

SEMESTER – V

MODULE – 1

INTRODUCTION TO PUBLIC FINANCE

Q.1 Examine the scope and functions of public finance.

Public finance is that branch of general economics which deals with financial activities of the state or government at national, state and local levels. It is a study of income and expenditure of central, state and local government and the principles underlying them. According to Dalton “Public Finance is concerned with the income and expenditure of public authorities and with the adjustment of the one to the other. The economics of public finance is fundamentally concerned with the process of rising and Disbursement of funds collection of revenue and its spending for the functioning of the government.

Professor Richard Musgrave defined Public Finance as, “The complex of problems that centers on the revenue-expenditure process of Government is referred to traditionally as public finance.”

According to Taylor, public finance studies the manner in which the state through its organ, the government, raises and spends the resources required. Public Finance is thus concerned with the operation and policies of the fiscal public treasury

The definition of Public Finance by **U.K. Hicks** in Public Finance highlights the satisfaction of collective wants which in turn leads to the need to secure necessary resources carry out their purposes.

SCOPE OF PUBLIC FINANCE

Prof. Dalton categories the scope of public finance into four areas which includes public income, Public expenditure public debt and financial administration.

(a) **Public revenue**

The study of various sources of government's income, the principles guiding the raising of income (e.g. canons of taxation), their relatives merits and demerits and their effects on the economy (e.g. impact and incidence of taxation).

(b) **Public expenditure**

The study of the manner in which public expenditure is classified, the principles guiding publicexpenditure (canons of public expenditure), causes of growth and effects of public expenditure.

(c) **Public debts**

The study of public debt forms a very important part of public finance in modern times as governments are increasingly resorting to debt to meet the growing needs of the people. Public finance studies the sources, burden and impact of public debt.

(d) **Financial administration**

This includes the study of the preparation, passing and implementation Of the budget, budgetary policies and their socio-economic impact, inter-governmental financial relations, fiscal management and fiscal responsibility.

FUNCTIONS OF PUBLIC FINANCE.

The functions of public finance all activities with regard to collection of revenue and expenditure on various activities. Earlier theories public finance narrow definition of the functions to be carried out by public authorities. It is clear that the area of state activity has enlarged over the past two decades which increased the functions and scope of public finance.

1) Economic activities of the state

The scope of public finance was confined to the traditional functions of the state, that is, provision of defense, law and order, justice and civic amenities. But with the emergence of welfare states the scope of public finance was broadened public finance now includes the use of the budget as a tool to correct distortion in the economy, to mobilise resources, to maintain price stability create employment prevent market failure, achieve growth equity and maximize social welfare.

2) Functional Finance

The government should maintain a reasonable level of aggregate demand at all times by using the budget. Most developed economies followed functional finance policies in order to control trade cycles. Developing countries followed such policies to promote economic growth.

3) Fiscal Operations

The scope of public finance includes fiscal operations and their objectives. Fiscal operations refer to raising public revenue, spending to achieve certain goals and financial administration. For such operations, the government uses fiscal tools like taxation, public expenditure and public debt. The following are the objectives of fiscal operations;

(a) Allocation of resources

The most important objectives of fiscal operations is to determine how the Country's resources will be allocated to different sectors of the economy in order to achieve predetermined goals. The national budget determines how funds are allocated to different heads of expenses. The policy of public expenditure is used by the government to directly undertake resource allocation for different sectors. On the other hand, the government can use taxation and subsidies to indirectly influence resource allocation.

(b) Distribution

Fiscal operations can be effectively used affect the distribution of national income and resource. Taxation and public expenditure policies are used by the government to reduce inequalities. Progressive direct taxation impose heavier burden on the rich than the poor. Public expenditure on social infrastructure and subsidies on food housing, health and education help reduce income inequality.

(c) Stabilisation

Developed economies experience business cycles. Economic stability implies absence of sharp cyclical movements in the form of booms and depressions. To bring about such stability, counter-cyclical fiscal operations are adopted. To counter depression and recession, government expenditure is increased to generate employment and taxes are reduced to encourage consumption and investment. During inflation, public expenditure is reduced and taxes are raised.

(d) Economic growth

In developing and underdeveloped economies, the objectives of fiscal operations are more promotional in nature. The basic focus of fiscal operations in such economies is the use of budgetary operations to achieve growth and development. This is done by encouraging capital formation and investments through public expenditure and tax incentives to private sectors.

Q.2 Examine the similarities and dissimilarities between public finance and private finance. OR Distinguish between public finance and private finance.

Public finance deals with study of income, Expenditure, borrowing and financial administration of the government. Private finance is the study of income, expenditure, borrowing and financial administration of individual or private companies ..Both public and private finance are fundamentally similar in nature but different from each other on various operational aspects .The similarities and differences between public and private finance have been explained below.

SIMILARITIES:

1. Objective

Satisfaction of human wants is the main objective of both public and private finance. The main aim of public finance is to satisfy social wants and that of private finance to satisfy individual wants.

2. Principles

The principle of maximum social benefits is the guiding principle followed by the government while spending its income. Individuals also follow the principle of maximum satisfaction when spending out his given income

3. Income, Expenditure and borrowing

The resources or the income for both government and the individuals are limited .In case of shortage, borrowing can be done for both and both are under obligation to repay the borrowed money.

4. Policies

Both the private and public finances adopt policies for maximizing welfare. In Private finances as well as in public finance only sound policies will enable maximization of welfare and benefits.

5. Administration

The effectiveness and success of measures adopted by private and public sector depends on the administrative machinery. If the administrative machinery is inefficient and corrupt it will lead to losses and wastages.

Dissimilarities: (Distinction between public and private finance)

1. Magnitude :

The most significant difference between the two types of finances is in terms of size and magnitude. Households and businesses have relatively smaller amount of resources available to them and hence their budgets are smaller in size as compared to those of governments.

2. Public Scrutiny:

Personal budgets of households are a private affair and not made public. In case of businessfinance, the budget is made known to the stakeholders and General public for information and scrutiny. In case of public finance, every budgetary decision has to be made known to the people of the nation.

3. Source of revenue:

Private economic units earn their income by using assets owned by them. Their sources of income are salaries, wages, interest, rent and profits which arise out of transactions. In case of governments, the source of income are taxes and non tax revenues. In case of taxes, fees, fines, fines there in an element of compulsion

4. Sources of borrowing:

Private economic units may borrow from informal sources like friends, Relatives ,moneylenders as well as from formal sources like banks and financial institution. Public bodies can borrow almost on a continuous basis from internal and external sources. They can borrow from the people, the central bank, Commercial banks and other financial institutions as well from external sources.

5. Motive:

In case of public finance, the decisions are reached through political and administrative procedure and based on common social objectives. Private finances is governed by profit motive for businesses or satisfaction of wants of individuals and households.

6. Time dimension:

Both private and public financial activities try to balance between the immediate objectives and future goals. But private economic units, especially households, are primarily focused on fulfillment of present and immediate wants. In case of public authorities, the focus is on both present and future

7. Income Expenditure adjustment:

Generally, while a private economic unit adjust its expenditure to income, public bodies adjust income to expenditure. Private finance will try and adjust expenditure according to income and in order to do so may even forego fulfillment of certain wants. On the other hand, Government are guided by welfare and growth consideration for which expenditure have to be predetermined. Since they have the power to raise fund through taxation, borrowing, deficit financing, they try to adjust their revenues to the predetermined expenditure requirements.

8. Assessment of outcomes:

It is much easier to measure and evaluate the outcome of private financial activities than the outcome of public financial activities.

In case of private economic units, the outcome may be measured by profits of business, fulfillments of wants of households. In case of public finance, the outcome has to measured and evaluated in terms of multiple parameters. These are social welfare, economic growth, security, Productivity and efficiency.

9. Nature of the budget:

Private economic units aim at surplus budget. Having a surplus is considered economically prudent. This is not the case with government budgets. In countries that need to grow and develop rapidly, deficit budgets need to be followed. A long term surplus budget indicates that the government may not be fulfilling some of its obligation.

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

**Q.3 Explain the Principle of maximum social advantage OR
Examine the Daltons version of Principle of Maximum Social Advantage. OR
Critically examine Daltons Principle of Maximum Social Advantage.**

The 'Principle of maximum social Advantage' was introduced by British economist Hugh Daton. According to Hugh Dalton, "Public Finance" is concerned with income & expenditure of public authorities and with the adjustment of one with the other.

Budgetary activities of the government results in transfer of purchasing power from some individuals to others. Taxation causes transfer of purchasing power from tax payers to the public authorities, While public expenditure results in transfers back from the public authorities to some individuals, therefore financial operations of the government cause 'Sacrifice or Disutility' on one hand and 'Benefits or Utility' on the other.

The principle of Maximum social Advantage states that public finance leads to economic welfare when public expenditure & taxation are carried out up to that point where the benefits derived from

the Marginal Utility of expenditure is equal to the Marginal Disutility or the sacrifice imposed by taxation.

Hugh Dalton explains the principle of maximum social advantage with reference to:

- A. Marginal social Sacrifice
- B. Marginal Social Benefits

This principle is however based on the following assumptions:

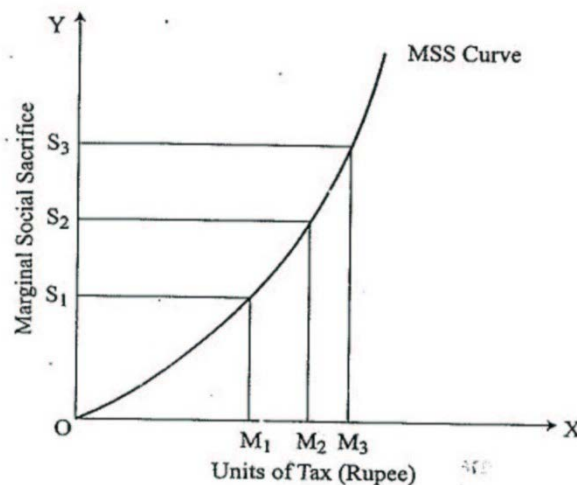
- (i) All taxes result in sacrifice and all public expenditures lead to benefits.
- (ii) Public revenue consist of only taxes and no other sources of income to the government.
- (iii) The government has no surplus or deficit budget but only balanced budget.
- (iv) Public expenditure is subject to diminishing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

Marginal Social Sacrifice (MSS)

Marginal social Sacrifice (MSS) refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax

Every unit of tax imposed by the government taxes result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing i.e. the total social sacrifice increases at an increasing rate. This is because, when taxes are imposed, the stock of money with the community diminishes. Every additional unit of taxation creates greater amount of impact and greater amount of sacrifice on the society. That is why the marginal social sacrifice goes on increasing.

The Marginal social sacrifice is illustrated in the following diagram:



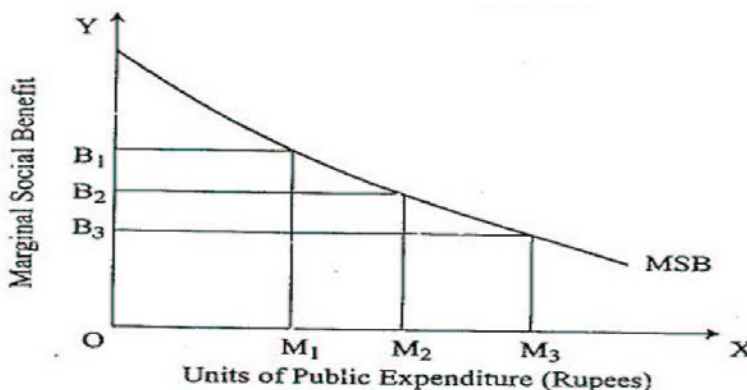
The above diagram indicates that the Marginal Social Sacrifice (MSS) curve rises upwards from left to right. This indicates that with each additional unit of taxation, the level of sacrifice also increase. When the unit of taxation was OM₁, the marginal social sacrifice was OS₁, and with the increase in taxation at OM₂, the marginal social sacrifice rises to OS₂.

Marginal social Benefit (MSB)

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

Just as the marginal utility from a commodity to a consumer declines as more and more units of the commodity are made available to him, the social benefit from each additional unit of public expenditure declines as more and more units of public expenditure are spent. In the beginning, the units of public expenditure are spent on the most essential social activities. subsequent doses of

public expenditure are spent on less and less important social activities. As a result, the curve of marginal social benefits slopes downward from left to right as shown in figure below.



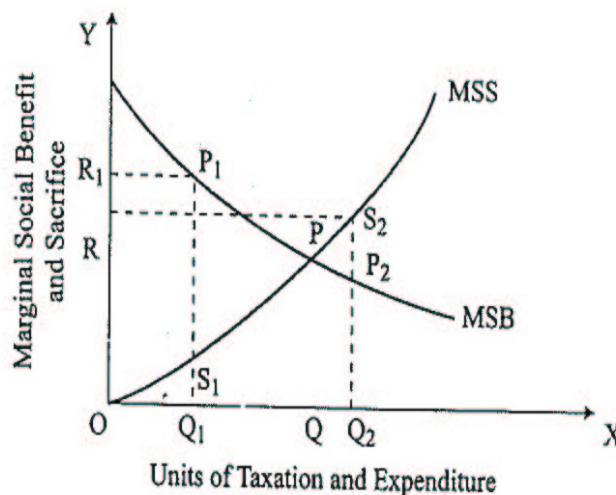
In the marginal curve from left to

that the social benefit derived out of public expenditure is reducing at a diminishing rate. When the public expenditure was OM_1 , the marginal social benefit was OB_1 , and when the public expenditure is OM_2 , the marginal social benefit is reduced at OB_2 .

above diagram, the social benefit (MSB) slopes downward right. This indicates

The Point of Maximum Social Advantage

Social advantage is maximized at the point where marginal social sacrifice cuts the marginal social benefits curve. i.e. MSS and MSB are equal.



At point P social advantage is maximum. Now consider Point P_1 . at this point marginal social benefit is P_1Q_1 . This is greater than marginal social sacrifice S_1Q_1 . Since the marginal social sacrifice is lower than the marginal social benefit, it makes more sense to increase the level of taxation and public expenditure. This is due to the reason that additional unit of revenue raised. And spend by the government leads to increase in the net social advantage. This situation of increasing taxation and public expenditure continues, as long as the levels of taxation and expenditure are towards the left of the point P.

At point P, the level of taxation and public expenditure moves up to OQ . At this point, the marginal utility or social benefit becomes equal to marginal disutility or social sacrifice. Therefore at this point, the maximum social advantage is achieved.

At point P_2 , the marginal social sacrifice S_2Q_2 is greater than marginal social benefit P_2Q_2 . Therefore, beyond the point P, any further increase in the level of taxation and public expenditure may bring down the social advantage. This is because; each subsequent unit of additional taxation will increase the marginal disutility or social sacrifice, which will be more than marginal utility or social benefit. This shows that maximum social advantage is attained only at point P & this is the point where marginal social benefit of public expenditure is equal to the marginal social sacrifice of taxation

Q. 4 Discuss the principles of Maximum Social Advantage given by Musgrave. OR Examine the Musgrave's version of Maximum Social Advantage.

The principle of Maximum Social Advantage has been interpreted by economist Richard Musgrave who termed it as Maximum Welfare Principle of Budget Determination. According to Musgrave, the principle explains that taxation and public expenditure should be carried out up to that level where satisfaction obtained from the last unit of money spent is equal to the sacrifice from the last unit of money taken in terms of taxes. In other words, it should be carried out up to the point where marginal social benefit is equal to marginal social sacrifice.

To illustrate his interpretation, Musgrave used Fig. in which, the size of the budget (level of taxation and public expenditure) is shown on the X-axis. On the positive part of Y-axis MSB is measured and on the negative part, MSS is measured.

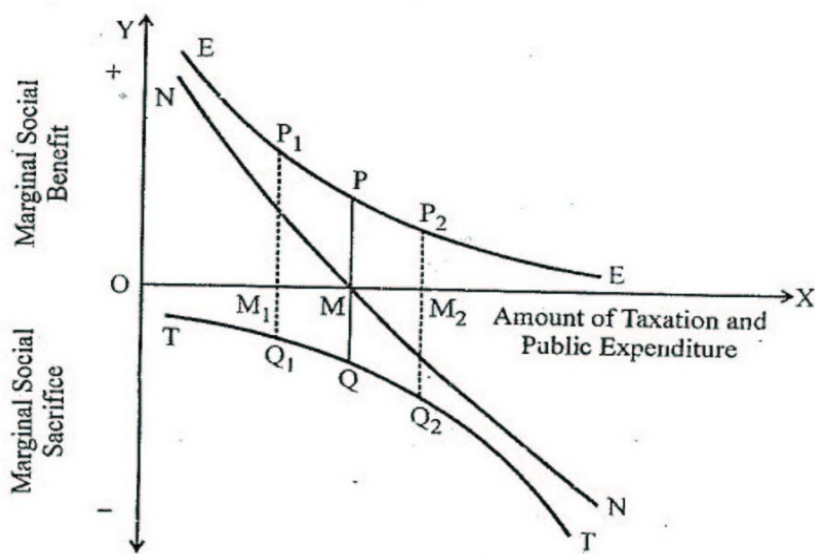


Fig.2.4 : Gains and Losses from Budget Operation

The curve EE, in the first quadrant, represents the marginal social benefit (MSB) of successive units of money spent as public expenditure, allocated optimally between different public uses. It falls from left to right because as public expenditure increases, MSB declines. The curve TT, in the fourth quadrant, represents the marginal social sacrifice (MSS). As additional units of taxation are raised from the people, MSS increases. Accordingly, the curve SS slopes downwards from left to right in the fourth quadrant showing rising MSS.

The curve NN measures Marginal net benefits (MNB) which is derived from successive addition to public budget. MNB is calculated by deducting MSS from MSB. The vertical distance between EE curve and TT curve measures MNB at different sizes of the budget.

The optimum size of the budget is determined at OM, where MNB is zero. At this size of the budget, the marginal social benefit MP is equal the marginal social sacrifice MQ (MSB = MSS). Since MSB and MSS are measured in opposite directions, marginal net benefit is zero at M (MSB - MSS = 0). At this point the MNB curve NN cuts the X-axis.

At any point to the left of M, say M_1 , MSB will be greater than MSS and MNB will be positive. It is beneficial to increase size of the budget as long as MNB is positive. So there will be a tendency to move from M_1 towards M. If the budget size exceeds M, say M_2 , then MSS will exceed MSB and MNB will be negative. Therefore it will be beneficial for the government to cut down the size of the budget and move from M_2 towards M.

According to Musgrave the optimum size of the budget is given by the point where the marginal net benefit is zero. This point corresponds to the point of maximum social advantage, as at this point $MSB = MSS$

Q 5 Give a brief note about Limitations of Maximum Social Advantage. OR Critically evaluate the Marginal Social Advantage.

The principle of maximum social advantage has been criticized on various grounds. The main practical difficulties in following the principle of maximum social advantage are discussed in the article.

i) Difficulties in Measuring Social Benefits:

The principle of maximum social advantage is theoretically explained with the help of the marginal utility analysis. The Marginal benefits of public expenditure and the marginal disutility on sacrifice of public revenue are concepts, the objective measurement of which is extremely difficult.

ii) Unrealistic Assumptions:

It is unrealistic to assume that government expenditure is always beneficial and that every tax is a burden to society. For example, taxes on cigarettes or alcohol can provide benefit to society, expenditure on social overheads like health care will give rise to social benefit whereas unnecessary increase in expenditure on defence may divert resource from productive activities causing loss of welfare to society.

iii) Neglect of Non – Tax Revenue:

The principle says that the entire public expenditure is financed by taxation. But, in practice, a significant portion of public expenditure is also financed by other sources like public borrowing, profits from public sector enterprises, imposition of fees, penalties etc. Dalton fails to take into account all such other sources.

iv) Lack of divisibility:

The marginal benefit from public expenditure and marginal sacrifice from taxation can be equated only when public expenditure and taxation are divided into smaller units. But it is not possible practically.

v) Large Budget Size:

The financial operations of the government involve collection of large sums of money from taxation and other sources and the disbursement of large amounts by way of public expenditure. The effects of small additional amounts of these on the community are difficult to measure. Therefore, in practice, the public authorities are not in a position to estimate the marginal benefits and the marginal sacrifices.

vi) Change in Condition:

Conditions in an economy are not static and are continuously changing. What might be considered as the point of maximum social advantage under some conditions may not be so under some other. For example, in times of war government expenditure and revenue must increase, and the increase is to the advantage of the community. What is optimum at one level of national income may not be so at a higher level. Therefore, it is difficult to determine the point of maximum social advantage.

vii) Different Periods:

The impact of many public projects is felt over the long period by both the present and the future generations. In order to determine maximum social advantage it becomes necessary to calculate social benefits from public expenditure in short period and in long period.

viii) Conceptual differences:

Taxes are paid by individuals and the sacrifice involved is felt at an individual or micro level. Whereas, public expenditure gives rise to public goods that are jointly consumed by all in a community. The benefits therefore are felt at a macro level. Many economists argue that it is neither possible nor desirable to compare micro and macro concepts by using the same criteria.

ix) Misuse of Government Funds:

The principle of Maximum social advantage is based on the assumption that the government funds are utilized in the most effective manner to generate marginal social benefit. However, quite often a large share of government funds is misused for unproductive purposes which do not provide any social benefits.

x) Contra – Cyclical Measures:

The Government has to undertake contra – cyclical measures to Control inflation, Overcome recession, Reduce increasing level of unemployment, etc.

In such a situation, the concept of Maximum social advantage cannot be adopted. For instance, to control recession, the government may introduce certain measures such as reduction in taxation in order to increase effective demand. Also, during inflationary periods, the government may increase tax rate in order to reduce demand and increase interest rates, so as to encourage savings on the part of people.

MODERN TRENDS IN PUBLIC FINANCE

Q.6 What is sound finance? Discuss the features of sound finance.

Classical economists believed that the less the government interfered in the economy the better it is. This belief, along with private ownership of factors of production, was the foundation of Laissez faire capitalism, which is a system where economic transactions are largely between private owners of factors of production and such transactions are free from government restrictions, taxation and subsidies. *Laissez faire* policy advocates market mechanism should be left free of any government interference.

In such a system, the role of the government was expected to be restricted to traditional areas like defence, law and order, justice, provision of civic amenities and therefore most government spending was expected to be restricted to these areas.

The role of the budget and fiscal policy did not extend beyond raising funds through taxation and spending on traditional functions. The primary belief was that the size of the government's budget should be small and the budget should balance. These beliefs form the basis of the principle of sound finance.

The following are some of the features of sound finance :

1. Say's Law:

Like many other classical principles, the principle of sound finance is also based on Say's Law, that is, "Supply creates its own demand." Since one man's expenditure is another man's income, aggregate demand will always be equal to aggregate supply. This belief forms the base of the argument on which classical economists argued in favour of sound finance.

2. Full employment:

The classical economists argued that since $AD = AS$, there cannot be over-production and under consumption. In other words, the economy cannot suffer from fluctuations like unemployment and inflation. Driven by profit motive, the private sector will ensure optimum use of resources. Therefore, there will be full employment in the economy. Only voluntary and frictional unemployment may exist.

3. Invisible hand:

Private owners of factors of production will always achieve maximum level of efficiency in their use of resources, as they are driven by self-interest and profit motive. The concept of Adam Smith's 'invisible hand' is used to explain how private self interest will result in collective social good.

4. Taxation:

According to the classical school of thoughts, taxes are harmful because they adversely affect willingness and ability to work, save and invest. Taxation was expected to be kept at a minimal limit. High progressive taxation will lead to slow economic progress. Redistributive effects of taxation were ignored.

5. Public expenditure:

Government spending was expected to be in the traditional areas like defence, law and order, justice, provision of civic amenities. Since government budget was not expected to be large in size, government spending was not large relative to total spending in the economy. Therefore, it was believed that government spending would not have any significant impact on the economy.

6. Balanced Budget :

In *laissez faire* capitalism, since all factors of production are normally owned and used by private individuals, the government can make use of such factors only by depriving the private sector. Therefore, there is no justification for the government to expand its expenditure beyond revenue and incur deficit budget. Budget should always balance except during wartime when government will have to expand expenditure to fight war. The state should not take up business activities because the private sector is considered to be most efficient.

7. Market efficiency:

The market mechanism is assumed to achieve maximum level of efficiency. Market failures are only temporary and the market is fully capable of correcting itself. Therefore there is no justification of any government regulation and restrictions on the market. The use of the budget to correct market failures was not considered.

8. Ricardian Equivalence Theorem:

Budget deficits are uneconomical, harmful and socially undesirable. They lead to inflation and harm economic progress. This belief was based on Ricardian Equivalence Theorem. Deficits will have to be later met by raising taxes. This is known to the people and they will increase their savings to pay higher taxes later. As their savings increase, they will not increase consumption and therefore, increased public expenditure will not be able to boost demand, production and stimulate growth.

9. Political View:

Sound finance is compatible with a political system that supports private ownership and minimizes government's role. Generally, ideologically the conservative parties believe in the principle of sound finance while the more liberal parties support functional finance. However, in practice most governments have been observed to follow functional finance.

Q. 7 Explain functional finance and discuss its features.

In the 1920s in Europe, and the 1930s in the United States, major economies experienced depression. During this period many economists started questioning sound finance principles. Low profit expectations during depression kept investment spending low, causing unemployment to rise. Given such a collapse of economic expectations, the economists favored, at least temporarily, giving up the sound finance principles and using government spending to stimulate the economy

Increased government spending during depression would mean running a deficit budget. But this was considered necessary as private investment was not forthcoming. Increased government expenditure in infrastructure building, job creation and paying social security would increase income. This would encourage spending and aggregate demand would rise and ultimately would help pull the economy out of the depression or recession. This view that fiscal policy can be used to offset undesirable cyclical fluctuations in output was later termed as 'functional finance' by Abba P. Lerner.

The concept of functional finance has the following features:

1. Market failures:

Market failures can have severe economic consequences in the form of depression and hyper-inflation. The Great depression of 1930s brought the powerful US economy down. In more recent times, the financial crisis of 2007-08 in the USA showed that due to excessive de-regulation, financial markets can fail and become the cause of a severe and long standing recession. Also, due to globalization, this recession has affected the economic prospects of almost every country in the world.

2. Importance of fiscal policy :

Taxation, public expenditure and public debt must be adopted according to the needs of the time. While classical economists believed that the main aim of public finance is to raise revenue, modern economists believe that the main objective of public finance is to correct imbalances in the economy. In periods of inflation a policy of surplus budget must be adopted and during depression, deficit budget must be adopted.

3. Aggregate demand :

Aggregate demand consists of consumption demand, investment demand, government expenditure and net foreign income. Modern economists believed that it is aggregate demand that determines level of national income and employment. Deficiency in aggregate demand results in unemployment. Government expenditure needs to be increased during such times to boost aggregate demand and to bring the economy out of depression.

4. Budget :

Modern economists believe that the government, through public expenditure, taxation, or deficit financing, can maintain full employment. During recession and depression, public expenditure should be increased and the budget should be expanded to increase aggregate demand. A deficit budget is perfectly justifiable to pull the economy out of recession. On the other hand, during inflation, the government may have a surplus budget by raising taxes to control consumption.

5. Income redistribution :

According to modern economists, the distribution of national income is as important as its size. A more even distribution of income would increase the average propensity to consume (APC) and would increase the level of investment and employment. Imposing high taxes on the rich and redistributing them to the poor through pension, welfare schemes and allowances. This will improve APC and increase aggregate demand, boosting investment, employment, production and profits.

6. Welfare capitalism :

Keynes advocated fiscal measures for controlling capitalism and preventing its collapse. Keynes gave importance to compensatory actions through fiscal measures for improving and maintaining the level of effective demand and thus the level of economic activity in the country. The concept of functional finance forms the basis of welfare capitalism that now exists in most of the advanced economies

7. Social objectives :

Public finance has to function in the interest of the entire society and not for the benefit of a select few. Every taxation, expenditure, borrowing policy and ownership and operation of public utilities must be measured on the basis of their effects on the entire society. Objective of taxation should be to redistribute income in the most socially just manner Expenditure on social security, poverty eradication, medical care and education will always be justified as they bring in distributive justice. Public expenditure and taxation should follow the objective of equalising marginal social cost and marginal social benefit.

Q.8 Explain the concepts of Redistributive Taxation and Anti Inflationary Taxation.

In reality taxes are used for variety of purposes. They are not only a major source of revenue for the government but they provide incentives or disincentives and correct market failures. Taxes also help in income distribution and reduce income inequalities. Direct taxes can also be used as an instrument to control inflation and bring stability in the economy.

A) REDISTRIBUTIVE TAXATION

Classical economists considered taxation as a means for raising revenue. But modern economists consider taxation as a tool for redistributing incomes among the various sections of society. Modern economists believe that taxation can be used for transferring income from the rich to the poor. This is referred to as redistributive taxation. Redistributive taxation are aimed at reduce savings of the rich and using the resources raised to increase the consumption of the poor

Income inequality harms the economy in many ways. Widening gap between the rich and the poor is not only socially undesirable, but is also harmful for the economy's growth. High degree of income inequality reduces average propensity to consume and may lead to depression and unemployment. Therefore, modern economists have recommended the use of taxation to redistribute income in a more socially desirable manner. Most economies use progressive taxation to redistribute income. Progressive taxes are generally imposed on income and wealth. They impose a heavier burden on the rich than the poor

A redistributive fiscal policy includes progressive direct taxation and public expenditure on social security, job creation and promotion of social equity. Such expenditure are in the form of old age pensions, unemployment allowances, free and subsidized housing, education, health care and food distribution. All these are aimed at reducing people's cost of living, increasing their capacity to consume and provide social justice

Redistributive taxation also increases people's average propensity to consume. When income distribution improves due to transfer of income from the rich to the poor, larger number of people can increase their consumption levels. This increases aggregate demand and leads to increased investment and employment.

However, highly progressive direct taxes have certain limitations. They result in tax evasion, giving rise to a black economy. At the same time, such taxes can adversely affect people's willingness and ability to work, save and invest. This can harm economic progress

Another limitation of redistributive taxation is that often government use the redistributive fiscal policy to fulfil their political agenda of winning elections by providing subsidies and transfers to a very large extent. This can result in excessive consumption, causing inflation and lowering the value of money. Besides, such a fiscal policy may result in large deficit and public borrowing, pushing interest rates upward. High interest and high inflation will harm growth

prospects.

B) ANTI - INFLATIONARY TAXATION.

In modern welfare states, the government has to incur huge expenditure to meet the growing social and economic needs of the people. In such a situation, taxation becomes an important source of funding such expenditure. Taxation plays a very important role in such economies. Through taxation, the government controls private consumption in order to make resources available for meeting collective needs of the people. At the same time taxation is used to redistribute income.

In most growing economies with large public expenditure, there is always the possibility of inflation due to excessive consumption. In such situations, anti-inflationary taxation is used to reduce propensity to consume. Anti-inflationary taxation may be in the form of higher rates of direct and indirect taxes. Anti-inflationary taxation that reduces consumption is justified if the resources released from private consumption are used by the government for increasing welfare of the society.

While redistributive taxation like progressive direct taxes is designed to reduce savings, anti-inflationary taxes are designed to reduce consumption. When the government uses taxation to reduce savings (redistributive taxation), the funds raised from such taxes are funds which might have been left idle by the people. But when anti-inflationary taxation is used to reduce consumption, the resources raised by the government are funds that people would otherwise have used for consumption. Therefore funds raised through anti-inflationary taxation should be used productively.

The general classical view is that all taxes are anti-inflationary and all public expenditures are inflationary. Modern economists believe that neither all taxes are anti-inflationary nor expenditures are inflationary. The effects of taxation and public expenditure depend on the state of the economy. During normal situations, any tax that reduces consumption and promotes investment may be anti-inflationary.