is in the form of sacrifice involved in the payment of taxes — in part with the purchasing power.

Similarly, when the state spends money, some utility is created in 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 of the welfare of the public expenditure.

As such, the maximum social advantage is achieved when the state in its financial activities maximizes the surplus of social gain or utility (resulting from public expenditure) over the social sacrifice or disutility (involved in the 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 maximized, i.e., when the size of the budget is such that the 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 are just counter-balanced by the disadvantage of a corresponding small increase in taxation or receipts from any other sources of public expenditure and public income.”

Thus, a rational state seeks to maximize the net social advantage of its fiscal operations. The social net advantage is maximum when the aggregate social benefits resulting from public expenditure are maximum and the aggregate social sacrifice involved in raising the public revenue isminimum. 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 using a diagram, as in given Fig1.1

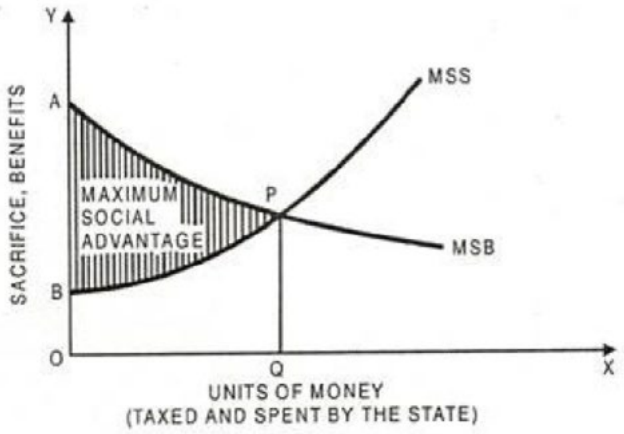


Fig 1-1 Maximum Social Advantage

In the given figure, 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 exceeds 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 amountof 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 become equal.
3. Marginal benefits and sacrifices must be equated.

To sum up, all fiscal operations, both as regards revenue and expenditure, should be treated as a series of transfers of purchasing powerthat must ultimately increase the economic welfare of the people. In this context, Dalton enunciated the principle of maximum social advantage and asserted that the financial operations of the government must be by this principle in a welfare state.

Market Failure and Role of Government

Market Failure and The Role of Government – An imperfect market outcome can be corrected by a change in the incentive structure or reallocation of resources. Economists often differ in their opinion about the type of market failure and the corrective measures required to resolve it.

Market Failure - Meaning

It's impossible to correct the market failures concept without understanding what it exactly is and why it stays. The most common interpretation of a market failure—failing to attain the standards of "a perfect competition in the general equilibrium of economics"— is easily identifiable in most, if not all the markets. While the price equilibrium is ashifting

target, consider all sellers and buyers in the market as sprinters in a race, with the exception that the finishing line keeps changing between right, left, up, and down.

A better pragmatic interpretation of market failures is where the economic participants aren't properly incentivized to push the markets towards more acceptable results. This is also where the most academic literature on market failure is concentrated.

A market failure harms the economy due to the non-optimal allocation of resources. In other words, the social cost to manufacture the goods or services i.e. all the opportunity costs of input resources used in the creation, are not minimized. This also leads to the wastage of resources.

Take for instance the common argument regarding the minimum wage laws. The law sets wages above the prevalent market clearing wageto raise the market wages. Many critics argue that the higher wage cost would lead to employers hiring a lesser number of minimum-wage employees than before the regulation was enacted. It led to more minimum wage laborers being unemployed, forging a social cost that led to market failure.

Reasons for Market Failure

Market failures happen because of the inefficiency in correctly allocating goods and services. The price mechanism fails to factor in all the costsand benefits involved while providing a particular good or service. In such cases, the market won't produce socially optimal goods. They will be either under or overproduced.

To fully understand the concept of market failure, it's pertinent that we recognize the reasons behind it. Because of the structure, markets can't be perfect. Most markets, as a result, are unsuccessful and need some kind of intervention.

Following are some of the key reasons for a market failure.

- ***Positive and negative externalities:*** An externality is the effect on a third party which is usually caused by availing a particular good or service. A positive externality is the optimistic spillover that is gained from the goods or services. For instance, while public education may directly affect only the schools and their students, an educated population will have positive effects on society as a whole. A negative externality, on the other hand, is a pessimistic spillover effect on a third party. For instance, passivesmoking could adversely affect people's health, even if they don'tdirectly indulge in smoking.

- ***Environmental concerns:*** Effects on the environment as an important consideration along with sustainable development.
- ***Lack of public goods:*** Public goods are those where the cost of production doesn't increase with several customers. For instance, a lighthouse has a fixed cost of production which remains the same throughout, regardless of whether just one ship or hundreds of ships use it. Public goods and services could be under-produced. There is little benefit, from the private sector, to erect a lighthouse because one can wait for somebody else to provide it, and then use the light, sans incurring any cost. Someone deriving the benefits of a product or service, without paying for it, is called a free rider problem.
- ***Underproduction of merit goods:*** Merit goods are private-sector products that the society believes are under-consumed. Healthcare, education, sports centers, etc are considered as merit goods.
- ***Overprovision of demerit goods:*** Demerit goods are just the opposite of merit goods, in that society believes are over- consumed, mostly with negative externalities. These include alcohol, cigarettes, drugs, and similar things.
- ***Abuse of monopoly power:*** An imperfect market restricts the output in an attempts to maximize profits.

Probable Corrective Measures for Market Failure

Using the definition of a broad perfect competition, a market failure can be usually corrected by allowing consumers and competing sellers to shove the market towards equilibrium over a while. Markets often tend to constantly move towards equilibrium, but never quite attain it because of limitations to human knowledge, besides changes in global situations.

Many policy experts and economists seek possible regulations and interventions for compensating a perceived market failure. Subsidies, tariffs, punitive or redistributive taxation, trade restrictions, disclosure mandates, price ceilings, and several other economic distortions were mooted to correct inefficient outcomes.

Other economic experts argue that a market is recognizably imperfect. Market failures, however, are improperly framed. Instead of asking whether market failures are related to perfect competition, they say that the question must revolve around whether a market performs better than other processes that humans may trigger.

Free market economists like Milton Friedman, FA Hayek, and others, have argued that a market is the only recognized discovery process capable of adjusting correctly to all inefficiencies. They say that a regulation