PUBLIC FINANCE

MEANING

- 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.

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

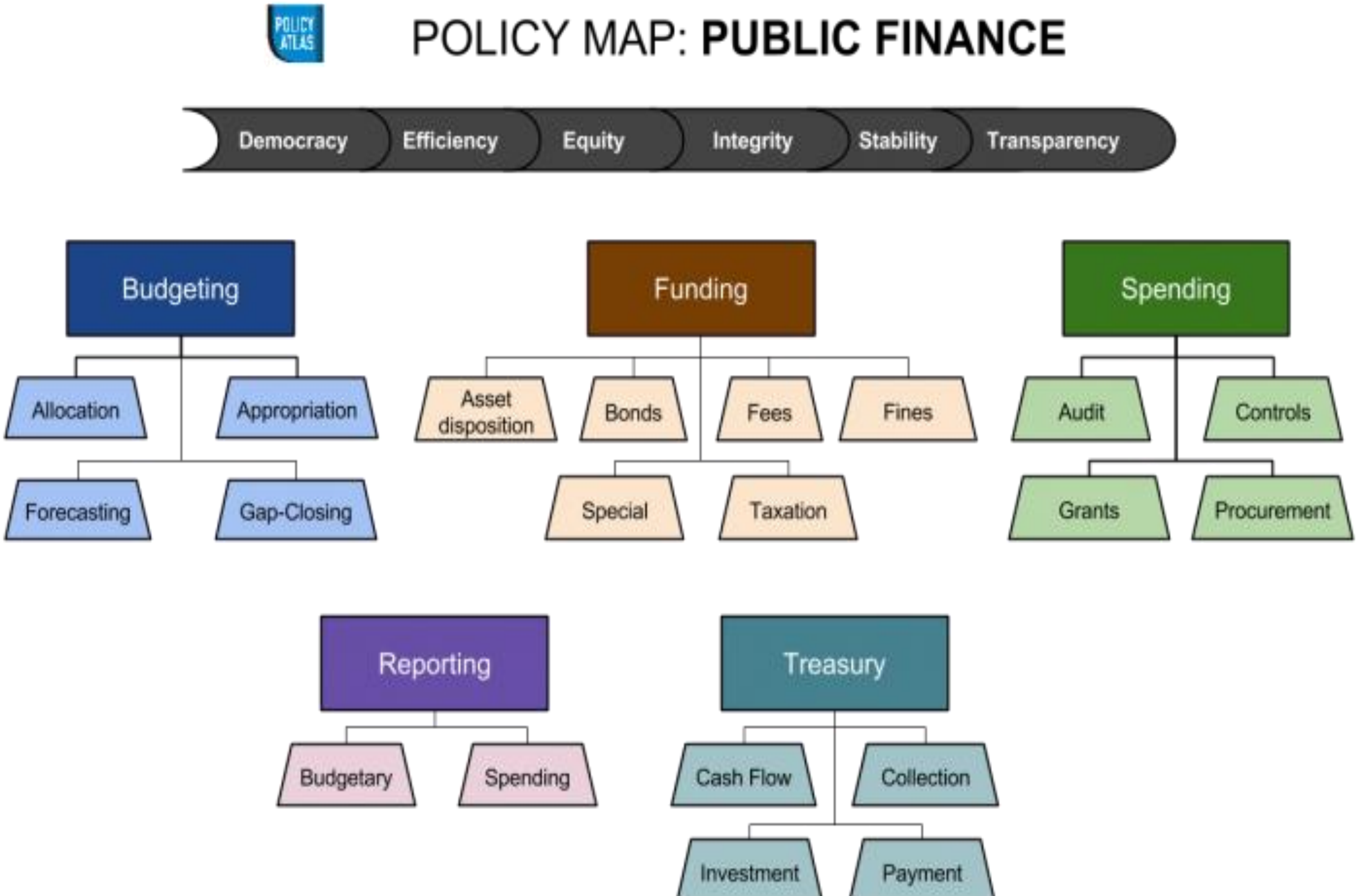
- **According to Hugh Dalton** “Public finance is concerned with the income and expenditure of public authorities ,and with the adjustment of the one to the other.

THE CONCEPT OF PUBLIC FINANCE

- **Public expenditure**: wages and salaries; subsidies and transfers; expenditure on goods and services such as infrastructures like road, electricity, telecom, and human capital accumulation like health and education; interest expenditure etc.
- **Public Revenue**: Different sources of government revenue with major focus on tax revenue.
- **Public Debt**: Often public revenue falls short of expenditure and government has to borrow from internal and external sources.

Nature of Public Finance

- Public Finance as Science
- Public Finance as Art


POLICY ATLAS
POLICY MAP: PUBLIC FINANCE
Democracy
Efficiency
Equity
Integrity
Stability
Transparency
Budgeting
Allocation
Appropriation
Forecasting
Gap-Closing
Funding
Asset disposition
Bonds
Fees
Fines
Special
Taxation
Spending
Audit
Controls
Grants
Procurement
Reporting
Budgetary
Spending
Treasury
Cash Flow
Collection
Investment
Payment

Scope of Public Finance (Subject Matter of Public Finance)

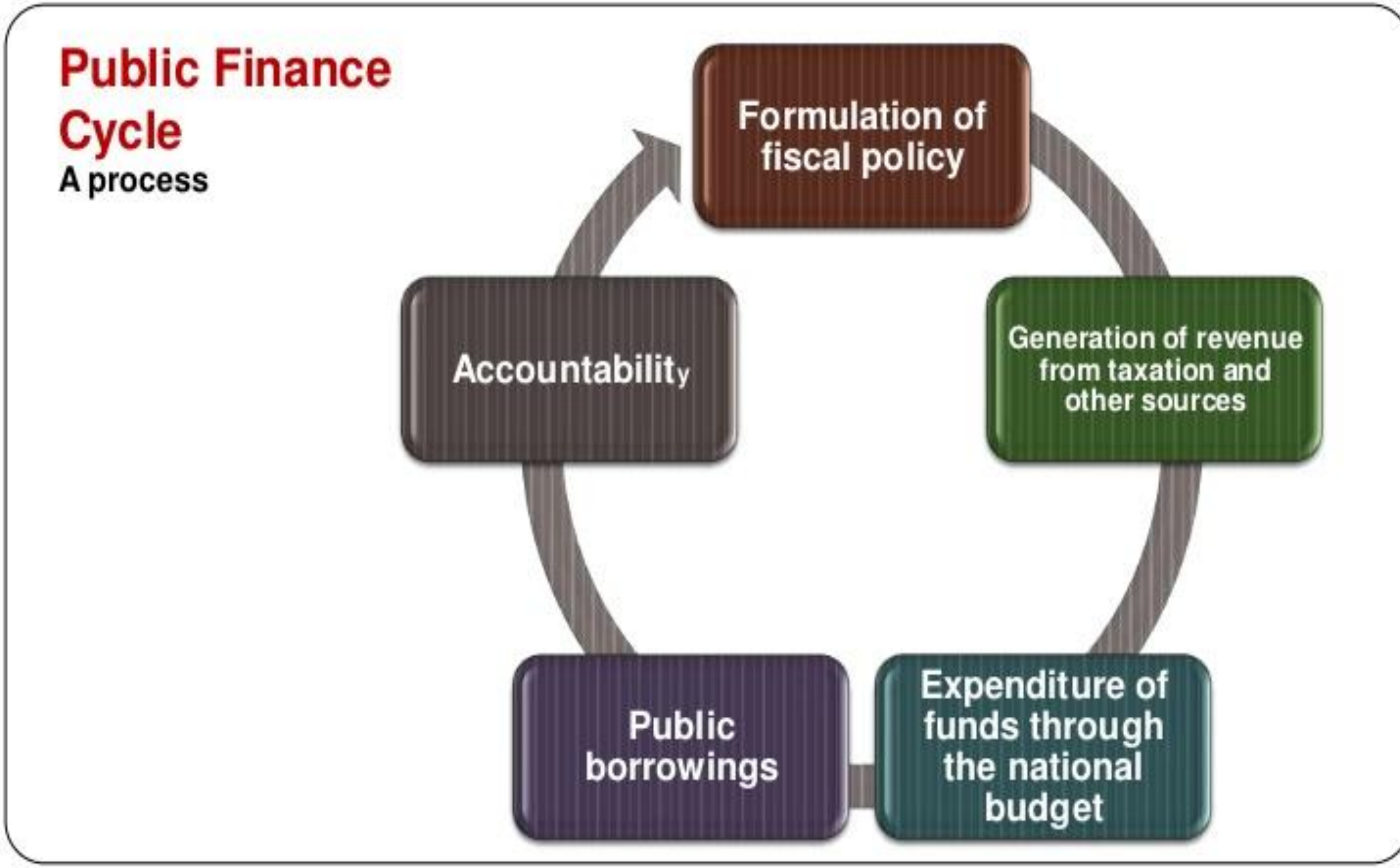
- The scope of public finance may be summarized as under:
- **1.** Public Revenue
- **2.** Public Expenditure
- **3.** Public Debt
- **4.** Financial Administration
- **5.** Economic Stabilization

Importance of Public Finance

- 1. Steady state economic growth
- 2. Price stability
- 3. Economic stability
- 4. Equitable distribution
- 5. Proper allocation of resources
- 6. Balanced development
- 7. Promotion of export
- 8. Infrastructural development

DIFFERENCE BETWEEN PUBLIC AND PRIVATE FINANCE

Private finance (individual)	Public finance (government)
An individual adjusts his or her expenditure according to his or her income.	The public authority adjusts its income to its expenditure.
A private individual tries to have a surplus of income over expenditure i.e. surplus budget.	A public authority will spend all that it gets
An individual can borrow money from other individual only and externally	A public authority esp a state can raised loans from both internally
Finances of individuals are limited	Finances of government are flexible
Private individuals cannot use force to get their income; they cannot compel others to get income	The government can use coercive method to realize revenues
Not a single individual can print notes	A state can print currency notes in order to meet its expenditure in difficult times


Public Finance Cycle
A process
Formulation of fiscal policy
Generation of revenue from taxation and other sources
Expenditure of funds through the national budget
Public borrowings
Accountability

Principle of Maximum Social Advantage

- The 'Principle of Maximum Social Advantage' was introduced by British economist Hugh Dalton.
- According to Hugh Dalton, "*The best system of public finance is that which secures the maximum social advantage from the operations which it conducts.*"

Principle of Maximum Social Advantage (MSA) ↓

- The 'Principle of Maximum Social Advantage (MSA)' is the fundamental principle of Public Finance.
- The Principle of Maximum Social Advantage states **that public finance leads to economic welfare when pubic expenditure & taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.**

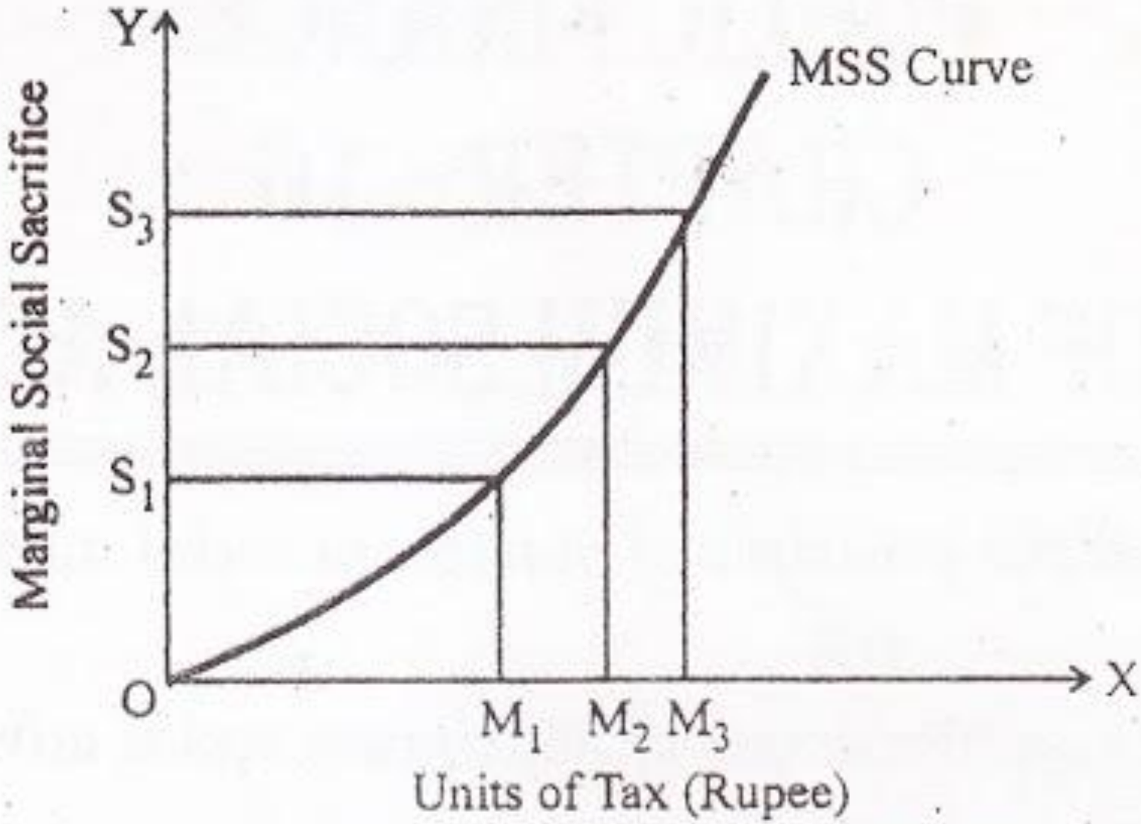
- Hugh Dalton explains the principle of maximum social advantage with reference to :-
- Marginal Social Sacrifice
- Marginal Social Benefits

his principle is however based on the following assumptions :-

- All taxes result in sacrifice and all public expenditures lead to benefits.
- Public revenue consist of only taxes and no other sources of income to the government.
- The government has no surplus or deficit budget but only balanced budget.
- Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

Marginal Social Sacrifice (MSS)

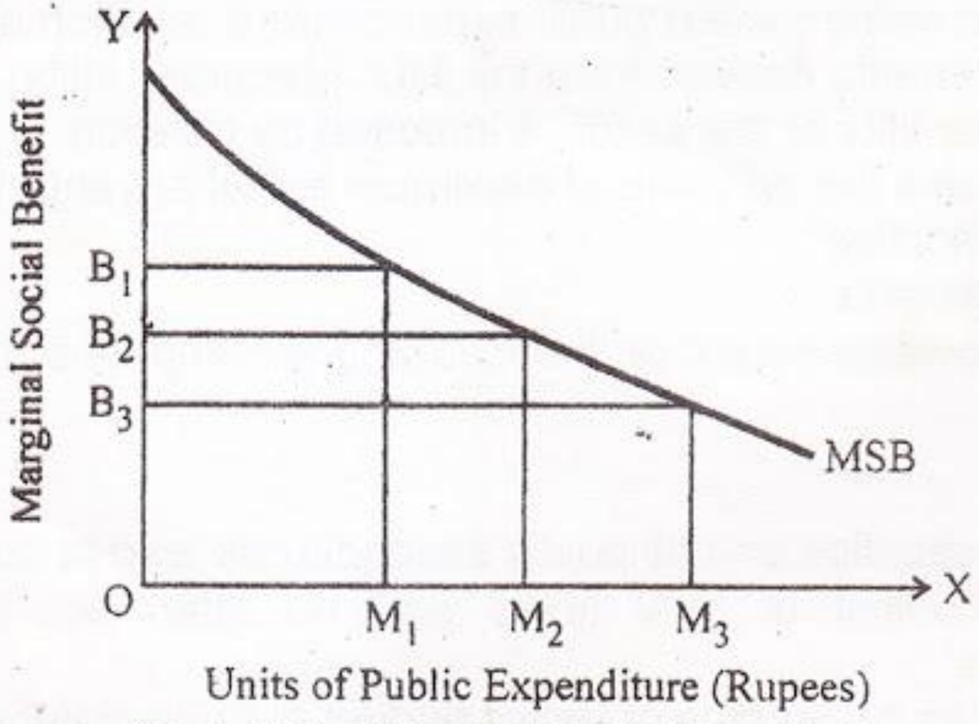
- Every unit of tax imposed by the government taxes result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing i.e. the total social sacrifice increases at an increasing rate.



Increasing Marginal Social Sacrifice Curve

Marginal Social Benefit (MSB) ↓

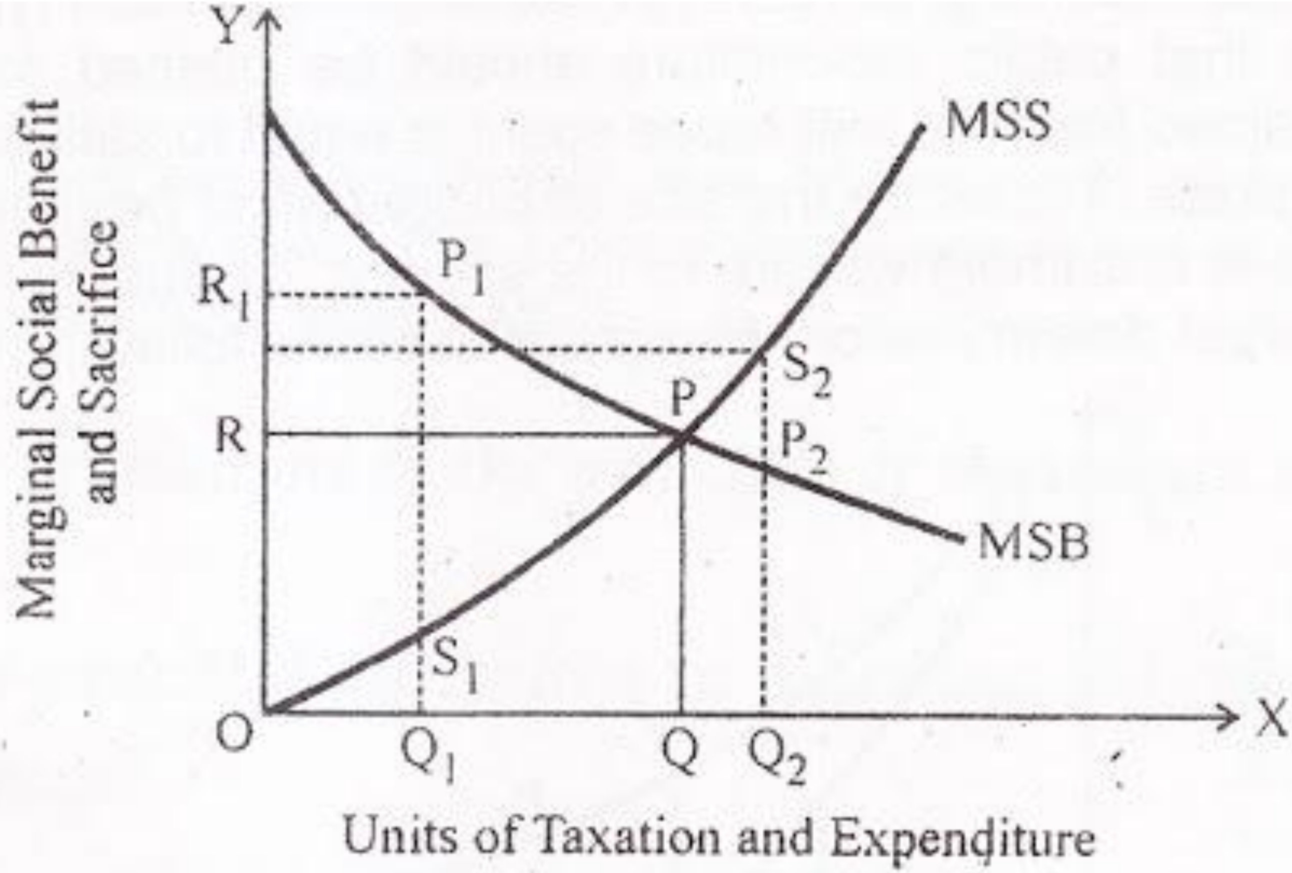
- While imposition of tax puts burden on the people, public expenditure confers benefits. The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal Social Benefit (MSB).



Diminishing Marginal Social Benefit Curve

The Point of Maximum Social Advantage ↓

- Social advantage is maximised at the point where marginal social sacrifice cuts the marginal social benefits curve.
- This is at the point P. At this point, the marginal disutility or social sacrifice is equal to the marginal utility or social benefit. Beyond this point, the marginal disutility or social sacrifice will be higher, and the marginal utility or social benefit will be lower.



Maximum Social advantage is obtained at the Point of Intersection of MSS and MSB Curves

- At point P, the level of taxation and public expenditure moves up to OQ. At this point, the marginal utility or social benefit becomes equal to marginal disutility or social sacrifice. Therefore at this point, the maximum social advantage is achieved.
- Maximum Social Advantage is achieved at the point where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equated, i.e. where MSB = MSS.

Criticism of the theory of Maximum Social Advantages

- **1. Non measurability of social sacrifice and social benefit:** The major drawback of this principle is that it is not possible in actual practice to measure the MSS and MSB involved in the fiscal operation of the state.

- **2. Non applicability of the low of equimarginal utility in public expenditure:** The low of equimarginal utility may be applicable to private expenditure but certainly not to public expenditure.

- **3. Neglect non-tax revenue**: The principle says that the entire public expenditure is financed by taxation. But, in practice, a significant portion of public expenditure is also financed by other sources like public borrowing, profits from public sector enterprises, imposition of fees, penalties etc.

- **4. Lack of divisibility**: The marginal benefit from public expenditure and marginal sacrifice from taxation can be equated only when public expenditure and taxation are divided into smaller units. But this is not possible practically.

- **5. Assumption of static condition**: Condition in an economy are not static and are continuously changing. What might be considered as the point of maximum social advantage under some conditions may not be so under some other.
- **6. Misuse of government funds**: The principle of Maximum social advantage is based on the assumption that the government funds are utilized in the most effective manner to generate marginal social benefit. However, quite often a large share of government funds is misused for unproductive purposes
- **7.** "The government has no surplus or deficit budget but only a balanced budget."- is an invalid assumption.

CENTRE STATE RELATIONSHIP

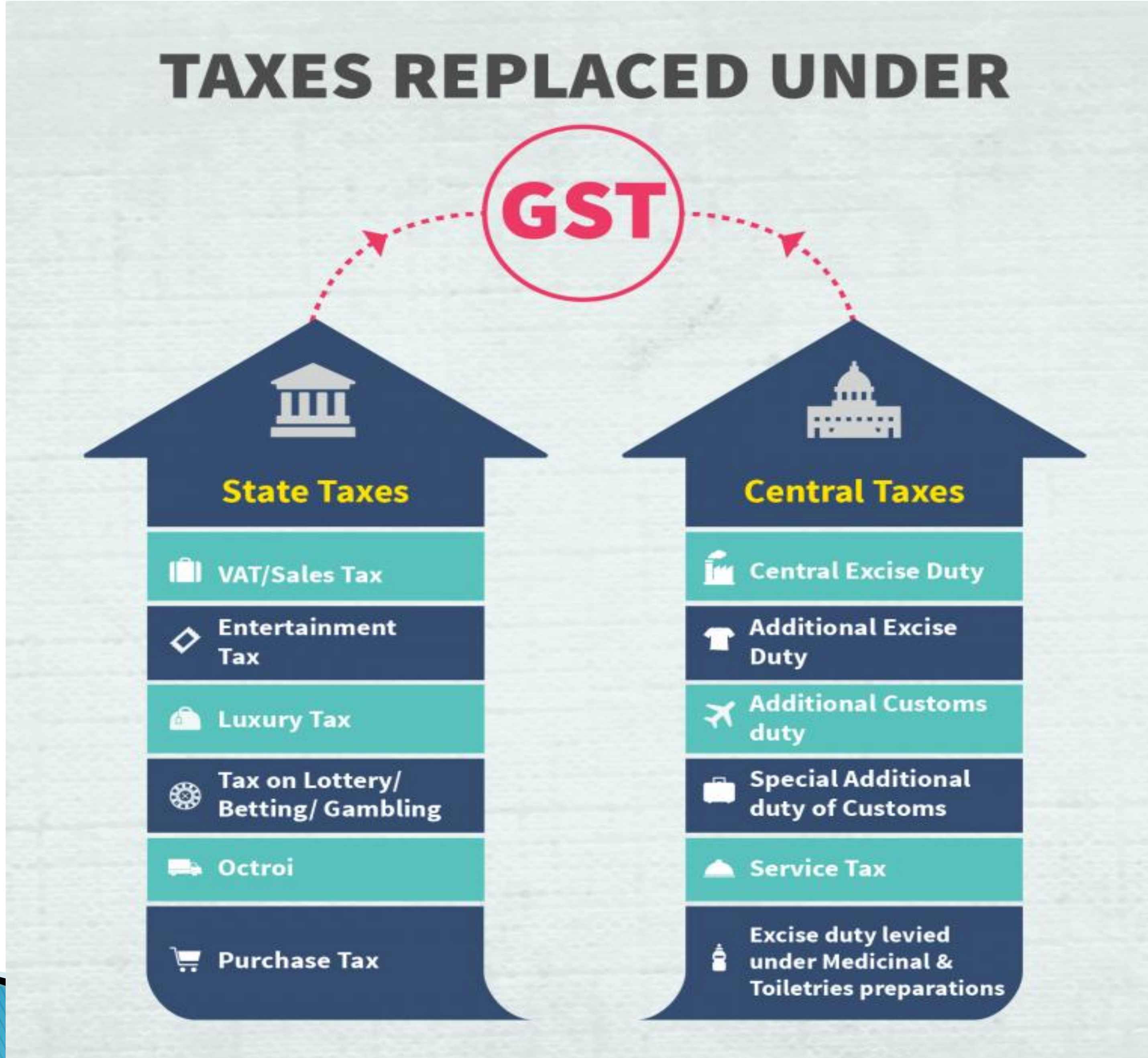
- Constitution does not give clear distinction between the Centre and the state to distribute financial resources and leaves much scope to the centre to decide.
- Financial relationship is much more complex in Centre- state relationships.

The distribution of financial resources between the Centre and the States is as under:

- **1. Taxes Exclusively Assigned to the Union:**
- (i) Customs and export duties
- (ii) Income tax
- (iii) Income from railways and postal departments.
- (iv) Excise duty on tobacco, Jute cotton.
- (v) Estate duty and succession duty in respect of property other than agricultural land.
- (vi) Corporation tax
- (vii) Taxes on Capital values of both individual and companies assets.

- **2. Taxes Exclusively Assigned to the States:**
- Succession and estate duty in respect of agricultural land.
- Taxes on Vehicles used on roads, animals, boats. Income from land revenue and Stamp duty except on documents included in the Union List.
- Taxes on consumption or sale of electricity.
- Taxes on goods and passengers carried by road or inland water.
- Toll tax.

- Taxes on lands and buildings. Taxes on Professions and traders.
- Duties on alcoholic liquors for human consumption. Taxes on opium and narcotic drugs.
- Taxes on entry of goods into local areas.
- Entertainment and amusement tax

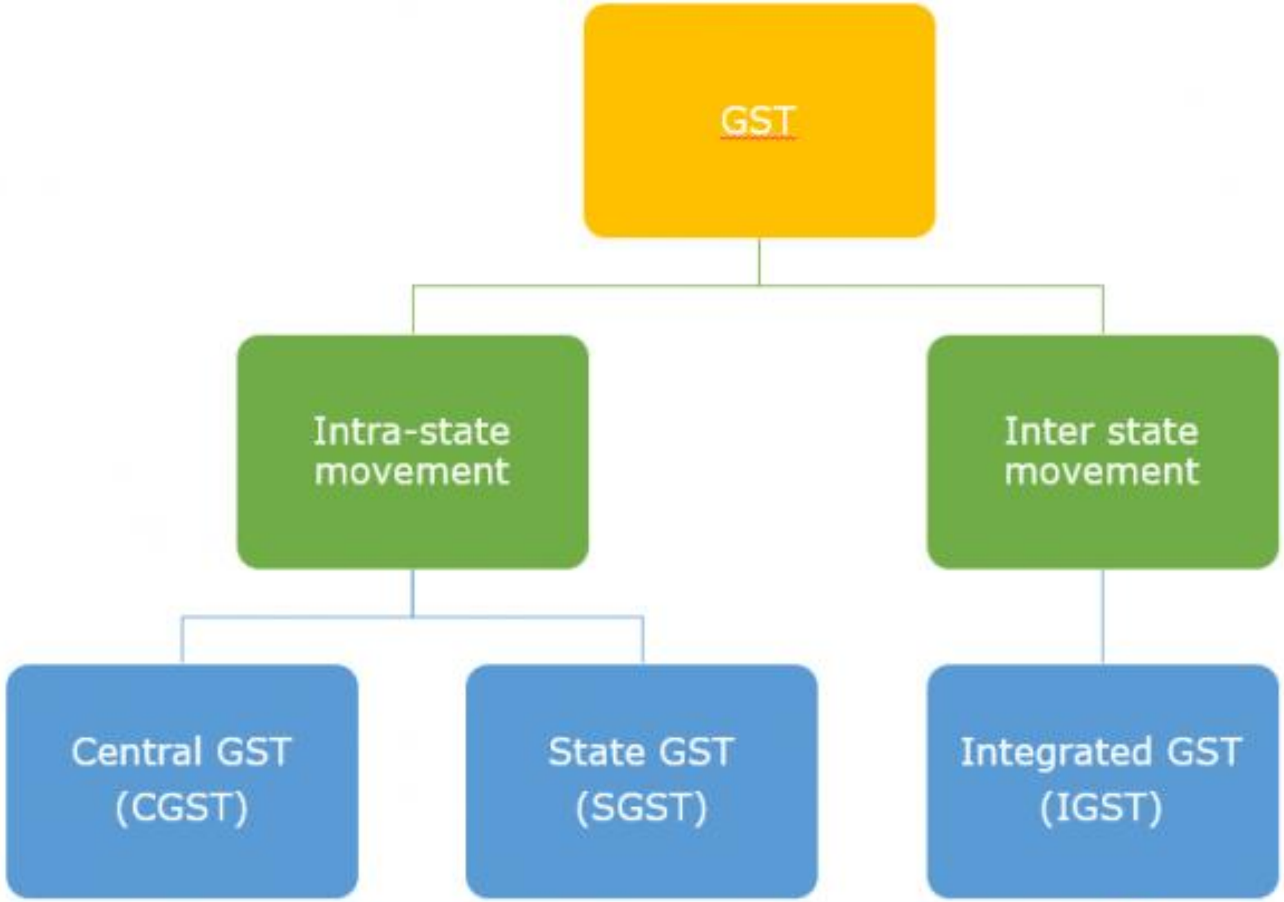


TAXES REPLACED UNDER
GST
State Taxes
VAT/Sales Tax
Entertainment Tax
Luxury Tax
Tax on Lottery/ Betting/ Gambling
Octroi
Purchase Tax
Central Taxes
Central Excise Duty
Additional Excise Duty
Additional Customs duty
Special Additional duty of Customs
Service Tax
Excise duty levied under Medicinal & Toiletries preparations

What is Central Goods and Services Tax (CGST)?

- Under GST, CGST is a tax levied on Intra State supplies of both goods and services by the Central Government and will be governed by the CGST Act. SGST will also be levied on the same Intra State supply but will be governed by the State Government.

Taxes under GST



clearTax

Taxes Which are not covered under GST

- 1. Custom Duty
- The Countervailing Duty (**CVD**) and Special Additional Duty (**SAD**) will subsume under GST, but the Basic Customs Duty (**BCD**) will be charged according to current law only and not GST.
- 2. Stamp Duty
- The buyer has to the pay stamp duty for the registration of the property, and GST will not cover Stamp duty and will be subsumed as per the tax levied by the government.
- 3. Vehicle Tax
- GST does not cover road tax, so the Vehicle Tax will not be charged under GST, and will remain under the **Motor Vehicle Act**.

- 4. Excise on Liquor
- For the time being, Liquor has been kept outside the GST. Alcohol needs a constitutional amendment to be brought under the ambit GST. Though Industry Experts suggest, the GST will impact the sector negatively in the future.
- 5. Tax on Sale and Consumption of Electricity
- GST will not affect the Electricity Bills as of now, and the existing tax system of VAT and Central Excise will prevail on Electricity Bills. The state will charge the **VAT** and Centre will levy the **Central Excise**.

- 6. Entry Taxes and Toll
- GST will not cover the Toll Tax as such taxes like road tax, toll tax, environment tax and others are directly paid by users and will be levied by States directly.
- 7. Entertainment Tax (Levied by Local Bodies)
- The imposition of the extra tax by local bodies is not covered under GST. Hence, in addition to 28 per cent GST, the local body extra tax will lead to **Double Tax.** This will indirectly lead to a sharp increase in the price of the tickets.

3. Taxes leviable by the Union but to be Collected and Appropriated by the States:

- Duty in respect of succession to property other than agricultural land.
- Taxes on railway freights and fares.
- Taxes on transactions in stock exchanges.
- Terminal taxes on goods and passengers carried by railway, sea or air.
- Taxes on sale and purchase of news papers and on advertisements published there in.
- 5. Taxes levied and collected by the Union but shared with the States.

- **Financial Emergency:**
- But in times of financial emergencies control of the union government over the states is immense. As soon as financial emergency is declared the Union government becomes so powerful as to direct the state governments to observe certain norms of financial propriety and other necessary safeguards.
- It can also direct the state governments to reduce salaries and allowances of its employees and even those of the judges of the High Courts. All money bills passed by the legislature, then are to be reserved for the consideration of the President.

- **Finance Commission:**
- In Centre state financial relations Finance Commission plays an important role. According to the Constitution the President is empowered to set up a Finance Commission after every five years to make recommendations to him about the distribution of net proceeds of taxes to be divided between the centre and the states.
- The Commission is also required to suggest the principles on which grant-in-aid of the revenues should to be given to the state governments out of Consolidated Fund of India.

- **Planning Commission:**
- In centre-state relations a very significant role is being played by Planning Commission. It has even reduced the importance of Finance Commission. It is an extra constitutional body. It has more resources to disburse than the Finance Commission.

- **Grand-in-Aid to the States:**
- According to the Constitution states are to receive grant-in-aid from the Centre out of Central revenue. It is to be given with the approval of the parliament to a deserving state out of Consolidated Fund of India. The amount in each case is to be decided by the Parliament.
- Special Grant-in-aid is also given by the Central Government to the state governments of Assam, Bihar, Orissa and West Bengal out of Consolidated Fund of India. The amount to be paid in each case is to be decided by the President of India.