INTRODUCTION TO PUBLIC FINANCE

Edited By
Dr.Dilfraz Singh

Printed by
LAXMI PUBLICATIONS (P) LTD.
113, Golden House, Daryaganj,
New Delhi-110002
for
Lovely Professional University
Phagwara

SYLLABUS

Introduction to Public Finance

Objectives

- The aims of this course are to introduce basic concepts of public finance, particularly in the context of macroeconomics policies, to the students.
- This course will provide students relevant theoretical methods to analyze government public finance policies.
- The course will emphasize on application of advanced macroeconomic to public finance.

Sr. No.	Topic
1	Meaning and scope of Public Finance; Principles of maximum social advantage; Issues related to economic activities of the public sector.
2	Instrument of public finance: concepts and role of budget; Public revenue: Revenue receipts and capital receipts.
3	Taxation and its cannons; Division of tax burden: Expediency theory.
4	Socio – political theory; Ability to pay theory; objective and subjective indices.
5	Incidence of taxes and the effects of a tax, Forward and backward shifting; Theories of tax shifting: the concentration theory; Diffusion theory.

CONTENT

Unit-1: Meaning and Scope of Public Finance

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the importance of Public Finance and its area
- Gain knowledge of the works of Modern States accurately
- Understand the subject-matter of Public Finance
- Explain Public and Private Finance
- Know the importance of Public Finance in National Economy.

Introduction

Public Finance is not a new subject itself and it has been studied till ancient times but scientifically, its study has become possible in current times. In ancient times, the area of this subject was limited but today its area has become more vast. However, the record of income - expenditure in ancient unitary system was kept but its format was limited because the functions of the state were very limited. Against this, the functions of modern state were expending continuously. Specially, after the establishment of Welfare State, the state has entered into economic lives of people that its absence cannot be imagined in current time. Today, the function of state is not only arranging for security and arrangement of law and justice but also it has to perform many welfare works. For example, India and other countries of the world have to perform many tasks such as social security, public security, justice, railway, heavy electrical equipments and atomic power etc. Economic planning and the wave of economic growth have completely changed the structure of the functions of the state. Naturally, the structure of income and expenditure will increase simultaneously with the increment in the functions of State. In this way, it will be difficult to say that State which was started for life only, it is working for good human life. It is clear that the need of suitable arrangement for income and expenditure of the state was felt as a result of increasing works of the state and its result was that today Public Finance and its problem are studying scientifically.

1.1 Meaning of Public Finance

Public Finance is related with income and expenditure of public authorities. The word 'Public' is used normally for Government or State. All type of Governments can be included in public authorities. That's why it can be said that Public Finance is related with income - expenditure of all type of Governments Centre, State and local and income - expenditure of all type of Governments can be studies under Public Finance Different experts have defined Public Finance. Some important are definitions are as follow:

According to **prof. Dalton "It deals with the income and expenditure of public authorities and with the adjustment of one to another."**[1.]

According to **prof. Findlay Shirras, "The study of the principles underlying the spending and raising of funds public authorities"**[2.]

C.F. Bastable says while defining it, **"Public finance deals with the expenditure and income of public authorities of the state and their mutual relation as also with the financial administration and control,"**[3.]

In the words of **Prof. J.K. Mehta, "Public finance then constitutes a study of the monetary and credit resources of the state."**[4.]

Analysis - It has been clear after studying various definitions of Public Finance given by various scholars that the basic meaning of Public Finance is about income and expenditure of public authorities of centre, states and local. But, in today's context this meaning has become more vast and expand. Now, Public Finance is not related the Governments income and expenditure only but Financial Administration, Accounts Auditing and Financial Control can also be included under this. Therefore, we can define Public Finance this way - It is that science which study the reactions upon society and economy of Fiscal Policy and Fiscal Activities and Public income - expenditure, debt and Financial Administration, basic principles of Accounts Auditing and Financial Control.

Stanford has defined Public Finance in following way, "Public finance is related with fulfillment of group needs specially. We study economic problems in it which arises within State or public sector such as how to divide resources between private and public sectors and how resources are allotted for fulfillment of different sources of Government expenditure under public sector." It is clear that public finance studies the problems related with adjustment and methods of various Government income and expenditure. The ways by which public bodies spend their money and the methods by which they get income and debt, these ways and methods are called the functions of Public Finance.

1. "It deals with the income and expenditure of public authorities and with the adjustment of one to another." *– Dalton*
2. "The study of the principles underlying the spending and raising of funds public authorities." *– Findlay Shirras*
3. "Public Finance deals with the expenditure and income of public authorities of the State and their mutual relation as also with the financial administration and control." *—C.F. Bastable*
4. "Public Finance then constitutes a study of the monetary and credit resources of the State." *– J.K. Mehta*

Hence, these methods are related with the function of fiscal or public treasury, therefore those are called fiscal operations also. In this way fiscal operations and fiscal policies have become part and parcel of Public Finance. The effect of fiscal operations and fiscal policies can be felt on national production, national income, standard of living, distribution of money and income and money market etc, and they affect the whole economic life of the country. In this way, every person of country is related with the methods of Public Finance.

Notes Fiscal policies are undivided part and parcel of Public Finance.

1.2 Importance and Scope of Public Finance

We will study the importance and area of Public Finance under following three headings -

1. Functions of State
2. The effect of Fiscal operations on economic life, and
3. The subject matter of Public Finance

(1) Functions of the State— Ancient economists believe in laissez faire, therefore they supported that the number of functions of State must be minimum. In 1776 **Adam Smith** wrote about the functions of State in his book "Wealth of Nations" first of all. According to **Adam Smith**, the duties of "a complete sovereign rich nation" can be divided into following three categories -

(a) To provide security to nation against war and injustice of other nations.

(b) To maintain peace, justice and system among citizens, and

(c) To build and conduct such public functions and public institutes, which can be highly beneficial for whole society, but they will not provide profit if started and conducted by some private persons. Their saying was that in such public functions, those functions must be considered main by which public functions of trade and commerce in State must be created. It is clear that these three functions are the primary functions of any Government. We can not imagine and static social system which do not consider basic functions to these functions. In today's time, the Government have to perform functions to achieve the economic and social goals which can be placed into **Adam Smith's** third category of work. Here, this is noticeable that in 18th century in England **Adam Smith** emphasized on the growth of these two branches (i.e., economic and social goals) of Government expenditure also.

But many economists, such as **Robert Owen** and **John Stuard Mill** in England who were the followers of classical school cast the attention of people towards laissez faire and supported Government intervention. **Sisomandi** in France also criticized the principle of laissez faire and suggested for Government control for the prevention of rights of poors. The socialists of many countries therefore suggested for socialization of resources of production in some form or other, by which labour class can be saved from the cruelty of famous capitalist economy. Economic depression of 1930 and the general principle of employment by keens proved valley of death for laissez faire. Keens told that it is possible to rise employment by fiscal operations of state and to maintain it at high level. In this way, Government intervention in economic life and support of admission are increasing continuously and this series is in continuation.

But, the concept of state and format of the functions of the state are changing slowly. This fact has been accepted widely that the objective of state is to provide maximum welfare to whole society. As a result of this concept of state, the functions of state have expanded and therefore they have to arrange for treatment, education, help to poors and health care and many other public services, by which there can be increment in the welfare of whole society. In today's time, state helps its public by many ways. For example, it increases the production power of country by arranging basic facilities such as railways, roads, electricity and post and telegraph, it takes necessary steps to reduce the inequalities found in the distribution of income, it controls the production and distribution of deficient things, it controls the rates of essential commodities and takes necessary steps to stop inflation and depression. During war time, state controls the whole resources of the country and gives them right direction to move so as war can be faced successfully.

The Government of advanced Countries are duty-bound and promise - bound that they maintain a static and wide level of the employment of the country. Their goal is that the economy of the country becomes active at the level of complete employment. It takes part in these programmes actively by which there must be increment in national income and economy must be moving towards progress. When the question of under developed or developing countries Governments arise, they are committed to the programmes of progressive economic growth. Therefore it can be possible that such countries develop their complete resources systematically. It is clear that the functions of state in all countries developed, under developed or developing have increased concretely and the possibility is that when the duties and responsibilities of the Government will increase, then the functions of state will expand more. The current situations of our country verify this fact. Our country is an under developed country. Therefore, for implementing developing plans, the Government is bearing new responsibilities on it and their admission is expanding and the counting of their works is increasing.

Do You Know? Adam Smith wrote about the functions of state in 1776 in his book ' Wealth of Nation ' first of all.

Self-Assessment

Fill in the blanks:

1. Public Finance is related with the income and .... of Public - Government.
2. The word .... is used normally for Government or State.
3. The functions of Public Finance is called the function of ....
4. Adam Smith wrote about function of state in .... in his book 'Wealth of Nations' first of all.
5. The economic crisis occurred in ....

1.3 Functions of Modern States

The state has to expand its expenditure to fulfill the expanded functions and for fulfilling the expenditure, it has to get money from adopting various means for given methods in Public Finance. Therefore, with the expansion of the functions and responsibilities of the states, the importance and area of study of Public Finance is also expanding continuously these days.

After analyzing the functions of Modern State, we know that the following services are required for welfare —

(a) To arrange expenditure for **Internal and External Security** and soldiers, police and other security services.

(b) **Justice** or solution for controversies.

(c) Organization and control of economic industries and other such services such as coinage, weight and measures, regulation of professional activities and Government ownership and conduction of some **Enterprises**.

(d) To develop social and cultural welfare by education, social help, social insurance, health control and other such activities.

(e) Irregularization of moral levels by controlling on manufacture and sale of medicines, sale of wine, gambling and other anti social activities.

(f) Preservation of natural resources.

(g) To maintain and expand the unity of state by controlling on the means of transport and communication and other such means.

(h) Government administration and aid to Government officials.

(i) Financial arrangement of Government and administration of fiscal control.

(j) Religion related functions from time to time.

Effect of Fiscal Operations—We know that by economic analysis that the activities of Public Finance leave solid impact on investment and usage. Therefore, they are used easily for immobilizing in economy and controlling for total demand. The main base for bringing immobilization in Government expenditure management in fiscal policy and the total expenditure of the country can be controlled by bringing change. But, in this direction, Government expenditure can become active only when Government spends more or less from its income in any definite time period. Therefore, developed countries take shelter in good fiscal policy for bringing stability in their economy and it is considered the best option fulfillment for that objective from all other options of economic planning.

Although there are some limitations for above mentioned statement, but it proved a powerful and only weapon for expanding under ownership in income and production and in some limitations. In advance economy, where per capita income is at good level, the main hurdle in the way of development in national income is that the demand does not increase in comparison with the increment in resources, therefore the chances of investment become less. The reason for demand is that marginal propensity to consume decreases with the increase in income. Therefore, if we bring more similarity in the distribution of income then usage work is enhanced and investment and total production decrease. In this way, industrial country having high income adopts economy having 'high labour and low profit' and by such any fiscal policies, our income and living conditions of people can be raised by bringing maximum similarity in distribution from income by such any fiscal operations. Therefore, for bringing economic stability in developed countries and for equal and justifiable distribution of national income and production, operations of Public Finance are considered important.

In underdeveloped countries too, the main objective of the Government is to develop economy of the country fastly and there must be equitable distribution of national production, and fiscal policy can be an important weapon against achievement of these objectives fiscal policy can effect the economy of the country, on one hand, it can do so by increasing in the quantity of public income and on the other hand, it can do so by quantity in public expenditure and its directional change. Three important fiscal policies, by which Government Treasury or the means of fiscal can be expanded, these are taxation, public debt and debt procurement. It is important that fiscal methods must be used by making suitable coordination between them, so as on the economic lives of people, it can spell best and vast effects as social welfare and economic progress.

This must be understood clearly that taxation is most important among these three methods. If taxes are levied intelligently and if they are implemented cautiously, then taxation can become an effective tool in fiscal policy. As an organ of general programme of growth, taxation can be used for achieving following objectives —

(a) By banning consumption or by subsidizing it, the means of origin must be transferred toward investment of consumption.

(b) To motivate and encourage saving and investment.

(c) To give resources to the hands of state from hands of public, by which public investment can be possible.

(d) To minimize economic inequalities.

In this way, it is clear that all these objectives match with the last objectives for high growth in national income and betterment in its distribution. Therefore, for the view of economic development and social welfare of underdeveloped countries, operations of Public Finance are important.

1.4 Subject - matter of Public Finance

Public Finance is that science which has relation with Governments income and expenditure. But, in modern time, its area and importance has been expanded. Modern political thinkers have divided it into following departments. Public Expenditure, Public Income, Public Debt and problems of Government Treasury in complete sense, such as Financial Administration. The precise details of these departments are as follow—

(1) Public Revenue – In this department, analyze and synthesis of receiving of public income and ideas of its expansion, rules of revenue and its other problems take place.

The following tasks are concluded under this department:

(a) What are the sources of Public Income i.e., categorization of Public Income.

(b) Revenue that is an important source of Public Income, what are the types of revenue i.e., categorization of Revenue.

(c) What things must be kept in mind while imposing Revenue i.e., Rules for Revenue Implementation.

(d) What is meant by the public power of giving revenue and it depends on what conditions i.e., Revenue giving capacity and its imposing factors.

(e) What effects is felt of Public Income on country's production and financial distribution i.e., effects of Public Income.

(f) Which factors are responsible for transfer of revenue from one person to another successfully? i.e, Factors of Revenue Distribution.

(2) Public Expenditure — This department of Public Finance studies the principles of Public Expenditure and its effect on country's financial life such as production distribution and its effect on various categories.

Under this department, study and synthesis of following problems take place —

(a) Categorization of Public Expenditure.

(b) What aspects should be covered in Public Expenditure or what not? i.e., The Area of Public Expenditure.

(c) What should be kept in mind while doing Public Expenditure? i.e., the principles of Public Expenditure.

(d) What effect does Public Expenditure cast on country's production and financial distribution? i.e., effects of Public Expenditure.

(3) Public Debt – Under this department, it is studied that why we bring Public debt, how we bring them, what is their mode of payment and their effect on society.

Under public debt, following aspects are studied –

(a) Under what circumstances, it will be compulsory for the Government to take debt i.e., the area of Public debt.

(b) What are the types of Public Debt i.e., the categorization of Public Debts.

(c) In what conditions, it will be better to take debt and in what condition, it will be better to impose revenue i.e., comparative study of debt and revenue.

(d) In what conditions, it will be better to take debt with in the country and in what condition, it will be better to take debt from foreign country i.e., comparison of internal and external debt.

(e) What is Finance Management of loss? Upto what extent Finance Management of loss can be done and what are its effects i.e., meaning of Finance Management of loss, its limitations and effects.

(f) What are the methods of returning of debt and what are the benefits and the limitations of each i.e., the principles of usage of Public Debt.

(g) What are the effects of Debt?

(4) Financial Administration - In this branch of Public Finance, methods of Administrative Control and the problems related to the preparation of budget is studied and analyzed. Under Financial Administration, following aspects are studied -

(a) How the budget is prepared, cleared and implemented.

(b) How the collection of different taxes is done by the officials and the institutions?

(c) How the conduction of Expenditure Department is done?

(d) Which department and officials are responsible for writing and auditing of Public Accounts and what are their rights and responsibilities?

Bastable has especially emphasized on the need and importance of revenue of this department. According to him, no book of finance can be considered complete unless it studies the problems of Public Administration and Budgeting.

Modern Aspect Regarding Subject - Matter

According to modern economists and thinkers, following two parts can be included in the subject - matter of Public Finance in addition to its four parts described earlier.

(1) Economic Stabilisation - Under this department, it is studied that in current scenario, the main objective of all economic systems is economic stability, how fiscal policy is adopted to maintain it? The Fiscal Policy is considered an important weapon to maintain judicial distribution in national income of the country. With its help, economical stability can be maintained by using production activities of the country.

(2) Economic Growth - According to some experts, the problem of economic stability is basically a problem of developed countries. In developing countries, the main problem is of Economic Growth. In this condition, in these countries, there is a need of growth in income, saving, investment and capital - establishment which can be possible by the usage of National Treasury Apparatus. In this regard, popular economist **Prof. Regnor Nurkse** rightly says, "It is my complete faith that in developing countries to solve the problem of capital - building, Public Finance has taken a place of a hero." In this way, it is clear that in planned growth in fiscal policy, which is a part of the subject - matter of Public Finance, its study is important.

The area of Public Finance and its subject - matter is not constant because it is growing continuously with the changes in concept of state, work of state and the problems of Economy.

Example It was already clear by the serious economic crisis of 1930 and Keen's writing named 'General Principle of Employment' how important are fiscal policies in bringing economic constancy and maintaining it. Nowadays, Government Income, Expenditure and Debt in Public Administration and the economic and social responsibilities of state are growing continuously. New problems are creating in Public Administration and security. Because of all these factors the area of public finance is expanding day by day.

Self-Assessment

State whether the following statements are True or False:

6. The functions of Public Finance lay emphasis on investment and usage.
7. Government Expenditure is the main base of Fiscal Policy bringing inconsistency in economy.
8. Fiscal Policy affects on the economy of the country.
9. Public Finance is that science which has no relation with Government's income and expenditure.
10. The area and subject - matter of Public Finance is not constant.

1.5 Public and Private Finance

On comparing Public and Private Finance, we know that if there are similarities in them, we also find dissimilarities, which is clear by following description :-

1.5.1 Similarities

The similarities found between Public and Private Finance are as follow:-

(1) Maximum Satisfaction – The objective of individual and State is basically same and this is satisfaction of human wants. Private Finance is related with the satisfaction of individual needs whereas public finance is related with the satisfaction of social or group needs.

(2) Balanced Budget – Man and State both get money and use it and each of them try to balance income and expenditure. Both of them try hardly to get maximum satisfaction by expenditure.

(3) Borrowing – When current income becomes less in comparison with current expenditure in both Public and Private Finance, then borrowing becomes important. Not only individual but state also has to payback the debt taken at the time of loss.

(4) Economic Choice - Both Public and Private Finance want to get maximum satisfaction and target by minimum resources, so both have to face the problem of adjustment of income and expenditure and problem of selection of economic choice.

1.5.2 Dissimilarities

Basic difference is found in many ways between Public and Private Finance such as objective, methods for getting Finance and quantity of resources etc. For example, as far as Public Finance believes in public welfare, whereas the only objective of Private Finance is getting profit. Former fulfills for the loss by imposing new taxes or by any other means, whereas later cannot do so. In the same way, the resources of Public Finance are big and enormous but the resources of Private Finance are limited. We will explain this topic in detail now.

(1) Determination of Expenditure - Public authority decides the amount of expenditure first of all which it has to use on different aspects to fulfill its some responsibilities and after that it searches for the resources to fulfill that expenditure. But, a person first of all considers his income and he decides the amount of expenditure after that which he has to consume on different aspects of consumption. The reason for this is that public finance can increase or decrease its needs of income accordingly, but no such flexibility is found in the income of a person. **Prof. Dalton** has expressed this thought in these words, "A person adjusts his expenses according to his income but Public Finance adjusts its income according to its expenses. **"But this satatement is true with some limitations."** For example, if the expenses and duties of a person increase then he tries to increase his income but on the other hand, any Government or Public authority can not increase their expenses by indefinite limit. They have to watch out how much income they can get without causing any harm to the economy of the country. Therefore, sometimes, Government have to decrease its expenses due to lack of resources.

(2) Compulsory Character - According to **Findlay Shirraj,** "Government expenditure has another characteristic, that is compulsory character found in it. Some expenses are those which cannot be terminated or divide by State, but it is not possible in case of a person. For example, the expenditure on security and Public Finance etc. is of compulsory nature. In the same way, state can force its people that they use a special variety of clothes, grain and other things, they buy those commodities on Government imposed rates and pay them on the installments decided by Government. But private person or professional firm cannot do so. Not only this, situations can also force a person that he spends a special amount on food minimum clothes and housing etc., and he must wear and buy a special kind or sample clothes. In all these matters he motivates only by interest, taste and choice but also he gets affected by the availability of goods and environment of society.

(3) Principle of Equi-marginal Utility - For gaining maximum satisfaction "a person divides his expenses on different commodities and services in such a way that marginal utility of expenses on all heads must be equal and total marginal utility must be maximum by getting complete expenses," There must be a same rule on distribution of Government expenditure between different objectives and heads. But, it has been found that a person is more capable to implement this rule in comparison with Government. The reason for this is that a person is more independent while choosing heads of expense of his will, while Government is not independent like that. Normally, there is a standard for a person for spending or not spending that how much profit, he is getting on a special expense - but Government - cannot make the base of its expenses to this standard, specially on the expenditure on security, establishment of law and order, education, help for poors etc. It is clear that Government is not independent on the matter of these expenses. Sometimes, government is forced for spending money on special aspects only, whereas, in the state of lack of pressure, Government do not like to do so. It is possible only when some same favour group or person in the country come in the position of criticism of Government and pressurizing it by becoming more powerful. The result is that Government expenditures increase on important aspects.

(4) Nature of Budget - A person believes in surplus budget or spending less than income normally and does not believe in deficit budget or spending more than income. But, Government or any other Public - sovereign can consider making deficit budget profitable specially making of surplus budget by person during economic growth and during war time is considered good and this task is considered his personal ability because an individual can collect money by savings only and can become rich, but Governments surplus budget means that taxation of high level and Government expenditure of low level, but in normal conditions, for Government balanced budget is considered good not surplus or deficit budget.

(5) Nature of Resources - The resources of getting income of a person are limited. Government can borrow money from general public and foreign countries when needed, but it is not possible for a person to do normally. The Government can take shelter of deficit financing of laws, it means it can print currency notes to increase its income, but no one can do so. Public authority can make such law by which it can handle profitable business and profession for the objective of increasing income itself, for example, it can nationalize private transport and private whole sale business. The Government can adopt coercive method for getting money from general public.

(6) Motive of Expenditure - In professional dealings, the first objective of private person is to get profit. But, the dealings of public bodies are motivated for the objectives of public - welfare not for the objectives of profit. For example, many services like public health, health service, education, activities of social security and water supply etc. are not considered profitable for professional front but they are considered very important for the welfare view of citizens and for the same reason such facilities and services are arranged by public services.

(7) Long Term Consideration - Private person or companies invest money liberally in those professional areas where there is a need of getting immediate returns but in those areas in which marginal returns are received and it got lately, **Private Capital Shies**, but Government never got affected by these views and thoughts. Therefore, Government handles these projects itself but they must be appropriate for the view of public welfare. The construction of multi purpose Hydroelectric Projects in India are its direct example. In this way, Government uses many expenses for the view of public welfare which are used for future and present. Future is as important as present and Government arranges for the arrangement for expenses for future and present, a person can not do so like that.

(8) Coercive Method - Government or public - sovereign can adopts the methods of force for getting its income. Suppose, a person does not pay due income tax then he can be punished by the court or he can be punished economically for increasing tax - payable on him. In this way, a person can not deny the payment of taxes if it is due on him. Private person or businessman cannot use power in that way for getting his income, the way Government does. That is the reason that in comparison to private persons or businessman, the income of Government is more assured.

(9) Publicity and Audit Test - Lastly another difference between public and private finance is important. A private person likes to conceal all his financial deals but Government publicizes more to its means of distribution of resources in various aspects of five - year plans and budget - proposals. In addition to this, audit - examination and evaluation of accounts of public services are done compulsorily but is not essential in respect to the person always.

Task Differentiate between public and private finance.

1.5.3 Trends in Public Finance

General Economic Theory has always affected the views of public finance and the Government activities. The ancient view of Public Finance was based on Classical Economic Theory but there were many revolutionary changes were seen after that. At last, modern economic theory was implemented which is called **keyne's General Theory of Full Employment**. Because of this theory, the ancient concept of public finance has been changed also.

Notes Keyne is considered the founder of Modern Theory of Public Finance.

As a result, the responsibility of new achievement in economy of public finance and fiscal operations have been developed.

(1) Classical Theory - The demand of ancient economical theory was that supply can developed its demand itself. Therefore, the situation of over production or un-employment never arises. This theory gives emphasis on full employment or full use of resources. If labour is movable and wages are flexible then full use of resources by private enterprises can be achieved and unemployment generates because of immobility of labour and inflexibility of wages. Ancient or classical economist thought that the expenditure of one person is the income of another person, but they also expressed that by decreasing the expenses of a person, we cannot decrease the income of another person, because the money saved by him by reducing expenditure will be invested, it means it will be spent on the expenses of industries of capital commodities. The meaning is that there will not be any reduction in effective demand. Classical theory of public finance is based on ancient general economic theory.

Classical theory of Public Finance is based on classical General Economic Theory. According to this, private enterprises become assure about the subject of full employment and the State is unsuccessful in raising the level of economic operation of state. If government increases its expenses by taxation then its meaning will only be this that the expenditure has come into the hands of Government from the hands of private person but it will not increase total demand in area of production. If Government increases its expenses by borrowing money then the meaning of it will be competition from private persons and dearness will increase. The meaning of this is that classical economists believed in balanced budgeting. Taxes always affect on savings in some way or others, therefore, as a result of reduction in private savings, the level of private investment can also decrease. It is clear that it affects on the moment of money inversely. So, they believed that small budget is the best budget. The most undesirable taxes are those which give more burden on private savings such as death tax, super tax and business tax and direct tax. But, on the other hand, in direct taxes affect on consumption, therefore, they can be considered harmless by economic view although they are undesirable too by social view. Its meaning is that classical economists have supported direct taxes. If the loss of budget is compensated by printing notes or by taking short term Government loan, then it increases inflation. Its reason is that the rate of interest does not increase much during short term period that it can deflate the private investment and this position can mismanage the increment in the expenses of Government. If the loss of budget is compensated by issuing long term Government bond these bonds are considered substitute of business bond on shares and inflation does not occur by them. The loss of budget decreases the rate of progress normally, if the Government does not use the full borrowed money in construction of monetary decorum. The following conclusions can be obtained by above mentioned analysis -

(1) The Government can not increase in the levels of economic operations within the country.

(2) The budget should be balanced.

(3) Small budget is perfect budget.

(4) Those taxes are harmful for the society which lie on savings such as income tax, death tax etc. The taxes which lie on consumption are less harmful.

(5) If we cannot spare ourselves from the loss of budget then this is convenient to issue long term bonds.

(6) Landing must be for productive investment only.

(2) Modern Theory - Keyne's Employment Theory is based on this general principle that the expenditure by one person is the income of another person. If the whole income is spent by a person then as a result of this the income of that person increases as much as that person has spent if a person does not spend a part of his income and this reduction in expenditure is not fulfilled by investment - expenses, then its effect will be that the lesser expense by a person will reduce the income of other persons. The persons will spend less because they will get less income and as a result of this, the income of other person will also decrease. By this either employment will be available as a result, there will be a reduction in national income.

However, Keynes has not accepted a view -

(a) That, the motive of consumption is to increase the movement of money inversely, unemployment increases and national income decreases by the trial of saving.

(b) That employment must be provided at the lowest level of wages. Against this, their view was that by reducing wages, the demand of commodities will decrease and condition of expulsion of labourers will arrive.

(c) The pattern of establishment of such economic system is found which is based on private property and which adjusts the level of full employment in itself.

Now, we will analyze that how the serious change in general theory of economy affect the theory of public finance. It is clear that Keynes has not accepted the classical theory of full employment and told that the balanced budget is not desirable in all conditions but budget is considered a powerful tool in current times such as - (i) Receiving full employment (ii) High level of investment (iii) Deny of inflation i.e., the lack of both inflation and deflation (iv) Best distribution

But practically, it can be difficult that all objectives are achieved simultaneously.

It can be said if inflation has increased more than its solution is surplus budget; and if deflation has increased more then the solution is deficit budget. If we want to bring the state of lack of inflation then it is important that total value of new savings (all Government and non-Government) must be equal to the value of new investment (all Government and non-Government). If the savings are lesser than investment then inflation will occur and costs increase. Inversely, if the savings are more than investment then deflation will occur, the cost will decrease and unemployment will increase. If there is an increment in employment income, new investment increases definitely to bring new savings. But, with the increase of income, the propensity to consume of people does not increase in such a way. As a result, consumption does not increase with the speed of raising income. Its result is that savings increase more and effective demand decrease, and unemployment occurs as a result of increment in effective demand. It is that state in which we know the importance of public finance. In this state, the state can increase effective demand by spending Government money on investment of roads, rails, public utility industries and business. The money invested by Government in such a way can be borrowed by people, and this borrowed money by the people to Government can be a part of that income which was kept by people in cash form instead of spending on commodities of consumption. The Government is in good state of taking money for investment by inflation caused by deficit public system. In this way, it can fulfill that loss of total expenditure which was caused by those savings of people which was not available for investment. Classical economists could not understand this important contribution of government expenditure. They have always objected to Government's invention in economic operations and said that the state cannot raise the level of economic operations. In the same way, classical economists have objected to the deficit financial system and Government lending, whereas modern economists place them into the category of important measures of public finance for increasing economic progress or bringing economic stability.

1.5.4 Taxation and Equitable Distribution

Classical economists do not support this fact that the taxation must be used as a tool for transferring from rich to poor people for income, but under the modern concept of public finance, taxation is considered as an important source for increasing social justice and reducing the inequalities in income. In addition to this, classical economists believed in imposing taxes on poor in comparison to rich and they supported indirect taxes in comparison to direct taxes. But modern economists believe that the taxes must be imposed on those people which are capable to save and not on those people, which are eager to consume goods. In other words, they said that the taxes must be imposed on rich instead of poor. Not only this against to classical economists, modern economists support progressive and direct taxation for this purpose so that they can be used as a tool for collecting Government income and just distribution of income in the country. Unearned income is considered undesirable as social view, therefore, the Government tries that a part of unearned income must be taken away by direct taxes (death tax and taxes on lotteries), but classical economists did not support it too. Indirect taxes contribute very much in public finance. But, modern economists do not consider this thing right that tax is imposed on every goods of consumption. Inversely they thought that the taxes must be imposed only on those things of consumption which do not create negative impact on general welfare of people, it means the taxes must be imposed on such goods which are used by rich, not poor.

1.6 National Debt

According to the concept of classical economists Government debt should be considered dead weight debt - not in the meaning that debt was tied, but in the meaning that by giving debt to Government useless means dead weight opportunities are provided. But, modern economists consider an important operation of public finance to Government debt. In modern times, Government debts are considered important to face many important situations such as for fulfilling deficit budget and to tackle the situations of lack of food stores and famine etc. The Government debt is considered very important because in modern times, to fulfill the objectives of public welfare is so dear that general income provided by taxation becomes less for it. The many other economists like **Keynes** have the opinion that such raised Government expense which is managed financially not by taxation but borrowing which is an effective measure to reduce economic crisis. For the development of natural resources of under - developed countries, Government borrowings are considered very effective.

1.6.1 Activating Finance

Prof. Baljeet Singh founded the concept of Activating Finance, we examine financial resources and apparatus on the basis of their functional structure and we discuss that what is the usefulness of financial management in economy. Activating financial management tells us about that how different methods of financial management create inflation in economy. Activating financial management believes in this belief that expenditure is incomplete and because of this, coordination is maintained between demand and production.

Such methods are used in activating financial management by which the flow of money is always maintained. If this happened then the levels of national income and employment will raise. The beliefs of **Keynes** and **Lerner** are appropriate for developed countries only where expenditure is more important. Semi developed and developing countries must emphasize on saving and investment. So, in developing countries, the implementation and conduction of fiscal policies must be in such a way that all resources must be used in employment to raise production and increment in income. The best use of resources must be done. Both managements have important place in developing countries. The desirable benefits can be obtained by implementing the belief of Prof. Singh in primary steps of development and the theories of Prof. Lerner in final steps.

New Trends in Public Finance - In modern times, the drastic change has been noticed in the structure and nature of public finance as a result of which its definition has some different type.

There are some important definitions in this regard which are as follow:-

(1) According to **Richard Musgrave**, "An investigation into the principles of public economy, move precisely into those aspects of economic policy that arise in the operations of the public budget."

(2) According to, **Otto Eckstein**, "Public Finance is the study of the affects of budgets on the economy particularly the effect on the achievement of the major economic objectives - growth, equality and efficiency. It is also the study of 'what ought to be'."

It is clear by following definitions that public finance is an ideal science with original science too. It studies the economic aspects of Government budget. These economic aspects are related with economic objectives. These are obtained by economic budget.

These economic objectives are - (1) Economic development, (2) Economic stability, (3) Justice and effectiveness. **Prof. Musgrave** has divided these economic objectives into three parts -

Economic Stabilization, Distribution of Income and Resources Allocation. It is clear that we study following both aspects -

(a) How to fulfill these objectives,

(b) How the economic system of different operations of budget get affected to fulfill these objectives.

In this way, it is clear that Public Finance is not only Positive Science but an Ideal Science also. Therefore, as a result of new emerging trends in Public Finance the area of Public Finance has increased much.

Public Finance in Developed and Under - Developed Countries - In modern times, all countries are progressing fast. There is a problem of economic development in under - developed countries; this problem is found in developed countries also, because they want to keep their economic development in continuous progression. Today, the Government's of nation's interfere in their economic lives, because of which the economic operations of the state got affected. In this way, because of growing influence of Government intervention in economic lives of country, in today's time, the importance of public finance in developed and under developed countries is increasing.

1.6.2 Developed Countries and Public Finance

On speeding up the economic growth of developed countries and on raising the level of lives of their citizen, public finance has sufficient importance there. Public Finance policies appear in the form of financial policies. The economy of developed countries got affected by this. The main problem of developed countries is - to maintain the level of economic life static. Under developed country, the objective of public finance movement is not to get economic development. **Arther Smithies** has expressed his opinion about America, "The main objective of financial policy is to control on total demand and it skips this traditional functions between traditional use for private sector." In developed countries, economic development occurs. Therefore, the Government tries that economic stability should be maintained for purchasing power.

In this way, public finance places an important role in maintaining economic stability in developed countries. Economic stability can be maintained by controlling total demand. Total demand affects by public expenditure consumption and investment. Total demand can be affected directly and indirectly by the policies of public finance. If the Government of the country keeps static the total demand by its budget policy then economic development can be controlled for bringing economic stability in developed countries, public finance is very important.

1.6.3 Under-developed Countries and Public Finance

There are some basic differences between the economies of developed and under developed countries such as the main problem of developed countries is to establish economic stability, whereas the main problem of under-developed countries is economic growth. Belief of **Walter Heller** is that public finance of developed and under developed countries are normally same. The main objective of public finance is to stop income and money, to promote investment and to provide economic stability. The main objective of Government in under developed countries is to speed up economic development in day - to - day basis and operations of public finance are used for this. Here the words of A.R. Prest are mentionable. **"Now it is not only accepted but it is hoped that the government has to work definitely for economic development."**

"For economic growth of developing countries, it is necessary to control and regulate economic life. These tasks are completed by the operations of public finance. Therefore, this fact is true that the policies of public finance in under developed countries perform important and useful work."

The importance of public finance in under - developed countries has been increased due to some other reasons, which are as follow: -

(1) Lack of Public Savings - In developing countries, the rate of savings is very less, because of which economic growth does not take place. For this, there is a need to collect finance, which can be increased by the suitable policy of public savings. In this way, in these countries, the importance of public finance has been increased.

(2) To Achieve Economic Resources - In today's time, it is considered the main task of the state to speed up economic growth in developing countries and to establish balance in it. It is difficult to collect economic resources of these countries forcefully, therefore, it is considered better to collect economic resources indirectly and public finance is considered best for it.

(3) Control on Private Sector - It is different to end private sector completely in under developed countries, because there is a fear of blockage of the speed of economic development by doing so. Therefore, right direction and control is necessary for private sector and this task is only done by the operations of public finance.

1.7 Role of Public Finance in National Economy

In modern times, the importance of public finance is increasing day by day. Although, according to classical economists, State has minimum interference in the tasks of public. Adam Smith considered State interference only in tasks like security, police and peace management. In the same way, the expenses by people are productive and expenses by Government are unproductive. In 19th century famous German Economist **Wagner** implemented the increasing operations of the state and then the tasks of the state in increased vigorously. In the beginning of 20th century, especially due to the economic crisis of 1930, public finance has been given due importance. The state is considered a welfare organization in modern times. Due to the situations like poverty, economic imbalance, professional highness etc. state interference has become compulsory in human life.

Karl Marx, **George Bernard Shaw** and **Sydney Web** have given importance to Government's efforts and intervention in place of individual efforts. The reason for the increase in the study of public finance is that public finance system of the country affects on every part. The function of public finance is not only collect finance - it is considered a powerful tool to encourage economic development providing social justice, maintaining economic stability and providing the state of full employment too. There is an important contribution of public finance in economic development of developing countries. Therefore, it is clear that Government is interfering in economic matters also.

Do You Know? Public finance has been given huge importance due to economic crisis of 1930.

We can study the importance of public finance in brief under following heads —

(1) Importance in Distribution of Resources.

(2) Importance of Public Finance in Distribution of Income and Wealth.

(3) Importance of Economic Stability.

(4) Importance in Collection of Resources for Economic Development.

(1) Importance of Public Finance in Allocation of Resources - The meaning of allocation of resources is their best selection by which it is clear that how to use land, labour, capital goods and other resources of the society - What goods are produced in what quantity and what methods of production must be used etc. Every country has economic resources in definite quantity. In this, natural resources like land, forests, mineral wealth and power source etc. are included also. It is mentionable regarding natural resources that by their availability only cannot raise the level of economic development of the country but their usage is also important for economic development. In addition to this, by natural and human resources of any country economic activities like agriculture, transport and trade etc, are conducted. This is the part of economy of the country. The whole economy depends on it. It is clear that the main objective of economic operations is to use appropriately and wisely. It can be known by following description -

(i) **Development of Economic Structure -** Government can arrange money for the development of economic structure by its budget policy. We can include the development of railway, electricity, road, transport, school, hospital, multipurpose projects etc, under this. In its absence, we cannot get economic growth in an organized way but in these plans, money is needed in large quantity. But, we cannot hope for their quick and direct result. Therefore, individual entrepreneurs do not have interest in investment. Therefore, it is the duty of the state that it can bear the expenses of economic structure, it can speed up the rate of capital formation.

(ii) **Rate of Population Growth** - Economic development is possible only when the opportunities of employment and increment in income must be more than rate of population growth. Therefore, Government can control population by giving more importance on family planning in its fiscal policy.

(iii) **Development of Backward Areas** - If relations and benefits are provided on taxes in backward areas then in highly congested areas, economic resources can be diverted towards the backward areas. By this, the help will be provided in progress and development of backward areas as well as balanced economic development is also possible.

(iv) **Development of Public and Private Industries** - In modern times, the state establishes and develops basic industries by preparing powerful economic structure. In addition to this, the Government can encourage individual investment in its public finance policy, such as (A) To reduce tax weight on individual industries, (B) To provide different industrial facilities to them, (C) To provide cheap loan facilities to individual industries and to open special financial institutes for this purpose etc.

(v) **Social Security Activities** - In many developed countries, public expenditure is used in large quantities on programmes like health insurance, unemployment insurance plan, old age pension, motherhood benefit etc. on serial wise security which has direct and indirect important effects on economy. It is clear by above mentioned discussion that public finance has important contribution in the area of suitable allotment and complete usage of available resources.

(2) Importance of Public Finance in Distribution of Income and Wealth - Today, there are inequalities in the distribution of income and wealth in many countries. On one hand, handful persons are wealthy and they misuse their wealth in many luxurious functions, on the other hand, general public suffer due to lack of wealth. Under free economic system, if economic power are not controlled then the problem of distribution of income and wealth becomes more serious. The inequalities of income is compulsory in all views like moral, social, economic and political etc. By eradicating the inequality of distribution of money, society will get maximum economic welfare. Due to inequality in income the structure of production becomes adoptable according to rich group. Maximum part of production consists of commodities of luxury instead of commodities of essential needs. In addition to this, the inequality in income encourages unemployment at last, as a result, economic insecurity develops for a large group of population, the balance between savings and investment is not possible and the economic system of the country could not function well in favourable conditions.

Now, we have to study that how useful Public Finance will prove to reduce the inequalities in distribution of income and wealth. Reliable economists considered taxation as a negative thing generally for distribution of wealth. Their saying that the only purpose of taxation is to get income for the state. But, in modern times, this fact is wholly accepted that fiscal policies play an important contribution in reducing inequalities of distribution of money. By public expenditure, the inequalities of distribution can be reduced by raising the level of lives of poor people and by taxation this objective can be achieved by lowering the level of rich people. In this way, there are two main methods to bring equality in distribution of money -

(i) **Public Expenditure** - This can be the source to redistribute income in favour of poor people. If Government spends the maximum part of its income in such a way that it benefits more to poors then there will be less inequality between real incomes. Therefore, the Government have to spend more on people with low income. In this regard, government have to -

(a) do social services like free education health and arrangement of housing etc. for poors.

(b) save poors from unemployment, illness, hardships of old age

(c) provide special economic aid for the increment in the production of essential commodities by Government

(d) start balanced development programmes in different areas of Government economic system then this policy will be more successful to reduce inequalities of income and to raise the level of lives.

(ii) **Taxation -** Taxation is an important source to reduce the inequalities of money also. First of all German economists **Wegner** supported vigorously eradicate the inequalities of money through the medium of taxation. Income tax reduces the inequality of income due to the difference in income and wages, whereas inheritance tax reduces the inequalities due to the difference in wealth specially. Therefore, money can be transferred to the poor group from rich group by progressive and direct taxes, because by extracting tax from rich group people, it can be spent on such social services whose real benefit have to be availed by poor group. Although, public expenditure and taxation run side by side to each other, but taxation is very important in reducing the inequality of distribution of money also because taxation is not necessary for reducing the level of income of only rich person but it is very important to get money for the programmes of Government expenditure. Progressive tax reduces the inequalities of income but the tax increases inequality of income.

It is clear by above mentioned discussion that the efforts in the direction of equal distribution of income and wealth by public finance, they cause favourable effect on saving and investment and it helps in developing economic system of the country and it increases economic and social welfare of the country.

(3) Importance of Economic Stability - Economic stability means changes in production, employment and cost. The increment in production, employment and cost is the symbol of growing up the economy of the country. Inversely, reduction in production, unemployment and dearness are causing dearness in economy of the country. Therefore, for full employment or economic stability, we can discuss the importance of public finance in this way that how production, costs and employment can cause effect by it to fulfill the desired objectives.

Here, it is necessary to understand the meaning of full employment and value - stability. According to **Sir William Beverage**, "The concept of employment symbolizes that special state in which we get more vacant spaces in comparison to the number of unemployed person." According to American economic union, "The meaning of full employment is that all those able persons who want to work on definite salary rates, without delaying more, the work can be received in productive works." In this way, the stability of cost means lack of alternative changes in general level of costs.

Famous economists believed that the state of full employment is always maintained in the society. Their beliefs were based on "Supply is the mother of demand" laid by J.B. Therefore, there cannot be unemployment in economic system because all that which is produced, its balance is necessary by money because modern economists strongly denied the above mentioned beliefs of famous economists and clarified that the state of full employment is not always found by the efforts of private enterprises of the country. According to **Keynes**, there are always ups and downs in capitalist economy. Sometimes the state of full employment occurs and sometimes the state of incomplete employment occurs. If a state of complete employment is found at a particular time then it is matter of chance.

Full employment and the facts related in this regard means the basic factor affecting production employment and cost inform the cost of total production. Its reason that there is no difference between total cost of national production and sale of goods by industrialists. It means total production is equal to national income. Therefore, it is clear by above mentioned details that economic stability effects the economy of the country to a good level.

(4) Importance in Collection of Resources for Economic Development—What is the importance in collection of resources for economic development? We can clarify this by the following details—

(i) Capital Formation - Capital formation has central importance in economic development of any country. It can be tackled by the point of suitable circle of poverty in semi developed countries and because of which there are chances of favourable changes. Therefore, the objective of the operations of public finance must be the usage of resources from saving and investment means from capital formation for consumption and other non - developing functions. The Government can help in many ways to increase capital formation. According to **Dr. R.N. Tripathi**, because of low rate of savings in capital formation, therefore, for getting increased rate of saving so that investment must be maximum, the Government can adopt following ways -

(a) Direct physical control

(b) Increase in the rate of present taxes

(c) To collect the savings from public enterprises

(d) Public debt

(e) Deficit Budget

(a) Direct Physical Control - This is very effective in reducing consumption and comparative investment. Although, its administration is not comfortable in semi developed countries, however direct physical control is a necessary part of fiscal policy.

(b) Increase in the rate of Present Taxes - To impose taxes and to increase the rate of present taxes, which can be said progressive clearly, place an important place. The structure of tax can be as follow –(i) Those resources of rich group which were lying useless or which are not used profitably - it can be achieved by imposing income tax, wealth tax etc, the tax can be imposed on Government commodities. (ii) To impose tax on increased income of farmer group is necessary. For this purpose, taxation can be imposed on land and other type of wealth.

(c) To Collect the Savings from Public Enterprises - In developing countries, there is less saving in enterprises due to high cost but if the public enterprises are conducted effectively then better results can be achieved by them.

(d) Public Debt - Desirable saving can be achieved in the form of Government debt. To increase the savings of people, Government debt letter is safe source. The institutes can invest their money in Government debt letters. Although, per capita income is very less in semi - developed countries, therefore the area of public debt is very limited, its meaning is not that there is not any type of saving in country due to sale of public debt letters. Short savings have special importance in these countries. In present times, many international institutes like World Bank and international development union etc. provide sufficient debt to developing countries.

(e) **Deficit Budget -** The state of deficit budget arises when the Government gets enough by taxes and debts received by public and other sources of income, then it spends more than it. The finance system of deficit Government must be used cautiously. The excessive usage of this method brings drastic changes in economy and can destroy the economy.

(ii) Change in the Production Structure - Fiscal policy is motivator in speeding up the resources of public area. By expanding public sector, the Government can expand such enterprises which are considered important by the view of national favour. In addition to this, the objective of public finance related operations is to speed up individual investments in desired directions too.

(iii) To Remove Unemployment - The problems of unemployment and invisible unemployment are becoming complex in under - developed countries. There is a short term problem in fully developed countries which is created by the effects of business circles. But, in developing countries, unemployment is a major problem which can only be solved by long term development policy. Therefore, the chances of employment can be expanded by increasing investment by taxation public expenditure and policies related to debt in the country.

Task What is the importance of public finance in arranging resources for economic development?

Self-Assessment

Multiple Choice Questions:

11. In what public finance believed?
    (a) In public welfare (b) In self welfare
    (c) In profit (d) All of the above
12. What is the only objective of private finance?
    (a) To do public welfare (b) To get profit
    (c) To cause harm (d) All of above
13. Which operation is considered Government borrowing by modern economists?
    (a) Complete (b) Incomplete
    (c) Important (d) Total
14. To which country Wagner belonged?
    (a) India (b) Russia
    (c) America (d) Germany
15. When did economic crisis occur?
    (a) In 1930 (b) In 1830
    (c) In 2001 (d) In 1999

1.8 Summary

- The economy of public finance is related to the fulfillment of group needs specially. In this, we study those economic problems which arise in state or public sector, such as how to divide resources between private and public sectors and how allotment of resources for satisfaction of different resources of Government expenditure under public sector.
- The implementation of General Theory of employment by Keyne and Economic depression of 1930 became the bell of death for the policy. Keyne narrated that it is possible for the state to increase employment by fiscal operations and to maintain it on high level.
- In under-developed countries too, it is the main motive of the Government that the country must progress fastly economically and there must be equitable distribution of national production, and fiscal policy can become an important tool for the fulfillment of these objectives.
- The area and subject - matter of public finance is not static, because it is expanding continuously with the changes in functions of state and problems of economy.
- The basic difference is found between public finance and private finance in many matters such as objective, the methods of receiving finance and the quantity of resources etc.
- The classical view of public finance was based on classical economic theory but there were many revolutionary changes in this theory later. At last, modern economic theory was implemented which is called Keyne's General Theory of Full Employment. Because of this theory, the classical concept of public finance changed.
- Keyne's 'Employment Theory' is based on this basic concept that expenditure by a person is the income of another person.
- The concept of employment symbolizes about that special state in which working persons have more space in comparison to the number of unemployed persons.

1.9 Keywords

- Budget - The account of income and expenditure
- Fiscal operations - The activities of fiscal
- Inflation - The usage of more money than business needs of the country
- Taxation - To impose tax

1.10 Review Questions

1. What do you understand by public finance?
2. Describe briefly about the functions of modern state.
3. What do you understand by taxation?
4. Write down the similarities found between public finance and private finance.
5. Write a short note on the following—
   (a) Taxation (b) Public Expenditure

Answers: Self Assessment

1. Expenditure	2. 'Public'	3. Fiscal	4. 1776
5. 1930	6. True	7. False	8. True

9. False	10. True	11. (a)	12. (b)
13. (c)	14. (d)	15. (a)	

1.11 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. India Public Finance Administration—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*
5. Money Banking International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
6. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*
7. Public Finance—*Nand Kishore Parsad, ABD Publication. 2011.*

Notes

Unit-2: Principles of Maximum Social Advantages

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Theory of Maximum Social Advantage
- Know about the Maximum Social Advantage
- Know about the Conceptual Fact during Imposing Tax
- Know about the Conceptual Fact during Expenditure.

Introduction

'The Principle of Public Finance' means fundamental rule by which financial policy of state must be decided. This fundamental rule is called the principle of maximum social advantage or the principle of maximum net social advantage or the principle of maximum social welfare. **Prof. Pegu** and **Prof. Delton** were two such famous economists, to which whole credit can be given for implementation of this principle and its famousness.

Classical economists **Adam Smith's** opinion was that operations of state and the quantity of taxation must be minimum. Following Adam Smith, his famous franchise student **J.B.C** told that, **"The best plan in all plans of finance is to reduce expenditure and the best tax in all taxes is that whose amount is minimum." Adam Smith** and **Recordo** thought that non - Government expenditure is productive and Government expenditure is unproductive. That's why those economists thought that, "Every tax is an evil and every Government expenditure is unproductive." Inversely, **Prof. Dalton** told that giving emphasis that, "It is not true to say that every tax is an evil in itself." For example, if we impose tax on narcotic drugs, wine and other objectionable substances, then these products, which are injurious to health, decline is reported in their usage and it brings solid welfare to the society. **Dalton** has also supported Government expenditure and objected this classical concept as it is unproductive. "Blind faith persons, remain biased about government expenditure of all types. But, we have to believe this fact clearly that government expenditure of any type is good." For example, the Government expenditure on agriculture, industries, public health, education and justice etc. is not considered unproductive because such type of expenditure increases economic and social welfare. But, **Prof. Dalton** has said that also, **"It is not true to say that all type of public expenditure is good. For example, the government expenditure on unnecessary wars is clearly an evil."** Now, this fact is clear that this concept of classical economists that every tax is an evil and every Government expenditure have been rejected forcefully by unproductive, modern economists. They believed that the economic testing of productivity of Government expenditure is that too that expenditure creates how much economic welfare. For example, the Government expenditure on education and health usually is more productive than non - Government expenditure on commodities of luxury. In this way, any operation of public finance if, increases society and economic welfare of society completely, then it will be considered compulsory otherwise not.

2.1 The Principle of Maximum Social Advantage

This principle directs economic welfare of society, as whole, operations of public finance. Public revenue and public expenditure are two important operations of the state. It is necessary that direction or execution of these two financial operations of the state must be done by some basic principle so that maximum social profit can be obtained by those operations. **Prof. Pegu** and **Prof. Dalton** were two such famous economists who were responsible for implementation of this basic principle. According to the principle of maximum social profit, the state has to get its income and to spend its money in such a way that there can be maximum increment in the welfare of public. When the government imposes tax then some uselessness and disutility occur. On the other hand, when the government spends money there is some increment in usefulness and utility. Therefore, the Government has to adjust its income - expenditure in such a way that the maximum surplus of any utility occurs and the quantity of disutility must be minimum. But, here, this mentionable that by doing so, there will be maximum increment in individual welfare of all people; it can be possible that there can be more reduction in the welfare of some of them. If there is an increment in big quantity in number of people then it will be considered that there is maximum net welfare of society completely. **Prof. Delton** has expressed it in these words, "**As a result of operations of public finance, the nature and quantity of money produced and between the categories and different persons there are many changes in the distribution of that money. The question is that do this changes; leave a profitable impact on society? If it is so then it will be considered that the operations of public finance are justified, otherwise not. The best system of public finance is that can obtain maximum social profit by the operation organised by them."**

Notes **Prof. Dalton** called this principle '**The Principle of Maximum Social Advantage**' and **Prof. Pegu** called this principle '**Principle of Maximum Aggregate Welfare**'.

2.1.1 Extent of Public Revenue and Expenditure

Prof. Dalton pointed out to this thing that upto what extent Government expenditure must be increased? How to divide Government expenditure between different uses? How to collect Government income? And how to divide it between different categories? In the words of **Prof. Dalton**, "Government expenditure must be used in every direction upto that extent that equal balance can be maintained in loss caused due to increase in any other source of taxation or any Government income. This rule

Notes

presents an ideal limit for both Government expenditure and Government income." Its meaning is that by every additional unit of imposing tax, the weight of sacrifice by public will increase, but by the expenditure of that tax, the quantity of benefit received by public will decrease continuously. In this way, by imposing tax and regarding spending it, a point will come where profit received by any unit of money spent by state, will be equal to the sacrifice by the public due to any unit of tax imposed by Government. This is that state when the Government has to stop its extending step regarding to income and expenditure because it is that point on which marginal sacrifice is equal to marginal benefit. This is the optimum limit of financial task of Government. In this way, the Government expenditure must be done upto that extent where marginal utility received by Government expenditure must be equal to the marginal disutility due to taxation or Government income.

Maximum social welfare can be understood easily by following example:

Unit of Currency	Sacrifice from the every unit of tax	Satisfaction from every unit of expenditure
1	5	16
2	7	12
3	9	9
4	12	7
5	16	5
6	20	3

It is clear by the above table that marginal sacrifice is increasing due to the increase in every unit weight of tax on society. Inversely, from every additional unit of Government expenditure, its utilities decreasing as comparison to earlier for the society. Here, on third unit of currency, marginal social sacrifice and marginal social advantage are equal i.e., 9 units. Here, the limit of tax and public expenditure will be fixed. This fact has been cleared by the given diagram in which there is curve line of disutility or SS' sacrifice line and BB' benefit or utility curve. These two curve lines intersect each other at point P. In addition to this, OX line represents the amount of money spent and slant line OY represents sacrifice or the amount of benefit of money spent.

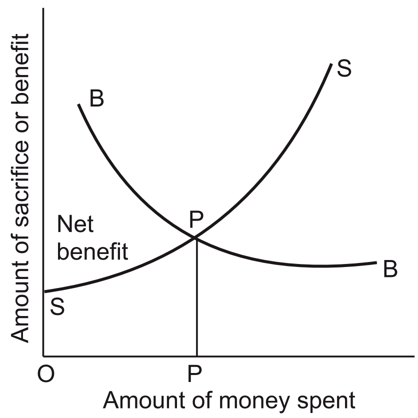


Fig. 1

If the curve line of benefit BB by the area covered is subtracted from the area covered by sacrifice curve SS' then we get net benefit which we get by spending as equal to OP'. OP' expenditure is at adoptable state at point P because at this point, utility money spent by last unit of money is equal to

Notes

utility lost by last unit of money. Sacrifice curve SS' is an upwardly growing curve because with each unit of money received for Government expenditure the amount of sacrifice increases. But, inversely, benefit curve BB' is a decreasing curve, because as the expenditure increases, the benefit decreases with into every unit. Point P, where two curve lines meet each other, show the adaptable limit of financial operation of state. It is that point where marginal sacrifice is equal to marginal benefit received. The explanation of maximum social benefit can be expressed by total social sacrifices and total social benefit. Maximum social benefit will be achieved at that point where the difference between total social benefit and some social sacrifice is maximum.

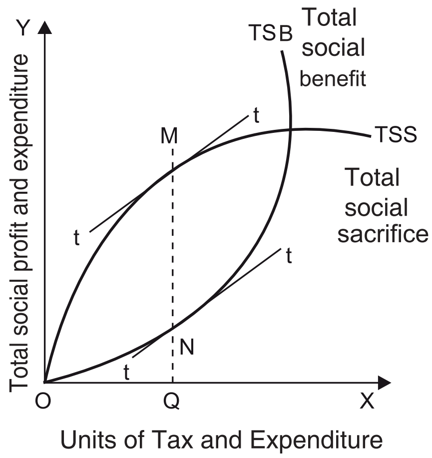


Fig. 2

In fig. 2, TSB curve shows total social benefit received from public expenditure whose curve is in upward direction. This curve shows that as the public expenditure increases total social benefit increases. But, it decreases after a point. Inversely TSS curve shows total social sacrifice produced due to tax which shows that total sacrifice increases with the amount of tax but total sacrifice increases rapidly after a point.

Here, the difference between TSB and TSS will be gotten as net social benefit which has been denoted by MN here. Therefore, the Government has to spend in the quantity OQ so that maximum benefit can be achieved.

Do You Know? The explanation of the principle of maximum social benefit can be given by total social sacrifice and total benefit curve also.

2.1.2 Distribution of Resources

Distribution of resources between different uses must be in such a way that marginal return of satisfaction must be equal in all uses. For example, the distribution of expenditure between aspects of help of poors in such a way that equal return of satisfaction must be achieved from last shiling imposed on every post. From here, there is a principle of Equi-marginal utility or maximum satisfaction which is imposed on public finance. Then, suppose that expenditure on agriculture is more than the marginal utility of expenditure on marginal utility defence then comparison to the expenditure on defence, the expenditure on agriculture is gaining more satisfaction. In this state, it will be better to

Notes

transfer agriculture to defence of resources. This transfer must be on that time, when the marginal utility received from both directions must not become equal.

2.1.3 The Thoughtful Facts While Spending

(1) Marginal utility from every expenditure must be same. If marginal utility on expenditure on education is more than the expenditure on health then the expenditure on education must be more. The expenditure like security education, health, transport etc. must be utilized in such a way that the same marginal utility must be obtained.

(2) The expenditure must increase production. The expenditure on roads, railways, wells the source of entertainment, school and health centres is appropriate. The expenditure on defence is unproductive but is necessary because the society have to be secured, the country must have to be preserved from internal and external quarrels.

Clarification by Diagram

In fig- 3, the marginal social benefit received from public expenditure on agriculture by AA curve has been depicted. In opposition to this, DD curve tells the marginal expenditure social benefit received from public expenditure.

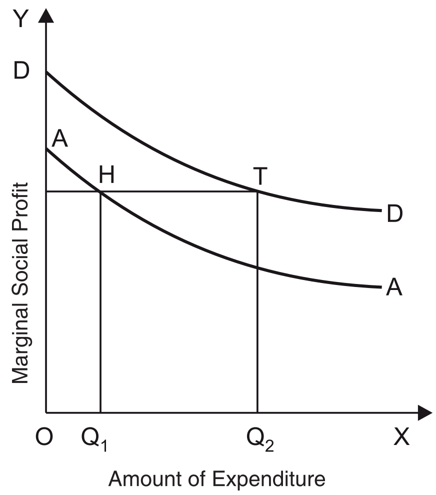


Fig. 3

The maximum social benefit will be received at that point where the marginal social benefit received from both aspects are equal. The position of marginal social benefit received from both in figure will be $HQ_1 = KQ_2$. Therefore, OQ is spent on agriculture and OQ_2 is spent on security then the marginal social benefit from both will be received in equal quantity and it will be maximum social benefit.

2.1.4 The Thoughtful Facts While Imposing Tax

1. The government has to watch while imposing tax that the tax must be imposed on those people who have capacity to pay tax. The weightage of tax must be same on different persons.
2. The production power of the society must not be minimized while imposing tax and there must not be any hinderance in the capital making.

Notes

3. The marginal utility of money decreases when rich persons have more money and they do not have to sacrifice much while paying tax. Therefore, tax must be imposed on rich person with greater rate so that the sacrifice must be same. For example, X, Y, Z are three persons their economic status are different. If the same tax is imposed on these three person then their sacrifice must be the following as shown in the table below:

Unit of Rupees	X	Sacrifice Y	Z
On giving tax of 1 rupee	10	15	20
On giving tax of 2 rupees	15	20	25
On giving tax of 3 rupees	20	25	32
On giving tax of 4 rupees	26	32	40

For making the same sacrifice, the tax imposed on X will be ₹ 3, on Y will be ₹ 3 and on Z, it will be ₹ 1 which become clear in fig. 4.

2.1.5 Distribution of Burden of Taxation

Prof. Pegu said that the distribution of burden of taxation between different sources must be according to the principal of least aggregate sacrifice. In other words, the burden of taxation must be divided between different sources in such a way that the marginal sacrifice of each source must be the same. In the words of **Prof Pegu, "If we want-to bring the state of least aggregate sacrifice then the taxes must be divided in such a way that the marginal utility of money paid as taxes must be same for all taxpayers."**

For example, if the utility of last unit of rupees paid by A is less then the utility of last unit of rupees paid by B, then the burden of tax on B must be lightened and the tax-burden of A must be increased. This process must be in continuation till that time when the marginal sacrifice of last rupee of A and B both must not become equal.

Clarification by Figure

In fig- 4, AA, and BB**,** curves show the marginal social sacrifice paid by the persons A and B. These curves are in upward direction which show that as the amount of tax will be collected, the amount of marginal social sacrifice will increase. Aggregate sacrifice will be least in that condition where the marginal social sacrifice of A and B will be equal. In this condition, the Government must impose tax equal to OQ2 on individual A and OQ1 on individual B because here the marginal social sacrifice by A is equal to the marginal social sacrifice by B i. e., $TQ_2 = HQ_1$.

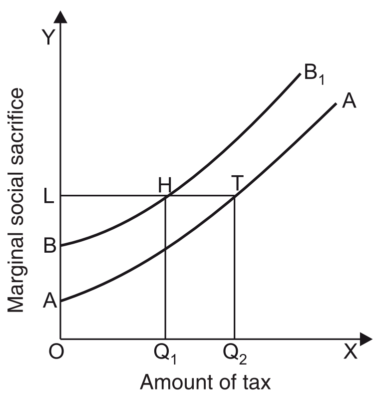


Fig. 4

Notes

Task Show the distribution of burden of taxation on the Map.

Clarification by Musgrave

Prof. Musgrave has tried to explain the principal of maximum social benefit with the help of fig. 5

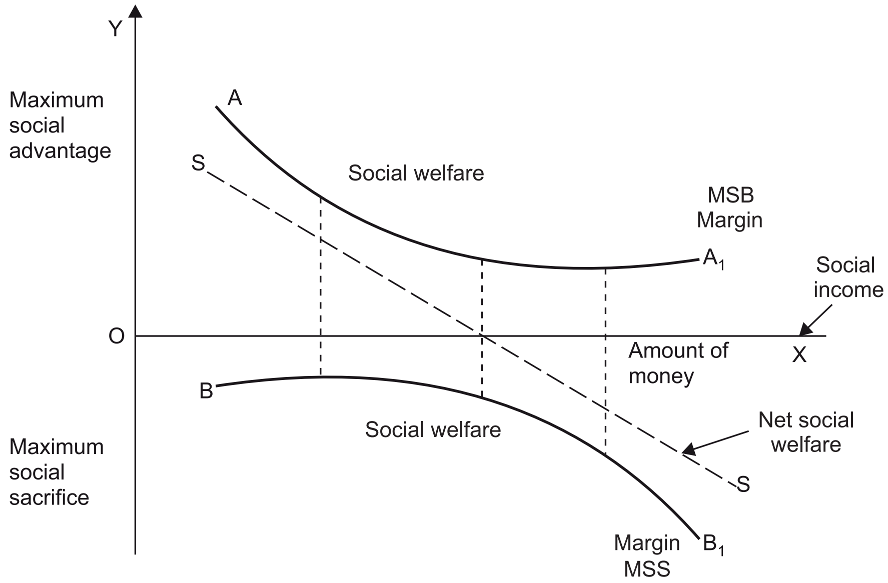


Fig. 5

In fig. 5, OX denotes public income. The upper part of OX shows social welfare and the down part shows social sacrifice. AA_1, depicts marginal social welfare and BB_1, depicts marginal social sacrifice. The bending down of AA_1 shows the fact that the welfare received by the additional amounts of expenditure is decreasing. BB_1, curve shows that as the burden of tax will increase, the amount of sacrifice of taxpayer will also increase. SS_1, curve shows net social welfare which can be known by subtracting AA_1, from BB_1, i.e. from social sacrifice is subtracted from social benefit. M is that point where actual social welfare is maximum and OM is that amount of money which the government has to receive as tax from society and has to spend as public expenditure.

Self-Assessment

Fill in the blanks:

1. The principal of public finance is also called the principal of ………………….. .
2. Adam Smith was ……………………. .
3. When the Government spends money then there is some increment in …………… .
4. ……………….. utility must be same by each expenditure.
5. The expenditure must be so that it increases ………………. .

2.2 Maximum Social Advantage

As a conclusion it is said that there are three basic principal which guide the Government in financial operations and to achieve the ideal of maximum social benefit, they help the Government –

1. The Limit of Expenditure – The Government expenditure must be up to that extent, where the benefit received by public from the last unit of money spent by state must be equal to the sacrifice on public received by that unit.

2. The Distribution of Resource of the States –The distribution of resources of state between different aspects of adventure must be done in such a way that the marginal result of satisfaction received from each source must be same.

3. Distribution of Tax – The distribution of taxes must be done in such a way that marginal utility of money by people must be paid as taxes that must be same for each taxpayer.

Test of Social Advantage

Prof. Dalton expressed view on some kits of tests of social benefit. He said that some targets must be achieved by the operations of public finance. By which, completely, there must be increase of social benefit of the community. The tests suggested by them are as follow:-

(1) Preservation of Community – It is the duty of every Government that it must defense the society from internal unrest and mismanagement and external attack. The confidence develops in citizens from internal unrest and external security and their economic lives are progressive because of which social benefit increases. Therefore, it is very necessary that army, police and courts etc. must be established so that the country can successfully face the threats of internal and external enemies. It is the duty of state in every situation that it must increase the welfare of its citizens economically and uneconomically both types. It follows the principal of peace and co-existence; otherwise there will be increase in disutility expenditure on army, police, courts etc., which will leave a positive impact on economic life of the country.

(2) Improvement in Production – The other motive of the operations of public finance must be that the level of production in the country must be raised so that economic welfare of the society must be increased. The meaning of increment or reform in production is that- ''(a) The increase in production power, so that more production can be achieved by less efforts by per labourer **,** (b) The reform in the organization of production, so that the wastage of economic resources due to unemployment and other factors, (c) The reform in structure and infrastructure of production, so that such goods must be produced by which the needs of society can be fulfilled in best ways." Therefore, the objective of operations of public finance (Government expenditure, taxation and Government debt etc.) must be that these three objectives must be fulfilled by which there can be increment in production and economic welfare of society.

(3) Improvement in Distribution – While deciding the policy of state, the third fact must be think on that it has been seen that there must be that suitable distribution between different categories of society for production i.e. the distribution must be in such a way that the fluctuations and dissimilarities found in income of different persons and families must be ended. The distribution of income must be according to the needs of family and must be according to their efficiency and efforts. Due to unearned income, the in equalities produced in income cannot be bared whereas efficiency and hard work must be given just respect must be rewarded. In the words of **Delton,** "The meaning of reform in distribution is that – (a) To reduce the inequalities found in income of different individuals and families which are found normally in cultured society, (b) To end heavy fluctuation at different times, some individuals and families, specially in wages of persons of poor category of the society" Therefore, it is very necessary that suitable distribution of income and money for economic welfare must be done.

Notes

(4) Economic Stability and Full Employment – Economic instability (i.e. to create the situation of economic slow down) is an important sign of free economy. Many evils produce from it, such as unemployment and over production can increase the social welfare of people whereas stability remains in commercial direction in the country and fluctuations have to be ended in it. Therefore, the objectives of fiscal operation must be that economic stability have to be maintained at high level of employment. The effects of depression can be controlled by increasing government expenditure on tasks like public construction by fiscal operations and in this way employment and effective demand can be increased. In the same way during the time period of rising in costs, by government debt and heavy taxation, the price level can be brought down.

(5) Provision for Future – The individuals give importance to present as compare to future. As a result their financial activities are motivated by the effort of satisfying their present needs or life long needs. But, the state has double responsibility because it has to care for the favour of both present and future generation. Therefore, it is suitable for the state that it gives importance to large benefits of future generation in comparison to the small benefits of current generation. In the words of **Dalton," The state is the preserver of future as well as present. A person dies but that society remain alive who is the part of person. Therefore, the state has to give preference to the large social benefit of future in comparison to small social benefit of present**."

Notes During the period of influctuation, by government debt and taxation, the price level can be brought down.

Limitations

The principle of maximum social benefit is a basic principle of public finance and it is considered a guiding principle of financial operations of the state. But, in spite of this, when this principle is implemented practically, many problems are faced. The main are as follows:-

(i) Disadjustment between disutility and utility- It will be a very difficult task for the state that it maintains balance between disutility produced due to imposing tax and utility obtained by people from Government expenditure. An individual faces difficulty too in his practical life while doing so and on reaching that point normally where his disutility of sacrifice is equal to the utility of income and there is more difficulty for the state while doing so because the task of imposing tax and spending it of Government is not completed by a single person, but it is completed by lacks of Government servants at different places and in different departments.

(ii) Future Expectation – The state can guess about the future and can watch that what events can happen in future, but on the basic of these guesses and prediction, it is very difficult to assume that the expenditure by the Government which is creating disutility in present will provide more utility in comparison to that in future. Therefore, it is very difficult for the state if not impossible to maintain balance between government expenditure of marginal disutility of taxation and marginal utility of Government expenditure. To maximize net social benefit, the success of the state depends on this facts upto some extant that how much capability it has in assuming correctly about these result of its financial operation and the ability to do can approach now whereas the officials and workers to do this work are very sensitive and intelligent. Therefore, it is very necessary that the construction of Government administration must consists of such planning constructor's experts and official of higher qualifications at each level which are capable of obtaining maximum benefit from Government money spent in a definite time.

Self-Assessment

Multiple Choice Questions:

6. How many basic principles are there which guide government in financial operations?
   (a) Three (b) Four
   (c) Five (d) Six
7. Which economy has economic un-stability as its important feature ?
   (a) Slave (b) Free
   (c) Slave and free (d) None of these
8. The increment in production means –
   (a) Destruction in production power (b) Equilibrium in production power
   (c) Increment in production power (d) None of these

2.3 Summary

- By the wording "The principal of public finance" means that fundamental rule by which the financial policy of the state can be decided.
- The classical economists like **Adam Smith** thought that the operations of state and the amount of taxation must be minimum.
- The best plan among all plans of finance is to reduce expenditure and the best tax among all taxes is that whose amount is minimum.
- According to the principle of maximum social benefit, the receiving of income of state and expenditure of money must be in such a way so that welfare of public can get maximum increment.
- The Government expenditure must be done up to that level in every direction by which in the benefit received to society from more increment of this expenditure and inversely in the loss due to some increase in any other source of any Government income or taxation, the equal balance must have to be maintained. This rule presents an idea limitation for both Government income and expenditure.
- The distribution of resources between different uses must be in such a way that marginal return of satisfaction must be same in all uses.
- If we have to bring the state of minimum aggregate sacrifice, then the taxes must be distributed in such away that the marginal utility of money paid in the form of taxes must be same for all taxpayers.
- The reform in distribution means- (a) To reduce the inequalities found in income of different individuals and families which are found mostly in cultured societies, (b) To end heavy fluctuation in some individuals and families, especially in incomes of people of poor group of society at different times.

2.4 Keywords

- Revenue –Income of state
- Defence – Protection

Notes

2.5 Review Questions

1. Explain the principle of maximum social benefit.
2. In which ways the resources are distributed?
3. What facts must be kept in mind while imposing tax?
4. Write notes on following –
   - The limitation of expenditure
   - Tax distribution

Answers : Self Assessment

1. maximum social benefit	2. economists	3. utility
4. marginal	5. production	6. (a)
7. (b)	8. (c)	

2.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
3. Money Banking and Public Finance—*Sundaram V, Alpha Pub., 2009.*

Unit–3: Issues Related to Economic Activities of Public Finance (Exp.)

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know the Economic Effect of Public Expenditure
- Understand the Influence of Public Expenditure on Production
- Know the Influence of Public Expenditure on Distribution

Introduction

The working – ability of public increase when they are provided essential facilities to work. The transfer in special plannings of economic resources by public expenditure increases production many a times. The Government can reduce the ditch of inequality of Government money with the help of tax policy, in the same way, the inequality can be reduced with the help of public expenditure also.

3.1 Economic Effects of Public Expenditure

The result of public expenditure in every modern nation is increasing day by day. Therefore, the analysis of economic effects of such expenditure is very important. By following **Delton,** we can divided these effects proudly in three parts – (i) The effect on production (ii) The effect on distribution and (iii) other effects

3.1.1 Effect of Public Expenditure on Production

Some people believe that public expenditure are totally unproductive and it cannot increase the production of the country. But, this belief is not right. The people forget that many public expenditure are mere **Transference** of money between people only – such as to give interest on public debt by Government or to give pension to elderly people. Here, the government gives money to the other category of people by taking it from one category of people. The public expenditure on education and public health increases the working – capacity of people directly. In the same way, canals rail, road transport etc. increases the production power of the country also. The reform of agricultural land and the expenditure on development of forests are production directly. But some public expenditure are those which do not help in production directly, such as expenditure on war. According to many people, this expenditure is definitely unproductive because the expenditure of this type bring the young ones of the country many essential commodities of the country iron, coal, oil, etc. to the area of war from the area of production, where they destroy. This idea seems right but if we examine closely then it will be clear that expenditure prevents economic loss and slavery in the country by protecting from external attack and in this way it is helpful in production work indirectly.

> *Notes* We will surely have to accept that there is very much expenditure on armies these day and there is an urgent need in reduction of it.

The effect of public expenditure on production is as follow:-

(1) Increment in power of working- ability and savings in public – The working ability of public expands when they are provided with essential facilities to work. The expenditure on education, health, transport etc. Government is such expenditure which provides help to people in their work. Therefore, all those expenditure expand the working ability of people production power increases due to increase in working ability and when income is more then the power saving will increase automatically. In brief, it can be understand in such a way that there is a need of economic income for increasing the power of saving and increased income can be obtained when there is an increment in work–ability and to increase work – ability, expansion of education and other many things. Government spends on all these, because Government expenditure increases the work – ability of public and power of saving.

(2) Increment in desire to do work by public and to save –Government expenditure is of two types- one is related to present and other is related to future. By present expenditure, there is an increment in desire to work and to save. By public expenditure many individuals motivate to raise their life standards. It is possible that some individuals may develop bad habits, by denying them, the Government has to help in the form of commodities and service. Individuals have always desire to progress, they can form their desire in work by public expenditure. Therefore, by public expenditure, the desire to produce their own develops in individuals. In this way, if the Government promises to give economic benefit in future then it is possible that the interest to work and to save in individual increases by this, such as illness and unemployment benefit, because of which state gives its contribution instantly, where as benefactor becomes ready to give his contribution if the Government increases the rate of benefit with the increment in amount work then the desire of work will also increase.

(3) Promotion of production resources in country – Transference in special employments of economic resources by public expenditure increases the production some time. The government can tackle this type of transference by giving contribution or economic aid to private enterprises in special business or by bearing loss in those business it self. This type of interference is essential, but, it will produce industries or it will increase the power of production by arranging for future instead of present. This type of interference i.e., economic arrangement for future is very important for the view of increasing production power and by this view, to increase human capital with physical capital is very important. According to this view public expenditure on railways, roads, canals and other means of irrigation, scientific and industrial research, social insurance etc. is very important, economic help to reduce the value of essential food product, education, health is beneficial. In addition to this, Government can increase saving by reducing public debt and this saving will increase production.

Do You Know? The government can increase total production by utilizing useless resources and running new industries in backward areas by giving economic aid.

(4) **Economic development by plans –** If Government makes new plans for the progress of industries, then this expenditure are considered productive expenditure, because the economic development of the country increases with the increase in production.

Self-Assessment

Fill in The blanks:

1. In every modern nation, the result of ……………………. expenditure is increasing day by day.
2. ……………….. of public increases when it is provided with essential facilities.
3. Government can increase the income of poor group in the form of …………….. .
4. ……………….. helps poor group by debt and social expenditure.
5. The fluctuation of employment can be controlled by ……………… of workers working in government expenditures permanent.

3.1.2 Effect of Public Expenditure on Distribution

With the help of tax policy, the ditch of inequality of money can be reduced, in the same way, with the help of public expenditure, inequality can also be reduced. If the Government spends according to maximum social benefit, then the economic inequality of society can be reduced very early. This inequality can be reduced by following ways –

(1) Spending more for poor groups – The government has received money from rich group by taxes, that must be spent on favour of poor group, then economic inequality of the country will be reduced and country will get maximum favour . If Government wants to reduce the inequality of money then it has to spend on management of education, health, hygiene, gardens and water etc. The work–efficiency of poor- group will increase, their income will increase and their standard of living will increase. The benefit of those facilities will be obtained mostly by poor group by which they can save money on the expenditure of these and can buy other commodities and can consume them. By this, poor person can also raise the level of his living by consuming more and more goods. On the other hand, the rich group has to spend money to get these facilities and there is less money remaining for the consumption of other commodities. In this way, the inequality between the standard of living of both reduces slowly.

(2) To increase the income of poor group directly – Government can increase the income of poor group directly. This increment can be giving aid at the time of unemployment, the buying power of poor group increases by this and they can increase the amount of their consumption.

(3) Aid by debt and social expenditure – The government can help poor group by debt and social expenditures. By which their standard of living can be raised and the inequality between poor and rich can be reduced. The objective of this type of debts or social expenditures is to bring economic equality.

(4) Assistance by progressive contribution – The government tries to bring economic equality in society by providing contribution to poors also. These contributions are also progressive, in ratio and good like taxes too. As the income of any poor reduces, so as the amount of contribution given to him increases then it is called progressive contribution. On the other hand, on reduction of income of it the amount of contribution also reduces then it is called unprogressive contribution and when contributions are given according to a definite percentage rate of income then it is called proportional contribution progressive contribution can reduce economic inequality in society. Therefore, Government has to give progressive contribution only.

According to **Pegu** – "Any work by which the original income of poor individuals increase, but national structure does not get reduction in any way by it, economic welfare has to be increased normally."

Task The economic inequalities can be reduced by increasing income of poor group directly. How?

3.1.3 Other Effects of Public Expenditure

With the help of public expenditure, the Government can solve the problem of unemployment by placing the demand of labour permanent. For solving the problem of unemployment, following aid can be taken by public expenditure –

1. **Government can spend its expenditure in running of new business by** which many people can get employment. By this policy, the problem of unemployment can be solved by increasing employment. This policy has been adopting in India these days. Major portion of public revenue of India has been spending on five year plan. Because of this lacs of unemployment labourers have got employment.
2. **The fluctuation of employment can be reduced by making the employment of workers in Government departments permanent.**
3. **The unemployment will also be reduced by spending on individual business to nature of classical Government businesses.** Whenever, there is fluctuation in individual businesses then many labourers become jobless due to this, but on the nature of Government businesses become same as the nature of individual businesses, they get the jobs in Government businesses.
4. **There is a fear of unemployment on depression in trade and industries.** If in that condition government spends on helping industrialists or running new industries, then by policy, the fear of unemployment will be reduced.

Conclusion –The production, distribution and labour problem of country depend actually on public expenditure. Public expenditure will try to run them smoothly, so as the economic condition of the country will improve.

Self–Assessment

State whether the following statements are True or False:

6. If Government spends according to maximum social principle, then economic inequality of society can be removed very early.
7. Government has to spend the money which has been received by taxes from rich group on the favours of rich group.

8. Government can increase the income of rich group directly also.
9. Government tries to bring economic inequality in society by giving grants to poors also.
10. With the help of public expenditure, the Government can solve the problem of unemployment by placing the demand of labour temporarily.

3.2 Summary

- In every modern nation, the result of public expenditure is increasing day by day. Therefore, the analysis of economic effects of the expenditure of this type is very important.
- Some people believe that public expenditures are completely unproductive and they cannot increase the production of the country merely. But, this belief is not true.
- The work–efficiency of the public increases, when it has been provided with essential facilities to work. The expenditure education, health, transportation etc. by government are such expenditure by which the people get much help in their work.
- Public expenditure are of two types – one is about present and another is about future. By public expenditure, the desire to work and to save in individuals increases.
- The government can reduce the ditch of inequality of money with the help of tax policy, in the same way, with the help of public expenditure, inequality can also be reduced.
- Government can increase the income of poor group directly. This increment can be done by helping at the time of unemployment and by helping at the time of old age, the buying capacity of poor group increases by this and it can increase the amount of its consumption.
- By making the employment of the workers working in government departments permanent, the fluctuation of employment can be prevented.
- By spending in making the nature of individual industries same like classical government industries, the unemployment will also reduce.

3.3 Keywords

- Transference – From one hand to another hand
- Contribution – Little charity

3.4 Review Questions

1. What is the effect of production on public expenditure?
2. How public expenditure affects distribution?
3. Describe other effects of public expenditure.

Answers: Self Assessment

1. public	2. Work – efficiency	3. direct	4. Government
5. employment	6. True	7. False	8. True
9. False	10 . True		

Notes

3.5 Futher Readings

Books

1. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking International Trade and Public Finance—*Nee. Thai Somshekhar, Anmol, 2004.*
4. Public Finance—*Supreet Singh and Anil K. Gupta, Dominant, 2012.*

Unit-4 : Instrument of Public Finance : Concepts and Role of Budget

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Meaning of Budget
- Understand Important Things Related to Budget
- Know some Facts about Budget in India.

Introduction

The first step of public budget is to arrange financial resources by Government and to spend them. The meaning of any budget is limited to this step.

In many countries, there is a belief that public budget must be for one year. In many countries the beginning and closing of 'fiscal year' are found on different dates. According to the belief of many people, the time period of budget must be at least two years. According to them, a big part of the year is spent on implementing budget and preparing next budget. It is important to know for the meaningful information on budget, that what are the provisions and customs in the constitution of our country for receiving and expenditure of Government. All those receiving received to Government of India which come under their ownership, they are kept in those accounts which are called 'fund' collectively.

4.1 Meaning of Budget

The budget of a modern government is a detailed document. In there is social wise content of expenditure and total financial receivings of government with introductory amendments, there are guess of financial flow, and there is description about policies and activities of government related to this.

Therefore, for knowing the suitable meaning of public budget, be aura of its main dimension is compulsory, which is as follow –

Notes

1. The first main dimension of public expenditure is to collect financial resource by Government and to spend them. The meaning of budget was limited to this dimension only.

There are some objectives against each Government, for getting them, it chooses policies and activities. To collect resources and the task of spending them remains connected to these activities. Therefore, one meaning of public expenditure are considered that they area detailed be aura of collecting financial resources by Government and spending them. Proposed receivings for short duration (maximum one year) and proposed expenditure on following heads and are shown in serial wise category in it. The budget of a considerable year is presented to parliament or other concerned member of legislative assembly at appropriate time before starting it that year and in this way, through the medium of budget, each head of receiving and expenditure shows their proposed decision.

2. This is not expected by a modern Government that they decide in an unorganized way about their receivings and expenditure heads. The recourses coming towards Government are the gifts to society basically and it is their moral duty that the overuse of these resources do not happen by any means. In addition to this, all heads of budgets have deep relation to it, due to this, their structure must be according to the structure of goal achievement. Due to this, the beaura of budget cannot be kept limited upto proposed receiving of considerable year (or short term) or proposed expenditure normally essential discussions are kept the serial wise (and categorized in other type) receivings and four set of payments, which are as follow –

(i) Actual data of previous year,

(ii) Budget Estimates of outgoing year,

(iii) Revised Estimates of outgoing year,

(iv) Budget Estimates of incoming year,

Notes In this part, there are two sets of additional receiving of serial-wise proposed expenditure amounts. In one set, those amounts are shown which are proposed keeping same the present tax structure and in another set, the tax structures in budget and other financial resources and policies etc., after proposed amendments, desirable guesses are shown.

3. In this way, the budget shows the evaluation of possibilities of problem, facts, goals of society, country and economy of country and their receiving.

4. It has been in most conditions that 'Budget Expectations' of current year and 'Revised Expectations' are different. The possible explanation is given in these differences in budget.

5. In most cases, for some expenditure matters of public expenditure, the government is committed officially and after arranging resource for them, remaining resources – receiving are earmarked for some instructed expenditure heads.

6. It is possible that, legislative authority will present it in two or more than two parts. It can be possible for many reasons –

(i) When there is multi–level government in country then it is hoped that addition state governments and local governments of central governments budgets must be presented separately.

(ii) Budget can be presented in parts at any level of government. For example, from the budget of central government in India, the part of 'railway budget' can be placed before parliament before 'General Budget (means Main Budget) or separately.

Notes

(iii) Sometimes, due to election or any other reason, public budget comes to legislative authority for general time period (means one year) or less than time period and for remaining portion of year, the number to execute it comes after second portion of budget.

Do You Know? During the year (means during duration of budget) Government has to spend additionally and for additional resources due to some reasons. For this task, government prepares a supplementary budget and execute it. The resource of necessity of supplementary budget can be done by its activities and policy modification or due to the result of external conditions, Government needs a supplementary budget.

7. The distribution in item and item-categories of budget depends on law structure of country and account pattern. With this compulsory categorization some other categorization techniques are adopted for making budget meaningful and assuming its result, which will be discussed later in this unit. In the same way, the explanation of classical categorization of Revenue and Capital Account will be given in 'Type of Budget.'

Self-Assessment

Fill in the blanks :

1. The budget of a modern Government is detailed ……………….. .
2. ………………. can be presented in parts at any level of Government.
3. The distribution of heads and head - categories of budget depends on law structure of country and .... Pattern.
4. First main dimension of public budget is to collect .... Resource by Government and to spend them.
5. The basic resources of Government are the .... of society.

4.2 Some Concepts Associated with Budgets

Duration - There is a custom in many countries that public budget must be for one year. In different countries, the beginning and end of 'fiscal year' is seen on different dates. In some countries only 'fiscal year' matches with their calendar year. The general duration of budget in India is one year which is counted from 1st April to 31st March of next year. In favour of modification of dates in this fiscal year suggestions have been given many a times, but not single suggestion has gained acceptance. The logic of suggestion givers is that India has been an agricultural country which has more importance for Kharif crops; therefore, our fiscal year must be started from October/November.

According to the beliefs of many people, the duration of budget must be two years. According to their logic, a big part of the year is spent on execution of budget and in preparing next budget. Therefore, due to the custom of yearly budget, resources are used extravagantly.

Secrecy - The datas of budget and budgetary proposals in India are kept secret till the last moments of presentation of budget. Due to this, secrecy (excluding Prime Minister or Chief Minister), the whole budget remains secret for other members of ministry.

Many people believed that by the custom of this secrecy, no special benefit is obtained, but loss occurs. Businessman and other people guess about the proposals of budget. Due to this, they become successful in benefiting by other type and increasing costs. For investors, there is difficulty in long term decision

Notes

making. Therefore, it is the idea of those people that the datas of budget and other proposal must be kept secret. Known - government elements get the chance of getting contribution in their selection by discussion only, so that the government can know that what are imagined effects of its budgetary proposals on society and economy and how they can become better.

According to another belief, secrecy can be beneficial about some special matters. Therefore, keeping the secrecy of such matters, public must be aware about the presentation of budget proposals (specially tax related) and other matters and they must be discussed independently.

A 'Good' Budget

Any budget can be considered as good when it is a possible helper in receiving of different chosen objectives of society and economy. But, here, the main problem is that there is always dispute about these objectives. But, in the view of legislative authority also those objectives are appropriate; a 'good' budget must be helpful in its aid.

How to evaluate this fact that how the budget in question will be helpful in receiving the desired goal? For this, there is a need of detailed analysis of datas and proposals of budget. A good budget is that which has this analysis or the analysis of this type can be done smoothly. In this context, we can give emphasis on this fact that government need not to take debt for its current expenditure such as wages of government servants, payments of interest, expenditure on security of country etc.

4.3 Some Facts Concerning Public Budget in India

It is necessary for budget related meaningful knowledge that for the receiving and expenditure of government that what are the provisions in the constitution of our country and what are the customs. In this context, we have to note firstly that the receivings of government can be in its own ownership, or it can be as a form of identity (The main form of these identities is debt). On this base, the receivings received in the form of 'identity' there isn't any need of permission of Parliament (or legislative assembly of state) for returning them to their owners and for some other expenditure heads.

1. Consolidated Fund — All those receivings of government of India which comes under its own jurisdiction, can be kept in those accounts which are called 'Consolidated fund of India'.

(i) Before 80th amendment of constitution, the whole receivings and some partial receivings from taxes debited by government of India go to state governments. Therefore, the arrangement was like that all other tax receivings in addition to the part received to states in receivings of income tax go to the consolidated fund of India and from this consolidated fund, the part of receivings of state (including part of receivings of income tax) can be transferred to them. The budget of union state areas without legislative assembly, are consolidated in the budget of government of India, therefore tax receiving of union state areas also went to consolidated fund of India. Now, the situation is that a predecided part of receivings of all taxes of government of India excluding (a) taxes imposed under Article 268 and 269, (b) surcharge on taxes, and (c) Taxes imposed for special provisions and it is out of bounds of consolidated fund of India.

(ii) Indian government also received different types of taxes and revenue. All these go to the consolidated fund of India. The examples of these receivings include currency, coinage and mint, interest receiving, profit, external Grants-in-Aid and contributions, tax-ratio revenue.

(iii) Some receivings in capital accounts go to consolidated fund. This includes internal debt of different types collected by government of India foreign debt and debts given earlier by government of India and receivings etc. Constitutional state is considered when debt

Notes

receivings are placed in consolidated fund, government have debited them on availability in present and guarantee of received amount in future and that Government will pay them from consolidated fund also. All those dues of government of India which are payable from "Consolidated Fund of India", are called "Public Debt of Government of India" or "Public Debt". According to this fund, every state has its consolidated fund.

2. Public Account—By government of India and all other amounts are called 'Public Account of India' collectively. All these amounts remain deposited as identities with government. Therefore, for returning them, government need not have to take permission from parliament. The main examples of other dues are- (a) Small Savings, Deposits and PPF; (b) State Provident Funds; (c) other accounts; and (d) Reserve funds and deposits. The payment of these debts can be done without execution from Parliament. According to this fund, every state has its public account also.

Task What do you understand by consolidated fund?

3. Contingency Fund of India—The country may have to face such situation where government has to spend immediately, but there is no time and opportunity to take permission from parliament. For tackling such situation, it is considered suitable for keeping some amount as advance for the government which is know as **contingency Fund** of India. Expenditure from this fund from time to time is executed by parliament and possible modification is also done from total amount. In this way, there is a '**consolidated fund**' for each state. There are two categories of payments from consolidated fund of India.

In first category, there are those items which are 'charged' payment of this fund, i.e., there isn't any need to implement these payments (expenditure heads and proposed expenditure amounts on them) in parliament. These become a part of expenditure party of that budget without execution. Some examples of these 'charged' payment heads have been mentioned earlier. Accordingly, there are some 'charged' payments also on consolidated fund of each state. The payment of any type cannot be made without prior approval from parliament (and legislative assemblies in matters of states) from consolidated fund.

As the public account is considered, the receivings in them are according to such predetermined conditions that government is bound by law by time table of their payments and other conditions. Therefore, there is no need of prior permission of parliament (or legislative assembly of state) for payments from this account.

Self-Assessment

Multiple Choice Questions:

6. Whose beginning and ending are seen on different dates on different countries?
   (a) Fiscal year (b) Financial year
   (c) Public Finance (d) None of these
7. Which year matches with fiscal year of some countries?
   (a) Financial (b) Calendar
   (c) Hindi (d) Public
8. Some receivings from Capital Accounts go to which fund of India?
   (a) Contigency (b) Public
   (c) Consolidated (d) All of these

Notes

4.4 Summary

- The budget of a modern government is a detailed account. There is serialwise description of all financial receivings and expenditure of government, including proposed modifications; there are possibilities of financial flows; and there is description of policies and activities related to government.
- There is a custom in many countries that public budget must be for one year. The beginning and ending of 'fiscal year' in different countries are seen with different dates**. 'Fiscal Year'** matches with their calendar year in some countries only.
- Many people believed that no special benefit is received from the custom of this secrecy, but Loss occurs. Businessmen and other people guess about the proposals of budget. Due to this, they become successful in increasing costs and benefiting from other type.
- A budget can be said good when it is helpful in receiving of different chosen objectives of society and economy. But, there, the main problem is that there is a dispute regarding these objectives.
- It is necessary to know for meaningful knowledge regarding budget that what are the provisions and customs in the constitution for our country for receiving and expenditure of government. First of all, it must be noted in this regard that the receiving of government may be in their ownership, or can be in the form of identity. (The main objective of these identities is debt)
- All receivings of government of India which are under its ownership, are kept in those accounts which are called 'Consolidated Fund of India' collectively.
- All other amounts received by government of India are kept in those accounts; they are called 'Public Account of India' collectively.
- The country may have to face such situation where government has to spend immediately, but there is no time and opportunity to seek permission from parliament.

4.5 Keywords

- Supplementary - To satisfy
- Charged - Debtful

4.6 Review Questions

1. Whats is the meaning of budget?
2. What is a good budget?
3. Describe some facts related to budget.
4. Write short notes on following:

   (i) Duration (ii) Secrecy

Answers: Self Assessment

1. account	2. Budget	3. accounting	4. financial
5. assets	6. (a)	7. (b)	8. (c)

4.7 Further Readings

Notes

Books

1. Public Finance—*New Royal Book Company*.
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking International Trade and Public Finance—*Nee.Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Supreet Singh and Anil K.Gupta, Dominant,2012.*
5. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Notes

Unit-5: Public Revenue: Revenue Receipts and Capital Receipts

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Meaning and Importance of Public Revenue
- Know the Source of Public Revenue
- Understand different Element of Tax
- Get Knowledge about Gift and Contribution.

Introduction

In today's age of economic planning, the importance of origin in economy has some importance as public revenue of public finance. In current time, due to the increment in tasks of states, the amount of public expenditure increases. The taxes are those essential payments in source of public revenue which are done by tax payers for government in such hope that they will get direct benefit in return of these.

5.1 Meaning and Significance

There is a need of income for fulfillment of a person's needs, in the same way government needs income for successfully completing its tasks. Income of all types received by government is called public income. In the study of public finance, the government income has the same place which is gained by production in study of economy. The production is necessary for the fulfillment of consumption, in the same way, for the fulfillment of the government expenditure, government income is essential.

Income received from different sources of government is called government income or government revenue. But, **Dalton** has used government income in both meanings - broad and limited. He named them public receipts in Broad Meanings and named them public income or public revenue in Limited Meaning. In public revenue, taxes, the cost of commodities and services received by government industries, income of administrative operations like fees and penalty and gifts and contributions are included. But, in public receipts, all those incomes of government can be included which they receive during a particular duration. In other words, public receipts = public revenue + income of all other sources such as individuals, debts from banks and issue new money letter.

In the age of economic planning, the importance of origin in economy has same importance as public revenue of public finance. In current time, due to increment in tasks of states, the amount of public expenditure is also increasing. For the fulfillment of this increased expenditure, it has become necessary to increase public income. In modern times the objective of income related sources is not only receive income, but to affect production, employment, planning and other economic operations as a form of an effective fiscal tool. An arrangement of powerful resource for fulfillment of desired objectives by deciding a definite policy in regard of public revenue as well as public expenditure and public debt policy in every economy is done. Therefore, in current age, public income for each economy, whether developed or undeveloped has been proved important. The familiarity and success of government depend on whole public income. In the same way, for both private individuals and government, the practical importance of methods of public revenue and study of its nature has been increased.

Notes Government Receipts = Government Revenue + All other Sources of Income.

Self–Assessment

Fill in the blanks:

1. All type of income received to government is called .... income.
2. In the public finance, the government income has the same place which is gained by .... in study of economy.
3. Production is necessary for the fulfillment of......................... .
4. Government receipts = government revenue +....................... .
5. In today's age of economic planning, the importance of origin in economy has same importance as .... of public finance.

5.2 Sources of Public Revenue

Now, we will study different sources or forms of government revenue. These resources are following-

(1) Taxes

(2) Commercial Revenues

(3) Administrative Revenues

(4) Gifts and Grants

Now, we will study all these sources separately -

Notes

5.2.1 Taxes

Taxes are those compulsory payments which are used without any such hope towards government by tax payers that they will get direct benefit in return of them. According to **Bartable**, ʹʹ Tax is that compulsory contribution of money present with person or individuals which is given in lieu of service in government tasks.ʹʹ According to **Prof. Seligman**, ʹʹ Tax is that compulsory contribution given to Government by individuals which is paid in the payment of expenses in all general favours and no special benefit is given in lieu of that.ʹʹ According to **Trussing**, ʹʹThe special thing is that in regard of tax in comparison to all amounts taken by government, quid pro quo is not found directly between taxpayer and government administration in it.ʹʹ

Characteristics of a Tax

It is clear by above mentioned definitions that some specialties are found in tax which are as follows :-

(1) Compulsory Contribution—Tax is a contribution given to state by people living within the premises of country due to residence and property etc. or by citizens and this contribution is given for general use only. Though it is a compulsory contribution, therefore, no individual can deny from the payment of tax. For example, no person can say that he is not getting benefit from some services provided by that state or he didn't get the right to vote, therefore, he is not bound to pay tax. Therefore, tax must be paid by each individual which is imposed by state, whether he is adult or minor and citizen or foreigner. If a person denies to pay tax, he must be prosecuted.

But, there are some limitations of taxes. For example, if tax is imposed on some special product then he can escape tax by not using that product. Suppose if tax is imposed on wine then government can force some person to pay tax only when he uses wine. But, if he doesn't drink, then he cannot be forced to pay tax imposed on wine. In addition to these limitations, tax is compulsory payment and its speciality separates it from other types of government revenue.

(2) Personal Obligation —Tax casts personal obligation on taxpayer. Its meaning is that if tax has been imposed on some person then it is his duty or obligation to pay it and don't try to avoid it in any condition. For example, tax is imposed on incomes of persons then there can be many sources of income of persons, therefore it is possible that government may not be aware of all sources of income of people. In that condition, it is the duty of taxpayer that he must declare all his income and pay tax according to it.

(3) The Tax is Imposed for the General and Common Benefit —The contribution that is received from taxpayers in the form of taxes, it can be possible that it cannot be spent for their profit only, but it must be spent in favor of common people. It can be possible that a person is not capable to fulfill all his needs specially to fulfill those needs where huge amount is spent there such as construction of hospital. In that condition the state arranges for such services for the benefit of all people. Therefore, for bearing this general burden, the tax is imposed on all those people who are capable to pay it.

(4) No Relation between Taxation and State Services —Payment of taxes not done by state for the payment of any special service given to a person and tax is not paid for this purpose that some special benefit has been given to taxpayer by state. In this way, tax are not paid because taxpayer has received benefit from state or state has provided service for it.

But, there is some limitations also of this speciality. For example, land tax is paid by those individuals only who have land or those who get benefit from land. In the same way, entertainment tax is given by those individuals only who get benefit from entertainment. By highlighting on this condition, **Prof. De Marco** has said about the limitation of tax that the law of taxation in modern state is based on the assumption of an exchange relationship that is the exchange of a payment of the state for the provision

Notes

of public services by the state.[1] Therefore, according to **De Marco**, "The tax is the price which citizen pays to the state to cover his share of the cost, the general public services which he will consume.[2]

But, here, this is mentionable that contribution is received in form of land tax by farmers, it can be possible that it is not only use for their benefits only by the state, but also it must be given for the benefit of all society. In the same way, government receives contribution in lieu of the profit received from entertainment by people; it is possible that it must be used for the benefit of whole community instead of the benefit of only those. In this way, the amount paid in the form of tax by individual and benefit received from the government service have no relation between them. Therefore, it is a compulsory contribution and this contribution is for the benefit given to general public and there is no relation between service given by government and tax paid by them.

Do You Know? It is the duty of taxpayer that he must declare his whole income and pay tax accordingly.

Elements of Tax

On the basis of above mentioned analysis, it can be said that the main elements of tax are as follow-

1. Compulsory Contribution —Tax is a compulsory contribution, if the directions instructed by law are imposed at the time of paying tax.

2. Taxes are Imposed by a Government—Taxes are imposed by government only. If the management of any temple or any other organization makes compulsory to give a special amount for one year for each family, then it cannot be said tax in any condition.

3. Involvement of Sacrifice—The emotion of sacrifice lies within the payment of tax because taxpayer pays in the general favour of society.

4. Social Welfare—Tax is imposed for the objective of welfare of whole community, i.e. revenue received from tax, at one hand, it is spent for the welfare of whole society but for special category of society and, on the other hand, the inequalities of revenue remove from this expenditure.

5. The Benefit is not the Condition for the Payment —To receive benefit is not a compulsory condition for the payment of tax. Taxes are not paid merely because taxpayer receives benefit from government expenditure, but they are paid because they are compulsory. If the taxpayer receives any benefit then it is not necessary that it must be in ratio of tax paid.

6. No Relation with the Cost of Service —The benefit which is provided to individuals by government service tax is not imposed to utilize the cost of that benefit, i.e. tax has no relation with the cost of that service which is provided by the Government to individuals. For example, it is possible that poor person gets benefit from government expenditure but he gets very less effect of taxation.

7. Payment from Income—Taxes can be imposed on income and on capital also. But, they are paid from high income only.

1. "The law of taxation in modern state is based on the assumption of an exchange relationship, that is the exchange of a payment of the state for the provision of public services by the state."
2. "The tax is the price which citizen pays to the state to cover his share of the cost the general public services which he will consume."

– 4 and 5 Antonio de Viti de Macro, First Principle of Public Finance, pages 112-113.

Notes

8. Individual Payment—Taxes can be imposed on individual's property or any commodity, but they are paid only by individuals.

9. Legal Collection —Tax is a legal collection.

5.2.2 Commercial Revenues

Commercial revenues are those incomes which are received in the form of produced goods by them or cost of services. In other words, that revenue is called commercial revenue which it received by selling goods of public enterprises or services by government. This revenue is called price and it is so because it is received in the form of goods provided by Government and cost of services, payment of postal expenditure, toll tax, interest of money given on debt by government approved corporations, costs paid for the beer of government godowns, costs of electricity distributed by government, payments of rail services etc, are included in commercial revenues. Sometimes, government generates revenue from the production of goods like steel and mineral oil. But, in spite of this, savings or surpluses from commercials enterprises are not considered an important source of revenue in most countries of the world.

Difference between Tax and Price

The main differences between tax and price are as follow:-

1. **Difference in Payment —**Tax is a compulsory contribution which is paid by each individual, who buy goods and services produced by government.
2. **Difference in Benefit —**There is no guarantee of this thing that whether any benefit will be received or not in lieu of that payment, and if benefit is received then what will be the amount and nature of that' but costs are direct payments given in lieu of goods and services and the amounts of their payments depend on amount of services and goods purchased. **Prof. P. E. Taylor** expressed this thinking in these words, "The characteristics which separate revenue of other categories from commercial revenue are : Direct receipts of goods or services in lieu of payment and secondly, adjustment of amount of payment with cost of goods or services broadly."

It is mentionable here that it is not the condition that there can always be a condition of equality between marginal production cost or average and cost of goods produced by government. It can be possible that there can be a state of conflict between general social policy adopted by government enterprises and business policy, such as rates of postal expenditure or about fares of tunnel ways that these rates and fare do not complete the cost of services. In such examples, it is considered desirable that government service for social welfare must be available broadly; if the cost of goods and amount are equal then in that condition it is possible to avoid it. There are some other examples in which for the distribution of total commodities and services, government monopolies are established, and it is so because monopoly benefit can be obtained. The main examples of it are rail service and distribution of electricity in India. French Tobacco monopoly is also a good example and government controlled beer shops also come in this category. It can be possible in these matters that in the establishment of these monopolies, the only objective of government is to get benefit, but have to keep control on distribution of services and commodities by them. **Taylor** said that, "It is possible that monopoly activities for the objective of control in this area is as important as possibilities of benefit."

Government can enter in the area of their sale and production of goods and service for many reasons. It can be possible in some matters that private enterprises are not willing to establish such enterprises because they have very less possibility of benefit, or because the receipt of benefit or results will be obtained by them in long term duration, for example, postal service and construction of dams and canals producing electricity etc. Some other essential services can be taken over by government so that the rights of consumers of private organizations can be saved, such as city transport service and water supply service. Thirdly, in some other matters, it is considered that the said service can be provided more cheap and best by government in comparison to private individuals, such as production and distribution of electricity. Fourthly, there are some matters in which government can take control of those enterprises which have their basic importance in economy. The production of related goods from such enterprises by government is considered in the favour of whole country. Iron and steel heavy electrical appliances, oil and minerals etc. are some examples of such enterprises. Here, it will be important to mention that the nature of such professional incomes is mainly like those costs which are given to non-governmental producers of goods and services.

5.2.3 Administrative Revenues

Those receipts which are placed in the category of administrative revenue are fees, license, penalty, receipts from mortgaged property and control on property in absence of heir and special assessments. One characteristic of this receipt is that a person gets relaxations that he can pay them or not. Secondly, these receipts give direct benefit to the person or impose fine on him. But, in that state it is not essential that there must be a relation between money paid or cost of benefit and cost of benefit received. There is a special characteristic of administrative income that it is received in the form of by product of administrative works of government. And this is the reason that these are called 'administrative income'.

The short descriptions of these administrative incomes are as follow -

Task Differentiate between tax and cost.

(A) Fees

The definition of **Prof. Seligman** is as follow - "Fee is that amount which is given to pay the cost of each such recurring service provided by government which is mainly in favor of public but which provides such special benefit to fee payer that can be measured." In this way, fee is that payment which is given to government to fulfill the costs of those administrative services which are completed in the favor of whole public but provide special benefit to individuals. Therefore, fee is paid by those individuals only which get special benefit from the services provided by government. For example, if a student wants to get benefit of education by studying in government school, then he must have to pay fees.

Difference between Fees and Price

There are many major differences between fees and price -

1. **Cost Optional, Fees Compulsory -** Costs are always voluntary payment, but fees can be compulsory contribution also, if both are paid in lieu of special services.
2. **Quid Pro Quo -**The element of quid pro quo which is found in tax is also present in fees, but this element lacks in costs.
3. **Professional Operations -**Fees is not the payment for professional service, but it is mere production of administrative operations of government but costs are payments for professional operations by government.

Notes

(B) Licence Fees

The nature of licence fees match with fees up to some extent but there is some difference in it and fees. "Licence fee is paid in that condition when government administration is requested that it must provide permission or privilege instead of providing service of definite kind and more clear." Registration fees of motor vehicles, payment of permit of driving motors and license fee for keeping revolver are such examples. No one can be forced to pay fees in these matters, but any person who wants to use revolver or motorcar then essential fees have to be paid for that. The benefit which a fee payer gets after paying fees, that is in the form of practical facility and law to use motorcar or keeping revolver.

The objective of that fee is sometimes that the implementation or control of activities and operation of different type, for example, responsible individuals must be given licence of revolver for the establishment of law and order. In this way, for controlling the sale of wine, licences are given to run wine shops. In the favor of public-security, motor driver are instructed to get licence for driving and these licences are given only when a person is found fit to drive a vehicle. Therefore, the factor of control which is found in licence fee separates it from fee and tax both.

(C) Special Tax Assessment

In the words of **Prof. Seligman,** "Special assessment is that compulsory contribution which is paid in the ratio of special benefits provided and whose objective is to pay the cost of special reform in property purchased." When government takes the tasks of public reforms like road construction, arrangement of sewer and arrangement of light in roads and streets in its hand, then the whole public get general benefit whose property like shop, house etc. is on that road. As a result of these reforms, the costs and rents of these properties increase. So, it is possible that government may impose some special tax on the people of that area to pay back some part of such expenditure. Such special tax imposition is done in the ratio of increment in the cost of property and it is different from this view.

Characteristics —According to **Seligman** following characteristics are found in the imposition of special tax -

1. It has factor of special purpose.
2. Special benefit received from government service can be measured in it.
3. Special assessments are not progressive, but they are proportional according to the benefits received.
4. They are imposed for special local reforms.

Comparison of Special Assessment with a Tax

Similarities - Following similarities are found in it:-

1. **Objective -** Both of them have element of public purpose, because whether government has been received income in the form of tax or in the form of special assessment' it is spent in the favor of society as well as special individuals as a whole.
2. **Compulsory Contribution -** Special tax decision like tax is a compulsory contribution also. Therefore, the factor of compulsion is found in both of them.

Dissimilarities - Three dissimilarities are found between tax and special tax decision. These are following -

1. **Dissimilarities of Assessment** -The income received in the form of taxes is spent in the fulfillment of general objectives of government, but the income ending in the form of special assessments is spent on special local improvement.

2. **Basis of Assessment -** There can be many basis for imposing tax such as income, expenditure; the cost of property etc. but there is only one base of imposing special assessment, that is benefit. In other words, special assessment is calculated in proportion to the benefits received.
3. **Dissimilarities of Object -** Special assessments are imposed for the objective for getting money for some capital growth plans but taxes are also imposed for financial system of capital growth plans and for the fulfillment of current expenditure.
4. **Dissimilarities of Payment -** Special assessment is different from this point of view to costs because the payment of costs is optional whereas the payment of special assessment is compulsory.

(D) Fines and Penalties

Fines and penalties are not an important source of government revenue. Fine is related to punishment and penalty is given on breaking the law. The objective of both of them is to avoid crimes and to punish for any wrong doing.

(E) Forfeitures

The meaning of bails or bond or forfeitures of property is related to those penalties which are imposed on people by courts so that they failed to appear in court in a definite date or they didn't complete prior contracts. It is clear that the importance of the source of revenue of government is very less.

(F) Escheat

This source of government revenue is the symbol of claim of government on property of such person who died without appointing a successor or without making a will. In this state the amount deposited in bank of that person go in the custody of government. Under escheat, government can take over dissolved educational institutions or unclaimed property of trusts also. It is not an important source of government income.

5.2.4 Gifts and Grants

Gifts are those optional contributions which are given to government for such special tasks by private persons or non-governmental donors such as relief fund at the time of war or defence fund. These contributions are given to freedom fighters, kind hearted and other individuals at war, natural disaster or other such emergency situations. In modern government system, there is no mentionable place for these gifts excluding war time or emergency. It had important place definitely in classical government system but king, Nawab and Jageerdar etc. take gifts from their people. These days the total amount of gifts is so less that it has nominal place in revenue system.

The characteristic of receivings in the form of gifts and grants that are optional in nature and in return of this, it does not hope for any direct benefit. In the state of grants, donor government gives financial help for completing government task at any level. In unitary countries, central government gives grants-in-aid to state governments and state governments give grants-in-aid to local governments so that they can be made capable so that they can do their work successfully or with uniformity or can handle some special tasks such as construction and maintenance of highways. Therefore, these contributions can be unconditional also or can be given to complete some special tasks too.

Notes

Sometimes, government of a country receives contribution from other country which is normally called foreign aid. The good relations must have to be maintained between different plan heads of foreign aid. But, it will be suitable that this categorization must not be touched otherwise answerability towards Parliament which have been received from it that will end. But the government have to do this essentially that there must be such separate system to distribute the expenditure of budget according to plan heads so that the objective of budget making can be completed.

Self-Assessment

State whether the following statements are True or False:

6. Tax is a compulsory contribution by a person to government.
7. Tax doesn't impose personal responsibility on taxpayer.
8. Land revenue is paid only by those individuals which have land.
9. The emotion of sacrifice is not present in the payment of tax.
10. Benefit is given to people by government service.

5.3 Summary

- The popularity and success of government depends on whole public revenue. In the same way practical importance of study of nature and methods of public revenue for both private individuals and government has been increased.
- Taxes are those compulsory payments which are given by taxpayer to government in this hope that they will get direct benefit in lieu of this. According to Bastable, a tax is that compulsory contribution of money with individuals or group of individuals which is given to government tasks in lieu of service.
- Tax is contribution given to state by citizens living in the radius of a country due to residence or property etc, or by citizens that this contribution is given for common use only. It is a compulsory contribution so no person can deny from the payment of tax.
- Payment of tax is not done for the payment of any special service for individual by state and neither paid because the taxpayer got some special benefit by state.
- Tax is the cost given to government by each citizen which he pays in lieu of that part of cost of those public services which are used by him.
- Commercial revenues are those revenues which are received to government as costs of services or goods produced by them.
- Tax is a compulsory contribution which is paid by each such person on which it is imposed but the cost is paid by those individuals who buy goods or services produced by government.
- Tax doesn't give guarantee that benefit will be received in return of that payment and if happens so then what will the amount and nature of that, but costs are direct payments in lieu of goods and services and the amount of those payments depend on amount of services and goods purchased.
- The receipts which are kept in the category of administrative revenue, these are - fee, license, penalty, receipts in forfeitures and escheat etc. and special assessments.
- Special assessment are those compulsory contribution which are paid in proportion to special benefits provided and whose objective is to pay cost of special reform in property seized in view of public favor.

Notes

- The feature of receipts in the form of gifts and contributions is that they are of optional in nature and the individual who gives them doesn't hope for any direct benefit.

5.4 Keywords

- Land tax —Tax to be paid for land
- Cost — Expenditure
- Legal — Related to law
- Surplus — In large quantity

5.5 Review Questions

1. How government receipts are decided?
2. Describe briefly about different sources of public revenue.
3. Describe the characteristics of tax.
4. What do you understand by administrative revenue?
5. What is the difference between fee and cost?

Answers: Self Assessment

1. Public	2. Production	3. Consumption
4. Revenue from all other sources	5. Public revenue	6. True
7. False	8. True	9. False
10. True		

5.6 Further Readings

Books

1. Public Finance—*New Royal Book Company*.
2. Indian Public Finance System—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
3. Money Banking: International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Nand Kishore Parsad, ABCD Publication, 2011.*

Notes

Unit-6: Taxation and Its Canons

CONTENTS

Objectives

After studying this unit students will be able to:

- Know about Development related Things of Taxation
- Understand Different Canons of Taxation.

Introduction

In today's time, government expenditure is also increasing with the increment in tasks of government. Today an important problem against each government is that how to get income temperorarily by debt also, but they have to return it after some time. Some government income is received from government enterprises, administrative and judicial tasks and other such sources, but a big part of government income is received from taxation.

6.1 The Development of Taxation

In classical communities, people used to give their optional services to government. But, with the rise of state, for the conduction of government, tax or gifts and income from other enterprises have started receiving classical state hoarded property tax, income tax, commodity tax and collection of heir tax rarely and in small quantities and only in the form of emergency income. There is no need of any detailed system of taxation for brief expenditure for classical states.

If we have to rise tax systems of modern states, such as **Plehn** described, it can be reached more accurately in feudal system instead of classical fiscal system. After the collapse of Rome rulers fulfill their expenses for a long time from their income of own land and from the compulsory contributions for their citizens. At that time the fee of bazaars, fee of security, usage of roads and Ghats, rent of land etc. which were used as goods and services, were changed in money payment slowly and slowly and when money economy was born by this then these payments changed into taxes.

In the age of handicraft when new goods started to be produced and the enterprises of new types started to be established, so as land tax, production tax, boundary tax, road tax and other taxes were imposed on individuals products. It is mentionable that the change in the form of taxes of classical due amounts is not sudden but in a sequence.

After 1500, when modern state starts to rise then taxation developed an important place. With the increase in government expenditure, it became essential to search for new sources and they were searched in new properties new commercial activities and new goods of consumption, the importance of income tax and heir tax in 19th and 20th century. First World War increased expenditure for the fulfillment of this, the arrangement of taxation was made. Taxes were increased highly in nations engaged in war and new general sale tax and capital levies were imposed. Time after the period of war remained mentionable for the point of view of high taxation. In the end of 1929, long depression ended the usability of some famous taxes and the increment in government expenditure in social aid started the demand of new taxes. But, due to this, taxation didn't prove helpful for total economy in depression. These days, fiscal operations are helpful in the process of reconstruction due to changing economic political and social directions. Therefore, it is necessary to understand that what are the deciding factors of a good tax system, by which that tax system can fulfill the needs of economy of different situations.

Therefore, when this question is discussed in a complete sense and with a broad view, then the question arises that what must be the characteristics in a good tax system? **Firstly**, it must include good taxes because taxes construct tax system. **Adam Smith** was possibly first economist who followed the canons of taxation or rules of taxation. After that, other economist in which **Findlay, Shiraj, Vestable** are main followed the principles of taxation.

Notes After 1500 A.D. modern state rose.

6.2 Adam Smith's Canons of Taxation

Canons of taxation presented by Adam smith's are as follow -

6.2.1 The Canon of Equality

Canon of equality or equity is the first canon presented by **Adam Smith**. According to this, "The citizens of every state must contribute for the aid of government in proportion to their ability, means in proportion of that income whose enjoyment; they receive in security of state. By following this principle, the equality of taxation can be received and by neglecting this, the principle of inequality. Taxation tells clearly that government have to receive accordingly from each citizen for the fulfillment of their expenditure."

Do You Know? The canon of equality is also called the canon of equity.

Criticism - Its meaning is that a person receives income in security of state, the tax must be imposed on it by proportional rates. Although, **Smith** has said at one point that rich people have to pay more

Notes

tax accordingly to their money, its meaning is progressive taxation. But, modern economist are not agree with this statement that proportional taxes are sub equity. Therefore, for implementing the canon of equality, they promoted progressive taxation. In this way, there are differences about the rates of taxation means resources of taxation of Adam Smith, not about the objectives of taxation.

6.2.2 Canon of Certainty

Second canon of Adam Smith is canon of certainty. According to this, "Every individual who pays taxes, must be certain. The time of payment of tax, method of payment and amount of payment etc, must be clear to taxpayer and each other individual. In the matter of tax, the payment which is paid to any individual, its certainty is very important that on the basis of experience of all countries, but my view is that the inequality of large amount is not so dangerous so that the certainty of less amount."

Haidley supported this canon. He says that individual and government both have benefit because a person remains in certainty that what tax they have to pay and at what time. Inversely it helps government to balance its budget.

Criticism — It is said that payment of tax is compulsory. Therefore, it is definite up to some extent. In this state, this canon has no importance. But, this can be true legally. As long as the question of attitude arises, the utility of this canon is no less. For example, tax payers and tax officers know well about the payment of tax, rate of payment and time of payment etc, but disputes arise between them. We have seen many matters in which taxpayers are troubled by tax officers. The fact is that we have to face many practical hurdles while deciding tax so that the income received to Government can be fixed.

6.2.3 Canon of Convenience

The **third** canon of Adam Smith is canon of convenience. According to this canon, "Every tax must be paid at such time and according to such ritual that the payment of this is more convenient for the taxpayer." Its meaning is that the tax must be imposed in such a way and must be imposed at such a time when the taxpayer can pay it more conveniently. For example, the best time to receive land revenue is when the crops is harvested. In the same way, the tax on the rent of house must be received at such a time when taxpayer is more convenient to pay. Direct tax are so comfortable that the person considers them more convenient as cost of goods in comparison to payment of tax. The taxes imposed on goods of comfort in comparison to useful goods are more convenient.

Criticism - Smith has described those taxes also with reasons which can be collected with great convenience. It is tax on goods of luxury. "The taxes imposed on goods of luxury such as consumable goods are very convenient because the forms in which consumers have to pay them are very comfortable." The payment of these taxes is very convenient for consumers because when they buy goods slowly and slowly so as they pay taxes in bit and pieces and they pay when they like, because the purchase of goods at the best convenient depends on their desire.

6.2.4 Canon of Economy

The **fourth** and last canon of **Smith** is canon of economy. According to this, "Every tax must be imposed and received in such a way so that the money which comes by it in the treasure of state, people must have to pay less for it." The objective of this canon is that the administrative cost of tax payment must be kept minimum, means there must be minimum difference between the money coming from the pocket of people and money deposited in treasure. **Adam Smith** also said that the usage of the amount coming from cooperative treasure of tax due by public can be possible in four directions -

(i) **Firstly,** officers are needed in bulk for imposing tax and receiving it; whose salary will be so much that a big part of money will be spent on it received as amount of tax and then

Notes

taxpayers have to pay more tax than prior for state works. Therefore, it is essential that the administrative cost for payment of tax must be minimum.

(ii) **Secondly**, taxes can cause hindrance in business of people and can discharge people regarding the subject of starting some such branches of business which can become a source of earning for the people of majority.

(iii) **Thirdly**, some unfortunate people unsuccessfully try to avoid taxes and when penalty is imposed on them on being caught or their property etc. is forfeited then their business is ruined and the benefits received from that business to community by doing this is also ended. In addition to this, a corrupt tax officer becomes a big attraction himself for theft of taxes. Therefore, taxes must not be so heavy that they attract to hide taxes and the taxpayer gets unnecessary burden.

(iv) **Fourthly**, by the frequent visits of tax officers and unnecessary checking of accounts etc. there can be unnecessary burden, pressure etc, on taxpayers. Therefore, tax system must be very simple so that it did not become a cause of difficulty and sensation by tax officers.

Task Explain the canon of convenience.

Self-Assessment

Fill in the blanks:

1. In classical communities, people used to give their .... services for the aid of government.
2. After the year....................... , modern state arose.
3. .... was the first economist possibly who gave the principle of taxation.
4. .... supported the canon of convenience.
5. .... cost of payment of tax must be minimum.

6.3 Criticism of Adam Smith's Canons

It has been found after studying the canons of taxations that all other canons excluding the canon of equality do not prepare a definite base for tax policy. We can say them directions related to administration of tax officers instead of saying them canons.

The canon of equality or equity does not tell any definite measure of tax due to capacity.

Economists have considered the canon of taxation very important while having above mentioned defects in the canons of Adam Smith. According to **Prof. Shirraj, after Adam Smith "No expert could place the rules of taxation so clearly and simply so as Adam Smith did,"**

In the words of **Prof. B.R. Mishra - "The rule of ability is a principle of taxation, there are administrative rules regarding other three taxes."**

6.4 Other Principles of Taxation

The writer like **bastable** has followed some other principles in addition to **Adam Smith**. These principles are as follow -

Notes

6.4.1 Canon of Productivity

Bastable have placed his canons of taxation serial wise. In this series, he has given first place to the canon of productivity. In other words, "Taxation must be productive firstly." It is clear that Bastable has given top most importance to the productivity of tax. The productivity of tax can be achieved in two ways; Firstly, tax must be such that it can yield money for the conduction of government. In the words of Bastable**,** the main objective of revenue system is to get revenue for the expenditure of state, therefore, Finance Minister possibly assumes about its merits from the amount received by tax. Secondly, tax must be such that which doesn't discourage production from both views - short term and long term.

6.4.2 Canon of Elasticity

It is essential to have elasticity in tax system. Bastable has told that canon of elasticity is very important. He said that the taxes must be such that there must be flexibility in them according to the needs of government. The government can need more money for war, development work and other possible reasons for facing feminine or flood. In this state, the speedy increment in the resources of government when its tax system is elastic. For example, taxes imposed on property and goods are not so elastic, so as the income tax.

6.4.3 Canon of Diversity

There has been already big dispute between comparative benefits in single tax system and multiple tax system. One is about imposing tax from time to time by thinkers. For examples, physiocrates suggested about imposing single tax system on economic revenue of land. In the same way, many arguments can be given in regard of imposing single tax system on revenue.

Many defects are found in single tax systems

(i) It is possible that it doesn't provide sufficient revenue,

(ii) It is possible that the distribution of weightage of taxation by it is not satisfactory.

(iii) Its receipt can be difficult and costly.

(iv) There can be more greed to avoid tax.

Inversely, there is very less possibility of finding all these defects in Multiple Taxation**.** Whether arguments are concerned, the balance of scale goes against single tax system. Due to this reason, some writers have given emphasis on diversity of canon.

The meaning of diversity of taxes is that there must be many type of taxes like direct and indirect so that every category of citizens can give their contribution in revenue of state. Multiple tax system is given importance normally in comparison to single tax system. But, multiplicity in taxes is not considered appropriate, because multiplicity goes against the canon of productivity. If the number of taxes is high then its result will be that each tax within them will provide less revenue by which the cost of their collection will increase.

Dalton suggested that we must have to depend on less solid taxes than more. "It will be best that we have to depend on less taxes for a big part of government revenue." **Dalton** thought that if tax is imposed in excessive quantity then the efficiency of administrative system will ruin. Therefore, for maintaining the efficiency of administration it is necessary that the taxes must be imposed for limited time but **Prof. Arthur Young** says that, "If I am told to describe a good tax system is that which exerts

Notes

a very low pressure on number of people and high pressure on it." But, it must be in mind that there must not be any regressive effects of such taxes.

In the same way, it is suitable that the weight of taxation must be spread vastly on total economy, so that one part of it doesn't get much damaged. Therefore, it can be said conclusively that a good tax system must be based on the canons of multiple taxation, but by doing so, no damage of any type must be caused by the efforts of productivity.

Do You Know? A good tax system is that which exerts very less pressure on unknown number of people and not a high pressure on any one.

6.4.4 Canon of Simplicity

Tax must be such that the taxpayer can understand it easily. In other words, the nature of tax, its objective, the time of payment, the method of tax - decision and base etc. must be so that every taxpayer can understand it easily and can follow it. It is clear that this canon removes many difficulties of taxpayer but in modern tax system whose nature has become very complex, it is difficult to follow this canon. But, it can be said that administrative efficiency is an important deciding factor of a good tax system and that efficiency can be brought easily when tax system is easy. When there will be tax system then there will not be any difficulty to understand it then the tax pay will not have to face any kind of difficulty or administrative or account related tasks. As a result, the payment of income tax will also become easy for government. Therefore, the efficiency of tax system can be increased by adopting this canon of taxation.

6.4.5 Canon of Expediency

Its meaning is that the government have to impose only those taxes which are suitable and desirable. By this point of view, when the government impose a new tax or increase old taxes then it must be seen that what will be their reaction on taxpayer . Sometime, it seems that some taxes are also desirable and there are some characteristics which are found in a good tax but the government did not consider to impose that tax according to time. For example, a crop income tax is considered very desirable in India but it has not been implemented in that form till today. Therefore, in democratic countries, where the desires of public are respected, this canon has given due importance.

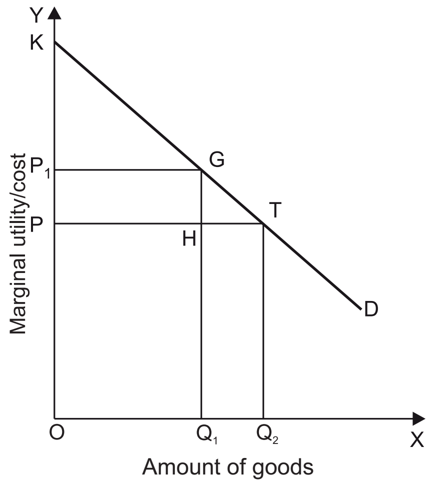
6.4.6 Canon of Co-ordination

In democratic countries, taxes are imposed by centre, state and local governments. Therefore, it is desirable that there must be coordination between taxes imposed by different governments, it is very essential for the benefits of both taxpayer and government, especially in democratic countries.

6.4.7 Canon of Consumer Surplus

According to **Marshal**, while imposing tax, government have to keep two factors in mind-(i) Tax must be imposed on those things by which consumers are getting saving so that the attraction can remain on consumers after imposing tax on those goods (ii) government have to impose tax on those goods only due to the tax from the sacrifice of consumer saving to revenue received to government then there will be maximum welfare. It can be clear easily from the figure given on next page:

Notes



Suppose D is marginal utility curve. Before imposing tax, the taxpayer receives OQ amount OP cost. Suppose the tax would impose on per unit then the cost becomes equalent to amount of tax becomes OQ_1, and amount decreases to OQ. In this state, the income received by tax is $GHPP_1$, which is product of amount of tax and amount of goods. In this state, the revenue of consumer is GP_1PT. Therefore net loss is GHT. In brief, we can say that the tax must be imposed in such a way, that there must be minimum loss of consumer saving.

Task Explain the canon of consumer saving by diagram.

Three Aspects of Tax

Describing about the canon of **Adam Smith**, Sir John Stamp has analyzed taxes by three views_

- On the questions of taxation it must be considered on the view of taxpayer.
- They must be considered by the view of government, and
- They must consider from the view of whole community as productive unit or economic society.

In this regard, **Prof. Canon** has rightly said that it is not any fundamental principal but it is the other way for saying this thing that equality and productivity are basic canon of taxation.

Many modern writers, in which **Garnier, Roscher** and **Ricca Salerno** are specially mentionable, has been tried that there must be some rules in regard of characteristics of a good tax system. In this regard, **Prof. Shirraj** has rightly said that, "No intelligent person has not succeeded in keeping in as the form of clear and easy rules of canon of taxation so as Adam Smith. Their fast and huge mind has given a new form to all checking and inventions and its heirs neither improved much in those canons nor they provided high place in those canons."

But, its meaning is not that the writers of later age who contributed in that direction have no importance. **Bastable** and other writers have followed those canons are counted in important deciding factors of a good tax system also. It is sure that whenever it is found that there is direct conflict, between those

Notes

canons then in that condition, most important canon used in comparison to less important canon, For example, in comparison to equality and convenience the canon of productivity is considered more important.

In the same way, more amount has to be given more importance than lesser amount or equality of more amount must have to be given more importance than lesser amount. It is main objective of tax system to give success to administration of states, if the equality and convenience of less amount has to be left for productivity then it will not be good to do so.

6.4.8 Characteristics of a Good Tax System

An ideal tax system is that which adopts all type of taxes in it as per need. The discussions which have been given in regard of canons of taxation from **Adam Smith** to modern economist, all these factors construct a good tax system. Some merits and some demerits are possible in every tax system. **Luytes** has to say in this regard, "Neither a tax is completely good nor bad." No system can be defect free practically. Famous philosopher **Admand Burk** has rightly said, "Imposing tax and to keep people happy is as difficult as to get affection and remain intelligent." A tax system can be suitable at any given time and can be unsuitable when time and circumstances change.

What must be the characteristics of a good tax system, it depends on factors like nature of government expenditure, reactions of public about government tasks, economic condition of the country and political condition etc. not only this, the characteristics of a good tax system will be different in comparison to developing economy in developed economy.

According to **Mrs. Hicks,** a good tax system must have following characteristics

- Taxation which is imposed on public must be according to the capability to pay. This capability depends on their income and family condition.
- The objective of tax must be definite for financial systems of public services.
- Tax system must be based on universality. In brief, we can say that a good tax system is that in which tax must be increased slowly and slowly, but on the occasions of emergency situations like war, heavy taxation can be considered practical. In normal condition, heavy taxation which gives un favorable effect on economic lives of people, is not considered desirable. But, we think that we must take shelter from the taxes of both kinds direct and indirect, but the tax system must be such that it does not cause adverse effect on progress.

> *Notes* An ideal tax system is that which includes all type of taxes in it.

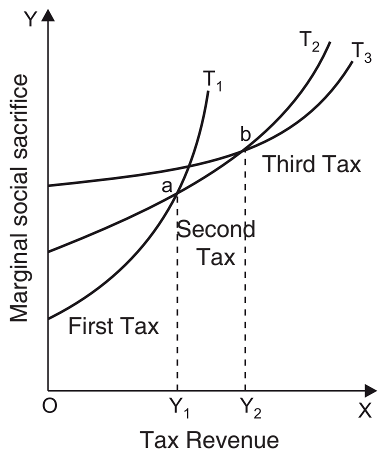
A good tax system must have following characteristics _

(1) Taxes are Parts of the Tax System

Taxes of state, it is good if we say taxes of state, must be seen as part of united tax system, otherwise it must be seen as many unrelated taxes, every tax must be viewed from this point of view that what is the appropriate place of them in tax system. Its decision can be taken by comparison between its profit and losses from other taxes of tax system. For example, how a tax can be good or bad separately. But as a part of tax system, its position can be opposite of it, because as a part of tax system, it is possible that it removes the ill effects of other taxes or increases the desirable effects of other taxes. It can

Notes

establish essential balance in tax system or it can deform current balance also. In front of leaders and members, this problem remains present that how to form balance, unitary and uniform tax system and the solution of this problem can be done only when in the whole structure of tax system frame of different taxes must be so well knit that it brings symmetry in tax system and its opposition must be less.



In comparison to any single taxation, Government receives more revenue from a complete mixed form. Briefly, it can be said that for gaining more revenue, the government have to provide more widely to the base of tax system. This fact can be clear easily with the help of diagram attached. In diagram, tax revenue has been shown on X-axis and marginal social sacrifice has been shown on Y_ axis. It has been shown here that marginal social sacrifice in first tax is less then second and third tax. Government will seek help from first tax for getting revenue firstly. For getting revenue, there must be increase in amount of tax but after point **a**, the marginal social sacrifice of first tax will be more than second tax. In this state government will seek help from second tax for getting more revenue. For getting more revenue the amount of second tax will be increased but after point **b**, the marginal social sacrifice of second tax will be more than third tax. In this states government will increase third tax for getting more revenue. In this way, it is clear that for getting more revenue to government, we have to locate the wide area of tax.

The usage of income tax and heir taxes are done to put on heavy load on goods used by high income groups. Such taxes can be imposed which can be reached up to in low income groups. Which ever tax is imposed, there selection must be according to organized social policy. In this regard a big problem is that how to find out the ratio of property tax, goods tax, income tax and other taxes in total tax receipts. Therefore, tax system must be such that which can present a suitable solution to all these problems.

(2) Maximum Social Benefit

Taxation must not be considered a source to receive government revenue only but it must also be considered a source for fulfillment of such social objectives such as to redistribution of money and to reduce in equalities of income. Taxation is also considered useful for financial arrangement of government services. It is also used for controlling and regulating consumption, for example, to limit the consumption of wine and other seductive drugs by imposing heavy production tax .By these measures, social welfare of country increases. In this way a good tax system is that which gives guarantee to the country about providing maximum social benefit and does not consider it a source to get only government revenue.

(3) Just Distribution of Tax Burden

A good tax system is that which guarantees about the matter of just distribution of tax burden. Three main canons are famous in regard of just distribution of tax burden_

(1) **Cost Theory**—Measurement of taxation must be done by cost of service provided by each taxpayer by government.

(2) **Benefit Theory**—Measurement of tax must be done on basic of benefit received from such service to each taxpayer, and

(3) **Ability to Pay Theory**—The decision of taxes must be done according to the ability to give tax by each person.

Cost Theory can not be imposed on those services whose payment is not done as costs, but can be done by other type (which has been told in the definitions of costs and fees of taxes described earlier). The costs in position of taxes can not be determined. Tax is a compulsory contribution which is taken from all citizens and it is not considered that the service provided by government has been used in what quantity by different individuals. In this way, cost theory cannot be implemented practically. Though, the cost of services provided to different taxpayers cannot be determined, therefore, the benefits received from service can not be determined excluding some matters like old-age pension. According to the theory of cost received from service, a pensioner has to return his whole pension to government as a form of taxes. There are some exceptions of this theory it is not clear that they have to be kept according to which rule and for how much time. At last, there is **Ability to pay Theory**, in this regard, this problem arises that how to calculate the ability to pay to each taxpayer, but this theory is considered best in comparison to all others. In reality, a good tax system is that which guarantees about minimum total sacrifice which exerts pressure on rich group more than poor group. Therefore, a good tax system is based on the theory of progression.

(4) Universal Application of Taxes

It is right that every individual have to pay it according to his capability and the people whose capacity to pay tax is uniform and burden of taxes must be same on them. But, in Indian tax system, this merit is not found up to some extent. For example, income tax in India is not imposed widely and uniform because on the revenue received from agricultural, tax is not imposed up to that extent so as it is imposed on revenue of non-agricultural areas. Because of this, dissatisfaction occurs in the mind of people which are engaged in non-agricultural areas. Because of this, there is a fear of developing imbalance in economy. Therefore, a good tax system is that which have to be imposed widely and in uniform manner on taxes on every individuals of society with out any differences.

(5) Revenues should Increase with the Increase in National Income

The structure of tax system must be so that with the increase in national income, its maximum ratio comes to government treasury and government do not have to get it. From this point of view, in comparison to the tax imposed on agriculture revenue or capital cost of land, the amount of land revenue per acre, which was fixed ten years earlier, is less beneficial.

In this way, fixed tax imposed on each shopkeeper is less beneficial in comparison to that tax which is imposed on their net income or total sale .In this way, a good tax system is that under which, with the increase in consumption, production, per person income and national income, the revenue of state also increases.

(6) Co-ordination between Direct and Indirect Taxes

The construction of a good tax system must not be done by mining one type of taxes, but under this, all type of taxes must be imposed in a balanced and coordinated way. Direct and indirect taxes must

Notes

have found a suitable place in tax system so that the result of revenue can be achieved in desirable quantity and there must not be any undesirable effect on production and consumption. Many benefits are those which are found in direct taxes, but not in indirect taxes. But, there is a defect in direct taxes that they are capable to exert tax burden on entire economy. Therefore, to fulfill the increasing expenditure of a modern government, they couldn't give revenue in suitable amount, then one thing is that the payment of indirect tax is suitable for tax payer. Therefore it is suggested that an economy means on distribution of production put any adverse effect, to get maximum government revenue, direct and indirect both types of taxes must be imposed.

In this way, a good tax system must not depend on progressive or only proportional taxes. Both types of taxes have their own merits and demerits. Therefore, for a good tax system, it is essential that the benefits of both type of taxes must be used in favour of economy and whole community.

Therefore, it can be said as a **conclusion** that in a good tax system, emphasis is not given on not only one type of taxes but by a balanced system and with balance of all taxes, taxes are imposed in such a way so that the revenue can be received from whole society and there must not be any adverse effect on economic development of consumption, production and whole country.

(7) Adoptability in Tax Structure

Tax structure must be so that there can be change in situations accordingly. Important objectives like control on economic height, establishment of complete employment, to see the nature of long term motionlessness, control on inflation in emergency etc. can be obtained their tax structures.

(8) Attention on Right of Taxpayers and Their Problems

The construction of good tax system must be done while keeping in mind the rights of taxpayers and their problems. In this regard, following facts are important:

(i) Tax laws related to tax must be more clear and easy so that a common person can also understand them.

(ii) Payment and receipt of taxes must be minimum in nature. There must be such time for tax policy and tax receipt which must be suitable for tax payers.

(iii) The complaints and difficulties of taxpayers must be resolved very quickly by suitable operations. In this regard, active administration can be more helpful. Tax due capacity from loose administration and infamous revenue policies are decreasing.

(9) Effects on Production

A good tax system concerns about speedy economic development of economy. It doesn't become a hindrance in development of business and industry. The structure of a good tax system must be made in such a way which separates additional resources from economy and doesn't create an adverse effect on direct or indirect form on ability to invest and save and work for people. Tax system must be such that which always promotes increase in production means it encourages people to work, to save and to invest. **Dalton** has expressed this thought in very limited words, "Taxation's best method from the economic point of view that it costs best or worst economic effects."

(10) Effects on Distribution

The old objective of taxation was to receive revenue only. In ancient times, the state had to do less works, so taxation was considered a source to receive money only, but this view 'Taxation for revenue only' is now considered such **Medevial Slogan** which is not imposed in current direction. It is said that in current time, the usage of taxation can be used as a weapon for gaining some social objectives, such as to reduce inequalities of revenue, to bend resources towards productive usages and to increase in social welfare of community. Those taxes which transfer revenue from people towards government which can possibly change non-governmental usage and investment and this situation can prove helpful in raising the level of national income. Therefore, as a conclusion, it can be said that a good tax system is that which guarantees about increment of national income and equal and just distribution of wages.

(11) Size of Revenue and Welfare

Classical economist believe that the last deciding factor of government revenue is the wealth with people of the country and government revenue can only be obtained by imposing tax on that wealth. In this way, they failed to find other sources like business income.

He also thought that non-governmental area receives losses in place of profit from transfer of resources. This principle that the government which imposes minimum tax and has minimum expenses is not good for current time. In modern time, to provide social justice and bring economic equality, The government needs wealth and it is an important source to reduce inequalities of taxation revenue and to bring social justice.

Here, this fact is also mentionable that we mean by the amount of government revenue, nothing else, but, availability of resources. The economic welfare of a country depends on this fact that how to achieve that available resources and how to use them. It is possible that in a country, the abundance of government revenue reduces the amount of economic welfare and it is possible only when the taxation providing huge revenue cast an adverse effect on production and distribution. Inversely, if taxation of a country encourages production and just distribution then the reduction in amount of government revenue, economic welfare can be seen in abundance. Therefore, the huge amount of government revenue casts favorable and mentionable effect only when it is spent intelligently on different aspects of expenditures. In this way, government expenditure is as important as government revenue.

In this way, as a conclusion, we can say that a good tax system is that which not only provide appropriate revenue to government but also reduce inequalities found in distribution of income and wealth and also increases social welfare of the country.

6.4.9 Tax Structure in a Developing Economy

The structure of a tax system in every economy must be such that it can fulfill the basic needs and objectives of an economy. Basic problem of a developed economy like India is to maintain **Economic Stability** so that the state of total employment can be maintained there. Therefore, in developed economy, the structure of tax system must be such that which helps in maintaining economic stability and total employment. But, the tax system of a developed economy is not considered suitable for developing economy. Because the main problem of developing economies is to speed up the speed of economic development. In this state, the structure of tax system in developing economies must be such that which increases the rate of economic progress by increasing rate of capital construction, inflation can be controlled and the inequalities in wealth and distribution of income can be reduced. In this way, it is clear that tax system of developing countries brings dissimilarity in tax system of developed countries.

In regard of tax system of developing countries **Prof. Kindley Berger** has said that there must be two main objectives of tax policies in those countries:-

- Unnecessary consumption increment and control on gambling etc. and
- To increase capital construction

Notes

According to **Meier And Baldwin**, the policy of developing countries can be effective only when it –

- Can increase the capacity of taxation of people
- Can make administration effective and honest, and
- Can establish justice and equality

But in these countries, while constructing a strong tax system, following facts must be kept in mind-

1. **Increase in the Rate of Capital Formation**—The rate of capital construction in developing countries is very low. Therefore, the main objective of taxation in these countries must be to solve these problems. By cutting current consumption by tax policy, saving can be increased. In addition to this, by redistributing resources in different productive and unproductive areas, the rate of capital construction can be increased.

2. **To Accelerate the Economic Development** —The main problem in developing countries is to increase the speed of economic development. In this condition, tax policy must be implemented in such a way so that there can be maximum increment in production of the country. For this, it is necessary to increase the capability of people to work and desire, the capability of saving and investment by taxation. For increase in production, with the help of taxation, resources can be redistributed in different areas.

3. **To Mobilize the Economic Surplus**—In these countries, there is expenditure on unproductive work like additional economic consumption by which capital construction gets damaged. There is expenditure on additional economic consumption. Therefore, tax system must be such that in these countries which can motivate resources to capital construction from personal consumption and can cause continuous growth in the base of capital construction.

4. **To Minimize the Economic Disequalities**—Economic inequalities are found in developing countries. Governments have to do this that it must construct such a tax policy by which economic inequalities of the country reduced. This objective can be fulfilled by taxation. Progressive tax policy can be adopted to bring equality in wealth and revenue means taxes must be imposed by higher rates on rich group and poor group must be given relaxation. In addition to this, the wealth received by taxes from rich group must be spent on services of social benefits.

5. **Control on Inflation**—Taxation is considered best weapon to control inflation. Due to expenditure and inferior management in developing countries, the serious state of inflation is found. In this type of state, on one hand, there is increase in investment and income but on the other hand, the production does not increase with that ratio as a result of this, demand and cost of commodities both increases and the state of inflation occurs. These countries have to seek help of taxation for controlling this. Tax system must be such that which reduces additional purchasing power of people and encourages desirable saving.

6. **Condition According to Ability** - Tax system must be such that in which all people give some contribution to government necessarily and taxation must be received according to capability. By doing this, two benefits will be obtained - firstly, government will receive revenue in high quantity and secondly the distribution of tax-part will be just. In brief, we can say that such type of tax system must be adopted under which all people can pay their taxes according to their ability.

Self-Assessment

Multiple Choice Questions:

6. Who implemented the canon of taxation?

   (a) Adam Smith (b) Headlay

   (c) Aristotle (d) Bastable

7. What must be the structure of taxation firstly?

   (a) Unproductive (b) Productive

   (c) Consumption (d) All of these

8. Which includes all types of taxes according to needs is called.......?

   (a) Defective Tax System (b) Equitable Tax System

   (c) Ideal Tax System (d) Destructive Tax System

6.5 Summary

- After 1500 A.D., when modern state rose, then slowly and slowly taxation gained an important place. With the increase in government expenditure, it has become necessary to search for new sources of income and they were searched by imposing tax on new business activities and new goods of consumption. In 19th and 20th century, the importance of revenue tax and heir tax increased.
- Depression starting in the end of 1929 and stretching for a long period has ended the utility of some famous taxes and the increment in government expenditure on social aid has produced the demand of new taxes.
- Every citizen of state must contribute for the help of government in ratio of their ability, means in proportion to that income whose pleasure they are getting in security of state. By following this canon, equality of taxation can be achieved and by neglecting it, the canon of inequality of taxation clearly tells that for fulfilling their expenditure, government have to receive tax from every citizen according to their abilities.
- Every tax must be received at such a time and by such a policy so that it must be best suitable for taxpayer to pay it.
- Every tax must be imposed and received in such a way that by it the money which comes in the treasure of state, extra money must extract in less quantity from the pockets of people.
- First of all, taxation must be productive.
- The main objective of revenue system must be to receive income for the expenditure of state, therefore, finance minister assumes about its merits by the amount received from taxes.
- Tax is neither completely good nor completely bad.

6.6 Keywords

- Taxation - To impose tax
- Income Tax - Tax on income

Notes

6.7 Review Questions

1. Highlight the development of taxation.
2. Critically explain the canon of certainty.
3. What is flexible canon?
4. What are the aspects of tax? Write them.
5. "With the increase in national income, government revenue also increases". Upto what extent, are you agree with this statement? Present your views.

Answers : Self Assessment

1. Optional	2. 1500 A.D.	3. Adam Smith	4. Headlay
5. Administrative	6. (a)	7. (b)	8. (c)

6.8 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*

Unit-7: Expediency Theory

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand Evaluation Process Related to Expediency Theory.

Introduction

In Expediency principle, this fact has been given importance that only those taxes can be imposed which can also be received and by which revenue can also be obtained. To impose such type of tax which can also be received, cannot be said nothing except meaningless effort. In this theory, this fact is also hidden that Government needn't have to think about its possible effects to adopt any considerable tax. If suitable amount of tax revenue can be received on being harmful of possible effects then such type of tax must not be acceptable.

7.1 Evaluation of Theory

(1) This theory is definitely based on a bitter truth, but this truth is only negative. On the level of practicability in front of every government and legislative assembly, it is the effort of different group that the burden of taxpayer must be imposed mainly on other groups. For sectarian or vested interests, government is pressurized by all types. Due to this, sometimes government takes decision related to tax due to pressure.

(2) This fact is also mentionable that for any government, it is not considered best to impose tax without viewing about their drawbacks. Governments have to decide to adopt any tax after thinking about various aspects like their administrative defects and cost to receive tax etc. Tax must be imposed in such a way that there must not be any unnecessary difficulty to taxpayers.

(3) Society remains unbenefitted from its many possible benefits on the basis of work-efficiency only for complete construction of a tax system. This fact is considerable that the tax leaves deep effects on economy. In this state, government must try that there must be increase in good-effects and reduction in bad effects. If in the construction of tax system, there must not be any discussions on its possible effects then it can prove harmful for the society.

Notes

Notes The conclusion is that it is not right to impose such tax which cannot be received. We must select the best tax among them by not considering all such 'able' taxes equal by which society and economy can get minimum loss and maximum profit.

Self–Assessment

Fill in the blanks:

1. To impose such tax which cannot be received, can be said a ....effort.
2. This theory is definitely based on bitter truth, but this truth is only ....
3. Society remain un-benefitted from its many possible ....on the basis of work-efficiency only for complete construction of a tax system.
4. We must select from the ....taxes by not considering all able taxes equal.
5. A government must be not impose any ....without not considering its defects.

7.2 Summary

- To impose such a tax which cannot be received is nothing else but a meaningless effort. In this theory, this fact is also hidden in it that government needn't have to consider its possible effects in adopting any considerable tax.
- This theory is definitely based on a bitter truth, but this truth is only negative. On the level of practicability, in front of every government and legislative assembly, it is the effort of different group that the burden of taxpayer must be imposed mainly on other groups.
- This fact is also mentionable that for any government, it is not considered best to impose tax without viewing about their drawbacks.
- Society remains un-benefitted from its many possible benefits on the basis of work-efficiency only for complete construction of a tax system. This fact is considerable that the tax leaves deep effects on economy.

7.3 Keywords

- Expediency - Work-efficiency
- Evaluation - To evaluate

7.4 Review Questions

1. What is importance of Expediency Theory?
2. Evaluate Expediency Theory.

Answers : Self Assessment

Notes

1. Meaningless
2. Negative
3. Benefits
4. Best
5. Tax

7.5 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Finance System—*Manjusha Sharma, O.P.Bohra, Ravi Books.*
3. Money Banking : International Trade and Public Finance—*Nee. Thai : Somshakher, Anmol 2004.*
4. Public Finance—*Nandkishore Parsad, ABD Publication, 2011.*

Unit-8: Socio-Political Theory

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know Socio-Political Theory
- Understand the Evaluation of Theory

Introduction

Wagner said that existence of private property and presence of heir is only possible by society and security of government. Their existence is not a product of any Divine Order. Therefore, it is the right of government that it must regularize ownership of property and heir by which favours of society can be secured.

8.1 Socio-Political Theory

This theory was given by Germany's **Adolph Wagner**. The basic concept of this theory is that the selection of taxes must be based on their social and political objectives. According to German Philosophy **Wagner** also thought that the solution of a problem must be done on social and political view not on individual view. Society is not a group of individuals only. It has its own existence and there is a logic to maintain it. It is the basic duty of each government that possible steps must be taken to fulfill this objective. Therefore, the objective of tax system is not fulfilling individual needs of member of society, but must be the security of favours of all society. In other words, the construction and implementation of tax policy by Wagner have emphasised on adopting modern favourable philosophy. Specially, Wagner said that we must reduce the inequalities of income through the medium of taxation and for this, small incomes must be tax-free.

Wagner said that existence of private property and presence of heir is possible only by society and security of government. Their existence is not a product of any divine orders. Therefore, it is the right of government that it must regularize ownership of property and heir by which favours of society can be secured. The thoughts of Wagner were opposed at that time but these thoughts have become base of fiscal policies of modern governments. These days, social and economic problems have become so serious that it has become difficult to even calculate them. No modern government can watch society suffering from problems like a mere spectator. In the solution of these problems, to help the society has become their main duty.

Task Where did Adolph Wagner live?

8.2 Evaluation of Theory

In comparison to expediency theory, the theory of socio-political tax is more acceptable. But, this theory has many drawbacks. In this theory, just equality in allotment of tax burden means morality of tax system is not considered properly. Due to lack of this tax system plays a role of making them capable and complex instead of helping in solving social economic and political problems. According to Royal Commission on Taxation, Canada, the highest objective of any tax system can be just allotment of its burden. Due to lack of this justice, the structure of society can get damaged and it can be destroyed. If tax players believed that tax system lacks justice, then they can think about tax evasion also.

Do You Know? There are many hurdles in adopting justfull system. Firstly, there are not any meaning of 'justfull system'. The second hurdle is that there are conflicts between this objective and other objectives of tax system. In these other objectives include economic development, economic stability, employment-promotion etc. The solution of possible conflict in objectives is possible in ' Tax-due-ability Theory'.

Self–Assessment

State whether the following statements are True or False:

1. Germany's Adolph Wagner gave Socio-Political Theory.
2. According to German Philosophy Wagner told that the solution of any problem must be given by individual view.
3. In comparison to expediency Theory, Socio-Political Theory is more acceptable.

8.3 Summary

- Germany's Adolph Wagner presented Socio-Political Theory. The basic concept of this theory is that the selection of taxes must be based on its social and political objectives.
- The objective of tax system is not to fulfill individual needs of members of society, but have to protect the favours of whole society.

Notes

- No modern government can see the society suffering like a mere spectator in the hands of these problems. To help the society in solving these problems is considered its basic duty.
- In comparison to Expediency Theory, Socio-Political Theory is more acceptable. But, this theory has many defects. In this theory, just equality in allotment of tax burden means morality of tax system is not considered.

8.4 Keywords

- Commission - Authority to perform task
- Taxation - To impose tax

8.5 Review Questions

1. Explain Socio-Political Theory.
2. Evaluate Socio- Political Theory.

Answers: Self Assessment

1. True
2. False
3. True

8.6 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L.Bhatia, Vikas Publishing House Pvt. Ltd.*
3. Money Making and Public Finance—*Sundaram V, Alpha Public 2009.*
4. Public Finance—*Supreet Singh and Anil K. Gupta, Dominate 2012.*

Unit-9: Ability to Pay Theory: Objective and Subjective Indices

Notes

CONTENTS

Objectives

After studying this unit students will be able to:

- Know about Index of Ability to Pay
- Understand Subjective Approach
- Know about Objective Approach
- Know about Index of Ability in Faculty Theory
- Know about Ability to Pay Theory and Under Developed Countries.

Introduction

Property is considered an important source of revenue in ability to pay theory. The revenue received from it can be from zero to huge amount of wealth. According to subjective approach, Sacrifice Theory is being used to measure ability to pay and in objective approach, Faculty Theory is being used.

Many thinkers believed that Ability to Pay Theory is a universal theory and it can be implemented easily in semi-developed countries.

9.1 Index of Ability to Pay

(A) Property - Ability to pay theory used to be expressed as faculty theory in its primary stage in comparison to revenue. In comparison to revenue, invested money of person and his property was

Notes

considered symbol of his ability to pay tax. The reality is that property is not a main objective of ability to pay, it can be considered an essential supplementary index. It has many reasons:

1. Property is an important source of revenue, but it is not right if we say that all properties provide revenue.
2. The revenue received from property is not received continuously.
3. The revenue is received from property can be of different type from zero to a big amount. It depends on nature state and utility of property. For example, it is possible that the house of a person situated in a village does not provide any tax. But, if the house situated in city then it can become a good source of revenue.
4. The tax which is imposed on property, it is imposed on its capital value. Therefore, if any year, no revenue is received on property then the taxes imposed on that property can not be considered just. In this condition, it can be said that property can not be considered primary or main concern of ability to pay.

Yes, property can be considered supplementary test of ability to tax due to following reasons:

1. **Additional Capacity** - The ownership of property provides its holder such additional capacity to pay tax whose receiving is not from net income.
2. **Ability To Pay -** There is more ability to pay tax in comparison to revenue earned from individual service from revenue received from property. In addition to this, the property received in heir ship provides the ability to pay tax in abundance to its recipients. Its reason is that the revenue which a recipient receives from the properties of unearned types.

(B) Income - The second index of ability to pay is income. Gross income includes factor of cost whereas net income is received by subtracting cost. Therefore, in comparison to some income, net income is considered a good index of measurement of ability to pay. **Adam Smith** was the first thinker who accepted that income is a suitable measurement of ability to pay tax.

(C) Size of the Family - While deciding the ability to pay tax of an individual, the size of the family should also be considered. If the incomes of both are equal than in comparison to small size of family, big size of family have more ability to pay tax. For example, if other things are same then in comparison to married couple having four children, a bachelor or unmarried person has more ability to pay tax.

(D) Consumption - It is also said that consumption that expenditure must be made measurement of ability to pay tax of individual. Sometimes, it is seen that the taxes made on the basis of property and income are not subjudiced. As a result, taxpayer tries to hide them by many ways. Therefore, **Prof. Fisher** and recently **Prof. Caldoor** suggested imposing tax on expenditure. But, the reality is that consumption - standard of ability to pay tax did not get any special place.

How to Measure Ability?

According to Pay Theory, a basic problem occurs that how to measure the ability to pay tax of a person? Two views are adopted for fulfilling this objectives -

(1) Subjective Approach

(2) Objective Approach

According to subjective approach, to measure ability to pay tax, sacrifice theory is being used and in objective approach, faculty theory is used for this task.

9.2 Subjective Approach

Subjective approach is based on psychological or mental activities of taxpayers. In Subjective Approach taxpayer face many type of difficulties like mental imbalance, pain etc. in paying of taxes. In this

Notes

way, when taxpayer pays tax then he has to sacrifice. If tax-burden is divided in just way, then each taxpayer has to do same sacrifice.

According to subjective approach, three basis are considered for taxation -

1. Equal Absolute Sacrifice
2. Equal Proportional Sacrifice
3. Equal Marginal Sacrifice or Minimum Aggregate Sacrifice

For implementing this concept, following beliefs are observed -

(i) Cardinal measurement of utility received by revenue is possible.
(ii) With the increase in income, marginal utility decreases.
(iii) No effect occurs on marginal utility of income level. Unit of income of all individuals and marginal utility related to this are same, therefore interpersonal comparison of utility is possible.

9.2.1 Equal Absolute Scarifies

According to this view, taxation can be just only when the amount of sacrifice of each person must be equal. In this regard **Dr. Dalton** said, "The distribution of burden of each factor of taxation must be such a way that directs real burden on all taxpayers must be equal". [1.]

But sacrifice is related to mental direction of a person whose measurement is not possible. Therefore, it is not right to compare the sacrifice of different person. If imposing tax is considered base for revenue then in that condition, three conditions can be imaginal for receiving equal sacrifice -

(i) Speedily Increase In Income - In that condition the utility meeting person with the increment decreases. In that condition, speed of tax will be progressive. In brief, with the increase in income, people will have to pay more tax. Its explanation can be given by diagram easily.

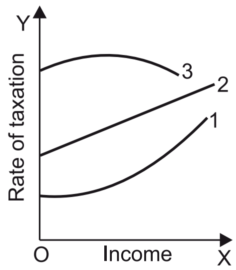


Fig. 1

In fig. 1, income has been measured in X-axis and rate of taxation has been measured in Y-axis. It is clear in figure that the rate of taxes can be made progressive by three types. It has become clear here that as the income increases fastly so as marginal utility decreases. In this way, the sacrifice for all taxpayers will have to pay equal tax on high rate.

Notes Equality in taxation means equality of sacrifice.

1 Dalton, op. cit., page 91.

Notes

Therefore, burden of taxation must be divided in such a way that each taxpayer have to give equal sacrifice. In this way, it is essential for bringing just equality in taxation that individuals living in same conditions must be treated well so that horizontal equity can be achieved and all individual living in un-equal conditions must be treated differently in matter of imposing tax, so that virtual equity can also be achieved.

Therefore, Mill gave this explanation that for bringing equality in real burden of taxation, identical people or person living in identical conditions must be treated in a same way.

(ii) Slow Growth in Income - If there is slow growth in income then marginal utility received by it will be consumed slowly. In this condition, we have to take help by proportional taxation for bringing equality in sacrifice.

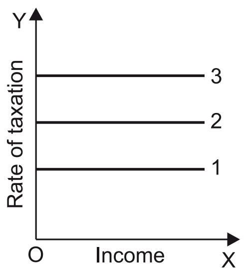


Fig. 2

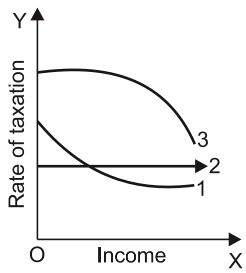


Fig. 3

In this way, the tax will be imposed from equal rate on all person having high and low income. It is clear from fig. 2. It is clear in figure that one of the three rates of taxes can be imposed.

(iii) Reduction of Income - In this state, as a result of fall in income, the marginal utility beginning from marginal units of income. In that condition, regressive taxation is imposed for equal sacrifice, means high income group will pay in high rates. The three rates given in the fig. 3, tax can be imposed on any rate. But, with the increase in income, to correctly measure the reduction of marginal utility of liquid is a very difficult task. As a result, the decision of rates of progression can be adopted freely, which cannot be called just. But, on high levels of income, if the amount of progression is higher than that amount, which is received by curve of marginal utility of liquid of a person, then it can be considered just**. It shows the reduction of rate of marginal utility of liquid with the increase in curve income and it can be stretched on this concept that by it, other social companion of that person remains unaffected".**

9.2.2 Equal Proportional Sacrifice

According to this theory, tax burden does not remain equal on taxpayers but it is definite in ratio of their economic state. In other words, the loss in utility due to imposition of tax must be in ratio of total income of taxpayers. In that condition, high income taxpayer will pay more tax in comparison to low income taxpayers. But the ratio of per sacrifice of income will be equal for all. It can be expressed as following-

$$\frac{\text{Sacrifice by A}}{\text{Income of A}} = \frac{\text{Sacrifice by B}}{\text{Income of B}}$$

In this way, according to this theory, direct real burden on each taxpayer will be in ratio to that economic welfare which he gets from his income. According to this, the construction of progressive tax structure is also possible because marginal utility of liquid decreases with the increase in income (in any ratio). In this way, it is clear that in comparison to equal complete sacrifice, taxation imposed according to this theory is more progressive.

9.2.3 Equal Marginal Sacrifice

According to this theory, not the total sacrifice of different taxpayers, but marginal sacrifice (means sacrifice by last unit of wealth of taxpayer) must be equal, so that the whole sacrifice of community will become minimum completely. In the words of **Prof. Pegu, "Such distribution of taxation, which must be according to principle of least aggregate sacrifice, it is possible that it must be equal to marginal sacrifice but not equal to total sacrifice provided by all members"**. The objective of state is to maximize economic welfare and taxation creates disutility for tax payers. Therefore, distribution of taxes must be according to the principle of least aggregate sacrifice, means by taxation, marginal sacrifice provided by each taxpayer must be equal.

According to this principle, decision of tax must be done in such a way that the amount of tax by taxpayer must be minimum and social benefit must be maximum. It is possible only when marginal sacrifice of all taxpayers must be equal. It can be explained by table and figure -

Suppose, there are three taxpayers A,B and C by whom government wants to receive ₹ 8/- as tax. Suppose, one of them has to give rupees then the sacrifice will be as follow -

Units money	Marginal Sacrifice by A	Marginal Sacrifice by B	Marginal Sacrifice by C
1	15	20	42
2	25	30	51
3	38	42	60
4	42	50	65
5	50	58	69

In this condition, sub-marginal sacrifice is 4 unit. Therefore, if government wants to receive ₹ 4/- from A, ₹ 3/- from B, and ₹ 1/- from C.

This condition can be explained easily by fig. 4. Here, the amount of tax and sacrifice by paying tax can be measured on X-axis and Y-axis. AA_1, and BB_1, shows the sacrifice of taxpayer A and B, which tell that whenever the amount of tax increases so as the sacrifice increases. Total sacrifice will be minimum when the marginal sacrifice of A and B, will equal. It will be possible only when government collects amount of tax OQ_1 from A and OQ_2 from B, because in that condition, marginal sacrifice Q_1M of A and marginal sacrifice Q_2N of B are equal.

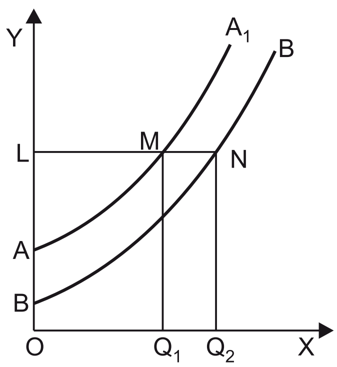


Fig. 4

Notes

For bringing equality, it must be done that taxes must be imposed on wealthy people and small income people from these receipts must be given bounties till that time, unit it doesn't get dead level of equality. But, if state doesn't do so that it doesn't touch low income groups, until high level group doesn't reach upto the level of low income group. Its meaning is that tax must be imposed firstly on that person whose income is maximum and it is so because it has to do minimum sacrifice on imposing tax. In this way, when his income comes to the level of other wealthiest person of society on reduction by taxation, then we have to begin imposing tax on both and it is so because when the sacrifice will be given due to payment of last rupee as tax by both, it will be equal. In this way, while imposing tax on both, they have to bring down the level of third wealthiest person of society. And this process must be continue till that time until the revenue of essential amount doesn't receive.

Task What do you understand by Equal Proportional Sacrifice and Equal Marginal Sacrifice?

Theory of minimum total sacrifice or theory of sub-marginal sacrifice clearly constructs maximum progressive tax structure. Therefore, such as **Prof. Pegu** has said that, **"The excess of all minimum income by taxes must be cut and equal incomes must be left on all inviduals after taxation".** Here, it is essential that low level income group must be kept free from taxation. The income of that minimum level must be such that it can fulfill the expenses done on essential needs of life. While imposing tax on individual, his family size must always be kept on mind.

9.2.4 Musgrave's Utility Model

Equal Absolute sacrifice, Equal Proportional Sacrifice and Equal Marginal Sacrifice can also be presented mathematically each person who sacrifices, its measurement must be done on that power of income which he leaves as tax.[1.] Now, if we assume Y income, T = Amount of tax paid and U = Total utility, then U(Y) = Total Utility Received from Disposable Income after Tax Payment then (subscripts) A and B are indices of different persons. **Three views of subjective sacrifice approach can be presented in mathematical form by following way:**

(a) Equal Absolute Sacrifice -

$$[U(Y) - U(Y-T)]_A = [U(Y) - U(Y-T)]_B$$

(b) Equal Proportional Sacrifice -

$$\left[\frac{U(Y) - U(Y-T)}{U(Y)}\right]_A = \left[\frac{U(Y) - U(Y-T)}{U(Y)}\right]_B$$

(c) Equal Marginal Sacrifice -

$$\left[\frac{da(Y-T)}{d(Y-T)}\right]_A = \left[\frac{d(Y-T)}{d(Y-T)}\right]_B$$

1 Musgrave—The Theory of Public Finance. Page 96.

9.2.5 Diagrammatic Representation

Prof. Musgrave has presented three aspects related to equal sacrifice - equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice by fig. 5.

As shown in figure, income has been measured on Horizontal axis and Total Utility has been measured on Vertical axis on up and down side of D.

In figure, income OZ or DC has been expressed as subsistence income whose utility has not been expressed here. Here CE curve and CF curve show total utility received from income and marginal utility. Now, suppose the income of taxpayer A and taxpayer B increase ZG and ZH from livelihood income. In that condition, taxpayer - A will get Total utility IE and Marginal Utility GF as equivalent. Inversely, taxpayer - B will get Total utility equivalent to KJ and marginal utility equivalent to HL. Now, suppose, Income Tax is imposed equivalent to MG then as a result, the utility of both taxpayers will reduce.

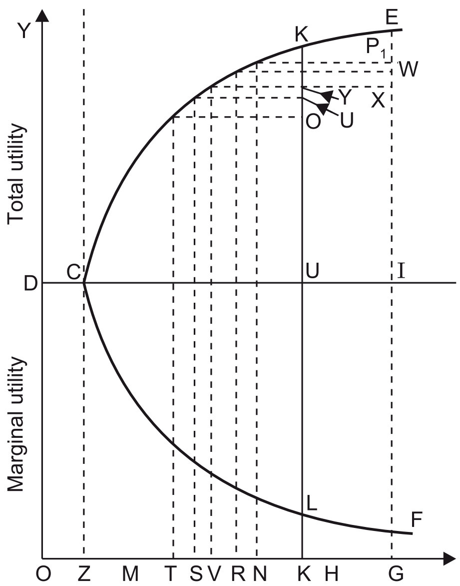


Fig. 5

Under Equal Absolute Sacrifice, taxpayer - A will pay tax equivalent to NG and taxpayer - B will pay tax equivalent to TH means the amount of total tax will equal to MG=NG+TH. If taxpayer- A will pay tax equivalent to NG then the reduction in its total utility will be equal to EP means NG=EP. Inversely, on paying tax TH by taxpayer - B, the reduction in total utility will be equal to KQ means TH=KQ.

Under Equal Proportional Sacrifice, taxpayer- A pays equal to RG and taxpayer- B pays equal to SH and in this way, total payment becomes MG=RG+SH. Where RG=EW and SH=KU. In this way the end of taxpayers will be as follows:

$$\frac{\text{Sacrifice by A}}{\text{Full utility of A}} = \frac{\text{Sacrifice by B}}{\text{Full utility of B}}$$

$$\frac{W}{EI} = \frac{KU}{KJ}$$

Under Equal Marginal Sacrifice, taxpayer -A pays equal to VG and taxpayer-B pays equal to VH and in this way, total sacrifice becomes MG=VG+VH.

Notes

In these conditions, both taxpayers marginal sacrifice will be equal to VN but total sacrifice will be equal to EX+KY which is minimum.

Do You Know? MG=RG+SH, where RG=EW and SH=KU

Under three concepts related to sacrifice of Subjective Approach, the short description of relative tax liability and nature of tax has been given under following table -

Burden on Taxation Under Different Concepts

Concept of sacrifice	Nature of Tax-structure	Burden on Taxation	
		High Income Group	Low Income Group
(a) Equal total sacrifice	Least progressive	Lowest	Highest
(b) Equal Proportional sacrifice	First concept in comparision of most progressive	Highest	Lowest
(c) Equal Marginal sacrifice	Excess speed progressive taxation (Highest rebate for lowest income)	Highest	Lowest

Which Concept is Superior?

The question is which concept is superior in three concepts or views related to Sacrifice Theory?

Adam Smith has said that, "Person should give contribution in proportion to their related ability". In this statement, meaning of word proportion can also be taken from 'Equal Absolute Sacrifice' under some circumstances and it can be taken as ' Equal Proportion Sacrifice' under some other circumstances. **J.S.MILL** has supported the theory of Equal Sacrifice but didn't define clearly the concept of 'Equality'. Later when the explanation of these three theories has been given, then there was no agreement in regard of thinkers that which concept would be considered best from these three aspects of Sacrifice Theory. In this way, there wasn't any agreement on this problem that how to decide tax rate schedules under best chosen category of Sacrifice Theory.

It is clear that some classical writers supported Equal Proportional Sacrifice and some supported Equal Total Sacrifice. But, all are agreed with **Pegu** who presented Equal Marginal Sacrifice as 'Last Theory of Taxation'. He supported this theory because least aggregate sacrifice (means equal marginal sacrifice) is also main objective of any modern government and an essential condition to maximize equal welfare of whole community. Therefore, earlier **Edge Worth** and later **Pegu** concluded that **Least aggregate sacrifice is the best theory of tax-distribution,** not because it is sub-judicial, but that so because its birth is for basic utility theory of maximum welfare. Edge Worth has said that, in comparison to Equal Absolute Sacrifice or Equal Proportional Sacrifice, it will be more convenient to implement least sacrifice theory. We only have to need that curve of general marginal utility is going down, not only this, what is the clear rate of bending down of this line? But, by binding on the view of list of unequal utility, this conclusion becomes defective.

Then, fast progressive taxation can cause adverse effect on absolute production of country as a result and on savings. Edge Worth and Prof. Pegu also accepted that fact that fast methods adopted for bringing equality can cause harmful effects on total production. Therefore, they suggested that there must be complete explanation of rule of least aggregate sacrifice from the view of arranging such effects.

1. Limitations of Subjective Approach

Subjective Approach has been discussed above it, has many limitations also. These are following:

(1) It is Difficult to Equalize Marginal Sacrifice Practically - Practically, it will be hard to equalize marginal sacrifice of all taxpayers. Two persons whose income and liabilities are equal then if they pay equal tax even then it is also possible that they couldn't do equal sacrifice. It can be due to difference in their interest and their behaviour.

(2) Sacrifice and Emotional View - Sacrifice is an emotional factor, which cannot be measured correctly by government administration. It can be felt only by those persons who is sacrificing. In addition to this, it is difficult to reach such situation in which total sacrifice of all individuals must be equal. Therefore, it is difficult to achieve the good of just administration of tax-burden in community.

(3) Wrong Base of Income - That income which is received by wealth and property, compare to income earned from individual service and hard works provides more utility to person. In addition to this, income received from wealth and property, which has been collected from efforts and hard work, provides more utility in comparison to that income which has been received in property received from heir. But, for measuring the capability to pay tax, from the point of view of subjective sacrifice, these facts is not kept in mind. In that condition, it is difficult to guess that how much sacrifice was given to which person.

(4) It is not Easy to Guess Marginal Utility - It is not possible that with the increase in income, the rate of reduction of marginal utility will be measured correctly. Its result will be that the decision of progression in rate of taxation will be done randomly. By this, the marginal utility of all will not promote the nature of being equal.

(5) Wrong Concept of Defective Marginal Utility of Money - It is clear that when income as ends towards very low level to medium level then the marginal utility of income decreases but when income ascends from medium level to high level then it can not be said that marginal utility decreases with the increase in income.

Lastly, its can be said, as conclusion that Subjective Approach for measuring the capability to pay tax is not only a useful concept, but an ideal also. The area to implement it in practical life is very limited and to achieve its goal is very difficult.

Task Write down the limitations of Subjective Approach.

Self-Assessment

Fill in the blanks:

1. The income received from .... doesn't receive continuously.
2. The quantitative measurement of .... received by income is possible.
3. With the increase in income, marginal utility............................
4. The principle of sub-marginal utility constructs the tax structure of maximum ....
5. .... can be presented as equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice.

Notes

9.3 Objective Approach

Many practical difficulties can be faced in implementing sacrifice principles and subjective approach, therefore some writers implemented objective approach for measuring capability to pay tax. **Prof. Salegman** used the word faculty for showing ability in objective approach. In this way, it can be named as faculty theory to pay tax.

Opposite to subjective approach, the principle of production-power keeps in mind the money value of taxable capacity instead of emotions of taxpayers and their sufferings. In this way, similar to Sacrifice Principle, the principle of production power is not based on psychological emotions of taxpayers, but is based on their tax payable capacity which is measured by their income, money and property etc. Therefore, the principle of production power considers many external factors in which income of taxpayer and their property are also included which really affects the taxpaying capacity of a person. For example, this principle not only considers income, but considers this fact also that how that income has been generated (means has been generated by individual labour or hardship or by property) and if it has been generated by property then how that property has gotten, means whether that property had been received in heirship or had been deprieved from individual efforts. The production power of any person depends on economic structure and if the ability to pay tax is measured upon them then the economic structure and the person in that economic structure who receives that benefit must also be considered. In this way, opposite to Subjective Approach of Sacrifice Principles, the Principle of Production power gives importance to social factor.

9.4 Index of Ability in Faculty Theory

According to the Faculty Theory, there are three important factors to measure the ability to pay tax of a person -

(1) The income of taxpayer

(2) The property of taxpayer and

(3) Consumption level or expenditure of taxpayer

(**A) Income** - Income is index of that wealth which is received by any activity by any family under a definite period in which the cost of authorised compactable consumer goods by him is also included. But, as a standard, only net income must be considered. High income individuals must have to pay more tax but the tax must be imposed in lesser quantity in low income individuals or they must have to get exempted. But, income cannot be made the suitable basis of tax ability of income because -

(1) It is possible that tax - ability can be different of two individuals having same income because the responsibility of one may be more from other.

(2) Some persons generate income from hard work; some can generate income from property. In that condition, tax can be imposed with same rate having same income.

(B) Property - Property and the amount of money generated is also considered an important standard of ability to pay tax. Its reason is that the level of standard of living not only affected by income, but also got affected from generated wealth and property. There are following difficulties in making it standard of ability to property -

(1) There can be some individuals in society whose income in very high but they are not capable due to fear of tax. In that condition, if property is considered basis for tax then such people will be free from tax.

(2) The basis of property is also confusing because the income can be received any year from

property and may not be received any year from property. In addition to this, different incomes must be received from equal size property.

(3) If tax is imposed on property then the people will hesitate to collect property and they will be confused.

(4) It is not possible to guess the real value of property.

(5) A general property tax, exerts burden on small property in comparison to big property, therefore, it is of regressive nature.

(C) Consumption Expenditure - Some economists like **Prof. Caldor** believed that true standard of capability to pay tax is neither income nor property. They said that economic welfare of people depends on that income which is spent, means not on income, but depends on expenditure. Generated wealth and property cannot provide satisfaction till that time until they are not used for consumption. Therefore, consumption is an important standard to measure capability to pay tax. This base to measure the ability to taxation of consumption level is not suitable practically, because -

1. High expenditure of a person is not an indicator of this fact that its tax-capability is high. For example, consumption expenditure of a big family comes from small family. But, its meaning is not that the tax-ability of big family is more consumption.
2. If it is considered as the base of tax ability then there will be reduction in its consumption as a result of this work efficiency of people will reduce, there will be bad effect on production.
3. It is right that the utilization of income is for fulfillment of needs (consumption) but income is not only used for consumption only. Saving is an important part of income which is utilized later. If the consumption is considered base for tax-ability then saving and investment will be neglected.

There are many limitations of objective approach also. Therefore, the question of method to measure the ability to pay tax remains unanswered. In reality, the facts is that in classical times, essential property was an important base of taxation. But in current times, income is considered just standard to measure ability to pay tax of individual. The benefit for making income as base is that under this, it is easy to make taxation progressive. But, practically, when the ability to pay tax is decided then we must consider property and consumption expenditure in addition to income. Here, this fact is mentionable that its quantity only is not important in connection to income but the source of income is also important, means we must consider this fact also that income has been earned by individual services or has been received from ownership of property. When the ability to pay tax of a person is decided then some other facts must also be considered such as size of family, regularity of income and that period for which income has been counted. In this way, it is clear that to achieve the objective of just distribution of burden of taxation, it works as supplementary of objective Approach. After the above discussion, it can be said as conclusion that from the view of just distribution of burden of tax, Ability Theory is most suitable theory.

Modern Views—Maximum Welfare Principle

For suitable distribution of taxation, modern economists have preferred welfare principle in place of justice principle. **Prof. Pegu** implemented marginal sacrifice principle keeping welfare in mind. As **Worth** accepted the fact of welfare, he said that welfare will be maximum when marginal utility will be equal. Inversely, **Pegu** has related the minimum group sacrifice principle to maximum welfare. In reality, equality principle and welfare principle of taxation both are defective. Both these views are narrow because they study only the taxation of tax. In reality, while studying the justice in taxes, only tax burden is not taken but those benefits must also be included which are receive from public expenditure. **Dalton, Pegu** and **Musgrave** tried to provide justice by including government services in problem of its distribution and burden of tax because tax and public expenditure both affect welfare.

Notes

The tax lessons welfare and public expenditure increases welfare, **Pegu** and **Delton** implemented two principles related to budget policy -

1. Government have to spend on different heads in such a way so that the marginal utility received from amount from each head must be equal.
2. Public expenditure must be increased till that extent so that the utility produced from this expenditure must not be equal to dissatisfaction produced from taxes imposed by state.

It is suitable for maximize social welfare by budget policy. According to **Musgrave,** "In the allotment of taxes, Minimum Sacrifice Principle matches with decision of public expenditure and both of these are found in general principle of budget".[1] Musgrave has tried to explain it by fig. 6. Public income has been shown on OX-axis in figure. AB curve shows satisfaction received from society from public expenditure. Inversely, A'B' curve shows marginal social sacrifice produced from taxation. AB curve is reducing down which tells that as the public expenditure increases, so as the amount of benefit and satisfaction of persons decrease. Inversely, A'B' curve shows that with the increase in taxation, the amount of sacrifice of taxpayer increases.

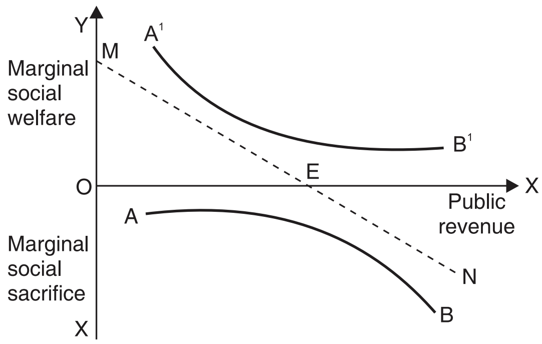


Fig. 6

MN is that net social welfare which is gotten by reducing A'B' from AA[1]. E is a point where marginal social sacrifice = marginal social benefit. Maximum social welfare will receive from this point.

9.5 Ability to Pay Theory and Under-developed Countries

Many thinkers believe that Ability to Pay Theory is universal and it can be implemented easily in under developed countries. But, it is not right because Ability to Pay Theory in condition of under-developed countries cannot made according to the structure of taxation, it has following reasons -

(1) **Economic Development** - The main objective of taxation is under-developed countries is to save for economic development. In under-developed countries, Ability to Pay Theory can be implemented when the inequalities present in distribution of income and property have to be reduced. But, the main objective of these countries is economic development. The reduction in inequalities of income is becoming a controversial topic. For fulfilling this subject, Ability to Pay Tax has not proved much helpful. In this regard, the comment of **NUXRE** is appropriate, "The primary objective of public finance in economic development is not to change inter-personal income distribution, but have to increase national income in capital construction".

1 "Minimum sacrifice approach to be the allocation of taxes is matched by a maximum benefit approach to the determination of public expenditure and the two are combined in a general theory of budget planning." **—Musgrave**

(2) **Limited Amount -** The main base of Ability to Pay Theory is income and property whereas their amount is limited in under-developed countries. To implement the tasks of economic development, government have to do financial management that is received by mainly direct taxes. Because of limited amount of income and property, tax is imposed in limited amount only.

(3) **Receipt of Resources -** From the view of Activating Finance and Functional Finance, receipt of resources are considered for development of taxation. If we consider this view then it cannot be basic theory in Ability to Pay Tax in under-developed economy because income of people in under-developed countries is very less more and differences are found in income. It is clear by above discussion that whether the Ability to Pay Theory is just, the situations in under-developed countries cannot be implemented.

Self-Assessment

Multiple Choice Questions:

6. Which view has been adopted to measure ability to pay tax by some writers specially American writers?

   (a) Objective (b) Subjective

   (c) Practical (d) None of these

7. The production power of an individual depends on which structure of society mainly?

   (a) Uneconomical (b) Economical

   (c) Social (d) Cultural

8. As a standard, which income must be considered only?

   (a) Powerful (b) Single

   (c) Weak (d) Dual

9. Which cost of property cannot be calculated?

   (a) Real (b) Unreal

   (c) Public (d) Market

10. According to many thinkers, Ability to Pay Theory is based on which theory?

    (a) Public (b) Universal

    (c) Individual (d) All of these

9.6 Summary

- Liquid burden of taxation must be divided in such a way that each taxpayer have to give equal sacrifice. In this way, it is essential to bring just equality in taxation and individuals living in same conditions must be treated well so that horizontal equity can be achieved and all individual living in unequal conditions must be treated differently in matter of imposing tax, so that vertical equity can also be achieved.
- Such distribution of taxation, which must be according to principle of least aggregate sacrifice, it is possible that it must be equal to marginal sacrifice but not equal to total sacrifice provided by all members.
- Persons should give contribution in proportion to their related ability. In this statement, meaning of word proportion can also be taken from 'Equal Absolute Sacrifice' under some circumstances and it can be taken as 'Equal Proportion Sacrifice' under some other circumstances.

Notes

- Opposite to Subjective Approach, that principle of Production Power keeps in mind the money value of taxable capacity instead of emotions of taxpayers and their sufferings.

9.7 Keywords

- Equity - Fairness
- Contribution - Give jointly with others to common purpose
- Equilibrium - Equality
- Bounties - Generosity

9.8 Review Questions

1. Why property has been called base of payment capability?
2. How the ability to pay tax is measured?
3. What is the difference between Objective Approach and Subjective Approach?
4. Explain equal Absolute Sacrifice.
5. Explain Musgrave's Utility Model Theory.

Answers: Self Assessment

1. Property	2. Utility	3. Decline	4. Progressive
5. Mathematical	6. (a)	7. (b)	8. (c)
9. (a)	10. (b)		

9.9 Further Readings

Books

1. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
2. Indian Public Finance Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking and Public Finance—*Sundaram V., Alpha Pub., 2009.*
4. Money Banking: International Trade and Public Finance—*Nee. Thai. Somshekhar Anmol 2004.*
5. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Unit-10: Impact, Shifting and Incidence of Taxation

Notes

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Impact of Tax
- Understand Incidence of Tax
- Know about Shifting of Tax.

Introduction

In general meaning, shifting of tax means to shift tax-burden on others by taxpayer. Shifting of tax is that process in which taxpayer tries to shift burden of his tax-burden on others. In this way, shifting of tax is deeply related to tax-burden, because to avoid tax-burden, shifting is used.

Tax-burden is also called incidence of tax. It is the last result of shifting, it is direct tax-burden.

10.1 Impact of Tax

Impact of tax is on that individual on which government imposes tax and he actually pays tax and the name of that individual is registered with government as taxpayer. For example, if tax is imposed by government on sugar at ₹ 10/- quintal then it is received from producer of sugar. Therefore, impact of tax will be on that producer because government receives tax payment from buyer. In other words, this producer "bears primary burden of payment of tax". According to **Seligman, "The immediate effect of paying tax lies on that person; it is called impact of tax".** When taxpayer could not shift the burden of a special tax on others then the burden of tax lies on impact of tax also. Direct tax are of that nature such as, income tax, property tax etc. affects impact of tax and shifting of tax which are deposited in government to easury.

Notes

10.2 Shifting of Tax

In general meaning, the shifting of tax means to shift the burden of tax to another by taxpayer. **Shifting of tax is that process in which taxpayer tries to put burden of his tax burden on others.** The process of shifting of tax happens when the pressure of tax and burden of tax lie on different individuals, such as sale tax is taken from businessmen firstly then the burden of tax increases on them, but when businessmen tries to put the amount of taxes on consumers by including in value of goods completely or partially then the burden of tax puts on consumers lastly. In this way, on reaching the state from incidence of tax to impact of tax is shifting of tax. In the words of **Prof. Musgrave,** "In classical meaning, the meaning of shifting of tax means that process by which the direct burden of tax is removed to last point from point of pressure by including tax costs". In this way, shifting of tax is directly associated with tax burden because shifting of taxes used to avoid tax burden. When shifting of tax does not happen then the impact of tax and incidence of tax lie on same person.

Types of Shifting of Tax

Shifting of tax is of two types -

(1) Forward Shifting

(2) Backward Shifting

When tax is impose on a product, but he puts it on buyer then it is called **Forward Shifting,** and opposite to it, when the tax is imposed on a producer and the producer transfers this tax to the person supplying raw goods or labours working on production then it is called **backward Shifting.** The types of shifting of tax can be explained by an example. When government imposes consumers tax on sugar and he shifts the burden of consumers tax of sugar on consumers then it will be called **Forward Shifting,** but if the producer of sugar succeeds in shifting tax burden on producers of sugar cane then it is an example of **Backward Shifting,**.

Notes Taxpayer tries to shift tax burden on others, which is called shifting of tax.

Self-Assessment

Fill in the blanks:

1. The burden of tax lies on that person on which government imposes........................ .
2. Producer bears initial ....of payment of tax.
3. ....is that process in which taxpayer tries to shift burden of tax on others.
4. Shifting of tax is directly related to ....
5. Shifting of tax is not beyond that point, that point is the point of ....

10.3 Incidence of a Tax

The burden of tax is also called **Incidence of tax.** in the words of **findail shiraj, " incidence of tax is the last result of shifting of tax, it is direct burden. In this way, in the problem of incidence of tax, it is analysed that who pays tax means on which the burden of tax lies".**

Notes

This definition clears that the burden of tax lies on that person who lastly pays tax means bears the burden of tax lastly. Such as tax is imposed on producer of sugar. If producer succeeds in shifting this tax on consumers by increasing the cost of sugar then the burden of tax bears on consumers because lastly the burden of tax will be on producer of sugar. If the producer does not get success in shifting the burden of tax on consumers then the burden of tax as well as impact of tax will be on producer. Normally, the producer of sugar cannot shift further on burden of tax and have to bear the burden of tax himself.

According to **Prof. Salegman,** "Imposition of burden of tax on last tax payer is called burden of tax".

According to **Phillip E. Taylor**, "The burden of tax lies on that person and cannot be shifted further".

In brief it can be said that incidence of tax includes following three factors -

(i) Incidence of tax is last burden of tax which cannot be shifted any further.

(ii) It is the burden of tax.

(iii) It is direct tax because it is equal to the total amount deposited in government treasure.

10.3.1 Distinction between Impact and Incidence of Taxation

Distinction between impact and incidence of taxation is done on the basis of primary and last burden of taxation. The main points showing distinction in impact and incidence of taxation are as follow -

1. Impact of tax shows primary burden of tax and incidence of tax shows the last burden of tax.
2. Impact of tax lies on that person which pays that amount where as incidence of tax is on that individual which bears that tax burden lastly.
3. The meaning of impact of tax is the payment of amount spent on tax whereas incidence of taxation means direct burden of tax.
4. Incidence of tax is on that person which cannot be shifted on another whereas tax in impact of tax can be shifted on others. In other words, **Impact of tax or burden of tax can be shifted, but incidence cannot be.**
5. To avoid impact of tax is called Tax Evasion which is illegal whereas incidence of tax or to avoid tax burden is totally legal.

10.3.2 Money Burden and Real Burden of Tax

Prof. Delton has differentiated between direct and indirect burden of tax as well as duplicate and original burden of tax. If a producer succeeds increasing costs of goods according to the amount of tax then **The Direct Burden** of tax lies on consumers because they have to pay more value of tax. Sometimes it happens that produce has to pay same taxes to government prior by which producer losses on that amount as interest, it is called **Indirect Burden.** In other words, when taxpayer has to deprieve of more amounts in comparison to amount of tax then it is called indirect burden.

Do You Know? Tax burden is on that person which cannot shift it further.

Notes

Tax Evasion - The income of person is taxable but he pays less payment on taxes by showing false accounts or by showing false sale then it is called tax evasion means taxpayer steals tax in it.

Tax Avoidance - It is a different state from Tax Evasion. When taxpayer saves tax while obeying law then it is called Tax Avoidance. Such as according to modern law in India, if salaried employee saves upto ₹ 80, 000 /- from life insurance, general provident fund etc. then he gets upto 20% of relaxation from income tax (maximum ₹ 16, 000 /-)

Difference between Tax Avoidance and Tax Evasion

There is difference between Tax Evasion and Tax Avoidance. When taxpayer pays the payment of tax but he shifts the burden of tax on others then it is called Tax Avoidance. For example the seller shifts the amount of sale tax on consumers. In Tax Evasion, taxpayer avoids paying tax by presenting false accounts.

There are following differences between Tax avoidance and Tax Evasion -

(i) Tax Avoidance is a natural and scientific process whereas tax evasion is an illegal process which is a punishable offence.

(ii) Government doesn't loss revenue from Tax Avoidance whereas government bears heavy economic loss from Tax Evasion.

(iii) Anyone has to bear the burden of tax in Tax Avoidance whereas payment of taxes is not done in Tax Evasion then there is no question of his burden.

(iv) There is no relation of moral decline from Tax Avoidance whereas Tax Evasion promotes undesirable tasks like dishonesty, corruption etc.

Task What do you mean by Tax Evasion?

Self–Assessment

State whether the following statements are True or False:

6. Burden of tax is called Incidence of tax.
7. Impact of tax shows last burden of tax and incidence of tax shows primary burden of tax.
8. To avoid impact of tax is called Tax Evasion.
9. If a producer succeeds in increasing according to amount of tax to values of goods then the burden of tax lies on producer.
10. When the taxpayer saves tax while following law then it is called Tax Evasion.

10.4 Summary

- Impact of tax is on that individual on which government imposes tax and he actually pays tax and the name of that individual is registered with government as taxpayer.
- The immediate effect of paying tax lies on that person, it is called impact of tax. When taxpayer could not shift the burden of a special tax on others then the burden of tax lies on impact of tax also.

Notes

- In general meaning, the shifting of tax means to shift the burden of tax to another by taxpayer. Shifting of tax is that process in which taxpayer tries to put the burden of his tax on others.
- Incidence of tax is the last result of shifting of tax, it is direct burden. In this way, in the problem of incidence of tax, it is analysed that who pays tax means on which the burden of tax lies.
- Distinction between impact and incidence of taxation is done on the basis of primary and last burden of taxation.
- If a producer succeeds increasing costs of goods according to the amount of tax then the **Direct burden** of tax lies on consumers because he has to pay more value of tax.

10.5 Keywords

- Shifting - Shift on others
- Incidence of Tax - To impose tax

10.6 Review Questions

1. What do you mean by Shifting of Tax?
2. Define Impact of Tax.
3. Explain Incidence of a Tax.
4. What is the difference between Impact of Tax and Incidence of Tax?
5. What do you mean by Monetry and real burden of tax?

Answers: Self Assessment

1. Tax	2. Duplicate	3. Shifting of Tax	4. Burden of Tax
5. Incidence of Tax	6. True	7. False	8. True
9. False	10. True		

10.7 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Public Finance—*H.L. Bhatia, Vikas Publishing House Pvt. Ltd.*
3. Indian Public Finance Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
4. Money Banking and Public Finance—*Sundaram V., Alpha Pub., 2009.*

Notes

Unit-11 Theories of Tax Shifting : Concentration and Diffusion Theory

CONTENTS

Objectives

After studying this unit, students will be able to:

- Understand the Theories of Shifting of Taxes or Incidence of Taxes
- Know about the Factors determining Incidence or Shifting of Tax
- Know about Importance of Incidence Problem Study.

Introduction

Naturalist economists of France expounded the Concentration Theory and France's economist **Kennard** and British Scholar **Mansfield** expounded Diffusion Theory. When tax is imposed on a goods or there is an increment in rate of old tax then the taxpayer tries to shift the burden of tax on others. The problem of justice is very important in impact of tax. Therefore, the burden of tax must be distributed equally on different categories of society.

11.1 Theories of Shifting of Taxes or Incidence of Taxes

Three main theories are presented in regard of burden of tax which are as follow -

(1) Concentration Theory - France's naturalist economists implemented this theory. They believed that net product is received from land only therefore the tax must be imposed on land. They thought that whether the tax is imposed on any individual or goods, its last burden will be on land means they concentrate on land lastly. Therefore, government must impose tax only on net income of tax but not by imposing different type of taxes. In this way, the tax process will be easy and collection of tax will be less.

Above mentioned theories have been criticized because economists believed that only land is not producer but other business are also producers therefore taxes must be imposed on other categories of society. The distribution of taxes will be just by it. However, Concentration Theory is defective but it shows this fact that the payment of tax can be done easily which is the base of modern theory of tax burden.

(2) Diffusion Theory - This theory is implemented by France's economist **Canard** and British scholar **Mansfield.** This theory is opposite to concentration Theory and shows that all taxes which must be imposed on any form, they spread in whole society. In other words, Shifting of tax occurs till that time until it spreads in whole society. According to **Canard**, if blood oozes out from a vein of body then the loss in not only that vein but this loss spreads in whole body, in the same way, if government receives tax from a special category then the burden of that tax divides on all other categories from the medium of shifting of tax. In this regard, **Prof. Findley Shiraj** gives the example quoting **Mansfield** that "The tax imposed on any place is like a pebble dropped in a lake which creates such circles in water that one circle gives momentum to another circle and the circumference oscillates from the centre".

The above mentioned theory has been criticized. The belief of this theory is wrong that each tax can be shifted. In reality, direct taxes cannot be shifted. **Secondly**, this theory tells the nature of spreading of tax; it doesn't clear the amount of tax. **Thirdly**, this theory runs parallel to the belief of absolute competition which is unreal and imaginary.

(3) Modern Theory of Incidence - The modern theory of burden of tax is based on analysis of value and cost. This theory assumes that the payment of tax can be given from surplus and it is part of consumption cost of tax goods. **Prof. Dalton** and **Prof. Taylor** believed that the shifting of those taxes is possible which are related to Price Transactions. That's the reason that direct taxes cannot be shifted because they are not related to Price Transactions. As it has been explained in the beginning that the payment of taxes can be done from surplus. If taxpayer doesn't get any surplus then he shifts tax and this shifting will continue till that time until this situation doesn't happen that he starts getting surplus. The costs of goods must be such that by which payment of tax can be given. If the cost of goods doesn't increase after imposing tax then it means that the seller is getting surplus at current cost. Inversely, if payment of tax cannot be given from current cost then the cost of good will be increased.

Notes It depends on the nature of tax, demand of goods and flexibility of requirement, production of goods, cost etc. That how much part of tax can be shifted on other by taxpayer.

11.2 Factors Determining Incidence or Shifting of Tax

If tax is imposed on a goods or there is increment in rate of old taxes then the taxpayer tries to shift the burden of that tax on others. It depends on above factors that upto what extent the burden of tax can be shifted to another Person-

(1) Nature of Tax - It depends on nature of tax that how shifting of tax can be done or not and if it can be done then upto what extent. For example, taxes imposed on net income such as sale tax can be received from consumers. If their adverse effect on sale by including cost of burden of taxes during short term, then the seller doesn't shift the whole burden of tax on consumers.

(2) Amount of Tax - If a tax is imposed in very less quantity by government on a goods then the businessman bears the burden himself and doesn't shift it on consumers. Its reason is that they do not want to annoy their customers. If the amount of tax is more than it is tried to be shifted on consumers by hook or crook.

Notes

(3) Elasticity of Demand - Shifting of tax depends on elasticity of demand. If tax is ought to be imposed on a goods if its demand is elastic then the tax cannot be shifted and businessman bears the burden himself. Its reason is that if the businessman increases the cost of goods then the consumers will reduce the demand of goods and the sale of the seller will reduce and he will get loss. Opposite to it, if the demand of goods is unelastic then seller will shift the burden of tax to consumers easily because consumers will not reduce the amount of goods on increasing the cost of goods. For example, the burden of tax imposed on essential goods can be shifted but the businessman bears the burden of tax on luxuries.

Shifting of tax in different demand elastic directions are shown in figure - 1(A), 1(B), 1(C), 1(D) and 1(E).

(i) When demand curve is completely elastic ($e_d = \infty$)

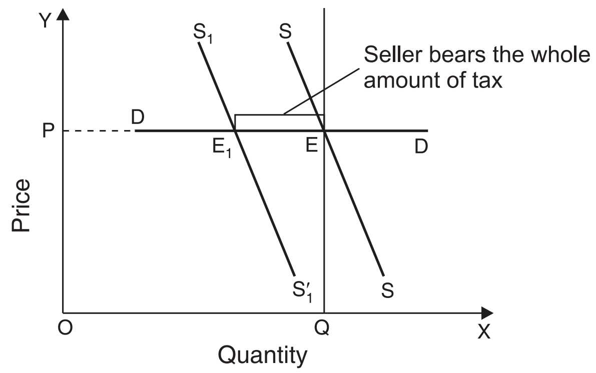


Fig. 1(A)

(ii) When demand curve is completely non-elastic ($e_d = 0$)

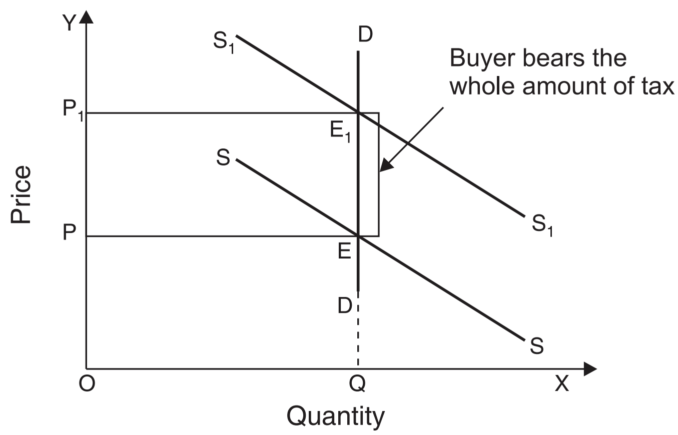


Fig. 1(B)

(iii) When demand curve is above than a unit ($e_d > 1$)

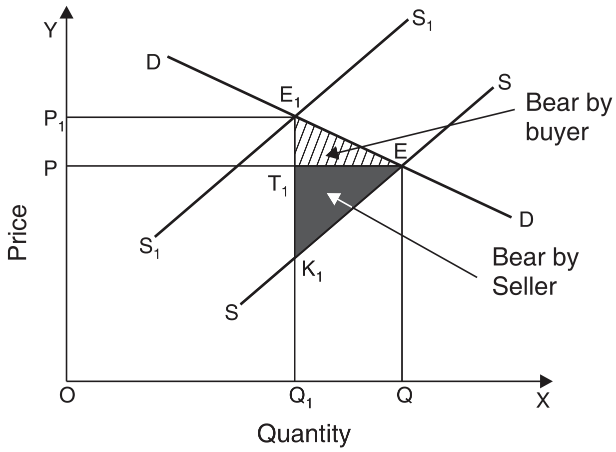


Fig. 1(C)

(iv) When demand curve is less than a unit ($e_d < 1$)

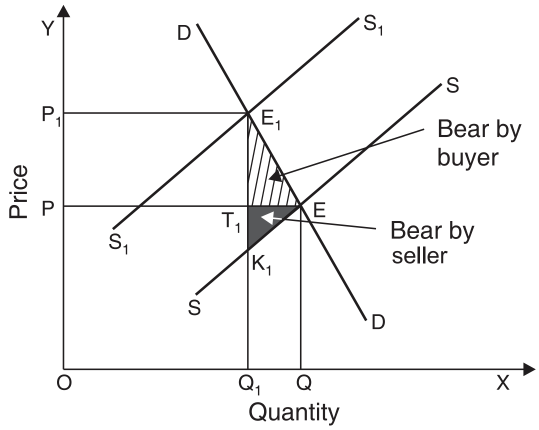


Fig. 1(D)

(v) When demand curve is equal to unit ($e_d = 1$)

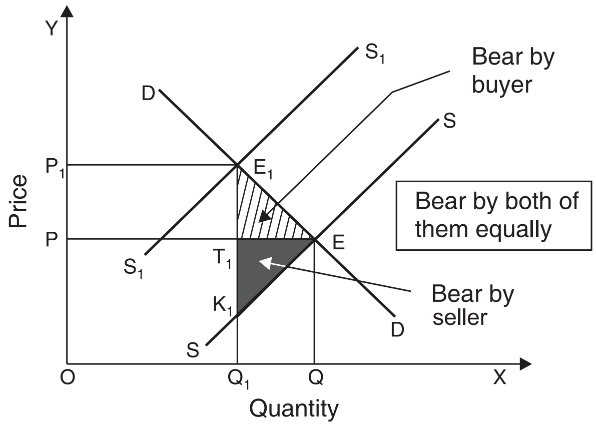


Fig. 1(E)

Notes

Taxation burden position in different curve state of demand

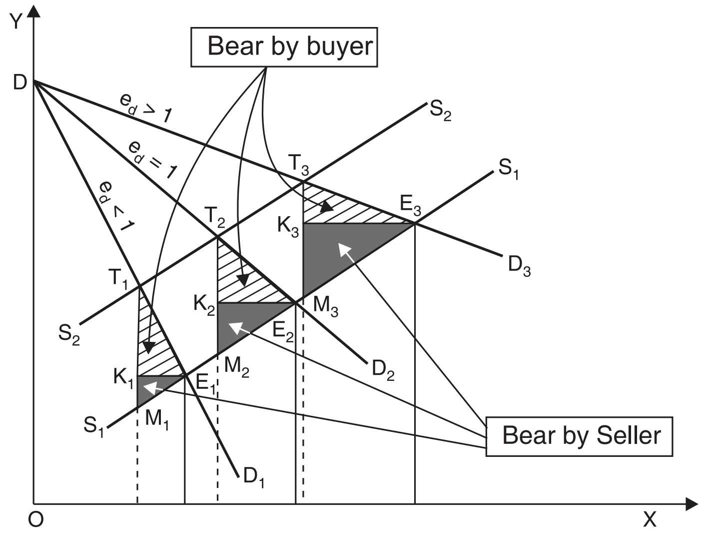


Fig. 2

In above fig. 2, it is clear that as the elasticity of demand increases so as the tax burden increases on seller means as the elasticity of demand will reduce so as the burden of tax will increase on seller and opposite to it, the elasticity of demand increase, the tax-burden will increase on seller.

(4) Elasticity of Supply - Elasticity of supply affects the shifting of tax. If the supply of goods is non-elastic then the burden of tax imposed on it will be on businessman because in that condition, buyer cannot affect the supply by increasing the cost of goods.

Opposite to it, if the supply of goods is elastic then the burden of tax can be shifted on consumers. Its reason is that as a result of tax, with the increase in goods, demand declines, then the businessman reduces the supply of goods because of which the cost doesn't decrease. In this way, the tax is imposed on a goods if the demand of that goods is elastic and supply is non-elastic then tax cannot be shifted. If the demand of goods is non-elastic then the burden of tax can be shifted.

Shifting of tax in different demand elastic directions have been shown in figure 3(A), 3(B), 3(C), 3(D) and 3(E).

(i) When supply curve is completely elastic ($e_s = \infty$)

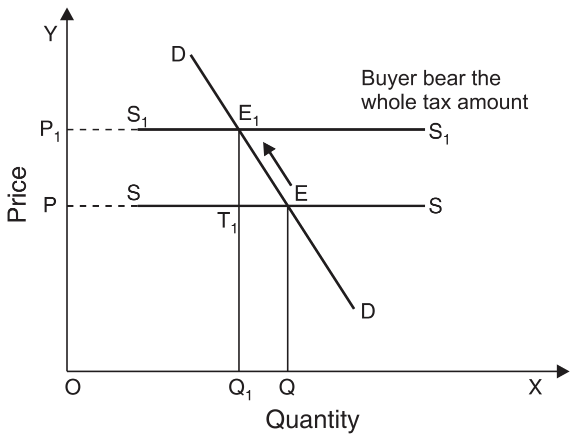


Fig. 3(A)

Notes

(ii) When supply curve is completely non-elastic ($e_s = 0$)

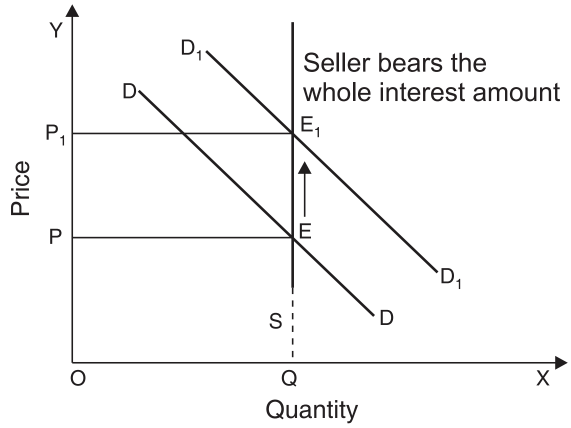


Fig. 3(B)

(iii) When supply curve is more than a unit ($e_s > 1$)

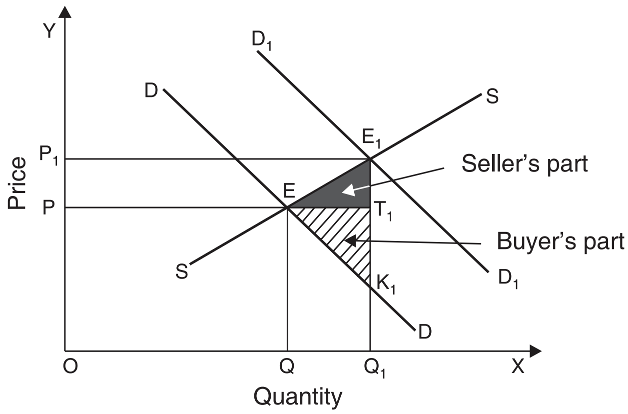


Fig. 3(C)

(iv) When supply curve is less than a unit ($e_s < 1$)

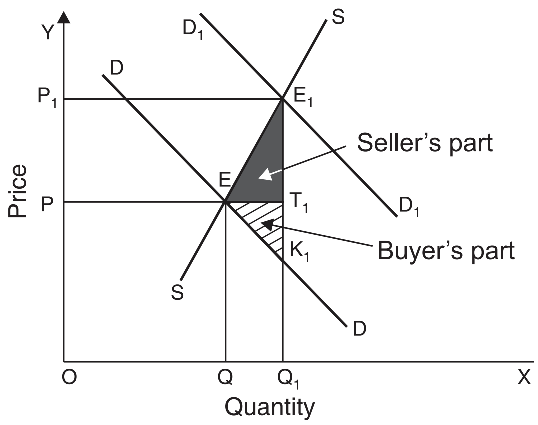


Fig. 3(D)

Notes

(v) When supply curve is equal to unit (e_d = 1)

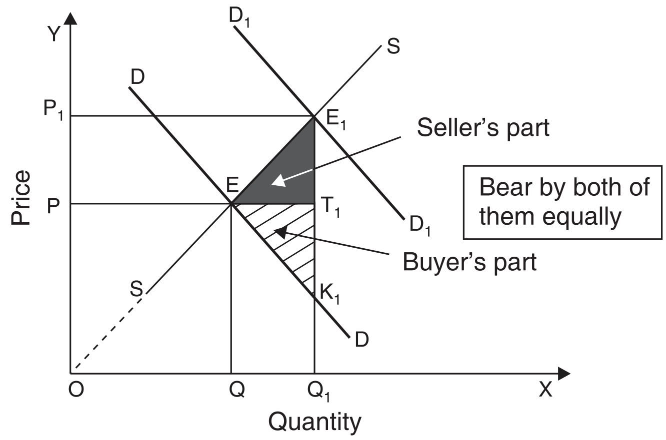


Fig. 3(E)

According to **Prof. Dalton,** "Each consumer tries to shift the burden of tax on seller by reducing their demand whereas producer or seller tries to shift the burden of tax on consumer by reducing the supply of goods. The real distribution of burden of tax is determined by their comparative powers to purchase".

In this way, the burden of tax depends on elasticity of demand and supply of that goods on which tax has been imposed.

(5) Competition in the Market - This fact leaves impact on shifting of tax that what is the part of competition, the amount of tax can be shifted because in that condition the shifting of tax depends on elasticity of goods. In this way, the condition of incomplete competition, the shifting of tax depends on this fact that how are the elasticity of demand and what is the factor of competition. It must be kept in mind that absolute competition and authority are imaginary direction of market. In reality, only incomplete competition exists.

(6) Object of Taxation - Some taxes are imposed to this objective that there shifting must be done such as, direct tax. But, the objective of some taxes on which taxes are imposed, must pay for it and their shifting must not be done such as income tax.

(7) Availability of Substitute - The tax is imposed on that goods if the substitute is available of a goods then the burden of tax cannot be shifted easily. Its reason is that when the producer includes the cost of goods in taxes as a result of that producer uses substitute goods which are cheap. The goods which do not have their substitute goods if tax is imposed on these goods then the seller easily shift the amount of taxes because consumer is forced to buy such goods.

(8) Basis of Taxation - Shifting of taxes can be done on the basis of special taxes mean on the basis of quantity, weight or size. But, it is difficult to shift taxes on the basis of **Advalorem** because when the cost of goods increase, the amount of taxes also increase.

Do You Know?	In the condition of absolute competition, the amount of tax can be shifted.

Notes

(9) Laws of Return - On shifting of tax, the rules of origin also affects whose detail is as follow -

(i) **Serialwise Origin Decrease Rule -** If the production of a goods is under origin decreases rule then its meaning is that when production increases, per unit cost increases. Therefore, when the amount of tax is added to income then the cost of goods increases more because of which there is a possibility of reduction in demand of goods. Therefore, the absolute amount of tax cannot be shifted.

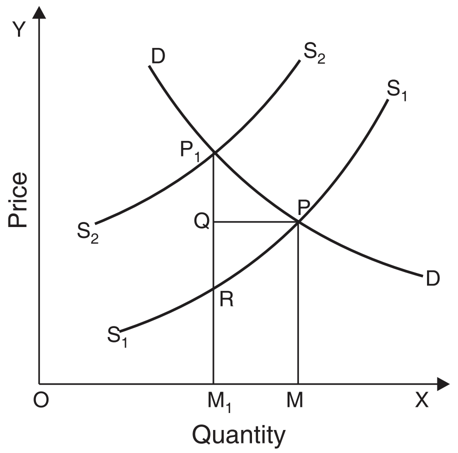


Fig. 4(a)

In fig. 4 (a), S_1S_1 is supply curve before imposing tax whereas S_2S_2 is supply curve after imposing tax. The cost of goods before imposing tax is PM and the cost of goods after imposing tax becomes P_1M_1. Therefore, the increment in cost is equal to P_1Q so the burden of tax on sellers is equal to P_1Q which is lesser than amount P_1R. In other words, the burden of tax on sellers is equal to QR.

(ii) **Serialwise Origin Equity Rule** - If the production of goods is under Origin Equity Rule then there is no effect on cost on increasing or decreasing origin. If amount of tax is added to the cost of goods then its demand doesn't get affected and the whole amount of tax is shifted to consumers by adding it to the cost.

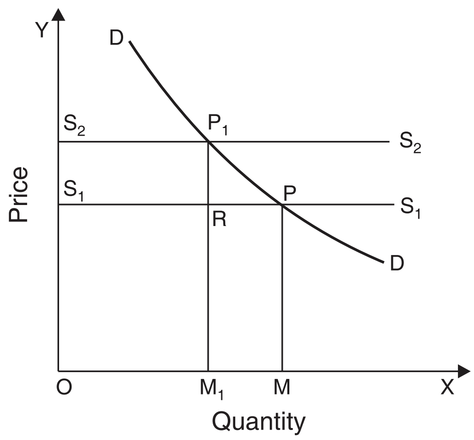


Fig. 4(b)

Notes

In fig. 4 (b), S_1S_1 is supply curve before imposing tax and S_2S_2 is supply tax after imposing. Cost before tax is equal to PM whereas the cost after tax becomes P_1M_1. In this way, the amount of tax is equal to P_1R_1. It is clear from the figure that the whole burden of tax is born by buyers and the seller - bears no part of tax burden.

(iii) **Serialwise Decreasing Cost Rule -** If the production of cost is under Decreasing Cost Rule then as the production increases, per unit cost decreases. If tax is imposed in that condition then the cost of goods may increase more than amount of tax and its burden will be on consumers.

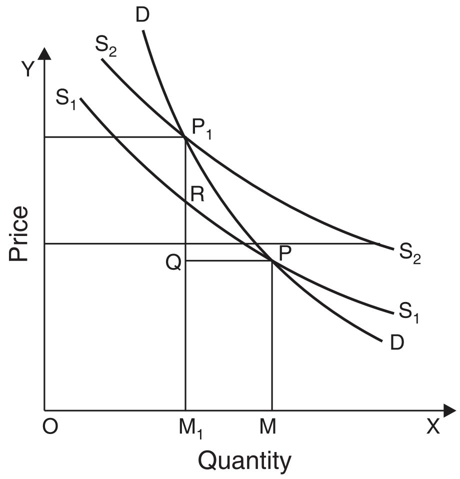


Fig. 4(c)

In fig. 4(c), S_1S_1 is supply curve before imposing tax and S_1S_2 is supply curve after imposing tax. The cost before imposing tax is equal to PM, the amount of tax is equal to P_1R whereas increment in cost is equal to P_1Q. In this way, it is clear from the figure that the cost of tax imposed in Decreasing Cost Rule increases more and buyers have to bear more burden than the amount of tax.

(10) Time Element - If tax is imposed on a seller for a short period temporarily then he bears the burden himself and doesn't shift it on his customers. But, those taxes which are imposed permanently, seller tries to shift them.

(11) Mobility of Capital - If the capital is mobile completely then the producer succeeds in shifting the burden of tax on consumers because he gets profit from it by the capital then the burden of tax cannot be shifted on consumers.

Task Describe the rules of production.

Self-Assessment

Fill in the blanks:

1. Direct taxes cannot be ....
2. The modern theory of tax burden and ....is based on analysis of ....

3. The costs of goods must be such that by which the amount of tax can be ....
4. Shifting of tax depends on ....of goods.
5. Elasticity of supply of goods affect ....of tax burden also.

11.3 Importance of Incidence Problem Study

The problem of justice is very important in taxation therefore the burden of tax in different categories of society can be shifted equally. But, until finance minister doesn't know that the burden of tax lies on which at last, he cannot just distribute the burden of taxes. Taxation is according to the ability to pay tax or not, to know this, problem study of last burden of taxes is very important. Such as if government decides that the tax must be imposed on producers of sugar because they have ability to pay. But, if these producers succeed in shifting the burden of taxes on consumers then the objective of government fails.

According to **Prof. Seligman, "To know the different economic effects of taxes the study of tax burden is essential".** In his words**, "It is only when have ascertained the incidence that we can proceed to discuss the wider effects of a tax".** [1.]

The last burden of tax has its own limitations. Not single units of tables have been developed till now by which we can guess rightly about incidence. But, instead of this, practical and moral both forms of incidence have utility of study, sometimes, it becomes impossible to know incidence due to changes in costs. Then it is not possible to differentiate between incidence and effect of tax. **Prof. Cannan** believed that, "**To know only that incidence lies on a particular person, it is not a proof of this that he is bearing more burden in comparison to others".**

Notes The tax system which will develop without giving attention towards incidence will be away from justice and equality.

11.4 Study of the Incidence of some Important Taxes

(1) Incidence of Tax on Income - Taxes imposes on income includes **income tax, additional benefit tax, municipal tax**, **capital gains** tax etc. Because taxes are imposed on net income, so their burden is on those individuals, on which they are imposed.

If tax is imposed on income received from wages and labour then they cannot be shifted normally. The shifting of this tax can be done on employers but employers will not be ready to give wages and labour that the tax has been imposed on the income of labourers. Its reason is that by imposing income-tax, there is no increment in production of employees.

Till the question of commercial net benefit arises, some economists believe that the cost of goods must be increased and it must be shifted in such a way but this theory doesn't appear appropriate because in reality, incomplete competition is found in market. Businessman cannot increase the cost of goods easily in incomplete competition. In this way, the burden of tax imposed on net benefit lies on businessman. If tax is imposed on income in large quantity then the burden of this tax lies on taxpayer. But, the tax is imposed heavily on production then it costs adverse effect on investment and production.

1 "It is only when have ascertained the incidence that we can proceed to discuss the wider effects of a tax." **—Seligman**

Notes

(2) Incidence of Tax on Property - The study of burden of tax on property for convenience of analysis will be divided on two parts - **firstly**, tax on total property which is used on production and **Secondly,** tax on that property which is used for the direct fulfillment of needs. When tax is imposed on ownership of such property which is used for production, then this tax can be shifted. For example, tax is imposed on building of factory then the producer includes in cost of goods by considering it cost and he gets succeed in shifting it on producers.

When tax is imposed on such property which is used for direct fulfillment by taxpayer, such as house for living, jewellery etc. the shifting of this tax is not possible because cost cannot be used in its shifting.

(3) Incidence of Sales Tax - The tax which is imposed on goods, the seller includes it into the cost of goods and gets success in shifting the amount of tax on consumers it means incidence lies on sellers but the burden of tax lies on consumers, but this statement cannot be generalized because the seller doesn't get success in shifting sale-tax. **Saler gets success in shifting only those goods whose demand is unelastic** and whose shifted goods are available, it is not possible for sale to shift the amount of taxes imposed on them.

That condition, can also be created that the seller by not shifting taxes on consumers (front shifting) shift it backward it means by not increasing the costs of goods, force bulk dealer or producer to sell it on low cost. Sometimes, the burden of sale-tax lies partially on buyer and partially on seller also which is decided by bargaining power of purchasing of consumers and sellers.

(4) Incidence of Taxes on Production - This tax is imposed on production of goods. The study of burden of taxes on production is similar to sale tax. The taxes which are imposed on production, they are included in cost of goods by producers and are shifted on consumers. According to **Philip E. Taylor**, "All taxes imposed on production, are considered production cost by producer or seller but on different production costs on which impact of tax occurs, shifting of taxes is different for them".

According to **Prof. Taylor**, three type of taxes are imposed on production -

(i) Those taxes whose amount are definite and they have no relation with the quantity of production.

(ii) Second type of taxes are those which fluctuate according to the ratio of amount of production. Under this category, we can include Excise Duty. These taxes are similar to variable taxes and they can be included in per unit cost of these goods. But, upto what extent, these taxes can be shifted; this depends on flexibility of supply of goods and elasticity of demand.

(iii) Third type of taxes are those which fluctuate with the change in variable cost but the change in immovable cost.

Prof. Taylor believes in regard of shifting of above mentioned taxes that, **"Any production tax can be shifted or not, it will depend on the power of saving against the shifting. The power of saving reflects in demand and supply of elasticity".**

(5) Incidence of Export and Important Duties - Export and Import duties are direct taxes. Generally, the burden of taxes lies on consumers because importer receives the amount of tax by increasing the cost of exported goods. When government imposes tax with the objective of conservation then the rate of these taxes became high. In that condition, importer could not totally shift tax and partially bears the burden of tax himself.

When government imposes tax **with the objective of receiving revenue** only then the rate of tax is not very high and the burden of such taxes can be shifted on consumers. But, this shifting will be upto which extent, this will depend on available goods, elasticity of demand of consumers etc. in the country.

The burden of **export Duty** lies normally on exporter but according to circumstances the burden of export duties can be distributed between importer, exporter and foreign consumers. If the demand of exported goods is elastic then the burden of exported tax lies on exporter. Opposite to it, if the demand of exported goods is inelastic and more active then the burden of imported tax will be on consumers of the country doing export. If the importer country has the right on goods and many countries in the world are their customers then the burden of import tax lies fully on exporter country.

(6) Incidence of Professional Tax - Tax is imposed on progressive basis on businessman of different types randomly by government means when the income increases with the business, the amount of business tax is also increased. This tax is like direct tax whose last burden lies on taxpayer. But, this tax can be shifted in some circumstances, such as if tax is imposed on the profession of a doctor then he can shift this tax on the fee received from patients but business tax on a businessman can not be shifted. In this way, the shifting of business tax depends on the nature of business.

Self-Assessment

State whether the following statements are True or False:

6. Taxes imposed on income include income tax, additional benefit tax, municipal tax, capital benefit tax etc.
7. If tax is imposed on income in heavy quantity, then its tax burden doesn't lie on taxpayer.
8. When tax is imposed in bulk on production then it leaves adverse effect on investment and production.
9. Import and Export Duties are direct taxes.
10. Generally, the burden of exported taxes lies on producers.

11.5 Summary

- Shifting of tax occurs till that time until it spreads in whole society. According to **Canard,** if blood oozes out from a vein of body then the loss is not on only that vein but this loss spreads in whole body, in the same way, if government receives tax from a special category then the burden of that tax divides on all other categories from the medium of shifting of tax.
- The modern theory of burden of tax is based on analysis of value and cost. This theory assumes that the payment of tax can be given from surplus and it is part of consumption cost of tax goods.
- It depends on the nature of tax, demand of goods and elasticity of requirement, production of goods, cost etc. that how much part of tax can be shifted by taxpayer on others.
- If tax is imposed on a goods or there is increment in the rate of old taxes then the taxpayer tries to shift the burden of that tax on others.
- Shifting of tax depends on elasticity of demand. If tax is ought to be imposed on a goods if its demand is elastic then the tax cannot be shifted and businessman bears the burden himself.
- Each consumer tries to shift the burden of tax on seller by reducing the supply of goods. The real distribution of burden of tax is determined by their comparative powers to purchase.
- To know various economic effects of taxes, the study of tax burden is essential.
- To know only that incidence lies on a particular person, it is not a proof of this, that he is bearing more burdens in comparison to others.
- Any production tax can be shifted or not, it will depend on the power of saving against the shifting. The power of saving reflects in demand and supply of elasticity.

Notes

11.6 Keywords

- Shifting - Roll down
- Elasticity - Flexibility

11.7 Review Questions

1. Explain serialwise laws of origin of equality.
2. Explain with examples serialwise laws of decrease of destruction.
3. Briefly explain the laws of origin.
4. What do you understand by the elasticity of demand of goods?
5. Briefly explain the theories of incidence.

Answers: Self Assessment

1. Shifting	2. Cost	3. Payment	4. Elasticity
5. Shifting	6. True	7. False	8. True
9. True	10. False		

11.8 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking: International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*

Unit-12: Diffusion Theory

CONTENTS

Objectives

After studying this unit, students will be able to:

- Know about Diffusion Theory
- Import Knowledge about the Errors of Diffusion Theory.

Introduction

There is a belief about Diffusion Theory that there is such a market system in economy which is competitive in nature and because of it, production resources can go easily and fastly from one employment system to another employment system.

12.1 Diffusion Theory

According to this theory, the last arrangement of taxes shatters in such a way on activities of total economy, goods and income that no definite form can be decided of its allotment. According to this belief, the existence of income residue is not only in agriculture, but also in heads of earned income from different sources. Due to this, as a result of total dependence on economic activities of different categories, taxation changes due to fluctuation in costs. Taxation by this process spreads in such a way that its last structure cannot be decided.

The hidden belief in this theory is that there is a such market system in economy which is competitive in nature and due to this, production resources can go easily and fastly from one employment system to another employment system.

Notes If these conditions are fulfilled then there is no difference from this fact that where is primary impact of taxes. Its effect spreads in whole economy in each direction.

Notes

Limitations

On observing this theory carefully, its many limitations are as follow -

1. If it is supposed that the last structure of taxes spreads in whole economy, then its meaning is not that government does not consider this fact while imposing tax that where it is imposing tax. Its reason is that the vast effect of taxation can take any form in addition to their last structure and the structure of these effects depend on this fact that when, where and how to impose tax, what are their rates and other related merits etc.
2. This theory is based on impractical beliefs. Total competition is not seen in market economy and in present time, unitary factor has become its essential factors. Therefore, it is not necessary that the structure of each special tax shatters. Opposite to it, in many matters, a pattern is found on fixing of taxation.
3. **Prof. Dalton** believed that the conclusion obtained by this theory, to obtain the knowledge of obtaining the last structure of taxes and discourage information of a suitable tax policy. But, the formation of tax policy is such a task which must be done smoothly despite of all type of hurdles.

Self–Assessment

Fill in the blanks:

1. The centralization of taxation is not ....
2. Taxation spreads in whole economy in such a way that its last formation cannot be.........................
3. The vast effect of taxation takes many forms in addition to its last.................. .

12.2 Summary

- According to Diffusion Theory, the last arrangement of taxes shatters in such a way on activities of total economy, goods and income that no definite form can be decided for its allotment.
- There is a belief about Diffusion Theory that there is such a market system in economy which is competitive in nature and because of it, production resources can go easily and fastly from one employment system to another employment system.
- If it is supposed that the last structure of taxes spreads in whole economy then its meaning is not that government does not consider this fact while imposing tax that where it is imposing tax.
- The formation of tax policy is such a task which must be done smoothly despite of all type of hurdles.

12.3 Keywords

- Diffusion - Spread
- Limitation - Shortage

12.4 Review Questions

1. Explain Diffusion Theory.
2. What are the limitations of Diffusion theory?

Answers: Self Assessment

1. compulsory
2. decided
3. incidence

12.5 Further Readings

Books

1. Public Finance—*New Royal Book Company.*
2. Indian Public Administration—*Manjusha Sharma, O.P. Bohra, Ravi Books.*
3. Money Banking ; International Trade and Public Finance—*Nee. Thai. Somshekhar, Anmol, 2004.*
4. Public Finance—*Nand Kishore Parsad, ABD Publication, 2011.*