**UNIT-3**

 **PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE**

 **or**

 **PRINCIPLE OF PUBLIC FINANCE**

 **Introduction:**

 The fundamental principle that should govern the financial policy of the State or the

management of public finance is the principle of Maximum Social Advantage. Public finance

comprises of two operations- raising of revenue and spending it. The income and expenditure

cannot be looked at separately. Public finance involves a series of transfers of purchasing

power from the public to the government and the principle of sound finance must ensure that

it results in some benefit to the community. Prof. Pigou and subsequently Dr. Dalton are the

two prominent economists who are credited for formulating and popularising this principle

of public finance. Dr. Dalton called the principle as the Principle of Maximum Social

Advantage and Prof. Pigou called it as the Principle of Maximum Aggregate Welfare.

**TAXATION AND EXPENDITURE**

 The main purpose of the theory of public finance is to combine the principles of

taxation and expenditure and to point out how much by way of revenue the government

should obtain and spend in order to maximize social welfare of the community.

 Taxation involves sacrifice on the part of the tax payer. It is subject to the law of

increasing sacrifice. Equal additions of public revenue involves a greater amount of sacrifice

or loss of utility to people. Public expenditure, on the other hand, is subject to the law of

diminishing utility. Equal additions of public expenditure should be carried upto that point

where the social benefit from marginal expenditure is just equal to the social sacrifice caused

by raising of marginal amount of public revenue.

**DIAGRAMMATIC REPRESENTATION**

 The principle can be explained with the help of diagram. SS1 is the sacrifice curve the

trend of which is towards increase. UU1 is the utility curve from public expenditure which

proves the application of the law of diminishing utility. These curves intersect each other at

the point P. This is the ideal point where the sacrifice and utility are equal. The State should

realise OT amount from the public and should spend the same amount. The point P is the

point of maximum social advantage.



If the State decides to realise OT1 amount and the spend the same amount, the

sacrifice will be T1L1 and utility T1M1. Here utility will be greater than sacrifice. Hence there

is scope for more taxation.

If the State increases the amount of its expenditure and revenue realised to OT2, utility will

be T2L2 and sacrifice T2M2. Here the sacrifice will be more than utility. Hence there is a case

for reduction in taxation.

**HOW MAXIMUM SOCIAL ADVANTAGE IS ACHIEVED**

 There are three fundamental principles of financial operation. They help the state in

achieving the ideal of maximum social advantage.

1. Public expenditure should be carried on upto the point where the benefit received

from the last unit of money spent by the state is just equal to the sacrifice imposed

in raising that unit of revenue.

2. The resources of the state should be so distributed on different heads of

expenditure that the marginal return of satisfaction from each of them is the same.

3. The taxes should be so distributed that the marginal utility of the money paid in

taxation is equal to all tax payers.

 **TESTS OF MAXIMUM SOCIAL ADVANTAGE**

 According to Prof. Dalton, the following are the important tests of maximum social

advantage.

**1. Preservation of the community:**

Internal peace and external security create confidence and promote the economic life

of the citizens. They enhance the social advantage. The State has the responsibility of

increasing the economic and non-economic welfare of the citizens. Thus the State has the

responsibility of preserving the community from internal disorders and external dangers.

 **2. Improvement in Production:**

 The State also has the responsibility of increasing the level of production.

Improvement in production increases the economic welfare of the citizens.

 Improvement in production implies three things :

a) Increases in production power, that is, a larger product per worker with a smaller

effort.

b) Improvement in the organisation of production so as to reduce the wastes of

economic resources and

c) Improvements in the composition or pattern of production so as to serve best the

need of the community. Hence the operation of public finance should aim at

securing all these objectives, so as to increase the production and economic

welfare of the community

**3. Improvement in distribution :**

 In an economy, the welfare of the community can be increased through a better

distribution of income and wealth. Taxation may be so imposed that it falls on the richer

sections of the community, while public expenditure is so planned that the real income of the

lower income groups of people is raised. Thus the distribution can be improved through

reduction in the inequality of income and wealth in the country.

**4. Stability and full employment :**

 Economic instability is a characteristic feature of free economies and is the cause of

so many evils i.e. unemployment and over-production in the community. The social

advantage to the community can be increased if business conditions in the country are stable

and all fluctuations are eliminated. Hence the aim of fiscal operations should be to bring and

maintain economic stability at high level of employment.

**5. Provision for the future :**

 Individuals are mortal but the community lives on. The Government has, therefore,

the double responsibility of looking after the interests of the present generations and promote

the interests of the generations to come. The State therefore should prefer large social

advantage in the future to a smaller one today.

 The principle of maximum social advantage is very difficult to practise in so far as the

comparative estimate of the advantages of different types of expenditure and different kinds

of taxes considered to be difficult. In spite of this, the principle should be kept in mind by the

public authorities of the country.

**LIMITATIONS OF THE MAXIMUM SOCIAL ADVANTAGE**

1. The State cannot apply the principle of cost benefit analysis in public economic

activities.

2. The disutility of the tax payer in a micro problem relating to individual whereas the

utility of the public expenditure to the society is a macro problem. Thus there is a

methodological inconsistency.

3. Governments also make public borrowing and enhance benefits for the people. In this

case there is no disutility involved. Disutility arises only in the payments of taxes.

4. In modern days the fiscal operations are adopted as a counter cyclical measure. There

is no consideration of equalising marginal benefit and sacrifice.